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GL Financial Group

House View

November 2017

GL FINANCIAL GROUP

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Dear Investor,

Welcome to the **GL Financial Group House View**, our newly designed publication highlighting the whole spectrum of our expertise, this year achievements, and a potential market forecast for the first half of 2018.

German Lilleväli, GL Financial Group President & Chairman, and Vladimir Mikhailov, Executive Director of GLFG, in partnership with GL Asset Management CEO Daniel Ryf are proud to introduce our first House View on lifestyle and investment priorities of Swiss High Net Worth Individuals, currency market trends, debt and capital markets, equity investment strategies and digital currencies.

We are confident you will find the 1st GLFG House View insightful and valuable when it comes to making investment decisions for the rest of the year 2017 and beyond.

We wish you successful and prosperous end of the year 2017!

German Lilleväli

President & Chairman
GL Financial Group

Daniel Ryf

Chief Executive Officer
GL Asset Management

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Executive Director
GL Financial Group

Contents

Central Banks Blow Government Bond Bubble

German Lilleväli

President & Chairman
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In 2017 central banks have purchased USD 2 trillion in financial assets. The FED, ECB and BoJ have grown their balance sheets by over 35% in the last decade. Many analysts and observers definitely agree this is the most unprecedented experiment by central banks in a whole financial and monetary history initiated. Such policies have already created huge imbalances between asset classes (equities, bonds, currencies, and derivatives), their prices and their valuations. Long-term interest rates are at their lowest and if they move up, it could happen too fast and cause serious problems and headache for investors. At the moment US equities are overvalued and trade at high levels compared to bonds based on the Federal Reserve model. This is why, in the likely scenario interest rates will rise again soon, it ought to have a negative impact on equities. Investors will have to reassess the markets, additional risks and their investment process in allocating funds in equities. Usually bond investors have a psychological threshold on US Government bonds "Govies" at 3%. It is called "red line" or "turning point. For the last three years we have reached that "red line" only two or three times forcing fund managers to re-evaluate their investments in corporate bonds as well as other lower graded bonds (High Yield, Junk), generally by reducing the fixed income stake in the portfolio.

Since 2009 central banks have repurchased Govies, equities, investment trusts creating a lot of hidden risks for the global financial system. In the current market conditions, investors, using outdated risk management models and tools, try to evaluate the risks of allocating assets in any issuances of bonds. They wrongly calculate possible losses in the event the bond bubble bursts. According to Haver[1], the global debt grew from USD 86 trillion in 2002 to USD 215 trillion in 2017. Only the Federal Reserve made the first steps to tighten monetary policy and increased Fed Funds rate from 0.25% to 1.25% in 2017.

[1] US-based data provider maintaining 200+ databases from over 1'350 government and private sources

Chart 1:
World Global Debt, USD Trillion

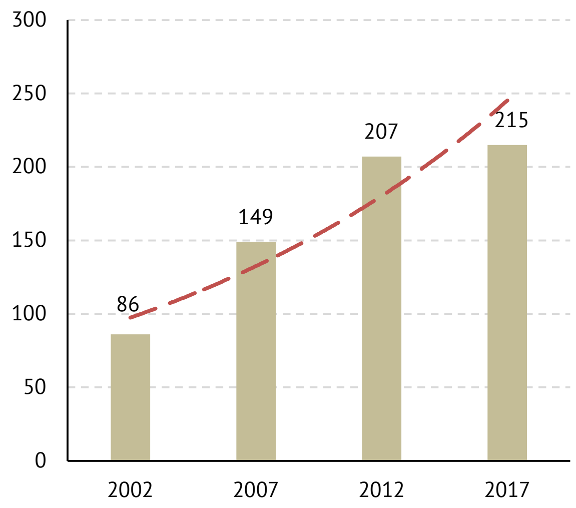
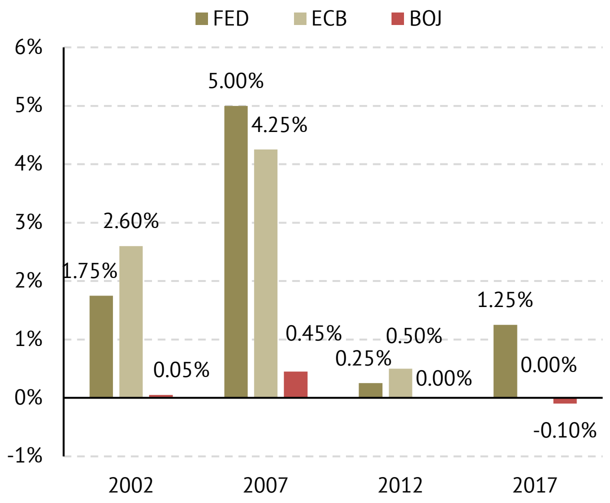


