Investment Policy

July 2019

Our market view in a nutshell – July 2019

- The sharp drop in bond yields, along with US stock indices making record highs, are providing **a boost to portfolios but generating some discomfort among investors**. One interpretation for the decline in bond yields is that **the economy is slowing** and the Fed should cut rates to avoid a potential recession. However, this does not explain why **equity and credit markets show no signs of stress**

- Although when looking at leading indicators **there are clear signs of a deceleration in economic activity at global level**, we expect that the improvement in financial conditions, combined with robust employment and consumer confidence, will help **the economy to recover in the second half of the year**

- In fact, we believe that the fall in bond yields has more to do with the **return of deflationary risks**, given that inflation remains stubbornly below the target of central banks. The Fed has realized that in the current environment of low growth and low inflation, **the process of normalization has reached its limits**, and any increase in interest rates will result in a tightening of monetary conditions

- Monetary policy is a key element of financial conditions, which in turn are increasingly important due to the **financialization of the modern economy**. In addition, the wealth of **households also depends increasingly on asset prices**. For this reason, we expect the Fed **to continue mitigating any outbreak of market volatility**

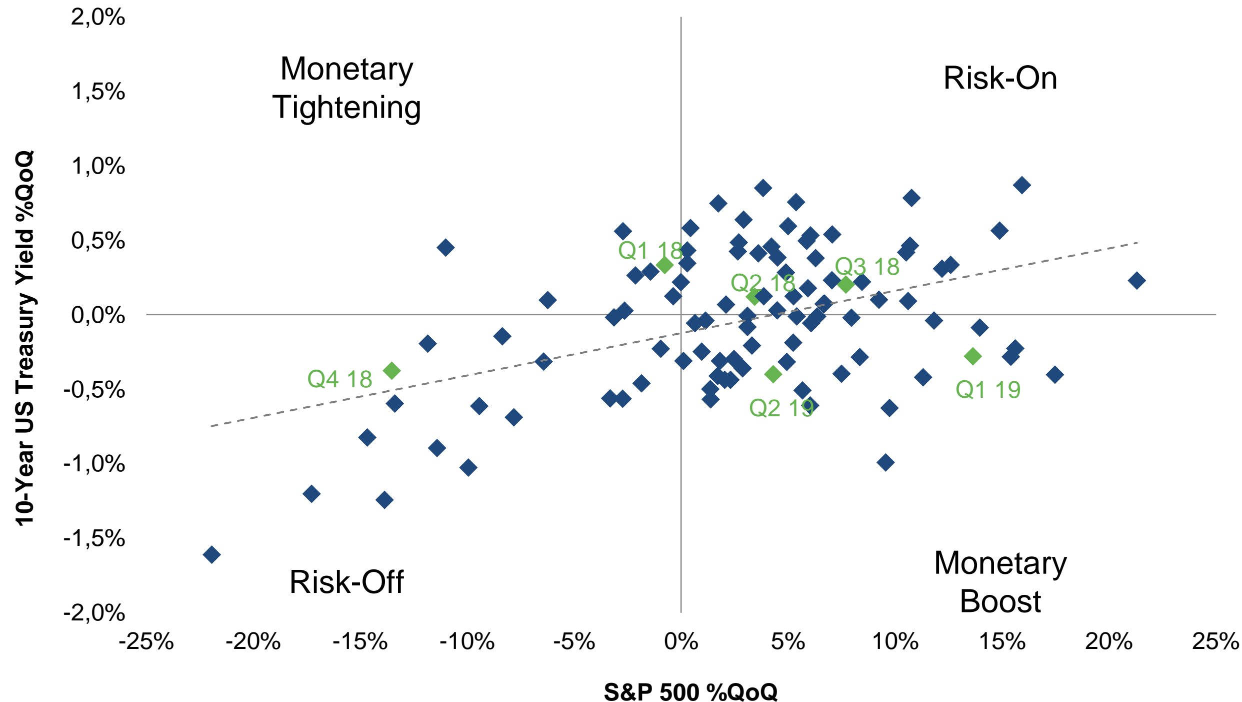
- On the **trade war** front, we believe that President Trump is running out of time to reach an agreement that he can present to his electoral base before the US elections in November of next year, so **we expect some kind of agreement in the second half of this year**. This should help improve business confidence and therefore be positive for risk assets

EWM Investment Policy

Asset Class		View	Rationale
Fixed Income	US Treasuries	+	Treasuries offer protection from a slowdown in growth, but we believe that current long-term yields are unattractive, preferring shorter maturities
	US Credit	+	Corporate debt and High Yield currently offer the best combination of risk and return. We prefer medium maturities as the yield curve has flattened considerably and there is little term premium to compensate for taking interest rate risk
	European Sovereign	–	High quality debt in Euros presents a very unattractive combination of risk and return as current yields offer very little cushion to weather potential interest rates increases
	European Credit	=	In European credit we only see value in subordinated debt, asset-backed securities and short-duration high yield
	Emerging Markets	=	Emerging Markets currencies and spreads have adjusted significantly to a stronger dollar and the uncertainties around global growth. With the Fed signaling being closer to the neutral rate, we deem current levels to offer fair value
Equities	US	+	After the recent market corrections and the increase in corporate earnings, valuations have improved. We have therefore increased our exposure to US equities, mostly through quality and growth oriented companies
	Europe	=	From a relative valuation perspective, we like European stocks as they trade at lower multiples, and we expect profits to pick up as economic activity accelerates
	Japan	=	Japanese stocks are the cheapest in developed markets, but have suffered recently due to sluggish growth, and concerns about global trade
	Emerging Markets	+	Emerging markets have corrected sharply since the beginning of the year affected by a strong dollar and trade concerns. We deem the correction suffered has been excessive, and continue favoring India, Frontier Markets and Brazil within EM
	Sectors & Themes	+	Amongst others, we favor Biotechnology and Healthcare
Alternative Investments	Multi-Strategy Hedge Funds	–	Multi-strategy / multi-manager hedge funds with daily liquidity are having a disappointing performance, particularly when compared with other less risky alternatives, like short-term corporate bonds
	Commodities	–	In the present late-cycle environment, with inflation pressures remaining subdued, we see limited upside for commodities
	Private Equity	=	Investing in late-stage private equity provides access to the asset class with liquidity provision up to a certain degree

\+ Overweight – Underweight = Neutral

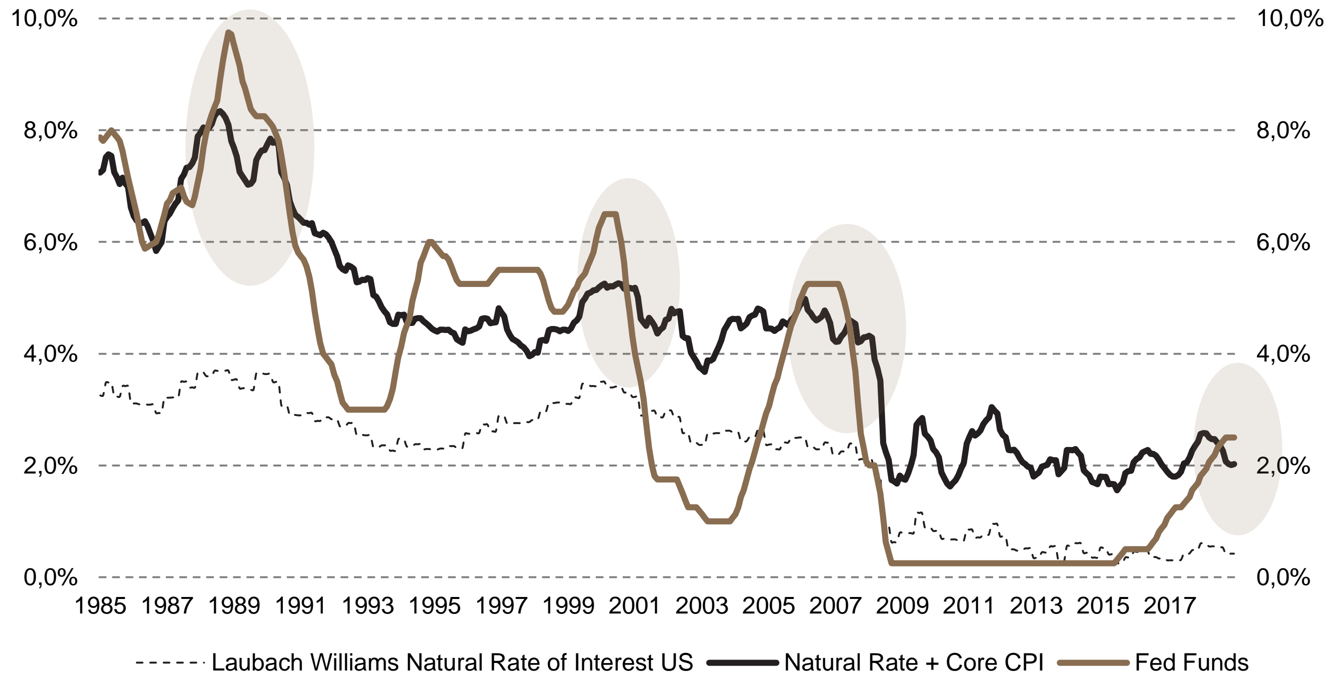
Bonds vs. Equities?



