Branch 23 Funds

Financial Market Review and Economic Commentary

31/3/2018

AG Employee Benefits

Introduction

Macroeconomics

Investors had quite a bumpy ride during the first months of 2018. While January rode the wave of enthusiasm for the tax overhaul voted into law by the U.S. Congress a few weeks earlier and the ongoing strength in economic data, investor nerves frayed in February and March, prompting a sell-off that pushed volatility over the 20-point threshold, far above the 12% recorded in 2017, the least volatile year in decades. This turbulence was mainly fueled by fears of mounting inflationary pressure, spelling a quicker-than-expected end to easy monetary policy as central banks increase interest rates. In addition, the release of a labour market report showing higher than anticipated U.S. wage growth heralded a burst of heightened activity. Additional causes of market turmoil included the looming spectre of a Cold War between Russia and Europe over the attack on a former Russian spy for the West, political paralysis in Italy after national elections boosted populists but failed to produce a winner with enough support to patch together a parliamentary majority, and President Trump's decision to fire the opening salvo of a trade war on Canada, the EU and China, the U.S.'s biggest trading partners.

MSCI World was up +1.48% (vs +3.17% for MSCI Emu) in January before shedding 2.09% followed by an additional 3.05% in February and March (vs -3.77% and -2.11% for MSCI Emu). The market turbulence was fueled by hints of faster inflation and fizzling job growth coupled with central banks' steps towards monetary policy normalisation. The Fed lifted its benchmark rate and 3 more are expected by the markets this year.. As this normalisation was later confirmed by new Fed head Jerome Powell, investors have since started to doubt whether they can count on the protective embrace of an accommodative U.S. central bank when markets go haywire. The ECB's removal of a long-standing explicit pledge to increase the size of quantitative easing *if needed* was also taken by market analysts as a signal. Meanwhile, on the other side of the Channel, the Bank of England has kept the door open to another interest rate hike in May to keep a lid on inflation pressures.

The best performers in 2017 fell from grace this past quarter due to various issues affecting GAFA megacaps (Google, Apple, Facebook, Amazon): Facebook came under fire for failing to protect user data and privacy, Nvidia plunged after suspending its self-driving vehicle testing, and Amazon tumbled in the wake of President Trump's Twitter tantrum over the company's controversial tax practices.

Despite the persistence of positive economic indicators, the Fed upped its outlook for GDP growth in 2019 and 2020. Although still well above the 50-threshold, the preliminary EZ composite PMI dipped, reflecting apparently reasonable fears that the eurozone's economy is losing momentum.

Bond Markets

Commentary on Rainbow Indigo, Green and Orange (World Strategic Funds) and Rainbow Blue (World Bonds)

Euro Area Bonds

At the start of the year, fears of mounting inflationary pressure and the ECB's shift to less accommodative monetary policy sent German and EU sovereign yields soaring. They fell back as of mid-February to hover just above levels recorded earlier this year in a flight-to-quality response amidst growing U.S.-China trade war jitters.

In spite of political risk in Italy after national elections boosted populists, Q1 was characterised by significant spread compression in peripheral markets. After Fitch upgraded Spain's sovereign debt rating one notch to A-, the Bono/Bund 10-year gap is now at its tightest since 2010. The Barclays Aggregate Treasury index finished the quarter with a solid performance of 1.43%.

Credit took a hit this quarter as financials were impacted by declining borrowing costs. Mirroring the stock market decline, high yield credit also underperformed (Barclays Euro HY: -0.51%). Highly sensitive to events in Russia, the Barclays Euro Emerging Markets index (-0.54%) felt the pinch of geopolitical tensions with the EU.

The Barclays Euro Aggregate index generated a return of +0.73% in the first quarter. The main contributors were the Aggregate Treasuries index (+1.43% in Q1) and the Inflation Linked index (+1.28%) while Aggregate Corporates (-0.39%) and High Yield (-0.51%) were the main detractors.

Rainbow Blue Euro finished the first quarter at +0.29%, trailing its benchmark by 45 bps.

Performance

- *Bluebay* started off the year as the star performer, generating an excess return of +1.36%, or 63 bps. This was primarily due to country selection, notably peripheral (sub-)markets such as Greece, Cyprus, Italy and Catalonia, where spreads tightened significantly. Its positioning in subordinated financials, however, caused it to give up some of its gains.
- *Insight Investment* finished the quarter on solid ground at 28 bps ahead of its benchmark. The main contributing factor was exposure to peripheral debt, particularly to Italy and Spain with their shrinking spreads. Certain investments in inflation-linked bonds also proved beneficial to the fund.
- The credit-oriented ***HSBC*** fund clearly felt the pinch on the credit market, lagging roughly 20 bps behind the benchmark Barclays Euro Agg Corporate which was down -39 bps at the end of Q1. The fund was particularly impacted by lacklustre performance in subordinated bank debt and corporate hybrids.
- *Wellington* finished the quarter on par with its benchmark. Its winning strategy on Spanish govies (overexposure) was not enough to compensate for its overweight position in financials.