Chart 2:
Key Interest Rates, % FED, ECB, BOJ



Source: Bloomberg, Haver, TradingEconomics

Despite the fact the Fed has already started rising its interest rate in 2017, European Central Bank and Bank of Japan did not act to unwind massive balance sheets and slow quantitative easing policies. The next logical step is to increase interest rates from historical lows, but ECB and BoJ are waiting for the right time and do not follow Federal Reserve. We expect Mario Draghi, president of the ECB, to start reducing the balance sheet at least partially until the end of the year. And for the Bank of Japan to follow in 2018. Therefore, conditions are emerging for a bear market on long-term bonds.

Another apparent fact indicating that corporate and government bonds are overvalued is the negative yields to maturity for government bonds in Europe and Japan. As of now, almost USD 9.2 trillion worth of government bonds, purchased by central banks, have negative yields. It means such bonds do not generate profits, which is coupon payment or nominal value growth. According to Reuters, Swiss banks paid USD 1 billion in negative interest rate charges in first half of 2017, up 40% year-on-year. The Swiss National Bank is charging a 0.75% fee on large deposits at the central bank.

Chart 3:
Debt to GDP, %

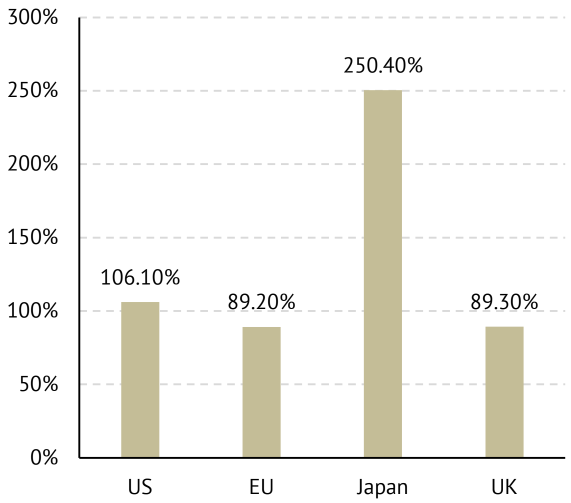
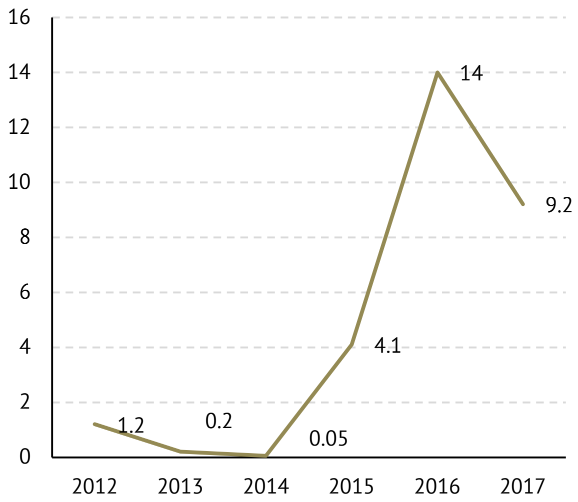


Chart 4:
Negative Yield Bonds, USD Trillion



Source: Bloomberg, TradingEconomics, Financial Times August 17, 2017 "Over USD9tn of bonds trade with negative yields"

As shown on Chart 3, Debt to GDP ratio is close to 110% for developed countries. Moreover, Japan has the highest Debt to GDP ratio 250% in a world. Bear in mind such level of debt, negative yields of governments bonds look like anomaly and misleading investors. According to US Federal Reserve Economic Data (FRED), accumulated US debt interest payments reached USD 1 trillion in 2017. Consequently, investors should keep in mind all those "imbalances" when investing in bonds. They generated that low interest rate environment for the past eight years.

