SYZ

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Introduction

Interest rate normalisation should revive hedge fund returns

ERIC M. SYZ , FOUNDER AND CEO, SYZ GROUP

I have been investing in hedge funds for more than 30 years. The first time was in the early 1980s, when I was a stockbroker on Wall Street, and friends of mine were doing a lot of business with what they called hedge funds. I didn't know what hedge funds were so I tried to find out. The next thing I knew I was standing in George Soros' office, and didn't know who he was. Soros was managing a few hundred million dollars at the time; and that's how I got acquainted with hedge funds.

I started to invest in hedge funds, and ever since I've been investing in hedge funds. Of course, in those years we got 15 to 20% returns by just allocating to 10 or 12 different hedge funds but we had an interest rate environment which was very, very different. People tend to forget that in those years hedge funds were returning in the 20s and 30s but interest rates were in the double digits. Now, in the current environment with the risk-free rate of return being where it is, it's very hard to perform anywhere, for hedge funds as well. Having said this we've always been investing in hedge funds even though the times were hard, and they fell out of favour.

One of the reasons why we decided to launch this conference was that the interest rate environment is getting back to a more positive note in the United States and around the globe. I think the deflationary period is over and people are no longer scared of deflation. I was just talking with somebody who thinks that there's a possibility Europe will see higher rates over the next few quarters, and that is a positive environment for hedge funds. It's disruptive for the market, but this often means there are also opportunities for hedge funds. I think there's going to be a new revival for this investment style.

Hence, we decided to take the opportunity to get you all here to listen to some of the hedge funds that we think are great people who we've worked with for many years, and who have done fantastically well over the years. As you can imagine, as we've been investing with hedge funds for more than 30 years my firm has garnered a lot of experience with a lot of people that invest in hedge funds. We've always had hedge fund allocations in our portfolios, sometimes more, sometimes less. Over the years we have had as much as 40% of our global balanced portfolios in hedge funds. This went down to something closer to 5% and now we're back to a 10 or 12% allocation to hedge funds. This is probably going to increase over the years to come. **THFJ**

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CREATING PERFORMANCE

WEALTH MANAGEMENT — ASSET MANAGEMENT

US Macro Portfolio Manager

Global growth, political risks and less financial repression: three reasons why I'm excited for global macro

US MACRO PORTFOLIO MANAGER

My background is in currencies and fixed income. I started about 25 years ago in fixed income at UBS and soon graduated from fixed income to currencies, which is where I've spent most of my career, initially as a market maker at Goldman Sachs and then on the asset management side at Goldman Sachs. I worked on the fundamental currency strategy performing currency overlay and adding alpha through currency markets. I'm a big believer that currency markets are one of the best sources of alpha out there and no matter what's going on in equity markets, or in fixed income markets, I think there are always good returns to be generated in currencies. I've been doing that since 1999 now and no doubt for years yet.

I am going to speak about global macro. I'm a little bit biased as I'm always excited by what's going on in global macro. Sometimes there's a lot of money to be made, sometimes there's less money to be made, but I do believe that there is always money to be made in macro. Today there's really two things that I want to focus on and the impact that they have on people's portfolios.

Economic growth is accelerating and outpacing forecasts

Firstly, the acceleration in global growth makes it feel as though the global economy has finally broken free of the shackles from the Global Financial Crisis (GFC), nearly 10 years after the bust, but now we're firmly in an accelerating global growth phase. Traditionally since the GFC we've always had economic growth disappointing forecasters and ongoing downward revisions to growth forecasts, whereas that's now changed and we're actually seeing an upside. We're seeing global growth accelerating and we're seeing upside revisions to global growth, with more optimism coming through, and that's expected to continue throughout this year and into next year as well.

What I think that means is the end of financial repression. Since the crisis central banks have held interest rates low and even negative, and on top of that have been very active in fixed income markets, driving yields lower and preventing them from adjusting, so it's been a low return environment. But because of the progress that's been made in global growth I think that there are some signs that that period of financial repression can move on.

Bonds may no longer provide portfolio insurance

Both of those factors mean that we should finally be in a rising interest rate environment, which is something new, something we haven't had to deal with really since the mid-nineties or 2000s. The implications for portfolios are, I think, that fixed income won't be able to provide the traditional protection that it has provided for equity portfolios. I do expect global fixed income yields to move higher so that the prices of fixed income portfolios go down. Fixed income has been a great diversifier in portfolios for the past 10 years, and it's always been there to help out when equity markets have had their periodic wobbles, but I'm not sure that's going to be the case going forward over the next few years. Hopefully, global macro will be able to take advantage of some of those trends and offer some of the diversification that portfolios need.

> "We're seeing global growth accelerating and upside revisions to global growth, with more optimism coming through."

Federal Reserve rate rises to exceed market expectations

I think that the first opportunity - something that I've been very focused on this year - is US rates. Now, simply put, I don't think they are pricing enough risk of Fed hikes in the US interest rate curve, nor enough risk premium further out on the curve. The US interest rate curve today, in terms of shape and levels, closely overlaps with the curve in December of 2008, just after Lehman Brothers had gone under and we were entering the worst part of the GFC. The US yield curve remains well beneath its levels in December 2013, just after the taper tantrum. For some reason markets are very, very reluctant to price in further hikes from the Federal Reserve, though I think that the Fed has made quite a shift. We're used to the Fed being a dovish institution, whereas I think currently they've shifted to a much more hawkish bias and are in the middle of a tightening programme. I think that they intend hike rates 25 basis points, once a quarter, provided that they have the opportunity to do so.

Obviously, they'll back off if equity markets are falling by 5 to 10%, but the sort of small kind of crash that we've just seen in the last couple of days won't bother them. We've basically got back to their idea of full employment equilibrium: we've reached their levels of NAIRU (Non-Accelerating Inflation Rate of Unemployment) and inflation has finally got within touching distance of their target.

I think that the Fed can hike three or four times this year and, if I'm right about growth, then they'll probably end up tightening three or four times next year as well. On top of that, they will start to run down their balance sheet, they will cease the reinvestments of their mortgage portfolio and that should add to yield-rising pressure at the back end of the curve as well.

That's much more than is priced in. There's a sort of wisdom that there's a lot priced in for the Fed, but it's really not the case. We've got about one and a half hikes priced for this year and about one and a half hikes for next year, and that's really not very much at all. I think that that's easily achievable. And even this year with the hike in March there was nothing priced in until a couple of weeks before. I think we could see something similar with June despite the fact that it's even less than 50% priced in at the moment.

Failure to repeal Obamacare could bring forward tax reform

I think that recent healthcare fiasco is an opportunity to add to shorts in US fixed income. I think that the health care failure in the US saves a lot of wasted time. Expectations were that the White House would put forward a healthcare plan, the Senate would reject it and they would back and forth it for months and that would take up a lot of legislative time, whereas now at least they'll be able to move onto tax plans a little bit sooner. I think that Trump will look to reach across the aisle and tax plans, combined with infrastructure spending, is something that the Democrats will be able to support. So I think that there's a higher chance of that going through, and I think it's something that people have really given up on. The Bank of America survey that came out last week suggested that only 10% of investors thought that tax reform would get done this year, and I think the probability is a lot higher than that.

The US economy's not in bad shape, it's close to equilibrium, so it doesn't need tax reform in order to see higher rates. In fact, if we were to see tax reform it's something that the Fed's not factoring into its forecasts at the moment, so the Fed would accelerate from its pace of three to four hikes a year and then we'd see even more of a selloff in fixed income. I don't think 10 year treasuries will get back

down below 2% again. I think we'll be moving up to 3% and above as we go through the year and into next year. That will lead to losses on fixed income portfolios that hopefully we will be able to profit from.

Easing US financial conditions conducive to the economy and rate hikes

Another reason I think the US economy is set to do quite well, and for further hikes to come through, is that since December 2015, which is when the Fed started its hiking cycle, financial conditions have actually eased quite significantly, as per the Goldman Sachs Financial Conditions Index. Financial conditions have eased further since the Fed hike in March, and I don't think that that's something that the Fed intended. I think that they are genuine about trying to slow the economy down now and to tighten policies, so, again, that leads me to believe that the Fed will be moving rates higher as soon as June, and that's only 50% priced in.