Global Bonds

The rise in U.S. interest rates that began in December of last year continued a steady upward climb in Q1 2018, increasing from 2.41% to 2.74% by the end of March. While elevated inflation readings and the Fed's move to tighten monetary policy were the main causes, the volume of new issues (with further growth expected once the tax reform package has been voted in) was also a contributing factor.

In a flight to quality, investors ditched credit markets and flocked to sovereign bonds instead, shunning financials in particular.

Rainbow Blue finished the first quarter at -0.55%, underperforming the benchmark by 30 bps.

Performance

- With an excess return of 33 bps, the ***Russell Investment*** Global Bond fund was the leader of the pack in the World segment. Anticipating a drop in sovereign yields, it wisely took a short duration position on the euro area and UK yield curves. However, overexposure to financials and high yield positions caused it to give up some of its gains.
- *Pimco* outdid its benchmark by 32 bps, generating an excess return of 0.36% this quarter. The main contributing factors were its overweight duration bias on the Swedish yield curve and overexposure to non-agency mortgage-backed securities, U.S. inflation, Brazil, etc.
- *Alliance Bernstein* generated a modest excess return of 10 bps this quarter. Between its exposure to U.S. inflation and astute selection of U.S. corporates, it managed to successfully offset its losses on European credit positions.
- The ***Aberdeen Standard*** credit fund closed the year on par with its benchmark. Losses in high yield were contained by its positions in Spain and the energy sector.

Equity Markets

Commentary on Rainbow Indigo, Green and Orange (World Strategic Funds) and Rainbow Red (World Equity).

Euro Area Equities

After an unusually long period of steady gains in 2017, the equity market sell-off in February marked a return to reality and may even foster a healthier investment environment over time. But investors were understandably unsettled, especially given the dramatic spike in volatility. The underperformance of European stocks versus U.S. equity markets also caught a great number of analysts by surprise. The main culprits were the strength of the euro against the dollar and higher projected U.S. corporate earnings once the tax reform package is voted into law.

With the markets in risk-off mood, defensive equities were the biggest source of gains, putting downward pressure on value strategies which gave up 3.04% at the end of Q1, more than 50 bps below growth strategies. Highly sensitive to events in Russia, European emerging markets managed to remain steady, delivering a positive return of +2.13% despite escalating tensions between Britain and Russia in March.

At the end of the quarter, Rainbow Red Euro was down -2.68%, roughly 13 bps ahead of its benchmark MSCI EMU which finished Q1 at -2.81%.

Performance

- *BlackRock* finished the quarter with an excess return of 0.90% versus its benchmark. The lift can be attributed to its sector rotation strategy: telecoms in January, financials in February, utilities in March.
- *BNPP AM*'s Best Selection fund trailed its benchmark by 37 bps, hampered by underexposure to utilities and an overweight position in financials.
- Despite the challenges of March, ***Invesco*** still finished the quarter 1.24% ahead of the benchmark. This rather cyclical portfolio with positions in finance, energy, media and industrials got a boost from its investments in energy versus bank stocks.
- *Métropole Gestion*'s value fund lagged 15 bps behind its benchmark this past quarter. With its bank stock picks (Unicredit, Intesa Sanpaolo), it started the year on a high followed by an equally auspicious February thanks to Nokia, but March wiped out all of its YTD gains. The culprits: Axa shares slid upon news of a takeover by an American insurer, and Carrefour shares sank after the retailer disappointed investors with dismal earnings and a cautious outlook for 2018.
- *Lazard*, a newcomer to the portfolio in March, started off on the right foot, posting a gain of 0.71% with its defensive blend fund.

World Equities

Stoking fears of trade war, President Trump sent shock waves through the global equity markets. The equity market sell-off in February marked a return to reality and may even foster a healthier investment environment over time. But investors were understandably unsettled, especially given the dramatic spike in volatility. In contrast with other equity markets, the prospect of higher projected U.S. corporate earnings once the tax reform package is voted into law was taken as a positive signal.

Growth stocks fared much better than value stocks in Q1: MSCI World Growth closed the month of March with a return of -1.86% YTD versus MSCI World Value at -5.52%. The ongoing weakness in energy (despite the March rally) and telecoms weighed on broader market sentiment once again this past quarter.

Emerging markets earned a negative return in Q1, with MSCI World Emerging Markets finishing the month of March at -1.11%.