Obviously, central banks should start soon reducing slowly that monetary stimulus to avoid any "shocks" to markets. Starting from October the Fed will unwind its massive USD 4.5 trillion balance sheet by selling government and mortgage bonds at open markets. It is very hard to predict what the consequences will be. Despite the fact, that Federal Reserve has increased funds rate from 25 bps to 125 bps in 2016-2017, dollar index DXY had a negative dynamics year-to-date (-12.1%). That is why we do not rule out that reducing asset purchases and tightening quantitative easing policy may have negative impact on global bond market with rising interest rates and spiking volatility across equities and bonds.

Of Swiss High Net Worth Individuals, their Investment and Asset Classes Priorities

Daniel Ryf

Chief Executive Officer
GL Asset Management

The Art of Building long-term Trust Relationship

In the last few years wealthy clients such as HNWIs holding extensive liquid assets to invest faced many investment challenges. Equity markets boomed driven by widespread Quantitative Easing (QE) measures of the major Central Banks to support economic growth in mostly developed markets such as the European Community and the US. The result of this extensive QE led to historically low levels of interest rates, some even negative such as the Swiss Franc and the Euro among others. These low interest rates had, of course, a positive impact for borrowers in the financial market. However, one of the most negative impacts was on holders of liquid assets in search of low risk investments with real positive returns. It has become very challenging to find such investment vehicles.

The real return approach has its importance. One can only preserve the value of wealth if the investment returns are at least equal to the rate of inflation in the specific investment currency.

In this article I will focus on Swiss HNWIs and their investment goals and approaches.

Definition of High Net Worth Individual (HNWI)

A so-called High Net Worth Individual or HNWI is a client segment which is usually used in the Financial Services industry to designate client holding a minimum of 1-2 million CHF, EUR or USD in bankable or investable assets (liquid assets). Other assets such as Real Estate, art etc. are not counted as bankable assets. A client who holds more than 50 million CHF, EUR or USD is generally called Ultra High Net Worth Individual or UHNWI.

In this article we will focus on HNWIs exclusively but there are very similar patterns between the wealthier HNWIs and UHNWIs.

Investment Priorities and Asset Classes

Priorities

The majority of HNWIs focus on keeping their lifestyle in retirement. Their worries lie with increasing living and health costs but also a sharp increase in health insurance in an ageing society.

Other priorities focus on the wealth planning for inheritance purposes or company succession planning or even a robust education for their children involving financial investment understanding.

Their three key focuses are: wealth preservation, generating a satisfactory income to retire comfortably and finally a tax-efficient transmission of the family wealth to the children.

As the future remains uncertain with negative impact on HNWIs priorities, they mainly concentrate on familiar and known investments and also on markets, primarily the Swiss and European markets.

In brief, for most HNWIs, the preservation of wealth and the familiarity of an investment in a known asset class or geographical region are of much higher value than generating higher returns at higher risks.

Asset Classes

Usually, a Swiss HNWI follows a conservative approach when it comes to investing. He/she is sceptical on all financial vehicles they are not acquainted with.

Cash

The typical Swiss HNWI holds around one third of their liquid assets in cash. This seems clearly high especially in times of very low or even negative interest rates on cash holdings (depending on amounts of cash holdings, banks charge negative interest). The million-dollar question is where nowadays one can invest to achieve a real and consistent return with tolerable risk?

Unlike 2-3 years ago, Swiss HNWIs are currently regaining more confidence in their personal financial future. However, they are increasingly concerned with the forthcoming market environments, the currency volatility and the obvious geopolitical risks and uncertainties.