The US unemployment rate has come all the way back down to the levels where it was in the 1990s when, during the middle of that credit boom and housing boom, interest rates got up to 5%. This is another reason for higher rates.

Term premium in US interest rates should come back

The Fed's estimate of term premium in 10 year interest rates, normally has a positive risk premium for investing in long dated treasuries, and at the moment there's absolutely no risk premium. I guess that's better than last year where it went to a negative risk premium, but at the moment there's nothing and, again, I think that risk premium in Treasuries is something that we can see moving higher over the course of the year and into next year, for a couple of reasons.

Firstly, as a result of the healthcare troubles I think that the tax reform plan will have to be less ambitious and will most likely just be a tax cut plan which will increase the budget deficit, obviously, and the need to borrow, and that will push interest rates up.

Secondly, it looks as though the Fed's moving towards a balance sheet reduction, so that should also push up this premium in the back-end of the curve.

Thirdly, we don't really know what the Fed's going to look like in a year's time; there are five members that are up for replacement, including the chair, Janet Yellen, and the vice-chair Stanley Fischer, and so Donald Trump has a lot of power to reshape the Fed, and I think that that's something that requires a little bit higher risk premium further out on the curve, too, which would argue for the 10 year Treasury yields again moving higher from where we are - and potentially by 100 basis points or so.

Global data surprises and inflation surprises are again at GFC highs. I guess that for short-term tactical reasons that perhaps gives you a little bit of pause for concern, as when surprises are this high then you tend to get a little bit of mean reversion as forecasts finally catch up with reality. But I think the fact is that global growth is very well placed at the moment, so any disappointment in interest rate markets over the next few months - as perhaps their measures like the ISM and other survey measures come down a little bit - should be faded (by shorting Treasuries) because underlying conditions are really quite good.

Structurally bullish on the USD

Secondly, I'd like to move to the dollar, which is something that's frankly caused me a lot of sleepless nights so far this year. I've been constructive on the dollar since 2012, since the advent of tapering and the Fed moving away from its emergency measures, and, on a structural basis I am still bullish on the dollar.

Just on a tactical basis I can see scope for a little bit of dollar weakness over the next couple of months as we go through April and we worry about a government shutdown potentially at the end of April, which is something that people are giving some degree of probability to at the moment, but which I think will ultimately be averted. Also I think that the dollar might weaken a little bit over the next couple of months as we go through the French election with, I think, ultimately Le Pen losing. This should release some pent-up capital into Europe and push the Euro dollar rate higher, and that would be negative for the dollar.

Yield advantage should support the USD

But on a structural, big picture, basis I'm still quite a dollar bull. I think that the US is on track to become the highest yielding of the G10 currencies and, in fact, I can see it overtaking Australia and New Zealand to become the number one high yielding currency in the G10 space, and that that should support the dollar. Based on three month interest rates, the USD has come from a number 10 ranking in 2012 up to being the number three most attractive ranked currency now in terms of yield, and that should generally be supportive, I think.

The only period when rising interest rates really were not supportive for the dollar was during that 2005-07 period when the Fed raised rates but the dollar declined, but I don't think that we had quite the same dynamics then. That was really the height of globalisation with huge FDI and capital flows going into emerging markets, which was putting downwards pressure on the dollar against emerging market currencies. Reserve managers were building up huge reserves and then diversifying those into sterling and Swiss and Euros and putting further downward pressure on the dollar. Also, the US had a huge current account deficit at the time and was struggling to fund that, the current account deficit was around 6% of GDP whereas currently it's only about 2.5% of GDP, so I think slightly different dynamics apply. The more normal sort of FX relationship, of higher interest rates strengthening the currency due to currency flows, I think is more likely to be what we see.

Persistent financial repression should weigh down the Yen

A lot of the other countries, I think, are well behind the Fed in terms of rate normalisation. Take Japan, for example; they have some very harsh financial repression in Japan with not only negative interest rates at the front end - but also a yield curve target at the back-end promising to keep 10 year interest rates basically around zero. Unfortunately I don't see any end this year to yield curve control in Japan. They have a bit of an inflation problem and a strong inflation target, but are still struggling to hold above positive territory, barely above zero. The Bank of Japan has committed to keep rates low and stable until it gets inflation - not just back to target but at 2% over the cycle - so it's allowing for some overshooting there. I think that Japan is one place that will continue to have financial repression, it will continue to hold interest rates low. I think that that makes the yen an attractive funding currency and should see it weakening against other currencies, not just the dollar but also the euro.

European growth surprising to the upside

Europe, and the European recovery, is something that we're focussed on as well at the moment and we think that there's opportunities to be had in Europe. One of the ECB's growth indicators was actually developed by one of our strategists when he was working for the ECB. Growth in Europe has been really surprising to the upside, and, in fact, over the last 12 months real growth in Europe has actually been stronger than in the US for the first time in an awfully long time.

Le Pen defeat should unleash risk appetite for Europe

I also think that there's potential for good inflows into Europe post the French election, into European equities, into peripheral bonds, as well, especially France. I think a lot of people have been scared off European assets by the French election and clearly there is a massive downside tail to a Le Pen win, but according to all of the work that we're doing that does seem really quite unlikely. We did a lot of work

looking into polling for Brexit. We actually thought there was a good chance of Brexit happening, and that's something that we wrote about. We also thought that Trump had a likely outsider's chance, but most of the work that we're doing suggests that Le Pen really does remain a tail risk and we wouldn't put the probability at any more than 5 or 10% looking, at all of the poll results. Obviously there are very significant events that would come to pass, which is I think why people have been holding off from buying European assets given the growth outlook there, but once that's lifted then I think that we should see good inflows into European banks, into European equities in general, and that should support the euro. So it's something that we're playing in the portfolio: long euro dollar; long euro against other commodity currencies as well; upside structures on European equities and shorts in European fixed income.

Speculative Euro shorts could reverse

Unemployment in Europe has come down very nicely, it lags the progress in the US but it is very much heading in the right direction and is following the pattern of recovery of the US. And euro positioning is still short; this is one of our internal positioning indicators where we try to estimate the leveraged account positioning in assets. We have a very strong flow of funds group, about 10 people looking at various different asset classes. This is very important to me, being a currency investor, to understand currency dynamics, and currently the market is still short euros. We can see that getting eradicated and actually even moving long Euros once the French election is out of the way.

The ECB may tighten policy

Also we're looking for some adjustments and a more hawkish stance from the ECB, which is quite interesting and something that we're looking forward to trading. There's clearly a lot of discussion going on at the moment about the interplay of the deposit rate and asset purchases and we think that there is a chance that interest rates get raised in Europe before the end of this year, either in September or December. Currently the deposit rate, which is the most important interest rate in Europe, is at minus 40 basis points, and we think that that could get raised perhaps up to minus 25 basis points, to make the corridor symmetric again. That's something that's not really priced and should be negative for the front end of fixed income curves.

And the ECB seems to be moving towards the limits of its asset purchases or QE. They're in the process of reducing it from EUR 80 billion to EUR 60 billion now, as we come into April, and we think that that will be reduced, again, from December onwards and that they'll taper that down to zero in the first half of next year.

Bund and BTP yields could move higher

I think interest rates yields in Europe are certainly being artificially held low by that, especially bunds, where negative yields apply. So with a higher deposit rate and potentially much less supportive flows from the ECB, I think that in the second half of the year we should see a nice move higher in interest rate levels in Europe and think that 10 year bunds could sell off 50, 60 basis points quite easily from here, and that also throws up some interesting opportunities in Italian fixed income.

Now, I'm not sure what the right level for a 10 year BTP (Italian Government Bond) is, but given the high debt levels and the lack of growth in Europe I don't believe it's 2%, which is where we are today. As we move into next year and the ECB stops its asset purchases and perhaps even looks to raise interest rates back to zero, we can see BTP yields moving significantly higher, and I think that that's throwing up some good opportunities, too.

One trade that's worked very well in the US is the equity risk premium trade, being long equities and short fixed income, that's something that's performed very well, and we think in Europe it's lagged behind massively. Fixed income is generally providing much better returns in Europe and we think that that dynamic is changing, so being long equities and short fixed income in Europe should provide quite good returns.