- **Bond and stock markets do not move according to fixed rules**. Sometimes, a drop in bond yields is a sign that the bond market anticipates an economic slowdown, leading to a fall in stocks; while at other times (as in the last two quarters), the drop in yields reflects an accommodative monetary policy that helps growth and, therefore, the stock market
- During the last year and a half, there have been a series of **abrupt changes in expectations** (partly influenced by the Fed's policy change), which make us think that there may be a **disconnect between equity and bond valuations**

Source: Bloomberg (Quarterly data 1995 – 2019)

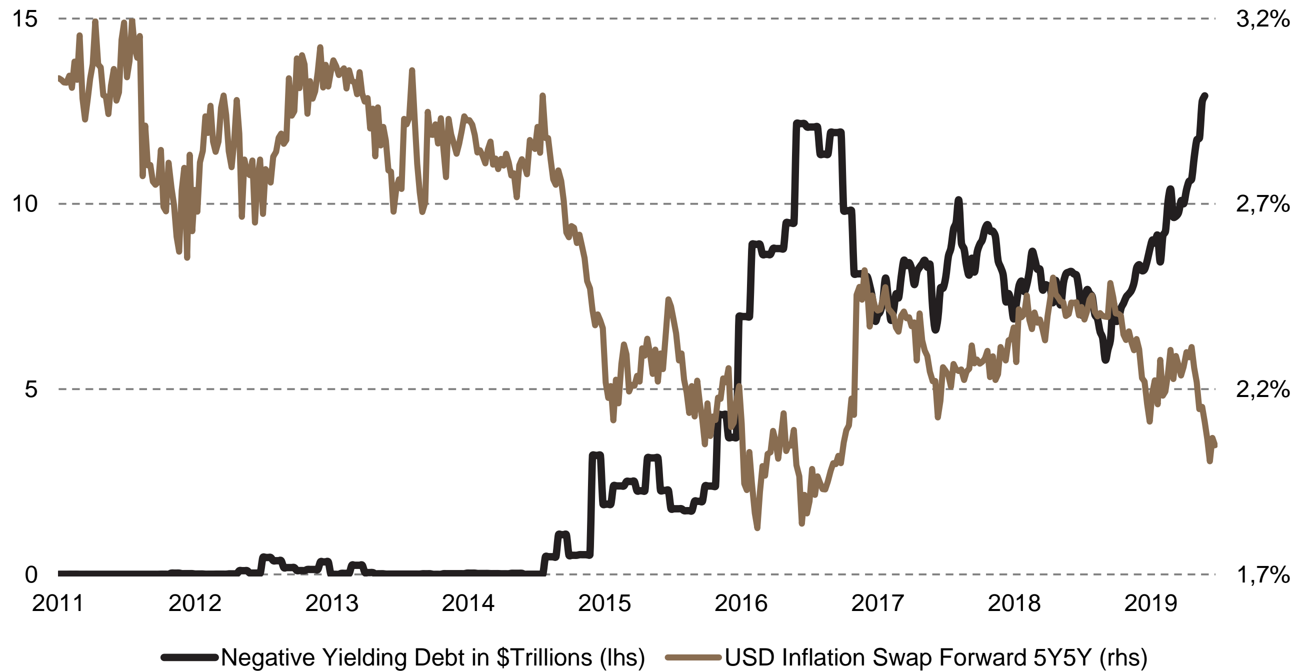
Normalization is over



- Stubbornly low inflation and subpar growth put a **ceiling on the natural rate of interest** (the rate at which the economy reaches full employment, while keeping inflation constant)
- The Fed has realized that it has probably **gone as far as possible in the normalization process**, and has embarked on a revision of its strategy with a view to be more effective in this new environment (see link)

Source: Bloomberg

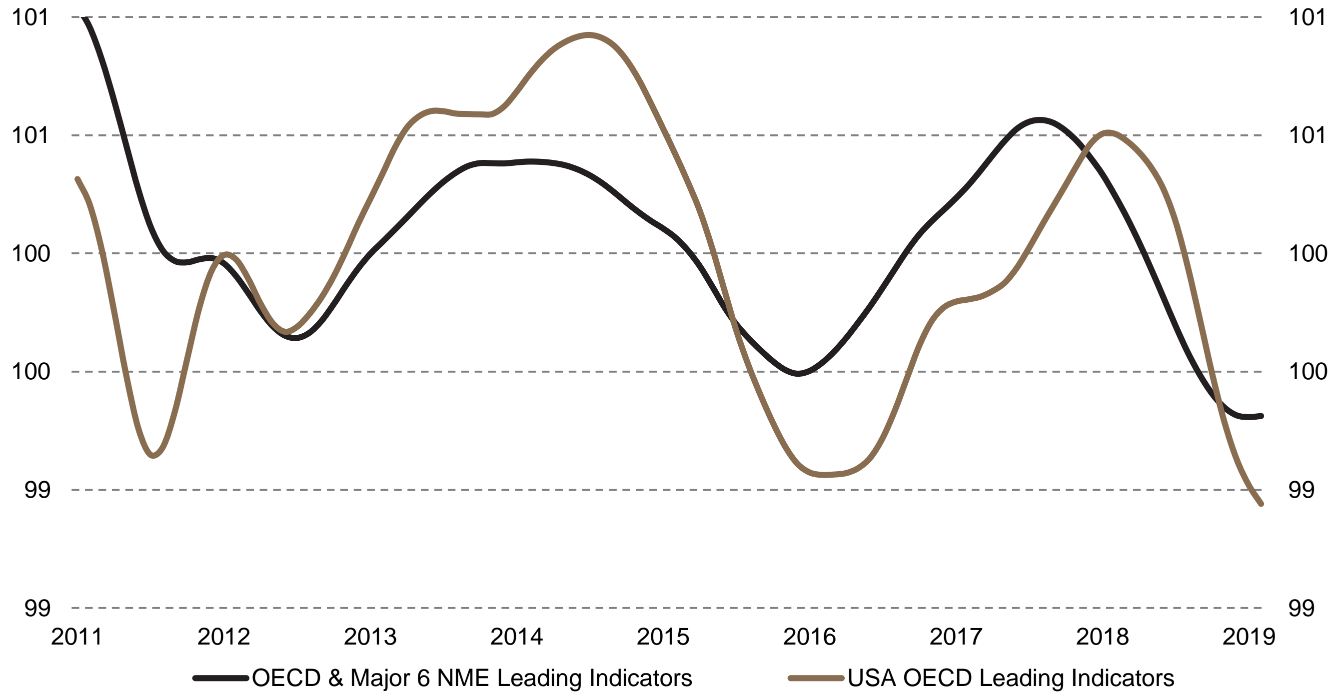
Deflation risk is back



- The Fed's u-turn has coincided with a **decline in inflation expectations** that speak for greater caution
- In fact, the deflationist threat is very **similar to that experienced in 2015-16, although this time with stable commodity prices**. The result is a fall in bond yields and an unprecedented amount of bonds with negative yields