Because of the above point, HNWIs stay invested into familiar asset classes and they stay passive in their approach. As mentioned, cash is usually an asset which gives people more comfort and security in uncertain times. On the other hand, as long as cash has to return at least the specific currency inflation rate otherwise it is actually losing value. Nevertheless, the feeling of security is evidently more important and still appears to give higher personal value than the economic factors. Cash gives HNWIs that security they are looking for, irrespective of the likelihood of negative real interest on cash. Alternatives such as cash-related structured products like Floored Floaters etc. can make sense but need personal financial advice to investors.

Fixed Income

Giving the low interest rate environment, fixed income such as government or corporate bonds does not deliver high returns in today's markets but hold inflation risk depending on the maturity time of the bond. The Quantitative Easing policy applied by central banks has made bonds fairly expensive and coupon rates quite low for the risk an investor has to take.

Besides cash, HNWIs favour that kind of asset class and invest mostly in well-rated government bonds and corporate bonds. However, greater returns could be achieved by investing in →

emerging market bonds or so-called high-yield bonds by accepting higher investment risk.

Thus, bonds are fairly popular with Swiss HNWIs in the line of what was mentioned in the introduction, security and familiar investments come before additional yield.

Investment Funds

Many HNWIs also utilise Investment Funds with a balanced asset class strategy. Opting for a fund gives them the opportunity to acquire a well-diversified portfolio, either actively or passively managed, following a specific underlying market portfolio.

Most of the funds HNWIs invest in do also hold a high allocation in fixed income and about one third in equities.

By allocating investments among various financial instruments one reduces risk. Such types of investments are usually for the HNWIs with at least a million in liquid assets to allow adequate diversification. Wealthier HNWIs could create similar diversification and exposure at lower cost by investing directly into the specific fixed income or equity. However, a direct allocation also means higher level of advice and time spent monitoring the investment.

Equities

The majority of Swiss HNWIs allocate in equities, usually making up for 20-30% of the total allocation.

As mentioned investors favour investing in familiar products, this is why, and as a rule of thumb, Swiss HNWIs invest in the Swiss equity market and Blue Chip European and US stocks mainly.

Many investors enjoy the (high) dividend yield of large-cap stocks in Switzerland and Europe. As a result, they concentrate their investments with a long-term horizon and so minimising the capital risk of a stock. This “buy-and-hold” strategy with equities is often implemented with good and well-known quality stocks.

Depending on the age of an investor the percentage of equity allocation varies. Younger HNWIs tend to have higher allocation whereas investors above 50 years of age tend to reduce their equity exposure for higher fixed income or cash allocation.

Alternative Investments

Again a majority of Swiss HNWIs are invested in Real Estate for their own living but also for investment purposes. Real Estate has had the benefit of continuous growth of value and has been a very secure investment also with some tax benefits.

Besides that, Real Estate has fixed income features such as monthly cash flow and low volatility in market price. Real Estate prices have risen continuously over the last 40-50 years and have outperformed any other asset class from a risk/return point of view.

As such Real Estate in Switzerland has always been a corner stone investment for Swiss HNWIs.

However, other asset classes such as commodities, currencies, Hedge Funds, Private Equity investments have not really been in the main focus of the typical Swiss HNWIs.

For a traditional HNWI investor, the lack of liquidity in the investment, lock-in periods, the higher volatility, and also the lack of experience in such investments made them disregard such alternative allocations.

In any case, investments in alternatives products are usually limited to w10% of total assets and are usually not encouraged by banks and financial advisors above that threshold.

Role of investment advice

As described, Swiss HNWIs have quite a conservative investment approach; and protecting their wealth is key. This leads many to invest into the classical asset classes with a high portion of their liquid assets being kept in cash.

On the other hand, about half of the Swiss HNWIs receive investment advices from financial advisors, banks or asset managers.

The reasons for getting external assistance vary but they clearly focus on retirement and wealth planning, access to more diversified investment ideas and optimising their total asset allocation strategy to get higher return and more security when it comes to their financial future.

However, Swiss HNWIs want to stay involved with the decision-making process. It is important for Swiss HNWIs to work with reputable and trustworthy advisors and institutions from which they can expect quality advice (and service) on their wealth planning needs and financial advice.

Investors who work with advisors tend to hold less cash and have a more diversified asset allocation policy. But again, here is where trust and quality of financial advice comes in. It is the job of an advisor to analyse the investors' financial situation, needs and plans to structure and offer them a clear and sustainable financial strategy including a well-diversified investment portfolio.