Emerging markets yields attractive given improving fundamentals

Emerging markets look quite attractive in this environment. Basically, emerging market balance sheets are in good shape and current accounts have improved significantly since the taper tantrum. Emerging markets have really been through a lot over the course of the past few years, starting with the taper tantrum, which led to huge outflows and a big move higher in interest rates in emerging markets, and then the commodity price bust, which was a big negative for emerging markets.

Whereas now we seem to have come through those, commodity prices have stabilised, and current accounts have improved significantly.

Interest rates are much higher across the universe, and valuation actually looks relatively cheap after several years of under-performance; you can get 6, 8, 10% interest rates in many emerging currencies, too, so I think that some of these currencies are quite attractive and something that we're focused on, relative to the dollar at the moment. But when the Fed gets a bit more hawkish later that perhaps won't work, so we quite like funding those through shorts in G10 commodity currencies like Australia and New Zealand and Canada. **THFJ**

"I expect global fixed income yields to move higher so that the prices of fixed income portfolios go down."

European Credit Markets
Stars Aligned vs. Perfect Storm

EMMANUEL WEYD, CIO, CREDIT EIFFEL INVESTMENT GROUP – OYSTER FLEXIBLE CREDIT FUND (UCITS)

I gave a title to this presentation, which is on European credit markets, namely Stars Aligned or Perfect Storm. Starting the year or ending last year we did our annual outlook thinking of upsides at Eiffel and we were thinking it's incredible how contrasting the picture is, if we look at where we are today. All the signals are very bullish, green lights, etc; on the other hand we can't help thinking about the tons of risks on the horizon and how they can play out over the year. That's really what is driving our current positioning in our portfolios and our thinking process and the framework we have for investing in Europe and credit at the moment.

Macro tailwinds in Europe

I'll start with the blue sky, where there are clearly good fundamentals. We are fundamental bottom-up credit people - we are not top-down people - but there will be a lot of things I will show you which are a bit top-down because I didn't want to get into individual names, etc. You'll see we have to look at the macro environment, and it's very interesting to see that for a very long time in Europe it hasn't been that favourable. But you now really have a tailwind from the macroeconomic environment in most countries, whereas it was really very divergent in the past few years in Europe. For the first time, the economic forecast is improving.

At the same time if you turn the clock back 12 or 18 months, you will remember what the fear was in Europe. It was, "oh, my god, we're getting into deflation, it's getting out of control, the ECB is doing incredible things because we're in negative inflation, with core inflation slightly below 2% mandate, etc".

Now, the index of inflation surprises is improving. The fundamentals are a clear blue sky, we like it. In credit we don't want it to be too hot, but, in Europe it's never too hot, it's rather too cold. Take Greece - and I'm not talking about the weather - I'm talking about the economy.

European banks' balance sheets have recovered

The second big fear around Europe, if you turn back the clock, was around banks. I worked for American banks, and in terms of the bad things I've heard about European banks, such as "they're undercapitalised, they don't know how to manage assets, blah blah", there is one thing which is true: European banks have been in as much trouble as their US counterparts - but it took them much longer to get back to normal.

Regulation is different on both sides of the pond but it's clear that regulation is becoming increasingly credit-friendly. It may be shocking to some of you who are in equities by saying European banks

Emmanuel Weyd
CIO, Credit Eiffel Investment Group – OYSTER Flexible Credit Fund (UCITS)

are doing great - because I know there's a huge profitability challenge for European banks - but as a credit guy, I love European banks. Everything that's been done for European banks in the past seven or eight years, has been done in the interests of the creditors: regulation, politicians, ratings agencies, creditors, even equity issuance. There was a point in the equity market where the highest valuations of European banks, from an equity standpoint, were the strongest capitalised banks, so that's music to our ears.

And the message I want to give here is that European banks are doing fine from a credit standpoint. The 40 largest European banks have raised EUR 40 billion of core capital since the crisis; some common equity, and tier one capital ratios are getting close to 13%. If you look at leverage, tangible equity to total assets has more than doubled (and is not distorted by multiple adjustments that apply to common equity ratios).

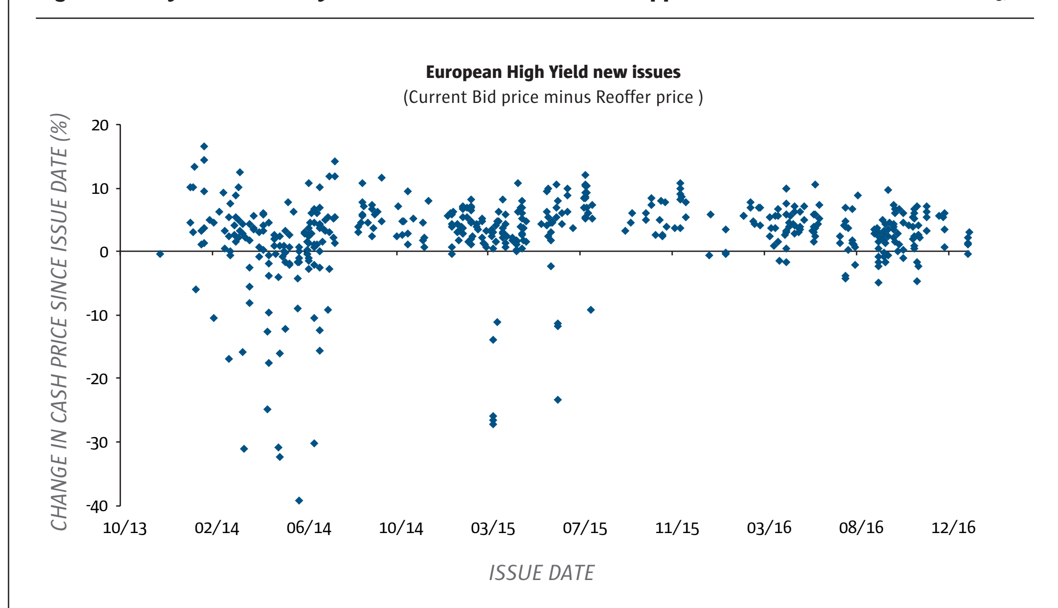
So that's very helpful, and at the end of the presentation I have one example of two credit issuers and how all this plays out in our investments. Banks matter, even for corporate credit. We are investors in banks' debt instruments and what happens to banks is also very important for debt instruments issued by corporates.

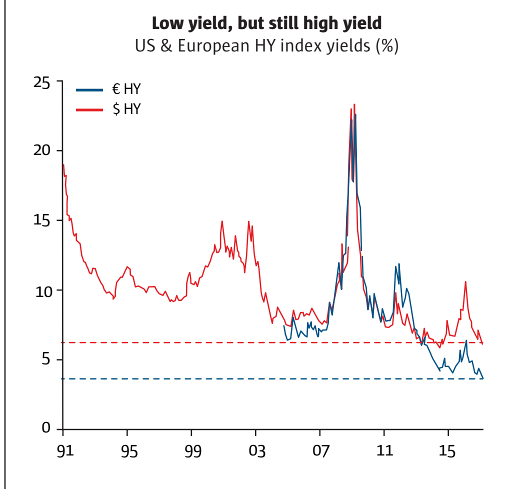
Issuance trends: leverage, cov-lite, after-market performance

Now, leverage starts to be a little bit contrasting. Leverage, as measured by net debt to EBITDA ratios, has increased to around four in European high yield corporate debt markets. You see a lot of new issues in the high-yield market with leverage about four times, where we start to be a little bit stretched.

For a couple of deals, the documentation package is less protective for creditors than it should be, or the textbook tells you it should be. We read a legal high yield publication, which is screaming all the time, in the interests of creditors, saying governance standards are degenerating deal after deal. Now, there's a simple answer around this whole cov-lite (covenant-lite) thing. I'm not saying cov-lite deals are good things, I'm just saying that you prefer 100 times to be invested in

Fig.1 Primary market: A key bellwether for investor risk appetite *Source: Bloomberg, EIG*





good companies issuing cov-lite deals than in bad companies issuing debt with strict governance.