Source: Bloomberg

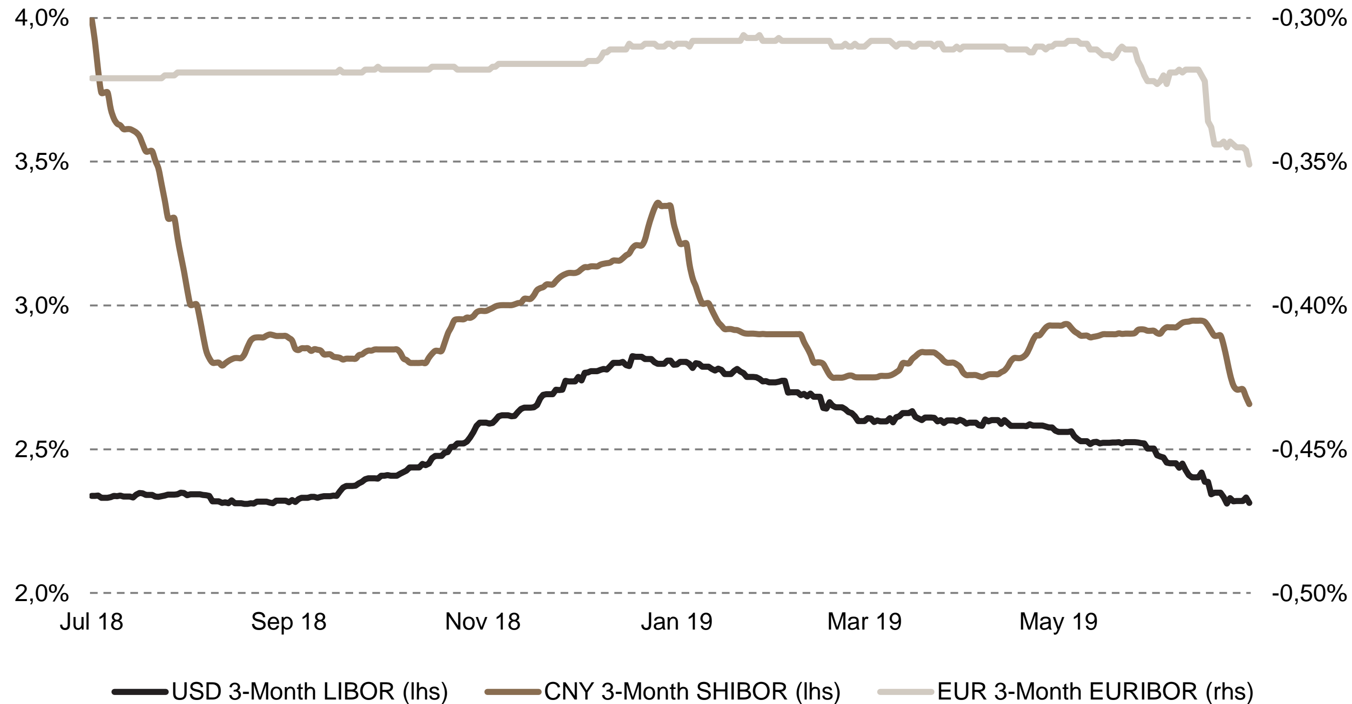
And global activity continues decelerating



- In addition to the renewed risk of deflation, **the global economy continues to show some signs of weakness**, which would support preventive cuts in interest rates
- However, **credit spreads**, which are our preferred recession indicators, continue to **point to a continuation of the current economic cycle**

Source: Bloomberg

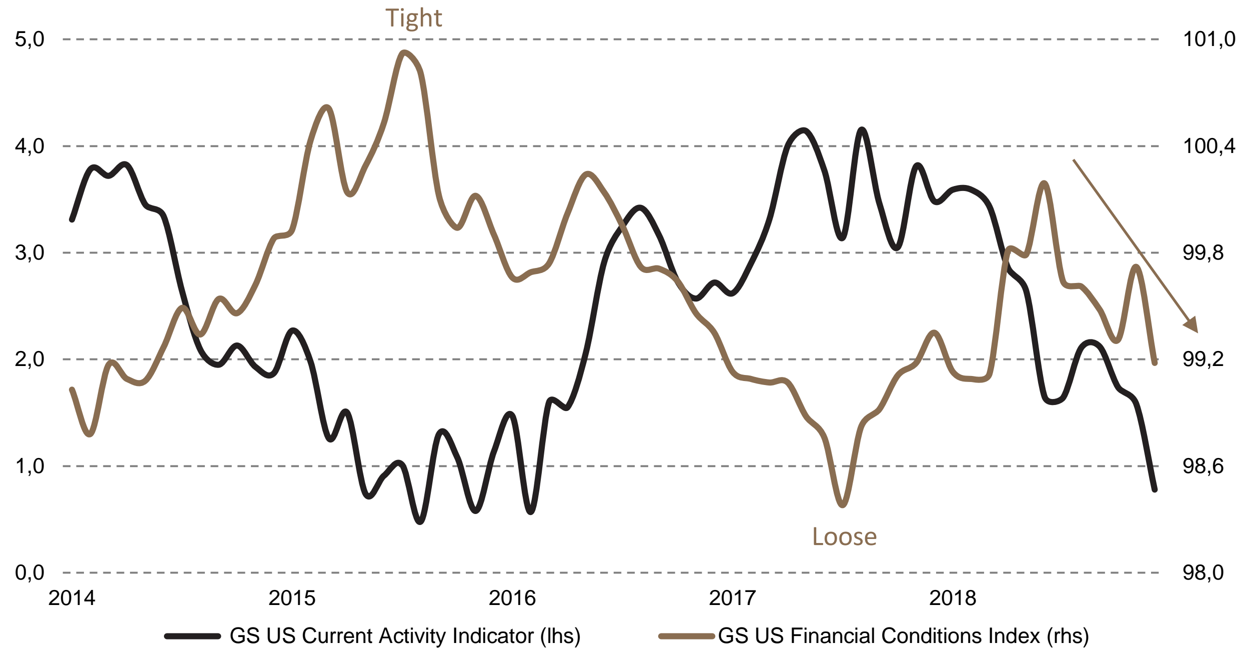
Easing cycle is global



- Just as the signs of an economic slowdown are global, so is the response of the monetary authorities, with the **main economies in the process of lowering interest rates**
- The scale of the **monetary intervention has been particularly large in China**, where the monetary and fiscal impulse should be accompanied by a pick up in growth