Experience shows that Swiss HNWIs would welcome the possibilities to invest in alternative products such as hedge funds, market neutral long/short strategies and possibly commodity once they receive the proper recommendation and know-how.

Long-term trusted relationships are key and they have to be built on quality and reputation; and time.

Smart Beta ETFs Use Factors All Wrong

Vladimir Mikhailov

Executive Director
GL Financial Group

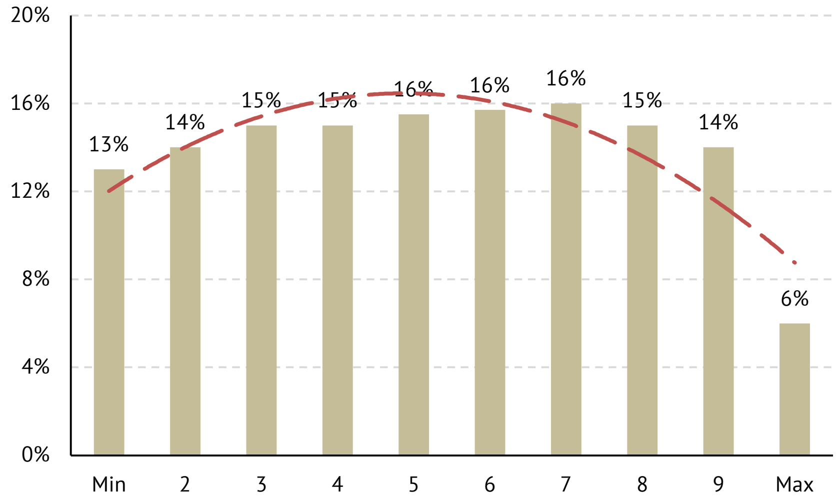
In June Bloomberg published an interview with Maneesh Shanbhag co-founder of Greenline Partners LLC, an asset manager based in New York City with half a billion asset under management. Shanbhag stated “the smart beta exchange-traded fund you just bought may not have been the wisest idea - at least according to an upstart quantitative investing shop with ties to the world’s biggest hedge fund. That’s because the utility of investing exclusively based on factors like momentum, value and low volatility is exaggerated by most providers. In fact, he says, factors only work as a way to find stocks to bet against.”

“There is a tiny bit that is good, but a lot in the space where the benefits are oversold, said Shanbhag, who runs what he calls “factor inspired” risk parity portfolios. “All of them are better at predicting losers than selecting winners. Yet most products are long only”.

“This is a frightening proposition, considering how ETFs that exclusively bet on stocks rising have ballooned in popularity. The issue comes down whether factors good at picking stocks that are primed to rise. At its core, factor investing targets shares with characteristics shown to beat the market over time. The logic has been applied to countless smart beta ETFs that, say, buy the 100 least volatile stocks in the S&P 500 Index, like the USD 7 billion PowerShares S&P 500 Low Volatility ETF, symbol SPLV. In the ETF universe alone, U.S. smart beta funds have grown seven-fold over the past decade, with total assets at a record USD 612 billion. Yet, according to Shanbhag, this is a lousy way to find the best shares to buy. What factors are good at identifying which stocks are most likely to fall something that doesn’t really benefit long-only ETFs. In addition, since smart beta funds focus on just a small slice of the investing world, the funds are less diverse and therefore more volatile. For example, if you sorted U.S. stocks by volatility over the past half-century, the most volatile group has the worst annualized returns, data analyzed by Greenline found. But after that, the benefits of the low-volatility factor level off, and the other groups’ returns are virtually indistinguishable from each other. In fact, the group with the lowest volatility posted annualized returns of 13 percent, compared with 16 percent for the middle group.

Powershares's SPLV had returned 82 percent since its inception on May 5, 2011, compared with the S&P 500's 83 percent return. In research published late last year, Greenline found the same effect over and over. After sorting by factors many quants use like momentum, value, quality and size the worst segments underperformed, but the others showed little dispersion. Most factors are already priced into the market, especially in U.S. equities, where a large number of informed players are chasing high profits, according to Shanbhag."

