Strategy

Risk management

On-going stress

New-Year opened with high emotion, stemming from the Middle East showdown and China (fervish CNY and domestic shares). Beyond the geo-political “noise”, a collapse of commodities, namely hydrocarbons, remains the elephant in the room. Indeed, it represents the lion share of revenues for large and influential countries (Russia, Brazil, Saudi Arabia). The plummeting of the Ruble, Real, Rand, etc. acknowledge for the magnitude of the strain, as well as the contentious - and politically delicate - Saudi budget for 2016.

Short-term speculation will continue over the “dollar-pegged” currencies (say Saudi Arabia) and vulnerable corporates (indebted, or with high production costs). Risks of “large” defaults (a “whale”) are on the rise.

The tug of war on energy prices gives no signs of ending-up. Saudi Kingdom, geopolitically more isolated and less stable than in last decades, as well as the contentious - and politically delicate - Saudi budget for 2016.

Still, the current “crisis” is not comparable to... 2008

Doomsayers compare today with 2008/9, as the collapse in high-yield energy bonds will announce a global crisis, just like the “sub-prime” did. Let’s try to figure it out in details.

Indeed, we are experiencing a significant negative “Wealth Effect”, a rise in risk premiums, and some pressure on earnings. But major differences exist. 1) The current strain is not affecting the global economy. It actually favours consumption and corporate margins, as well as large importers (say China). 2) The banks are marginally impacted, as indebted “actors” essentially tapered bond markets. Therefore, defaults would be largely spread among a large number of investors. 3) Contrarily to the end of the last decade, policy makers have little “dry powder” to reflate the economy and markets.

This last point is the most important source of concern: room for manoeuvre by policy-makers vanished in developed economies after several years of QE and higher public debt. Arguably, there remains some in China and in emerging countries.

The current crisis is of lower amplitude than 2008/9. But the vulnerability of the world economy and markets remains, as policy-makers will miss the means of action...

The pessimistic consensus is reassuring, but...

Large-scale withdrawals occurred last months from retail investors in all assets’ segments. This is partly explained by fiscal features in the US (tax credit), considering the disappointing performances of markets. Similarly, global asset managers (from asset allocation mutual funds) remain underweight risky assets.

Still, we concede a worrying disconnect between resilient developed equity markets and dislocating segments of the US corporate high-yield bonds”. Contagion was contained in credit markets last fall. But a liquidity mismatch between underlying distressed bonds and related ETF / mutual funds raises the spectre of severe dislocations, provided the (high) pressure stays in place a few more weeks!

This kind of de-correlation rarely lasts for long: this deserves particular attention

High stakes

Developed countries’ policy-makers expect energy to stabilise soon. Though insulated from most of the geo-political instability, the US is concerned for its strategic shale-gas industry, for the rise of the USD, and for cracks in the high-yield market. It isn’t enough for Obama to change its non-interventionist strategy in the Middle-East. The odds of a conflagration are significant, due to a continued leadership vacuum. The US will rather opt for domestic actions or modify regulation.

In a globally non-cooperative environment, other large stakeholders like China, Japan and Germany have limited appetite to take concrete actions.

Commodities rout is not over. Risks of contagion are on the rise, in spite of pretty sound economic fundamentals. Therefore we have implemented some risk reduction and adjustments in our asset allocation

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BLUE LAKES ADVISORS
Risky assets have been hammered in December by the renewed risk aversion

First, investors have been disappointed by the ECB measures announcement. Then, the Fed tightening finally came. And finally, the Chinese fears have been confirmed by a series of weaker than expected leading economic indicators.

In a higher volatility environment, investors will continue to shorten their time horizon and act with greater caution.

In that context, our different TAAs have slightly underperformed in December their respective SAAs. This bring the year-to-date performances to +4.6% in EUR, -1.0% in USD and -0.6% in CHF.

We have decided to reduce our risky assets allocation

We have decided to build a 10% cash exposure by reducing our equity allocation to 50% from 60%. We are now back to neutral on the equity part.

We stay underweight bonds compared to our SAA. We have also decided to reduce our risk exposure within the bond part. We have reduced by 5% our High yield exposure and at the same time to buy 5% on the US 30-year US Treasury to hedge the risks in portfolios. We keep a large part of our exposure invested in Investment grade credit.
Macroeconomy

Boring

Slowing world GDP growth...