At the end of the quarter, **Rainbow Red** was down -3.17%, a few basis points above its benchmark (-3.23%).

Performance

- ***Fiera*** was the top performer this quarter, posting a gain of -2.36%, or 1.32% of excess return. Its contrarian positioning proved to be a good move: exposure to non-traditional financials gave it a boost, in spite of the drop in rates that put a drag on growth in this sector.
- Quant fund ***AQR*** took a beating in Q1, coming in at 27 bps below the benchmark. The dramatic spike in volatility caused its valuation and momentum models to send out mixed signals.
- ***Russell Investments***' Global Regional Equity fund outperformed its benchmark MSCI World by 42 bps. Its winning strategies were strong diversification in the Pacific, Japan, the U.S. and Europe, and exposure to small and mid-cap stocks.

Rainbow Absolute Return Flexible Asset Allocation (RARFAA)

Investment Policy

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Performance

Primarily invested in bonds, the Rainbow Absolute Return Flexible Asset Allocation fund was down -0.74% at the end of Q1 2018.

Tactical Funds (EB Dynamic Portfolio & EB Neutral Portfolio)

Investment Policy

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In Q1 2018, the fund's position in equities was the main source of volatility. Bonds added alpha despite rate hikes at the beginning of the year. A somewhat greater exposure to emerging market equities and a balanced mix between the euro area and the World segment in terms of yields proved to be beneficial to the final return earned on these two funds.

Performance

The **EB Dynamic Portfolio** fund was down -2.38% at the end of the quarter but still beat its benchmark by 9 bps. At year-end, the **EB Neutral Portfolio** took a hit of -1.92% but still came in at 20 bps ahead of its benchmark.

EB Real Estate

Investment Policy

On the back of weak leads from the stock market, the real estate market got off to a shaky start of the year but still managed to outperform equities, with EPRA Europe delivering a return of -3.25% vs -4.70% for MSCI Europe. Spanish real estate was a source of alpha while France and the Netherlands put a drag on earnings. The industrial and residential sectors were the frontrunners while retail failed to gain any traction.

Performance

At the end of the first quarter, the **EB Real Estate** fund outdid its benchmark by nearly 40 bps with a return of -2.86%.

Our real estate managers' strategies proved successful: NN Partners (ING Group) generated an excess return of 111 bps (EPRA Net Return Index), buoyed by astute stock picks in Spain including greater exposure to the hotel sector. Germany and Switzerland were the portfolio's main underexposure areas. With a return of -2.80 %, AXA outperformed the benchmark, while BNPP AM came in at -3.58%, trailing its benchmark by a good 25 bps.

EB Equities Indexed

Investment Policy

After an unusually long period of steady gains in 2017, the equity market sell-off in February marked a return to reality and may even foster a healthier investment environment over time. But investors were understandably unsettled, especially given the dramatic spike in volatility. Stoking fears of trade war, President Trump sent shock waves through the global equity markets. The underperformance of European stocks versus U.S. equity markets also caught a great number of analysts by surprise. The main culprits were the strength of the euro against the dollar and higher projected U.S. corporate earnings once the tax reform package is voted into law.

Highly sensitive to events in Russia, European emerging markets managed to remain steady, delivering a positive return of +2.13% despite escalating tensions between Britain and Russia in March. World emerging markets earned a negative return in Q1, with MSCI World Emerging Markets finishing the month of March at -1.11%.

Performance

The EB Equities Indexed fund was down -3.47% at the end of the first quarter, trailing its benchmark by 66 bps.

EB Bonds Indexed

Investment Policy

The rise in U.S. interest rates that began in December of last year continued a steady upward climb in Q1 2018, increasing from 2.41% to 2.74% by the end of March. While elevated inflation readings and the Fed's move to tighten monetary policy were the main causes, the volume of new issues (with further growth expected once the tax reform package has been voted in) was also a contributing factor.

At the start of the year, fears of mounting inflationary pressure and the ECB's shift to less accommodative monetary policy sent German and EU sovereign yields soaring. They fell back as of mid-February to hover just above levels recorded earlier this year in a flight-to-quality response amidst growing U.S.-China trade war jitters. After Fitch upgraded Spain's sovereign debt rating one notch to A-, the Bono/Bund 10-year gap is now at its tightest since 2010. The Barclays Aggregate Treasury index finished the quarter with a solid performance of 1.43%.

Credit took a hit this quarter as financials were impacted by declining borrowing costs. In a flight to quality, investors ditched credit and flocked to sovereign bonds instead, shunning financials in particular.

Performance

Coming in at +1.11% at the end of March, the EB Bonds Indexed fund finished the quarter trailing the benchmark by 32 bps.

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