Chart 1: Factoring In the Losers. Sorting by historical volatility, benefits level off after most volatile decile



Source: Ken French Data Library, from 1963 to March 2016, Greenline Partners, Bloomberg; Min, Max – volatility; least volatile – most volatile

"Shanbhag has been using that philosophy in the equity portion of his risk parity portfolios a strategy that weights asset classes based on riskiness. Instead of investing in factors, he uses them as screens to weed out the losers. The New York-based asset manager returned about 13 percent last year, compared with 11.6 percent for Bridgewater's risk-parity All Weather fund and 9.5 percent for the S&P 500."

"He's not alone in his view. Some researchers believe that factors like low volatility and quality may just be another version of value, albeit one that's less effective for investors. Others think that gains in some factors may be due to a completely separate and unsustainable phenomena, like low-vol being overweight in defensive sectors that benefited from falling interest rates, Shanbhag said."

The article was provided by Bloomberg dated June, 27th 2017
"Smart Beta ETFs use factors all wrong" Dani Burger Markets & Quants

Equity Market-Neutral Strategies vs. Corporate Bonds.

Very often investors and fund managers try to compare equity market-neutral strategies with investments in debt assets, for instance, US Treasury bonds or Emerging Markets (Eurobonds) corporate bonds. With the appropriate structuring of investment portfolios using statistical arbitrage strategies, there are indeed many similar characteristics with fixed income asset classes. First, it provides a stable positive return with an acceptable risk level. Then, low levels of drawdowns and volatility over the long term. Finally, the strategy is fully denominated in U.S. dollars and has a high level of liquidity with massive trading volumes across stock exchanges in United States.

Bond investors also have undisputed arguments for choosing bonds as an asset class. Debt instruments are liquid assets and provide a stable return in the form of coupon payments and an increase in the asset's market value. Some investors buy bonds and hold them in portfolios until maturity. This strategy reassures investors. So, they do not track changes in the asset's market value. Typically interest payment is quarterly or semi-annual. The "riskiest" category of bond investors favours bonds with a "leverage" or use borrowed capital to generate higher yield at an appropriate level of risk.

Equity market-neutral strategies and bonds have some aspects in common. But, how well do investors assess their risk in investing in bonds and market-neutral strategies? According to our estimates, the maximum possible drawdown for statistical arbitrage strategies is 1.2%, which is clearly lower than any potential drawdowns and volatility in bonds, especially in Emerging Markets Eurobonds. During the crisis periods, the volatility of these debt instruments can reach as high as 14 to 17 percent. Consequently, the risk of investing in corporate bonds is much higher as compared to market-neutral strategies with the same level of potential yield. Of course, some investors may argue and say "we are ready to wait until maturity of bonds", but what is the percentage of such investors. And what if money is needed urgently? Therefore, in the case of a negative scenario, investors will have to accept losses and risks, which can turn out to be much higher than originally planned. In addition, when financial crises are coming, corporate bonds liquidity drops significantly, especially for Eurobonds and High-Yield Bonds. Investors are forced to deal with lossmaking prices and high brokerage fees.

If an investor turns to market-neutral strategies with a focus on US equities applying statistical arbitrage strategies, risks are offset by high portfolio diversification, a high level of instant liquidity, a neutral portfolio position with Beta as close as possible to zero, and the effective allocation of trading pairs using stock selection methods based on statistical and quantitative models. We believe that investments in equity market-neutral strategies will be in a great demand by investors taking into account the fact that US equities are overvalued and there is a high probability of healthy market correction. Moreover, the bond bubble created by central banks (see our article on the topic page 3) over the past eight years amid low interest rates and quantitative easing policies may burst any time soon.

Assuming that bond investors may bear significant risks in a rising interest rates environment and in an on-going reduction of major central-bank balance sheets, investors should switch to defensive strategies and allocate part of their capital to low-volatility investment funds and asset classes denominated in U.S. dollars.