Source: Bloomberg

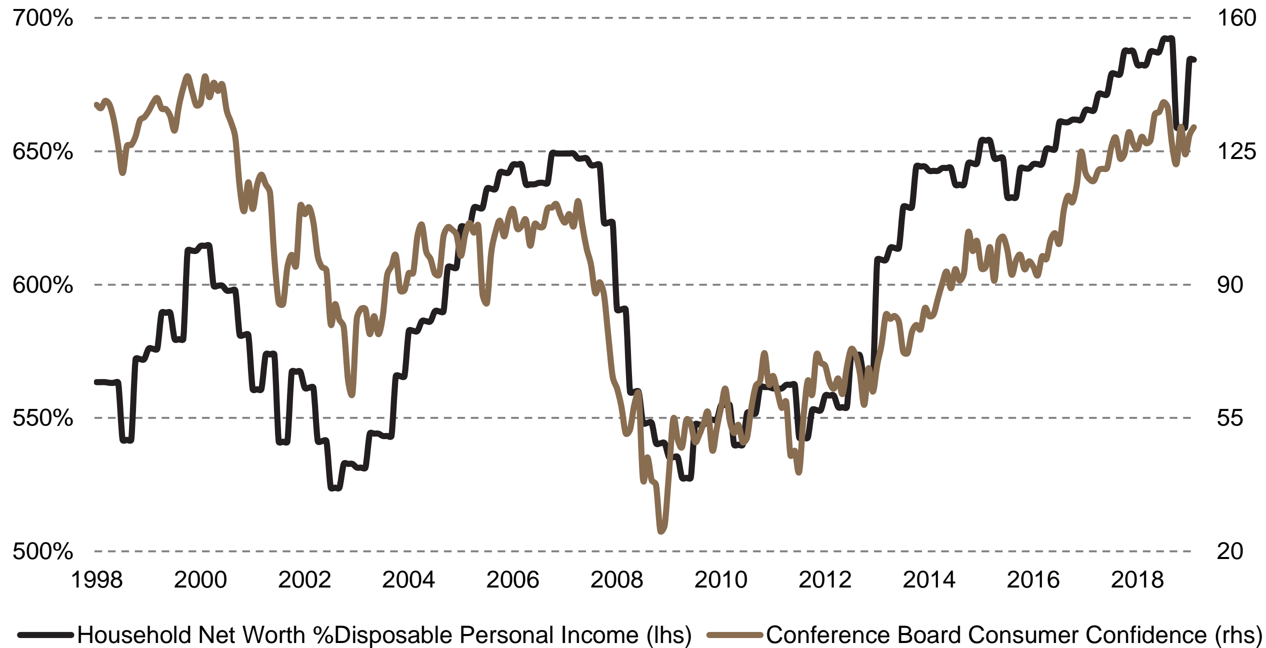
Financialization of the economy



- Monetary policy is a key element of **financial conditions**, which in turn are **increasingly important due to the financialization of the modern economy**
- We expect that the **improvement in financial conditions** since the beginning of the year will soon begin to have an **impact on the real economy**

Source: Bloomberg

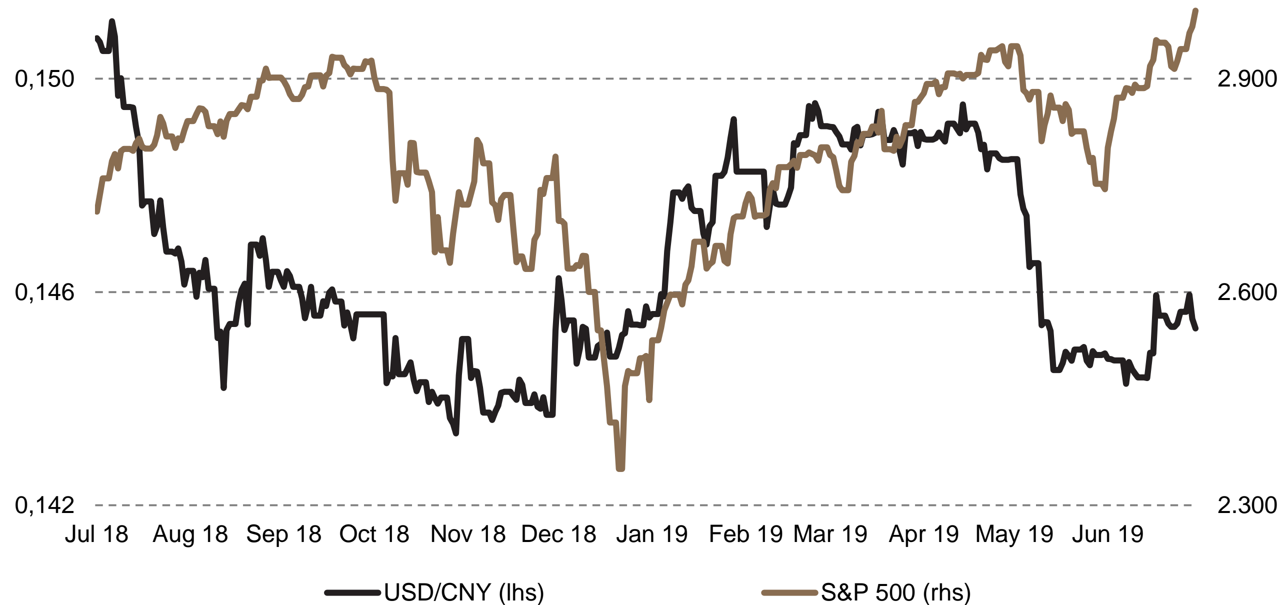
Higher dependency on financial markets



- Financial markets are another key element, since **the wealth of households increasingly depends on asset prices**
- Therefore, implicitly, since it can not be said publicly, **one of the objectives of the Federal R**eserve, besides maximizing employment and containing inflation, **is to mitigate the volatility of the financial markets**

Source: Bloomberg

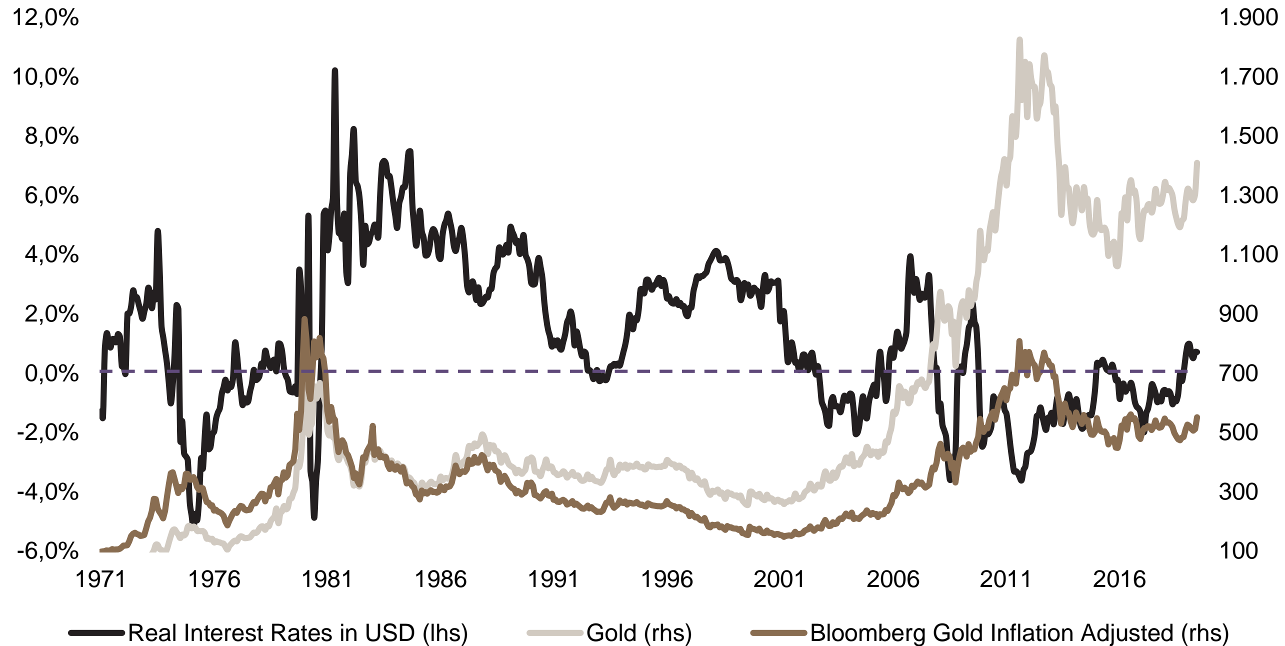
«Risk-Off» concerning trade war



- One of the main external shocks that has been affecting the world economy has been the **trade war** between the United States and China
- After several acts, **time is running out so that President Trump can have an agreement to present to his electoral base before the US elections** in November next year, hence, we expect some kind of agreement in the second half of this year