Quarterly global figures printed a negligible slowdown in Q3. On quarterly annualised figures, the US delivered 2% (4% in Q2), Eurozone 1,1% (1,4%), and Japan 1,5% (-0,5%). The global PMI muddled through in December, failing to confirm November improvement. It is still consistent with about 3% growth in 2016. Industrial production is contracting further, for the third consecutive month. This essentially comes from the US, while it is holding up well in Europe. Consumption is much more resilient, notably in the US and UK. It will be supported by resilient employment (including in Euro-zone) and disposable income over coming months. Consumer confidence remains well oriented. Non-financial private sector credit growth is sluggish out of the US.

China faces major challenges over the medium-term. Namely opening the capital account, cleaning its banks, addressing pollution, managing a delicate anti-corruption campaign, advancing the State-owned enterprise reform, etc. This creates uncertainty, but doesn’t fuel a hard landing insofar! The country’s leaders understand the challenges and own the resources and the political means to avoid it. After a marked slowdown in Q1 2015, China growth is stabilising. Latest data point to a gradual pick-up, confirmed by various activity (more reliable) proxies. GDP growth should reach 3% in 2016, with a better balance than in 2015. Renewed fears over China are overdone.

...and sluggish trade

Last available world trade data fell (-0.5%) in volume. In value terms, even lower results are due to the impact of a rising US dollar and of lower commodity prices. This setback namely comes from very weak exports in emerging markets. Japanese imports contracted markedly, courtesy of a weak JPY. Interestingly, European exports are losing momentum, as the impact of a weaker Euro is waning. The deceleration of the Chinese economy is symbolised by a close to 9% setback of imports in November. The scrapping of Doha round last quarter confirms less attention paid by policy-makers to multilateral trade agreements. The TPP, which has a more regional / political colour, might bring renewed impetus, provided it passes the US Congress this spring. World trade will be affected by sub-par growth and the commodity collapse.

Emerging countries will further struggle

Contribution of EC to global growth will remain low by recent years’ standards in a year rich in challenges. Foreign exchange reserves have diminished, capital inflows are down, currencies face sustained attacks, debt in foreign currency is pretty high, and productivity has deteriorated. The vulnerability of a few large emerging countries, and their dependency to commodity prices is actually visible through sovereign spread widening. It will take a calmer USD, more stable raw material prices to bring relief. Still, there remains some room to manoeuvre both in fiscal and in monetary policies. Inflation is still extremely polarised i.e. raging in Brazil, and sharply decelerating in China. This is primarily a reflection of currency developments. It may get worse before it gets better for EC. Among the largest ones, China and India will muddle through, while Russia, Brazil, Indonesia and South Africa will suffer.

The Eurozone literally landed in a no-flation world

Despite a small relief last couple of months, advanced economies headline EU CPI ended-up 2015 around zero, while core inflation remained stuck above 1%, including in Japan (1,2%). Long-term inflation expectations (5y5y) have stayed pretty stable above 2% in the US and 1,5% in Europe. Eurozone CPI deceleration over past years is stunning, especially considering the official ceiling of 2%. Indeed it has printed an average progression of 0% for 2015, with respective figures of 0,4% in 2014, 1,3% in 2013, and 2,5% in 2012. Zero per cent is simply the lowest figure since the Euro currency birth. Looking ahead, there is little chance of a sustainable pickup (beyond a short-term oil base effect), as services and wage progressions will remain muted. Although headline inflation may temporarily bounce next summer, Eurozone seems trapped in a no-flation environment. Disinflation pressure keeps on building in China.
Currencies

Last leg of the USD Super-Cycle

We remain USD bulls and see further upside against many G10 and EM currencies. Policy divergences will still be a factor in 2016. We have compared this multi-year USD rally to 2 prior “super-cycles”, one in the early 1980s and the other in the late 1990s. In those periods, the trade-weighted dollar rallied by an average of 45% and the cycle lasted a little less than 6 years in duration. If history is set to repeat itself, this USD rally has another 10% of upside and another year or 2 in duration. As we consider this the beginning of the end of the USD super-cycle, we expect some of the early movers in FX to slow down and even reverse in some cases. We expect outright USD weakness against JPY, which has reached extremely cheap levels and where further depreciation is not the answer for sustainable growth and inflation. For EUR, our forecast profile is modest.

The JPY is likely to join the USD as an asset currency

Structural flows are set to turn increasingly JPY positive. We believe that the market overestimates the BoJ future easing intentions. Japan’s policy approach may turn from monetary to fiscal stimuli, working in favor of the JPY. Higher assets volatility could add to JPY strength.