Recently, an issuer that we like a lot in this country, the third mobile operator, a company called Salt, the former Orange Switzerland, issued a deal, which was a leveraged recapitalisation. They issued 500 million Swiss francs to pay to their shareholder, a French mogul. It was not a creditor-friendly deal. That said, the deal on the primary side was a great deal because it was priced fairly. It had some cov-lite features (not all of them) but the underlying business is still strong and we still like this business. So we monitor this, but it's not the end of the world.

One of the key warning signs in the market is this primary issuance market that I've just alluded to. We monitor every single name new issue in the high yield market in Europe. We look at their issuing price, which is typically par, we look at their date of issuance, and we look at where they trade at today. This is shown below.

That's a great indicator of investors' risk appetite. Typically, in an overheating market you start to see the recent new issues starting to trade below the offer; that's a signal that the books are so huge that issuers are squeezing the last basis points from investors, and you have after-market performance becoming very poor. You also start to see that it can be quite stretched on some measures, and that you should really monitor this. When you start to see these dots basically starting to move below the zero bound, it begins to be a key warning signal. That means that risk appetite may turn very quickly and therefore you may have market gapping. So far it's ok, the primary market is working at full steam, any high yield issuer can issue in Europe (and when I'm saying in Europe it's not just in the Eurozone), but you really need to monitor this.

Why does US high yield pay more than European high yield ?

Now we're entering the more stormy zone. One indicator we're watching very carefully in European credit (and which might be a little bit counterintuitive) is the gap between dollar yields and euro yields, as shown in Fig.2.

The first thing you see is that both of them are quite low, and that's not really reassuring: there's no doubt that valuations are quite expensive. But let's leave that aside for a minute; what is very interesting is that you have 250 basis points of yield difference between the US high yield market and the European high yield market. That's an indicator we care about because a lot of high yield investors, or credit investors, are global investors, meaning if they see a US high yield company coming at 7.5% they will prefer it to the same one coming at 5% in Europe. We can see rotation out of European credit into US credit, and it's something you need to monitor very carefully.

Now, there are some reasons for this 250 basis point gap. The first one, which is quite obvious, is risk-free rates, which is about 200 basis points of the difference, because European high yield, whatever the issuing location, prices off Bunds. Even if it's an Italian or a Spanish borrower, they price off Bunds, they don't price off a BTP or OAT. The second one is composition: the US high yield universe typically has lower credit ratings. The third reason is duration, and the US has typically more duration as well, so you should have a little bit more premium. This gap between US and European high yield is very important to monitor, and it's never been sustained when it's above 300 basis points.

ECB asset purchases crowd out investors

I loved it when I was at an ECB press conference over a couple of years ago, a lady had a T-shirt saying "Stop the ECB Dictatorship". In the credit market we really feel that we're kind of prisoners of the ECB dictatorship because the ECB is buying fixed income assets and it started for some reason to buy credit assets as well. Now it buys investment grade assets. And I think something surprising will happen when the ECB will taper.

When the ECB entered QE they said they were doing it for three reasons: "We want to lower rates, we want to give a signal in terms of risk appetite to investors and we want portfolio rotation to happen". That has major consequences for us in credit, because this portfolio rotation argument is extremely important.

The idea was that by buying 60 billion or 80 billion a month, I keep buying, whatever the yields are. Private investors are crowded out from this market and forced to take more risk for yield. We calculated that about 400 to 500 billion of liquidity per year has to be redirected into other assets; so first, it got allocated into credit when the ECB was not buying credit; then it got allocated to non-eligible credit, which means high yield because the ECB is not buying high yield, they're buying high grade. And then, investors may be forced to buy something else such as real estate or equities.

Unwinding of ECB QE an unknown quantity

Now, that will come to an end. We don't know when, but probably towards the end of the year the ECB will signal it with more clarity, and next year they will implement it, so that means that this bond buying, which is huge, will have to be replaced. The market got addicted to credit markets, it got addicted to low spreads, low yield, and little volatility, even if sometimes you had lots of volatility in the fixed income market. We don't know how the unwind will happen. That's clearly a huge cloud on the horizon, probably the biggest of all, and that makes us extremely cautious in our deployment.

Would we have profited from predicting politics in 2016?

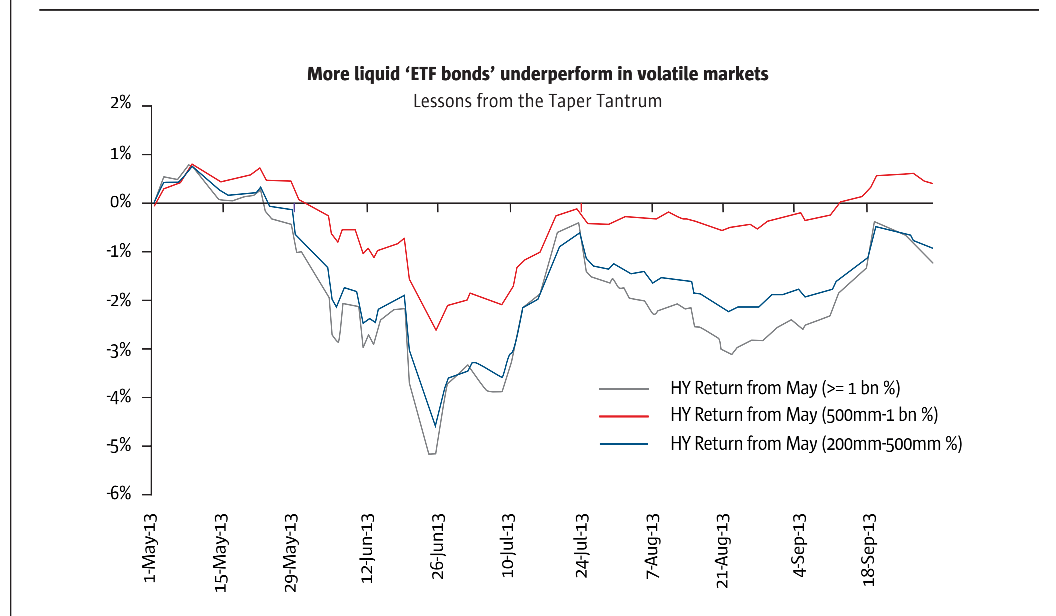
Everybody also mentions the political risk. Of course it's an important risk in Europe, and not only in Europe. It's a bit of an exaggeration to say, but, if you had started last year as a portfolio manager knowing that not Theresa May but Nigel Farage and Boris Johnson would have won the referendum; that Donald Trump would have been elected; that Marine Le Pen was ahead in the polls with a low probability of winning; that Five Star would be the number one in the polls in Italy and Renzi would have lost the referendum, you would have been very good.

The next question is: would you have any money? I'm not sure, because the market selloff after Brexit lasted two or three days. We had our list of loans that we wanted to buy if the market was to sell off post-Brexit. In fact there was very little gapping. After Trump, actually, that took two hours, and when Renzi lost it was a blip in the market. Of course, if Le Pen wins, that's not going to be a blip, but honestly I don't know.

UK credit offers limited premium for Brexit

So we have to live with that, we have to look at the implications, but it's a complicated story, this political risk. More importantly, if I focus on Brexit for credit, it's the execution phase of Brexit which matters a lot, because actually Brexit happened, nine months ago now, and nothing really happened from an economic standpoint. Of course, the pound

Fig.3 Below radar is beautiful *Source: Citi Research, YieldBook*



fell a lot, which helped the exporters, but the economy didn't tank, so that did not really change the credit fundamentals.

Credit spreads of UK names moved a bit but now there is no premium for Brexit for UK investment grade names and there's only a little bit of premium in high yield. Now, that premium in high yield is also skewed because a lot of UK names in the high yield index are retail names, and retail is challenged, as a sector, from a credit standpoint everywhere in Europe. But what we're concerned about, in the context of the Brexit negotiations which will start next month, is whether the rhetoric will become very nasty, and a lot of investors will start to sketch worst case scenarios. These include leaving the EU with no free trade; with no tariff agreements with the rest of Europe; no passporting agreement nor regulatory agreements with Europe for the financial sector, etc, etc. That's really something that has been ruled out by a lot of investors because, "oh, actually, Brexit happened and nothing happened, so that's a walk in the park". But we should not forget Brexit risks, and that's why we always want some premium in our portfolios for any UK name.