Source: Bloomberg

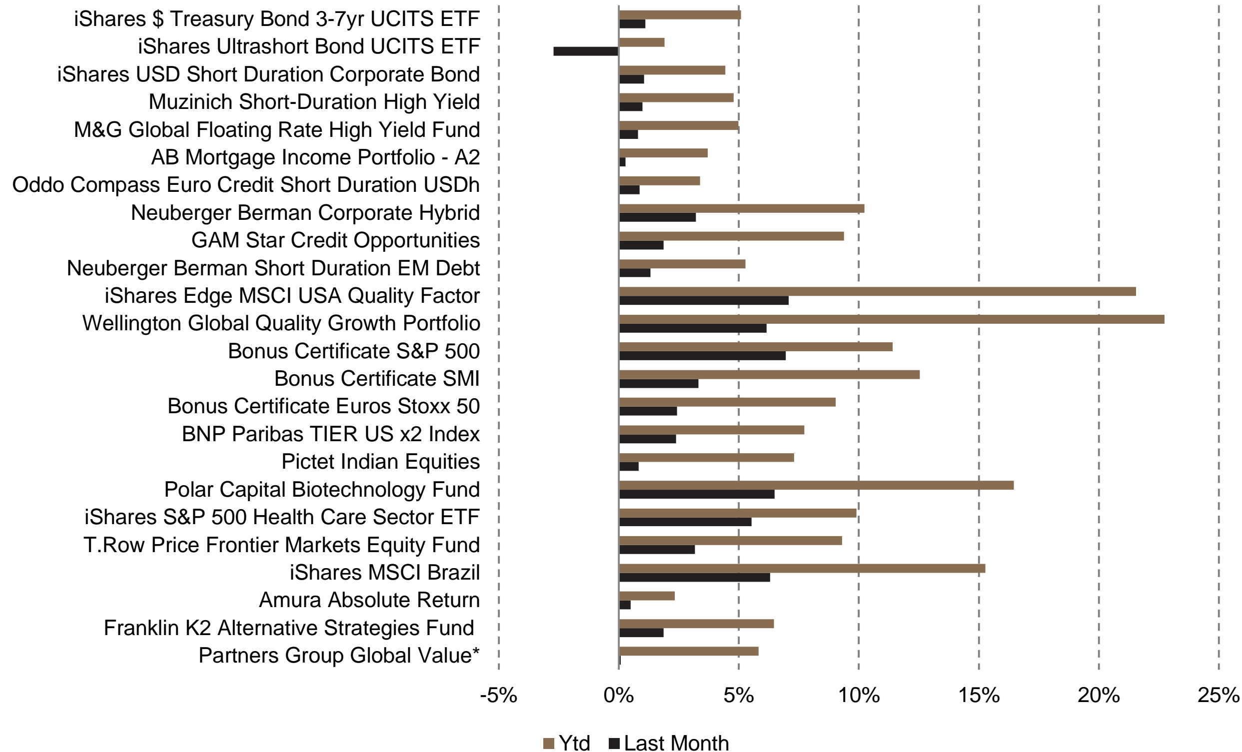
Gold's comeback?



- **Low real interest rates** (i.e., nominal interest rates minus inflation) have historically been associated with periods in which **gold has increased in value**
- **Gold appreciated massively in two periods: 1975-1981 and 2008-2011**. The first was associated with high inflation, while the second coincided with the introduction of QE. The latter created a bubble, since QE did not cause the sharp rise in inflation expected by gold supporters. **Current valuations, adjusted for inflation, seem relatively fair**

Source: Bloomberg

Model portfolio evolution



Source: Bloomberg ,as of July 1, 2019
* Fund publishes monthly NAV with a 1 month of delay

Investment scenarios

	Scenario 1 Recession by political/policy accident	Scenario 2 Goldilocks	Scenario 3 New regime
Drivers	• Global economic slowdown caused by political accidents or policy errors (Trade war with China, EU breakup, a too aggressive Fed, etc.) • Deflationary scenario due to a combination of low growth and structural factors, although the rise of protectionism would be inflationary • The Fed will have to reverse curse, which would be complicated if inflation is rising	• The fiscal stimulus in the US provides a short-term impulse to the global economy, but not enough to attain a higher growth trajectory • Inflation, particularly in the US will pick-up, but remains subdued globally due to structural factors (demographics, low aggregated demand, deleveraging) • The Fed will continue its normalization path	• Growth concerns dissipate, with economic activity accelerating in US, Europe and Japan • Inflation in the US increases, as a consequence of president Trump's fiscal stimulus, and pulls other developed economies off deflation • The Fed will have to step up the pace of rate increases and/or reduce balance sheet
Market impact	• Correction in credit due to a rise in defaults and a widening of corporate spreads • Correction in equities due to lower projected earnings, though low rates will offer support • Sovereign and IG credit to profit due to flight to quality and the continuation of an ultra-loose monetary policy globally • USD neutral to weak as flight to quality is counterbalanced by low interest rates • Commodities will fall	• Equities appreciate moderately, with Europe and Japan catching up with the US • Credit spreads remain stable as the credit cycle is further elongated • Sovereigns suffer as monetary policy is progressively normalized • USD appreciate moderately due to higher interest rate differentials • Commodity prices will rise in the short-term, normalizing once the impulse vanishes	• Impact on equities will depend on how much real economic growth is sustained, and how accommodative the Fed remains • Sovereign and IG bonds will face steep losses due to higher rates, particularly if long-term inflation expectations rise • Corporate credit will correct moderately if inflation comes together with higher growth • The USD will appreciate, particularly against those currencies facing deflation • Commodities will gain from higher inflation
Probability	35%	40% (+5%)	20% (-5%)

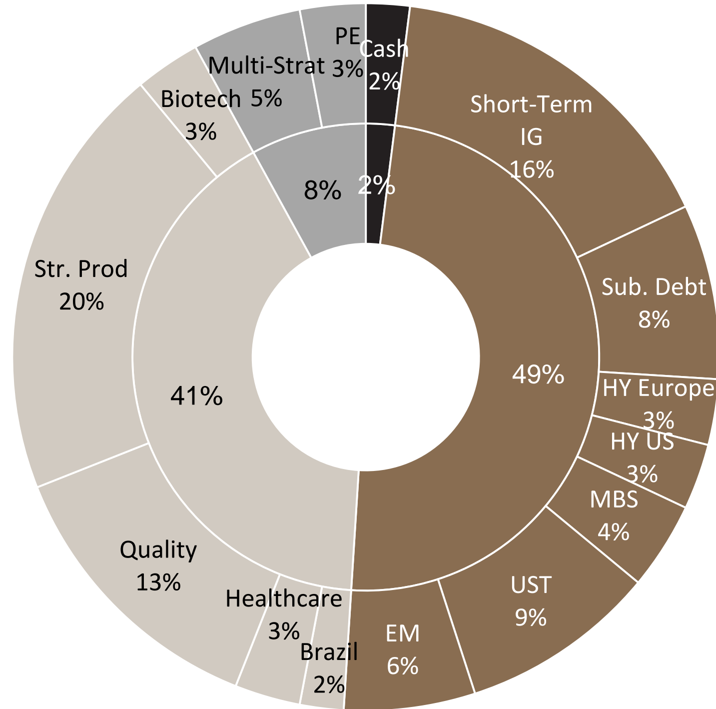
Short-term catalyzers

Fiscal stimulus in the US, improvement in macro-data globally, lower geopolitical tensions