Negative deposit rates have been a European phenomenon, but the impact of this goes well beyond widening interest rate differentials disfavoring European currencies. Negative deposit rates in Europe may see related FX weakening, with CHF offering the most bearish potential. Negative deposit rates, pushing large parts of yield curves into negative yield territory, does not bode well for “buy and hold” strategies. The performance of European currencies will depend on global risk appetite. EUR and CHF are true funding currencies. The ECB accommodative stance should limit EUR gains. However, there has been some loosening of the relationship between EUR performance and the relative expansion of the ECB balance sheet. Indeed, EUR appears to have priced in much of the anticipated expansion in the ECB balance sheet beforehand. Going forward, the pace of the EUR decline is likely to be determined to a greater extent by the global risk environment and the willingness of investors to use EUR as a funding currency. We remain EUR sellers into strength.

GBP risks are increasing and 2016 is set to be a challenging year. UK growth is expected to slow due to further fiscal tightening. Austerity measures could take 0.5% off in 2016. The BoE took an unexpectedly dovish turn by lowering its inflation forecasts. The BoE pushed back the timing for CPI to hit the 1% level to 2H16. Furthermore, the latest labor market dynamics does not provide an encouraging picture. The EU referendum, which we expect in September 2016, could also complicate the timing and pace of BoE tightening.

The PBOC will likely continue to manage a largely stable trade-weighted RMB and allow more flexibility in the currency following the SDR decision. We believe the pace of depreciation in the USDCNY will remain relatively muted around the SDR decision level.

EM currencies at the cross-roads

EM countries are unlikely to escape their growth crisis in 2016. Deleveraging is proceeding at a slow pace where it is needed the most and the global backdrop has yet to provide a stronger push. EM growth has slowed to around 3.25%, the lowest in well over a decade, and it is barely 1 point above developed countries. There are mild signs of bottoming out and we expect some pick-up next year. But this is mainly a reflection of fading recessions. In fact, we expect the pace of expansion over the next couple of years to remain subdued, the de-leveraging process and policy adjustments take time. For most of the last year, we saw the pendulum of risks swing between country specifics and global factors. In 2016, we will experience more and more devaluation from actually pegged countries. Emerging markets currencies pegged to the US dollar may come under pressure to devalue, particularly to improve their export competitiveness against the EUR, JPY and RMB. For emerging-market currencies exposed to China, there is a risk of destabilization if slow economic growth in the country forces another devaluation of the renminbi.

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January 11th, 2016
BLUE LAKES ADVISORS
Another tricky year for bonds

FOMC ‘dots’ remain above market pricing... whereas the ECB is seen on hold

The FOMC delivered the long-awaited 25 bps hike and all focus turned to the so-called ‘dots’, which now signal 4 hikes in both 2016 and 2017. The unchanged ‘dot’ for 2016 hides that most individual forecasts have actually been lowered. We believe that the Fed will hike 4 times in 2016 and 2017. We find the current market pricing too soft, as only 2 full hikes are priced in for 2016 and an additional 2 are priced in for 2017. Hence, we should expect US yields to continue trending higher in 2016. We are more bearish on the front-end of the yield curve. Therefore, we continue to expect a curve flattening. We see speculative accounts being already quite short treasuries. The sentiment is very negative for most maturities. We have seen this before as funds bet against Treasuries and got burned. Is it going to be different this time? Perhaps. For now it looks like a crowded short, a reason why we do not believe in a huge sell-off over the year, and are more in favor of a Q1 rally. The other main issue for 2016 will be the resurgence of US inflation.

The ECB disappointed the market expectations by delivering a much less aggressive series of monetary easing measures, which notably included a mere 10 bps cut in the deposit rate to -0.30% and no expansion of the ECB QE program, at this stage. Notably, Draghi was also rather upbeat regarding the economic outlook. The less aggressive December move indicates that more easing is still possible. However, the end of the aggressive easing does not mean that we are in for significantly higher yields in 2016. The ECB is still keeping yields up to at least the five-year segment on a very tight range. Hence, the upward move we expect for the 10-year yield is due mainly to the spillover effect from higher US yields in 2016. The BoJ decision to make some adjustments to its QE program came as a surprise. The most relevant change was the increase in the average maturity target range, while the purchasing volume remained unchanged. However, while Kuroda characterized the change as ‘technical’, we believe that an increase in the maturity of purchases could still be characterized as additional easing and would contain long-term yields for long.

We enter 2016 with reduced deflationary concerns on account of continued improvement in core inflation despite weakness in energy prices. This is a totally different mindset as in 2015. Global inflation leading indicators showed signs of bottoming. Break-even exposure will be a relevant hedging strategy in a period of higher yield volatility. The environment remains outright favorable for the periphery. With QE acquisitions set to resume, government bonds from will be supported again by the QE program until at least March 2017. The inclusion of regional and local government debt is another support for tighter peripheral spreads.