The Single European Currency Draws Strong Support from Investors This Year

Vladimir Mikhailov
Executive Director
GL Financial Group

Since the beginning of the year, the euro has increased by more than 12% against the U.S. dollar, following closely by other currencies such as the British pound and the Japanese yen. We believe that the growing demand for the single European currency emerged as it is expected the ECB tightens its monetary policy by November-December. Moreover, the economic activity in the euro zone is improving significantly and fewer political risks in the leading countries of the European Union, namely in Germany and France, also supported the euro. According to our estimates and in-house multi-factor macro model, the Federal Reserve's current forecast to raise the key interest rate from the current 1.25% to 2.25% by the end of 2018 is truly optimistic; and we do not rule out they will slow the pace of tightening monetary policy next year.

Surprisingly, political risks can also play an important role among investors across FX markets. This applies chiefly to the U.S. dollar. We believe that the Trump Administration policy could negatively affect the U.S. currency in the mid-term. First, it could mean trade conflicts with other countries, including China. Second, the domestic political situation in the United States continues to be tense, while quarrelling between different political groups could create preconditions for the impeachment of the President. Third, for the first time ever, the United States debt ceiling has exceeded USD 20 trillion, and President Donald Trump has even spoken about "abolishing the debt limit". Fourth, the Fed's upcoming balance-sheet reduction is a net negative factor for the U.S. dollar. According to the Federal Reserve's projection, by early 2020, the volume of assets on its balance sheet will decrease from the current USD 4.50 trillion to USD 3.45 trillion. Fifth, the upcoming U.S. tax reform will hurt the U.S. dollar due to lower tax rates, thus the revenue portion of the U.S. budget may also suffer.

On September, 7th Mario Draghi presented a new forecast for the EUR/USD currency pair in 2017-2019 during ECB Press-Conference.

According to this forecast for 2017, the weighted moving average for the EUR/USD currency pair should be 1.13 corrected from a previous forecast of 1.09. Then, for the period of time 2018 and 2019, the single European currency should trade between 1.18 and 1.19 against the U.S. dollar.

Chart 1:
EURUSD, ECB Forecast

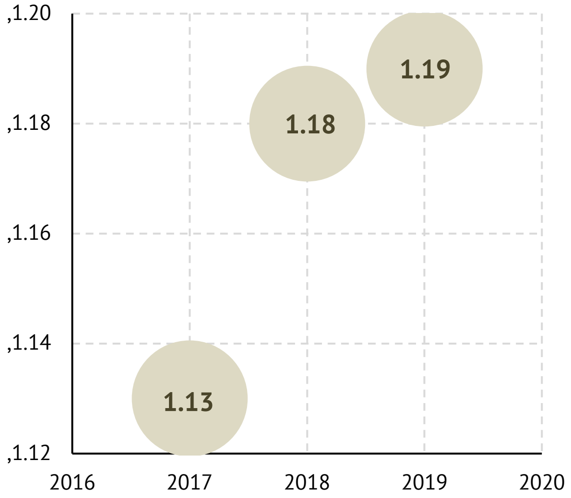
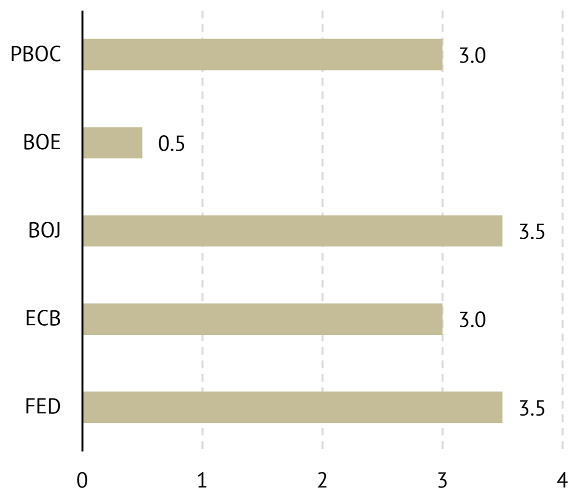


Chart 2:
Asset Purchases, USD Trillion, 2008-2017



Source: ECB, PBOC - Central Bank of China, BOE - Bank of England, BOJ - Bank of Japan, ECB – European Central Bank, FED - Federal Reserve

As shown on Chart 2, leading central banks purchased assets totalling USD 13.5 trillion from 2008 to 2017. As of today, only the Federal Reserve has started selling some assets from its balance sheet, while the ECB and the Bank of Japan continue buying government bonds and ETFs up to EUR 70 billion and USD 45 billion per month, respectively. We believe that by the end of the year, the President of the ECB may report a partial tapering of the quantitative easing programme, and the Bank of Japan should follow this trend in early 2018.