Minimising interest rate sensitivity

Everybody talks about rates and volatility and that the Bund cannot stay at 20 basis points or 40 basis points or whatever it is today. There are some products, some instruments in credit which are not rate sensitive, and that's the type of positioning that we favour in the portfolio at the moment because they give you protection and they also give you yield with little volatility.

One example, of course, is FRNs (Floating Rate Notes), which is a small subset of the high yield market, but still decent - you have about EUR 17 billion of products available. The PIK (Payment In Kind) market also is an interesting one on this front, but even in the fixed rate market - the largest high yield instruments market issued in Europe with close to EUR 400 billion, most of them have relatively short duration and are not trading as "spread product", as we say in our jargon. They're more trading on their cash price, so we would need a massive gap in risk-free rates for them to be really selling off.

Fragmented, inefficient European credit markets

Now, what is very interesting in European credit, is that it's fragmented, it's messy. Europe is messy, the EU is 27 members, the Euro currency has 20, and you don't understand who is in Europe or who is in what, or who is in Schengen. I always take this example of the telecom sector: in the US you have four mobile operators for a country the size of Europe, whereas in Switzerland, which is a small but very developed country, three mobile operators, plus a cable operator. Multiply that by the number of countries in Europe and you're close to 100 telecom operators across Europe. Each of these fragments has a large capital structure, which are credible. I took the example of Salt earlier and it has 1.5 billion of instruments trading in the Salt capital structure.

Now, you may ask, what's the point of that? The interest is that it's mis-priced, and that it doesn't react, it doesn't have the same market beta as the large cap structure. We did a study looking at the lessons of the taper tantrum, where creditors really suffered during May, June, and July 2013. Issuers in the US with between $200 and $500 million of outstanding debt not only sold off less than the most liquid and largest bonds but they also recovered much more quickly. Whereas the largest bonds, what I call the ETF bonds, because most of the large bonds about $500 million or above a billion are in ETFs, sold off much more dramatically, and it took them a lot of time to recover. This is illustrated below.

So within that, in those lower beta situations not only do you have a lot of value, not only are they under-researched or you have a competitive edge if you do your homework on the credit, but you also potentially have less volatility and less beta embedded on the long side when you invest in those names. If we compare volatility on the yield side and on the spread side, if you remove the underlying risk-free rate, you can see that US and European spreads are very close to each other and that's reassuring. It was not always the case, in the past, like post the financial crisis, you had a significant spread premium to invest in Europe against the dollar. Recently, it was the reverse; last year it was mainly driven by commodity prices and oil and gas prices, which are about 20% of the US high yield universe. But today European and US yields are flat with each other.

The second message here is that, you may say, high yield in Europe is expensive, but on a spread basis it's not necessarily that expensive; historically, it is expensive in our view but it's not the most expensive time the market has seen.

Dispersion between overpriced BB and underpriced CCC

But the third message is most important: you have a massive divergence. You have dispersion in pricing and you can see that European credit is clearly benefitting from the crowding-out effect of QE (remember the ECB was buying government debt therefore investors were buying investment grade, and then the ECB was buying investment grade, therefore investors were buying high yield. That's an exaggeration, but there's a little bit of that).

Well, of course, an investor or an allocator who was originally in a risk-free rate doesn't go and dive into triple C-rated assets, they start to go into double B-rated assets, and that's why double B assets are super expensive. Typically it's not rare to see a new double B deal at 200 basis points of spread, which was the spread of an investment grade company five or six years ago. Now single Cs are sometimes great opportunities, triple Cs as well are now recovering, and that's where you can make money in credit in Europe at the moment. **THFJ**

Cheap Capital Breeds Opportunity

Japan 2017

SETH FISCHER, FOUNDER AND CIO, OASIS MANAGEMENT COMPANY

Japan, for anybody who's heard the story, has done nothing since 1990, close to the last three decades. Japan has massively over-leveraged companies, leverage is extraordinary high, and so are cash balances. So people have learned the lessons of over-leverage and yet they've taken those lessons, I think, way too much to heart and every two to four years (in some cases five years) you have a change in management. They think they're changing management but they just continued the behaviour of the last 27 years. So leverage continues to go up very dramatically, and corporate cash balances are rising dramatically. That's created a whole host of opportunities, and a whole host of problems for corporate Japan as an investment market.

Herbivores versus Abenomics

Another Japanese problem is described in a video by Masaki Fujisaki. The phenomenon of herbivores in Japan: who are effectively, as she describes it, men in their 20s and 30s who are not interested in real physical relationships, who are not interested in sex, who are not interested in getting married, who are not interested in having kids. That same phenomenon has permeated the aggression in business, in being just a suit in a job for five years or for 10 years or for 50 years. However, the government has put an enormous amount of effort into trying to get animal spirits going and animal spirits, to some degree, should be pushing people to invest money and should be getting people to do things. So we have this phenomenon in Japan of, most recently Abenomics, but 10 year yields are around 0%, which created a whole host of opportunities.

Yield hunger compresses credit spreads

In the zero rate environment how are you going to make any money? One way is to buy some sort of yield, and so one way of buying some sort of yield is buying credit notes, while government bonds already yield zero and corporate bonds already yield close to zero. There's been an enormous issuance of credit notes in Japan.

This kicks off a phenomenon where you have an opportunity to go ahead and buy CDSs (Credit Default Swaps). We start off with the leveraged companies. There are some companies that are aggressive and that's certainly the trader companies in Japan, which have continued leveraging themselves. You can have theoretically infinite leverage at rates of zero and of credit spreads of zero, and so as a result you go ahead and you lever up. Valuations are rising dramatically, and CDS spreads collapse completely.

Asymmetric risk/reward from buying CDS

So now CDS spreads have collapsed from 200 to 100 to 45 basis points. Are you going to go ahead and buy CDSs of companies with six, seven, eight times leverage, for all of 100 basis points? On any sort of global metric and European or US metrics,

Seth Fischer
Founder and CIO, Oasis Management Company

that's extraordinarily cheap, and those spreads have continued to collapse dramatically just in the last year.

The fun part for me, anyway, is when you buy CDSs they can't go below zero, but they have an enormous amount of the upside. For some sets of companies, the current spreads levels are well below the widest spreads of the past five years, so these spreads can move.

All I've described so far is a phenomenon of spreads coming in dramatically. What I haven't described is options. Some people in the room know I do like options, because besides optionality what could the catalyst actually be to drive any value ? You have a scenario where Japan is a country where people do an enormous amount of things together. So long as the credit is acceptable they'll continue to buy bonds, but the minute it becomes unacceptable (and unacceptable is either because now you have colleagues who go ahead and say, actually, you can't sign off on those accounts, or you have public fraud, or you have what actually potentially looks like bankruptcy). But as soon as you break the social code, bonds collapse, and spreads widen dramatically. It's literally because either you're acceptable or you're unacceptable, and that's the reason that some of the spreads are such a narrow band. The market is not differentiating credit spreads in any way substantially. So credits are in an enormously tight band and when they become off-the-run all of a sudden spreads widen dramatically.

So you have this in Toshiba and Takata as examples of how explosive the spread widening can be. Toshiba CDS blew out from below 100 to nearly 500 basis points, while Takata bonds crashed from around 100 to 30.

Activist short sellers

The other catalyst for this is increased scrutiny in Japan. We'll get to the corporate governance code, we'll get to the Abenomics part of increasing scrutiny. But also there is a sudden advent of short sellers - and public short sellers - in Japan, who are scrutinising balance sheets. This is a phenomenon that has never happened in Japan. They go ahead and try to hold the companies accountable and the auditors accountable. And METI, the Ministry of Economy, Trade and Infrastructure, is going ahead and encouraging this where they're instrumental in cleaning up kind of a very insular corporate culture that has swept things under the rug.