Liquidity will be key this year

The lack of liquidity has been a hot topic over the last few years as dealer balance sheets have come under increasing regulatory and funding pressures. In 2015, the situation has intensified. The deteriorating liquidity over the last few years is not particularly priced in credit spreads. It is unlikely to be until credit investors are actively looking to liquidate the asset class rather. Our modest returns outlook on credit is driven by a scenario in which credit curves stay steep and bonds roll down them. Tighter rules forcing banks to hold more capital and curb speculative activities have boosted confidence in even the riskiest of lenders’ bonds, such as Additional Tier1 (AT1) securities. AT1s are gaining as banks strengthen their balance sheets before new capital rules start in 2019. The popularity of AT1 notes will climb thanks to the slowdown in new issuance.

We are less positive on the European high yield market & the US one, despite the first is less exposed to the unhealthy energy and mining sectors. Spread compression may be modest as valuation metrics are showing mixed trends. Taking this into consideration, we forecast defaults to increase marginally. Away from the distressed names, broader HY fundamentals are actually holding up reasonably well. In 3Q15, net leverage for the median HY issuer was up 0.2x year-on-year, but down 0.05x versus 2Q15. Median EBITDA growth was also surprisingly healthy at 4%. Liquidity metrics do present some cause for concern as balance-sheet cash/debt and FCF/debt are below long term averages, despite showing some improvement in recent quarters.

As the Fed seems finally on its way to start normalization, EM funding will be under tighter scrutiny in the years ahead. A moderate pick-up in growth and commodity prices are unlikely to lead to a meaningful improvement in EM credit fundamentals. Demand for EM debt is on a declining trend. Both EM sovereign and corporate funding needs are on the rise on wider deficits and rising leverage amid eroding cash buffers. Nevertheless, given light maturities and sufficient cash buffers, liquidity will generally not be a problem in 2016, apart from a couple of pressure points such as Venezuela & Petrobras.

+ Peripheral Subordinated debt
- Government Credit, High Yield
= Inflation
- Emerging

BLUE LAKES ADVISORS
Equities

A 1st half 2016, which could look like 2015, i.e. complicated

After a promising start in 2015, the market environment had deteriorated considerably in May for emerging markets and in August for developed countries because of 1) the explosion of the Chinese equity bubble 2) falling prices of raw materials, 3) China's economic slowdown, 4) recessive conditions in many emerging economies 5) failure of the monetary policies of reflation, and last but not least 6) decline in profits of US companies on the 2nd and 3rd quarter.

In 2015, Europe was up 10% thanks to exceptional first 4 months, + 26% for the Euro Stoxx, due to the sharp depreciation of the euro. The Nikkei also rose 10% thanks to good company results. For cons, the S&P 500 decreased by 1%, reflecting the decline in profits of US corporations as a whole. The MSCI World Index in local currencies were up slightly 0.2%. In the 2nd half, the volatility has increased significantly due to the Chinese economic risk and the change in monetary policy by the Fed.

Without profit growth, no increase in stock indices

During the first quarter of 2016, at least, these factors will remain present. We expect a further decline in US profits for the 4th quarter 2015 (-4.7%) and Q1 2016 (-1%), largely due to falling results for oil companies and a still strong US dollar. In 2015, US profits should decline by 1%, but we expect a recovery in 2016 with a growth of almost 8%, mainly due to a base effect coming from the results of oil companies. Concerning results of the European companies, they should be affected, among others, by economic and financial problems in emerging countries. Fears over China's economy will persist as long as the manufacturing PMI remains in contraction. In conclusion, stock indices will not rise as long as the visibility on earnings growth does not improve. We repeat it: over the medium to long term, profits drive stock markets.

The P/E ratios are slightly above historical averages. The estimated P/E ratios for 2017 are at 14x for the S&P 500 and 12x for Europe, while the annualized rate of profit growth over the next two years is estimated at +10%. Valuations do not seem exaggerated. But again, the evolution of corporate profits will be decisive.

The recent deterioration of geopolitics in the Middle East is a factor that could weigh on stocks. After the tensions between Russia and Turkey, relations between Saudi Arabia and Iran are suddenly deteriorating. The creation by Saudi Arabia of a Sunni army with 40 countries to fight the Islamic state has increased the risk of a Sunni-Shiite conflict. The geopolitical risk has increased.

We continue to favor Europe and Switzerland: the euro and the Swiss franc should remain low against the dollar, translating in general a possible positive impact on the domestic stock market due to the currency depreciation. Japan could underperform, as a lower Yuan hurts the outlook for Japanese exporters. In Q1 2016, frightened investors will keep a short-term investment time horizon, reducing the potential of rising stock indices.