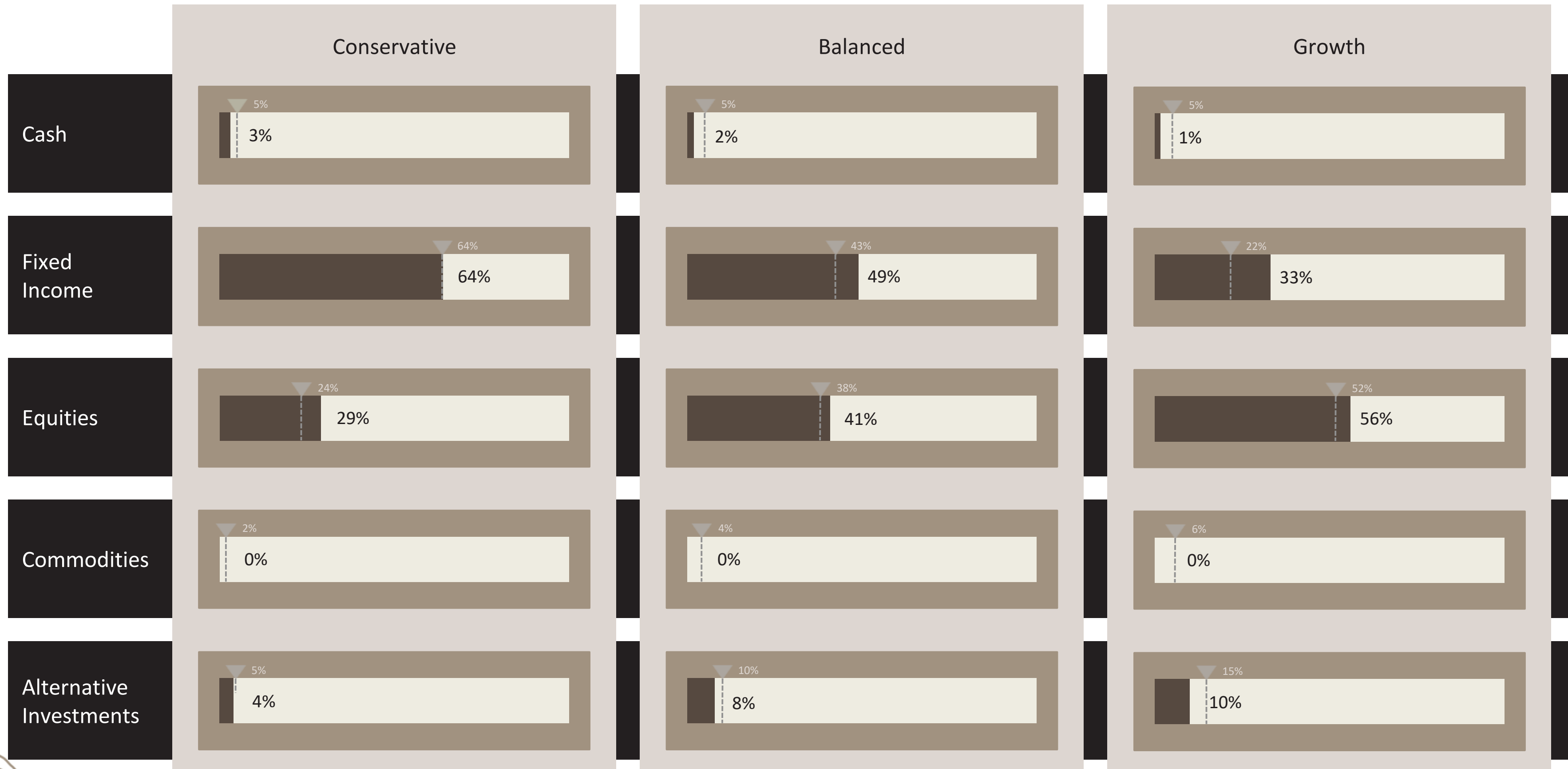
Other risks

Trade wars, Spread of populist political parties, China slowdown, Terrorism

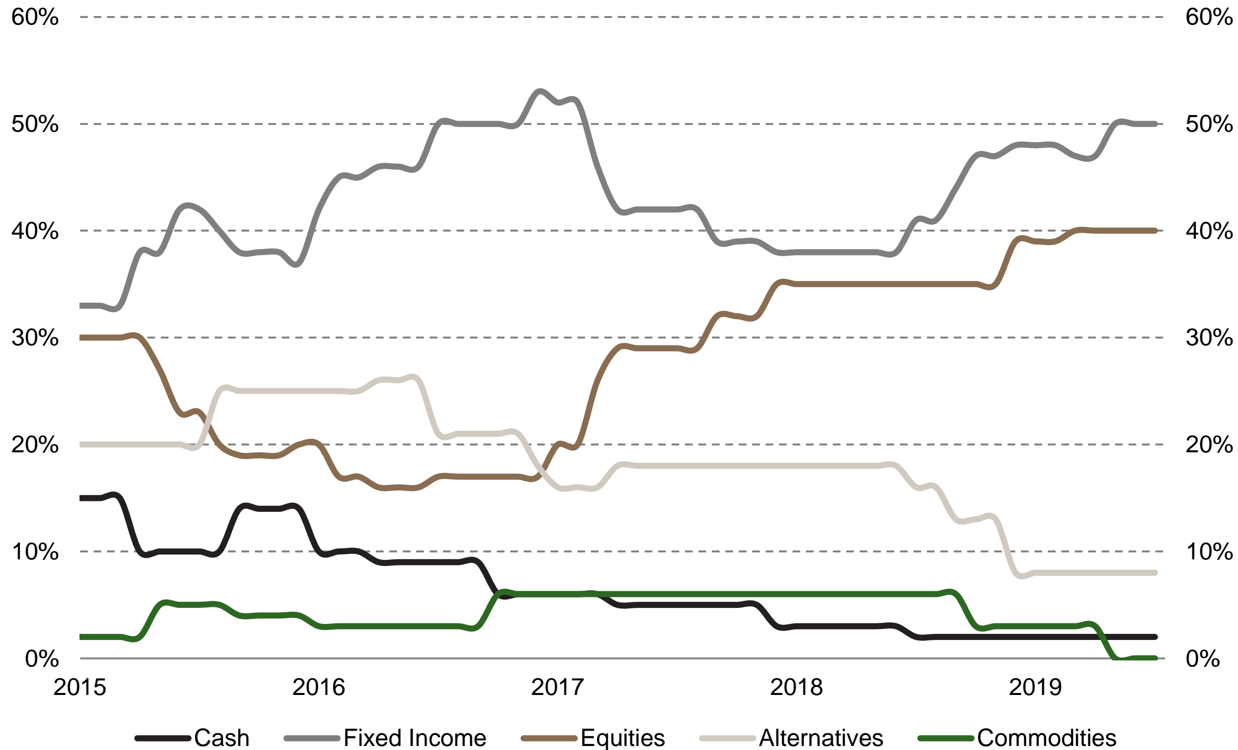
EWM Model Portfolio Balanced USD



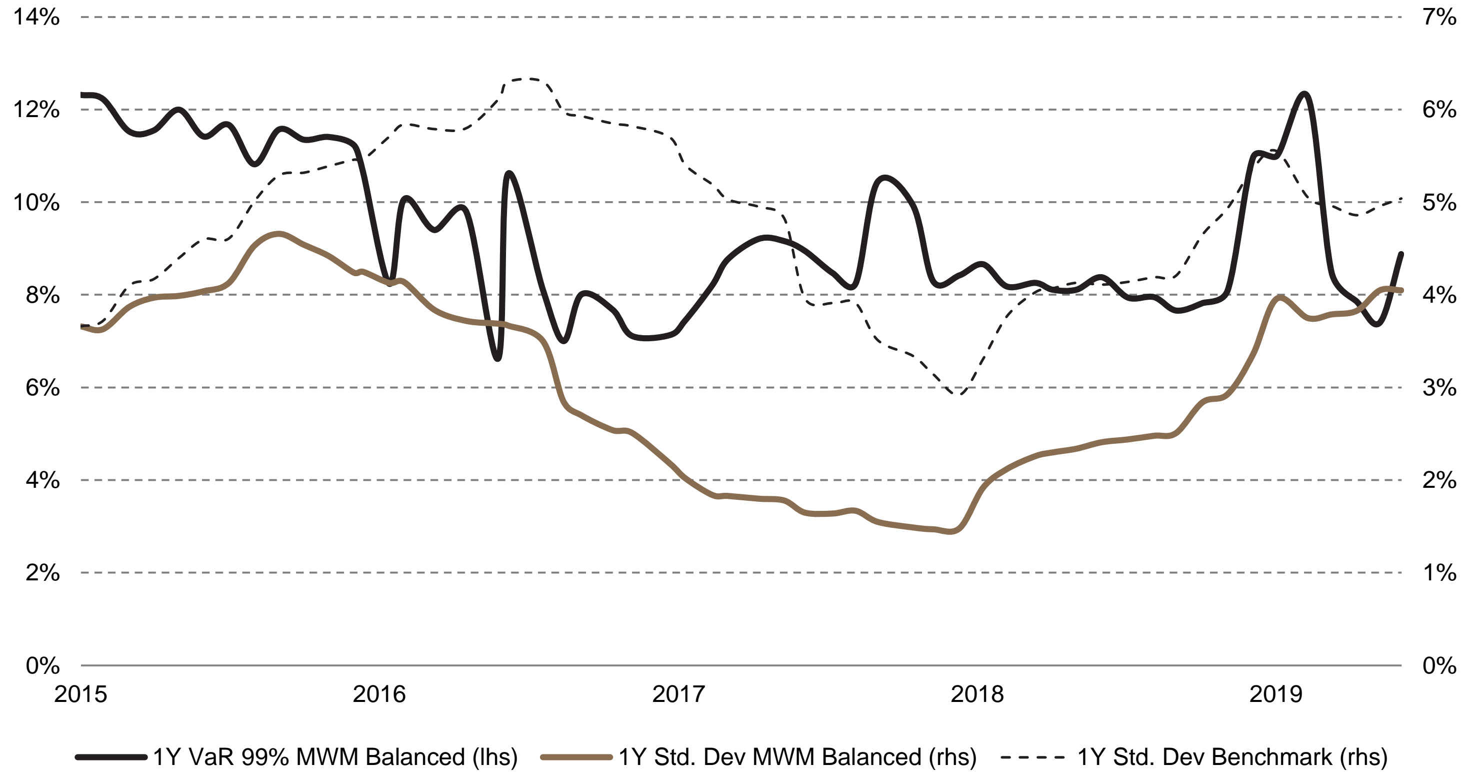
EWM Investment Profiles



EWM Model Portfolio – Asset Allocation evolution

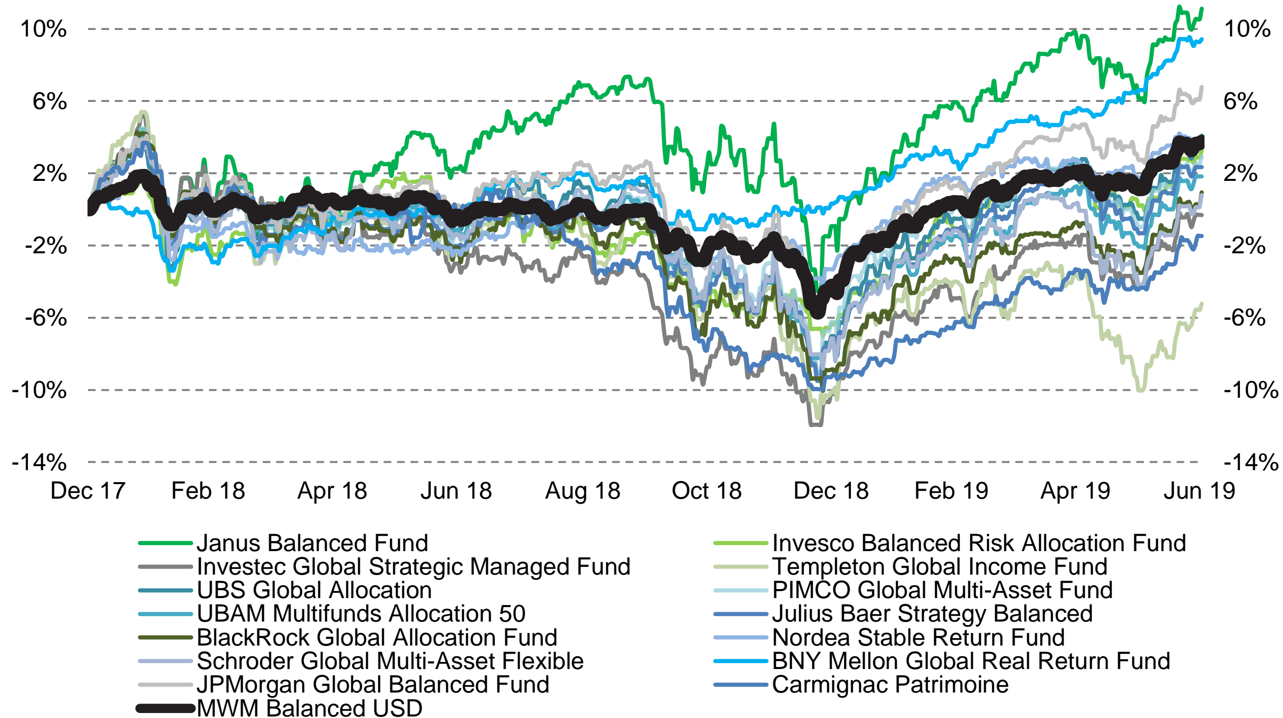