Saving face explains Toshiba and Olympus scandals

Toshiba is a big battleground, for example. They've gone ahead and had public exposures of trading companies that made enormous amounts of acquisitions back in 2011, 2012 when commodities were really high. You have all these European companies, European commodity companies, US commodity companies, Australian commodity companies who in 2013, 2014, took the pain and have now recovered. Whereas in Japan it just takes such a long time to take the pain, they haven't taken the pain yet, and so you have people who've gone ahead and scrutinised things and said assets are not worth the current valuation.

And so these write-downs are so embarrassing, and the phenomenon is to avoid embarrassment. All those scandals - Toshiba and Olympus are the best examples - are examples of places where people did things not because of personal greed or personal enrichment, they only happened to avoid personal embarrassment, avoid company embarrassment. If you lost money in 1990 you hid it until 2012, in Olympus' case, to avoid company embarrassment. Toshiba made a horrific purchase of Westinghouse, and avoided writing it down for years because of the personal embarrassment. You go ahead and invest way too much money in Australia and you don't write it down for years because of the company embarrassment that they slipped up.

But that doesn't stick to accounting principles and it doesn't help the companies in the long run. You have the tailwind of the government and the TSE (Tokyo Stock Exchange), to give them credit where credit's due, trying to clean this up. Additionally, all the trading companies, Mitsui and Co, Itochu, Marubeni, Sumitomo Corp, have all made an enormous amount of bad purchases over the last five or seven years, but have not written down the acquisitions and are now under scrutiny. They've occasionally taken it out of accounting gains to get there. There's increasing scrutiny, and that includes Yuki Arai of Well Investments, and Horizon, who is a Japan activist, interesting in terms of both speaking to Japanese, in

Japanese, and not being seen as a foreigner attacking Japan.

The equity revolution and holding networks
Abenomics is really about trying to grow carnivores and not herbivores; Abeonomics is about trying to get testosterone and animal spirits flowing in Japan, for lack of a better term. That's about the equity revolution, it's about getting ROEs (Return on Equity) up to 8%. One way to increase ROEs is you go ahead and get rid of cash. It's a way to get people to go ahead and invest in good businesses, and make good business decisions, be more aggressive in business.

It also means they're trying to get rid of the Holding Network (of cross shareholdings) in Japan. This is a mutual protection pact, where we don't really have to look out for each other, we just make sure that we stay in our jobs, and then we retire, we become senior advisors of this company and, yes, we get to keep our car, we get to keep our golf membership, and that's it, that's all that's really important. And now we realise that's a structural crisis for Japan. One way to fix this is to force people to say "you know what?, we're going to have to go ahead and take companies back but also in the meantime devote them to their economic best interest and not for your personal best interest".

Corporate governance code
This is a big shift in Japan and the government have just released a new part of the Corporate Governance Code, last month, and it's going to go into effect in two months' time. It's about seeing not just your voting policy but seeing how you voted, and counting your votes to hold their feet to the fire.

Rationalising listed subsidiaries
Japan has an enormous amount of companies that have listed subsidiaries, which historically had lots of ego associated with them. Japan has an enormous amount of cash-rich companies, and you go to meet them and you say, "hey, why are you listed?". And they say, you know what, it's good for our employees to get a mortgage. That's the reason you're listed, hey? All right, it makes recruiting easier. Oh, that's good, how many people do you recruit a year? One.

Huh? So there's a pride associated but they went ahead and listed an enormous amount of subsidiaries. They had subsidiaries because the shareholding code is under pressure, and that's leading to either, as we call it, divorce or marriage: divorce meaning you sell the subsidiaries and marriage meaning you bring them back into the fold, you bring them back into the family. Let's talk about the solution.

Private equity auctions
Divorce leads to these large firms being sold to PE funds, which have raised an enormous amount of money globally, and in Asia in particular. Then the additional nice part of investing large amounts of money in Japan is you can get massive leverage and not pay much for it in CDSs. Another result for that is you could issue really high priced LBOs to purchase these public companies. Valuations can be around 12 times pre-auction. You might ask why PE funds are prepared to do this, why they have money to do this? PE is competitive, and there's been no hostile activity in Japan basically forever. They only can participate in transactions they're invited into and there's been very, very few large scale invitations for them. When they have gotten these invitations in, and this is the beginning of it, they've been very competitive. You know from The Barbarians at the Gates, that the best place to be in the transaction is as a shareholder. As a result of the corporate governance code changing, we see there's a long, long list of other companies that are now in the midst of first round and second round auctions to be purchased by private equity funds.

Actually private equity funds might do a great job with the businesses, as those margins can increase, and they have an enormous amount of leverage at very, very, very cheap levels. It may be great for them but certainly it could be great for us in the meantime.

Minority squeeze-outs
So now we'll get to marriage. They want to go ahead and take back minority shareholders, but they want to do it at a cheap price. That's bad for minorities. Up until now that is the way business is being done. But is that the same way as business will be done going forward? No. In line with minority rights, in line with activist investors, global investors back in Japan, in line with the Corporate Governance Code, in line with people trying to protect individual investors and make sure that companies are looking out for shareholders, we're just not going to take it.

PanaHome's lowball offer from Panasonic
For example, Panasonic has proposed a merger with its 54% owned subsidiary called PanaHome, which builds houses across Japan, and has a wide range of other competitors. PanaHome in particular is very interesting because somehow over time PanaHome made 60% of its market capitalisation in cash, and overall is trading on a 12 times P/E. So stripping out the cash it is trading on a four times P/E, three times P/E, that's extraordinarily cheap.

I spoke to them back in March of last year and said, why don't you use the money for business? Why don't you go and take the money and use it for international expansion, use it to buy land for development, and their answer was mmm mmm mmm. And so I wrote them a more formal letter in September of this year saying, look, thanks for the mmm mmm mmm, but let's use the money, tell all the directors to use the money towards the company. What do you need 60, 70% of the market cap sitting in cash for? You're making money, you're cash flow positive, what are you doing with it? And so their answer to me was effectively a slap in the face; on December 22nd, they offered to buy PanaHome at a small premium. It was based on a valuation created by conflicted banks where this "independent" committee of two lawyers, an HR director (with no experience in this matter) and an accountant were going to advise on valuation. The only problem is they didn't even take the cash into consideration! We just didn't like this, we didn't think it was very fair, and we went out and bought 4.5% of the company at the time at a 1.5 to 2% discount to the spread.

We subsequently got out publicly, and told PanaHome, Panasonic, that we wanted a better offer. I'm continuing to engage time, including this morning, giving and receiving letters back and forth to them, but publicly I've gone ahead and created a website called Protect PanaHome (www.protectpanahome.com). This website goes through the rationale of why the price is too cheap, and goes to our fairness opinion, which is a true independent opinion. They countered with their own true independent opinion by somebody else because clearly that just covers their tracks, or attempts to cover their tracks. That's good because that's the first admission of a flaw in their process.

You know, there's two ways of attacking this. There's the flawed processes of how they determined this valuation, and clearly the offer price is flawed. We're also attacking the process and so we've gone ahead and not only created the website; not only been engaged with demands for meeting these directors; we also sent them our own true independent valuation. We now control 9.8% of the company and we were active at the AGM in June. Additionally we've gone ahead and asked other minorities, making up 20% of the entire company. That makes up roughly 45% of the 46% minorities that I've spoken to already, in addition to us, who told us "this is egregious, we're not happy with this". We've asked them for their proxies to negotiate with Panasonic.

It's a live conversation. What is interesting is that, A, I'm getting paid to do this because now it's trading about 3, 3.5% above the offer. Maybe the market gives us a 10% chance of winning, but I think our chances are higher, we'll see what actually happens. At the end of the day if we don't win now, the nice part about Japan is that we're very robust and we'll pursue this to the courts. You're welcome to visit our public website.

Government support for activists
There's an enormous amount of government support for engagement. We go to the FSA as well as the PKF and PFA, they're the largest pension funds in the world who are enthusiastically supporting this behind the scenes because they want the market to go up. So we've sorted out all of the Corporate Government Code and GPF, which owns 5% of all listed companies in Japan today. **THFJ**

Current Opportunities and Risks in the European Equity Markets

GUILLAUME RAMBOURG, FOUNDER AND CIO, VERRAZZANO CAPITAL

I am going to be talking about the prospects for European equities this year, 2017, and hopefully 2017 will be a good one for Europe, finally. That's always the hope at the beginning of the year and then somehow it always unfolds - or has done for the past few years - in not a great way. But last night I woke up at 3 am, I wasn't looking at Asian stocks like our fellow speaker. I was woken up by calculating in my head how many points Roger Federer would have if he won Miami, and it's been a pretty amazing start to the year for him, and maybe a parallel with Europe we'll see in the next few weeks.