Concerning the emerging markets, the risks appear to us still too high. We will come back positive when the dollar will end its appreciation and commodity prices will stabilize. China remains a conviction in the medium to long term, but with high volatility; China’s economic growth is slowing to 6%, but fears of a hard landing are exaggerated. While challenges remain as the huge local debts, restructuring of state enterprises and readjustment of industrial capacity (in progress), but the transformation of the economy is visible with a marked expansion of services and consumption of households. The Chinese government keeps a good leeway to support the economy. And in 2016, it is likely that the A-shares integrate the MSCI global indices.

Favor growth sectors in a more difficult environment

Macroeconomic and geopolitical fears argue for overweighting defensive sectors. As in 2015, we continue to favor Healthcare and TMTE (telecom, media, technology and e-commerce). In Consumer Discretionary, we favor Automobile which benefit from a structural growth. We stay away from the luxury industry, affected by Russia (recession and international sanctions), China (anti-corruption policy) and now the Arabian Peninsula (drop in revenues and austerity policies).
Alternative Investments

Capitulation?

Commodities: energy fell off a cliff, as key technical supports broke. The breach of the USD 40 on the downside, which had held in the aftermath of the 2008/9 crisis, opened the door to a “new (lower) regime”. Long-term fundamentals have not improved markedly enough to compensate for the gloom sentiment. An opaque geopolitical landscape and benign China data refrained strong hand investors from engaging yet. Therefore, it is early to call it capitulation. Still, for the second month in a row, commodities no longer trade homogeneously. A vicious circle has lately set-in in oil. But at the same time, Gold Natural Gas and Copper – which experienced their specific selling climax in H215 – have given early signs of lower volatility and of growing resilience...

Hedge-Funds: Hedge Fund managers didn’t manage to escape the significant setbacks of most asset classes / underlyings. HFRX indexes of Hedge funds globally declined in December by 0,42% (Absolute return) and by -1,1% (Global Hedge Fund Index).

Technical trend (short-medium term)

Precious metals
Gold did well in relative terms, as it recovered slightly in a low volatility rebounding pattern. Long-term downtrend is still in place.
Silver is underperforming the bullion, just like Platinum, which hardly benefitted from the risk aversion spike. Palladium downtrend accentuated lately, with no base in sight.

Industrial metals
Short-term, Copper managed to extract itself from oil “mechanical” influence and stabilised. Medium-Term: provided the on-going test of the support at USD 200 succeeds, one should expect the next move to be a shift towards the still declining 200dMAV at USD 250. Long-term trend is still down (declining MAV)

Oil
Very oversold lately. WTI and Brent are now in desperate search for new bidders. Absent a major surprise, a test of the USD 30 level is the most likely next move. Natural gas dramatically benefitted from colder weather, and rebounded sharply from the historic low of USD 1,8 reached in December. Short-squeeze fuelled a sharp reversal. Next technical target is USD 2,6, which may be reached shortly.

Fundamentals (medium-term)

A “risk-on” phase is definitely helping gold to regain some shine in the short-term. The odds of a more stable, to slightly higher price development have increased. The ounce is benefitting from volatility i.e. safe-haven demand, a slow pace of rising Fed funds, and of US inflation pick-up. A scenario where US growth would collapse, fuelling USD weakness and expectations of a new QE round, may ultimately provoke a strong reversal. This is still a low probability one.

On-going strain in China manufacturing demand is battering down Palladium and Platinum.

Copper: a bottoming-out process has possibly started. The oversupply problematic has become less central lately. Future capacity rise are very unlikely, considering on-going problems of producers, and demand should improve with a better H2 in China manufacturing. Contango is reassuring.

Residential and commercial real estate
REITs and housing investments will continue to offer diversification features and a good relative risk return profile in times of higher volatility.

Oil. No stabilisation is to be expected short-term, as China fears, strong USD, and unpredictable Saudi posture dominate. The odds of a bold reaction to happen are on the rise, as more and more actors, including the US and Gulf emirates are impacted. The rise in gasoline stocks is not worrisome, as actually due to weather related factors. The fall in crude inventory went unnoticed.

Natural gas: a V-shape recovery (+30% from the lows) brought price back to a more reasonable level. The collapse in Q415 resembled a capitulation. We expect more stable prices from here.

A measured pace in rising US policy rates will not hamper sound real estate fundamentals.

Eurozone: Housing is recovering on a broad-based scale, courtesy of the traction of the ECB reflacion policy.
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