EWM Model Portfolio – VaR evolution



[1] As of July 1, 2019
Source: Bloomberg

EWM Model Portfolio – Peer comparison

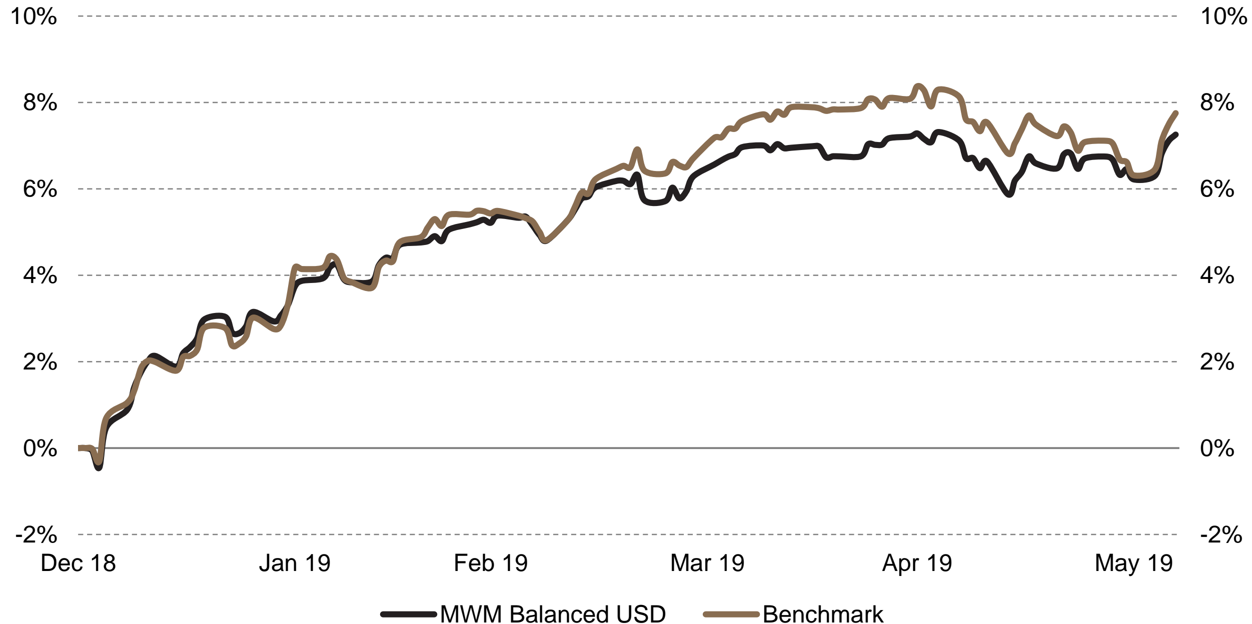


- **Total Return** (Ytd[1]): **12th out of 15**
- **Standard Deviation** (1 year[1]): **1st out of 15**
- **Downside Risk** (1 year[1]): **1st out of 15**
- **Sharp Ratio** (1 year[1]): **2nd out of 15**