Global and European growth accelerating

Starting with the macro backdrop, it's not too bad for Europe, maybe even a Goldilocks scenario. There are a lot less worries about deflation, no one talks about deflation anymore, so we're more in an inflationary trade with the US obviously continuing to be strong, and we'll see for how long. We're in this process of interest rates going up and the economy at full throttle, basically, with full employment, and Europe is benefitting from that. Obviously, Europe doesn't get as many headlines about its economic growth, but things are becoming better even in a country like France where GDP growth is picking up. It's still quite pedestrian, but we're talking about a 1.5% number, which is better than the usual, close to 0%, we've had for quite a while.

And then China is the question mark. We obviously had the big wobbles in the Chinese market in August 2015 and then January 2016. It seems like it is not a subject anymore, it might come back, obviously, at some stage, but China should be ok until October when they'll have their own elections, and I don't think they want to go into any dramatic issues with the US or Trump.

Inflation constructive for equities

Inflationary trade is a good backdrop, but it will also become at some point a risk for Europe because that's where we could have a tug of war between the Germans and the Italians, specifically; because the Germans now have deflation out of the way they have some ammunition to go and see Mister Draghi and say, "this QE exercise, we've had enough of it now, we don't need it anymore, core inflation is picking up, please let's look at tapering or even interest rate hikes", whereas the Italian economy, sadly, is the only one which is not rebounding, the only one where PMIs are not expanding, and an economy with a debt to GDP ratio that really doesn't need the 10 year yield to go up. But I think that's a subject for another day. For the moment inflation is helping European corporates in a big way.

European earnings growth is picking up, and is in positive territory. In contrast it's plateaued a little bit in the US, but we've had a pretty good earnings seasons for the last three, four quarters and there's no reason (apart from what we'll be talking about later) for these earnings for European companies to go back south. And, actually, the banks, which have been very poor in terms of earnings because they were crushed by the QE exercise in terms of net interest margin, are through the worst now. Even the banks should participate in much better earnings seasons going forward from here.

Guillaume Rambourg
Founder and CIO, Verrazzano Capital

Declining correlation bodes well for stock-picking

If we look back at changing levels of stock correlation, when correlation levels were quite low, that was the best time I had, and it was the best time most people had, in terms of European stock picking because there was no big macro issue dominating. I remember specifically between 2003 and 2006 the correlation of about, say, 35% was quite low; the VIX was below 10; there was no macro cloud on the horizon, so we could just put money to work. Obviously you got some good calls and bad calls, and when you got some good calls on a big gross exposure you were generating some returns.

Then we move to a different phase closer to 2008 where the correlation levels went very high, especially in Europe, and stayed high, at 60, 70%. That's obviously an environment which is not good for me as a stock picker because it's all pretty much about macro. We've had that now for many years in Europe. When we started Verrazzano five years ago we started straight into a Greek crisis where the bond yields in Spain and Italy were about 7%. It seems like a long time ago, but it's only five years ago.

Sector rotation

Correlation has come down dramatically. It doesn't feel completely as good as 2007 just yet, and I think it's been more a case of sectors de-correlating. Obviously we've had a massive sector rotation exercise out of growth into more cyclical areas of the market like banks, that started last September and accelerated obviously in a massive way post the Trump election and that inflationary trade. We feel that decorrelation has been more at a sector level, and even on a day to day basis, every morning there's going to be a cyclical day, or a switch back to quality growth, that has taken the upper hand again over the last six weeks. It's been more a case of picking your sectors, than picking your stocks.

We've had these big shifts in terms of cyclicals versus growth. Hopefully this year we'll see more stock picking within sectors, which will obviously make my life a little bit easier and more enjoyable.

Europe's valuation discount to the US is historically high

I'm just going to say a quick word on the valuation of Europe, which is not a strong argument because European valuation is always cheaper than the US. It's just a question of how much, and when we get reversion to the mean. We'll talk about outflows out of Europe last year, which was a very good, positive sign because the market should come our way after a lot of money leaving.

If we look at the valuation gap, over a period of five or seven years, you can see Europe since the trough of the crisis has greatly underperformed, some of it for very good reasons, because it took the Europeans five more years than anyone else to get their act together and to finally implement QE and take us out of the hole. Obviously there are a lot of mechanics involved, as well, and QE works a lot better in the Anglo-Saxon countries where that propensity to consume works very well. If you decrease taxes in Europe a lot of that money just finds itself into a savings account, whereas if you cut taxes in the US and the UK, that goes straight to Apple, Google, and a few other guys, basically, it goes back into the economy.

There are very good reasons for that under-performance, where you can see that we are now more than two standard deviations away. There could be scope for Europe to do a lot better at some point, but because of the French elections, because of Brexit last year, a lot of people are understandably sitting on their hands.

Europe – a hated market

The overweight in Europe was consensual in 2015 as we started QE, that's when a lot of cash came in, especially in that first quarter of 2015. All the Americans wanted to hear was QE, and when Draghi said the magic word they came in their hordes, which pushed the market 15, 20% higher in that first quarter of 2015. But since then we've had a complete reversal last year. In the beginning of 2016 Europe was pretty much everyone's favourite market for 2016, and it turned out to be a very difficult market. Between February and November we had 42 consecutive

weeks of outflows out of European equities. That phenomenon started way before Brexit but then accelerated in a major way, with a lot of America investors telling us, “we don’t understand Europe at the best of times and now you’ve just voted for Brexit, you’ve got your Italian referendum, you’re going to have French elections, you guys are not investment grade and, actually, we’re going to focus on the US”. Then that was accelerated by Trump and his “make America great again” and “take the money back in to the home market” themes.

Inflows despite Italian referendum

So that’s why it doesn’t take too much from here, for money to come back and for Europe to be a much better place. And we had a flavour of that in December, when we had that Italian referendum which, post-Brexit, everyone was waiting for. The result couldn’t have been worse, it was a 59% no vote to the new kid on the block, Renzi. He went for his own referendum and it seems to be that referendums don’t seem to be a great idea these days because the answer is no, whatever the question. After that 59% no, the Italian market was indicated down 3-4%, and yet in December Italy was the best market, up 13.5%, and Europe was up 6% with its first month of inflows in European equities, because then we were starting from such a low base. Since then Europe’s done ok, it’s outperforming the US a little bit recently, but, again, inflows coming back and it could have a major effect on European equities which, as we’ve seen, have been so, so bad versus the rest of the world.

Le Pen win a low probability

Moving onto the French elections, I’m not sure to what level of granularity I should be going into this, but, there are three people who could win it. Again, pretty binary outcomes here because if it’s Le Pen obviously we’re in new territory where obviously you’re looking at Frexit, we’re looking at a referendum to leave Europe, and there, I think, we’re in a scenario of a disintegration of Europe and it’s just how long or how quickly it happens, and how.

But that’s one scenario which seemed to be the base case until a few weeks ago, in London or the US where it seems to be that final chapter - the trilogy would be Brexit, Trump and then Le Pen. But living in Paris the scenario still seems low, I wouldn’t say 0-5% - I don’t want to underestimate it - but probably 20-25% probability. What it’s shown with her support is that she’s at 25-26%, but the level of certainty of people voting for her is very high, it’s 82%. It’s a little bit like Trump, he can lose the debates he wants, he can do whatever he wants and people are just going to vote for him whatever happens, so she’s in that camp and she’s got a very strong bedrock, because that 26% is actually 20-21 % with complete certainty.

Fillon was the frontrunner, obviously, for quite a few months, and he’s been involved in all kinds of issues, so he’s down to 17-18%, and, again, the level of certainty is very high because he’s down to the core, so that 17% is low, with a high certainty. And then the biggest uncertainty is, he’s at 25%, neck and neck with Le Pen, but his level of certainty in terms of the intention of votes, is only 62%, and that 62% is much higher than the 45% it was two or three weeks ago, so he’s getting there, he’s convincing people, but there’s still uncertainty there, so one false move, one statement, one potential affair, could take him down.

Fillon or Macron market friendly

But it’s quite a binary situation because these two (Fillon or Macron) would be very well received, we think, by the market as they are two of the most market-friendly people we’ve had in French politics, for probably the last 40 years, so that would be a positive outcome. One is more pro-European than the other, and he went to see Angela Merkel in Germany last week, so that would be a positive outcome, that would make Europe, investment grade and investable. It would give companies, we think, some visibility, and it would create probably a wave of M&A, which would be enormous in Europe from both European companies, integrating with each other but also, US or Asian companies saying, “well, we can buy European companies, Europe is not falling apart just yet”. That collapse might happen down the road, even with these guys, but obviously we’d have a clear view for two or three years that there’s a little bit of certainty there. So we’ll have to follow that closely.

Portfolio construction – core and tactical

Just going back to what we do, we’ve always been pragmatic in the way we run money, we like to have two clear paths in the book. One is made out of core fundamental ideas - a core idea for us is only deemed core if it’s researched and sponsored by one of our analysts in-house, and we have four analysts who do that work. That constitutes half of the portfolios with a 6 to 18 month time horizon. And then we always have a tactical book as well because there are some short-term opportunities, typically less than three months with short-term catalysts, that we try to capitalise on in Europe, and I’ll give you just a few examples.

Defensives sell-off made Danone and Imperial Brands investible

One of our core positions is Danone. Most of you will be familiar with it, we didn’t think we’d get back on board with this stock because it performed very well. We were provided a great opportunity with that sector rotation, which accelerated last November, and all of a sudden the stock, like every other staple pretty much, was down 15 to 20%, in just a few weeks. So a stock that was trading not too far from €80 we bought very low at €58.

Again, that illustrates that high correlation of stocks within sectors coexists with a very low correlation between sectors, and that’s what happened, between September and December. Every European bank, pretty much, is up 60%, every staple is down 20%, in a narrow range down 18 to 21, and that’s where we got on board with Danone, where we think the story is quite robust, and it keeps on beating peers on organic growth.

But we also re-entered Imperial Brands, which, again, we never thought we would be back on board with. The stock went from £41 to £34, again, with no change in estimates, just on the back of that sector rotation, and we think Imperial Brands is the number one takeover candidate this year. You’ve probably heard it elsewhere before, but for us it’s exactly in the same situation that SAB Miller was in two years ago where it was the last big deal globally in the sectors to go from four to three players. Again, Japan is the interested party, and also the UK is always a lot better for these M&A-type situations because there is a proper takeover code in the UK, so it’s the shareholder who decides. In France it’s not the shareholder that decides, it’s the government that will rubberstamp any deals, wherever they are.

Structural short in serial profit warner Pearson

A core short has been Pearson, which is very structurally challenged. They’re in publishing, they’re in education, but on paper, especially in the US, that is completely disappearing, and quite quickly. We made money three times on this one, it’s had three profit warnings. By some miracle between profit warnings, in the void where it recovers half of what it lost in the previous profit warnings, we rebuilt the position. Hopefully, there’s no place to hide, and even though the management is a little bit in denial and tries to scare the short sellers, saying “watch out we’re going to cut costs like crazy”, the company can’t cut costs as quickly as the top line is going down, so they’re in a really problematic situation. This is one of our core shorts in the portfolios.

Tactical long in Unicredito

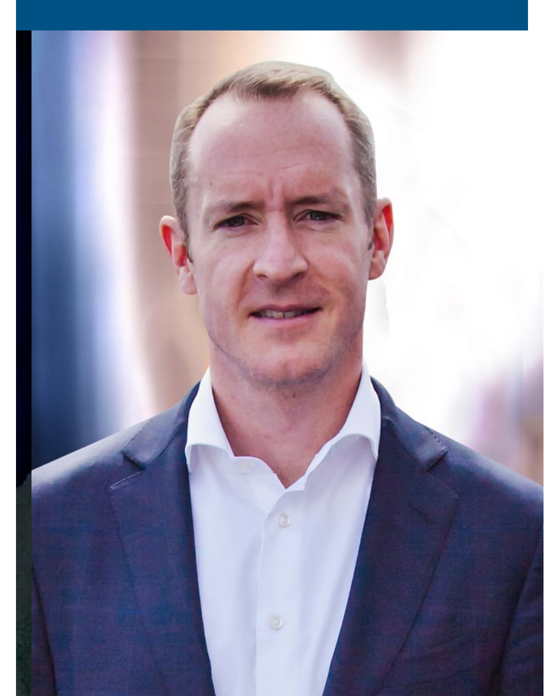
It’s very difficult to have core structural positons within financials, and that’s been the case for many years. But we have tactical positions. One Italian bank, Unicredito, went from €6 to €2 last year. It was the worst place to be, a financial, and in Italy, and raising capital, so it’s not a great recipe for success, but it got a new manager to come in selling a few non-core businesses. And then a capital raise, which obviously was not a surprise to anyone when it was announced in December, saw the stock go up by about 10%. Then we had a second bite of the cherry. That’s the type of stock where we’re looking to make 20-25% in three months. The problem is you still have a long queue of financials coming up and trying to raise capital (obviously Deutsche Bank a couple of weeks ago), so I think people are looking for these liquidity events as great liquid ways of investing in Europe. **THFJ**

Emmanuel Weyd
CIO Credit, Eiffel Investment Group

Emmanuel joined Eiffel Investment Group at the beginning of 2009. He is a portfolio manager of the OYSTER Flexible Credit fund (UCITS). He has 20 years of experience in the credit markets, including 7 years as a portfolio manager.
Prior to joining, he was a managing director at J.P. Morgan, where he spent 13 years and successively held senior responsibilities in credit research, credit origination and structuring and proprietary trading. He had started his career in credit research at Standard & Poor's. He holds a master from ESSEC Business School.

Seth Fischer
Founder and CIO, Oasis Management Company

Seth Fischer is the founder and Chief Investment Officer of Oasis Management, an Asia-focused multi-strategy investment group with a successful 15-year track record investing in all global markets across all capital structures. Prior to founding Oasis in 2002, Mr Fischer spent seven years at Highbridge Capital Management, where he managed the firm's Asian investment portfolio. Mr Fischer served in the Israel Defense Forces after graduating from Yeshiva University, New York in 1993 with a Bachelor of Arts in Political Science. He is a Board Member of the Karen Leung Foundation, a Board Member of Carmel School in Hong Kong, and Vice Chairman of the Ohel Leah Synagogue Management Committee in Hong Kong.



Guillaume Rambourg
Founder and CIO, Verrazzano Capital

Prior to joining Verrazzano Capital as a Founding Partner, Guillaume was co-portfolio manager of the AlphaGen Capella, AlphaGen Tucana and AlphaGen Acamar hedge funds at Gartmore Investment Management where he co-ran $5 billion in assets under management (AUM) at the peak across both strategies (peaked in 2008 and again in 2009). Guillaume joined Gartmore in 1995 as an analyst. He was co-manager from inception of both the AlphaGen Capella hedge fund (1999–2010) and AlphaGen Tucana (2005–10).In addition he co-managed European long-only mandates totaling AUM $8 billion at the peak. Guillaume graduated from ESSEC Business School in Paris (1993), majoring in Finance. The funds he co-managed were the recipients on various occasions of awards from Eurohedge for Best European Long Short Fund (Over $500m category): AlphaGen Capella 2001, AlphaGen Tucana 2006, AlphaGen Tucana 2009.

About SYZ Group
Founded in Geneva in 1996, SYZ is a Swiss banking group experiencing strong growth, focusing exclusively on asset management via two complementary business lines: high-end private banking and institutional asset management. SYZ offers private and institutional investors comprehensive portfolio management, with an active investment style and a focus on risk reduction that is clearly committed to providing absolute performance through alpha generation.
SYZ is an independent, family-owned company with a global footprint. The Group has approximately CHF 36 billion in assets under management (EUR 34 billion, USD 36 billion), a solid capital base and benefits from being privately held and independent.

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