[1] As of July 1, 2019

Source: Bloomberg

EWM Model Portfolio – Ytd performance

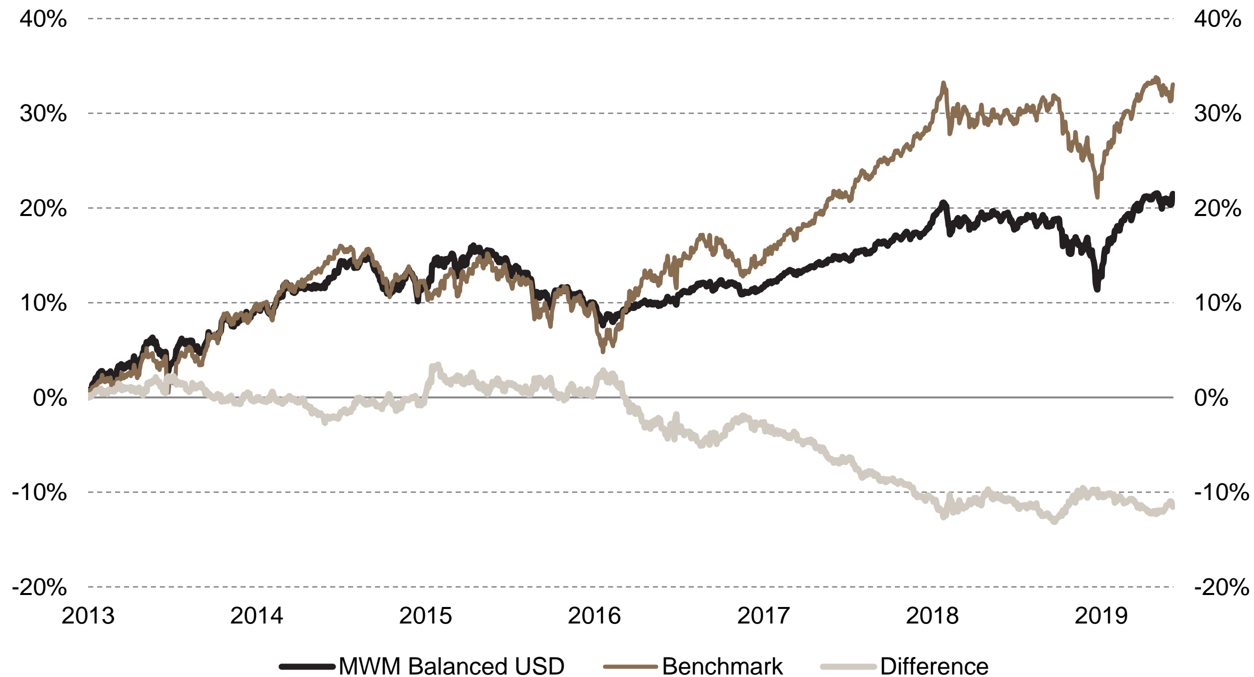


- **Total Return** (Ytd[1]): **9.43%** vs. **10.42%** Benchmark[2]
- **Standard Deviation** (Ytd[1]): **3.63%** vs. **4.34%** Benchmark[2]
- **Downside Risk** (Ytd[1]): **2.60%** vs. **2.92%** Benchmark[2]
- **Sharpe Ratio** (Ytd[1]): **4.65** vs. **4.39** Benchmark[2]

[1] As of July 1, 2019

[2] Benchmark = 5% Fed Funds + 43% JPM Global Aggregate Bond Index + 38% MSCI World + 4% S&P GSCI + 10% HFRI FoHF

EWM Model Portfolio – Historical performance (1)

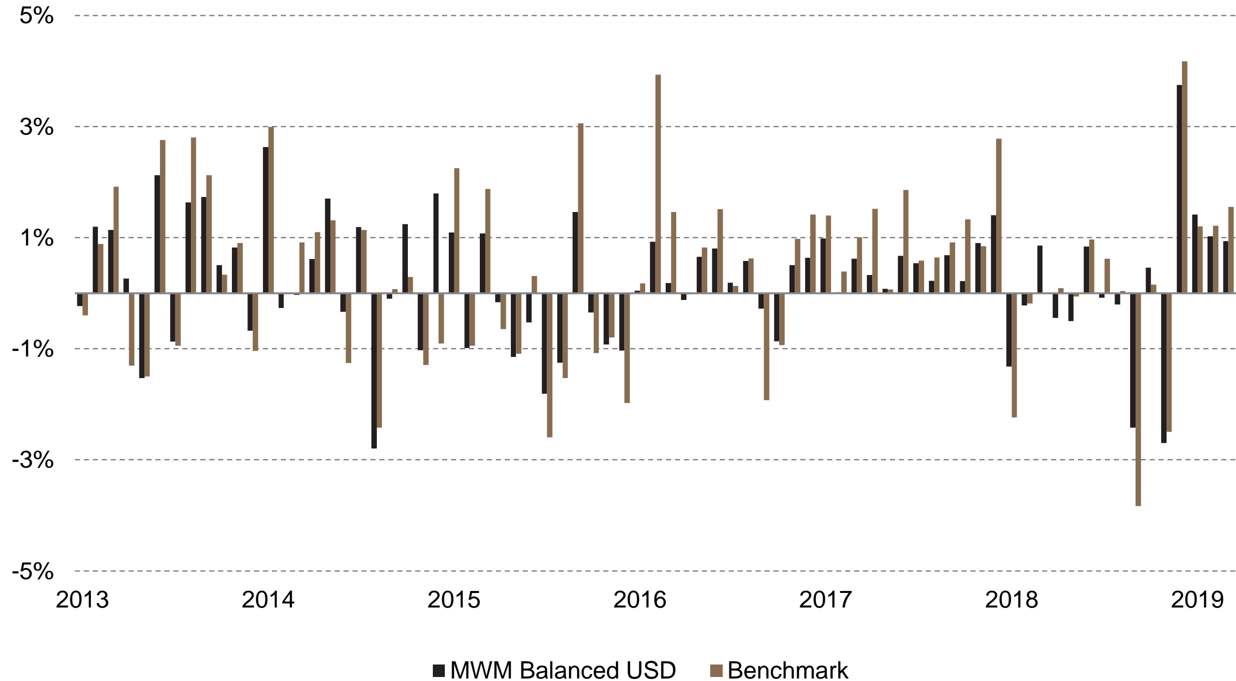


- **Total Return** (1 year[1]): **4.96%** vs. **5.26%** Benchmark[2]
- **Total Return** (3 year[1]): **9.11%** vs. **10.24%** Benchmark[2]
- **Total Return** (Since Jan 13[1]): **23.61%** vs. **36.12%** Benchmark[2]

[1] As of July 1, 2019

[2] Benchmark = 5% Fed Funds + 43% JPM Global Aggregate Bond Index + 38% MSCI World + 4% S&P GSCI + 10% HFRI FoHF

EWM Model Portfolio – Historical performance (2)



- **Standard Deviation** (1 year[1]): **4.05%** vs. **5.05%** Benchmark[2]
- **Downside Risk** (1 year[1]): **2.99%** vs. **3.59%** Benchmark[2]
- **Sharpe Ratio** (1 year[1]): **0.60** vs. **0.60** Benchmark[2]
- **Var 95% - 1day** (1 year[1]): **-0.44%** vs. **-0.50%** Benchmark[2]

[1] As of July 1, 2019

[2] Benchmark = 5% Fed Funds + 43% JPM Global Aggregate Bond Index + 38% MSCI World + 4% S&P GSCI + 10% HFRI FoHF

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