At the September Fed meeting, several key decisions were taken such as reducing assets on the balance sheet and keeping pace to raise the key interest rate. Recently, Bloomberg reported 70% probability of an interest rate increase by 25 basis points in December.

In the meantime, the sale of US Treasury bonds will take place progressively to avoid a sharp increase in US government bonds yields. In June of this year, the Federal Reserve announced they were ready to sell assets from their balance sheet beginning in October for first USD 10 billion and USD 30 billion in Q4 2017, then USD 60 billion in Q1 2018, USD 90 billion in Q2 2018, USD 120 billion in Q3 2018 and USD 150 billion in Q4 2018. By Q1 2020, the balance sheet should be reduced from USD 4.5 trillion to USD 3.45 trillion.

Chart 3:
Interest Rate Policy, % FED

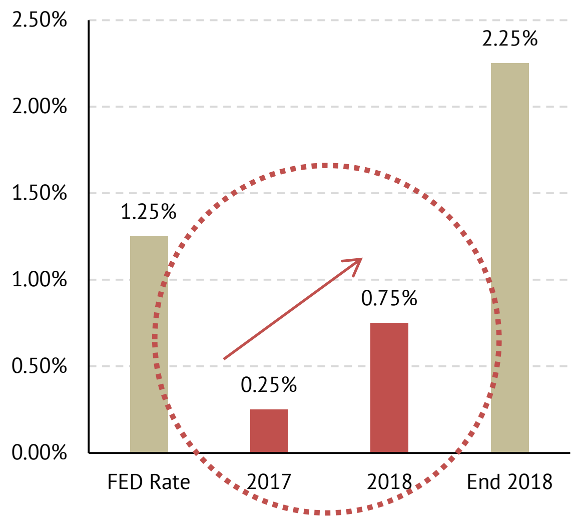
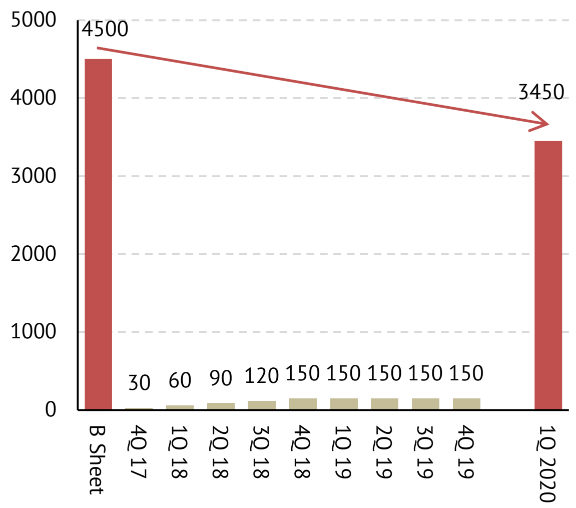


Chart 4:
Asset Reduction Programme, USD Billion



Source: U.S. Federal Reserve, Bloomberg, U.S. Federal Reserve Balance Sheet

In the next six months, we expect the European Central Bank to reduce its assets. The ECB's balance sheet has grown to a record EUR 4.2 trillion. Besides, it seems likely the ECB President, Mario Draghi, will announce a 25 bps key interest rate rise as early as Q1 2018. Such announcement could potentially trigger sell-offs in government and corporate European bonds in the mid-term. The U.S. Federal Reserve frequently sets the tone for a tightening of monetary policy. The other major central banks – the ECB, the Bank of Japan and the Bank of England – usually follow the lead. Presently, about USD 9.2 trillion government bonds held on the balance sheet of central banks (mainly in Europe and Japan) have a negative yield. This means those debt assets do not generate any revenue, i.e. coupon payments or an increase in the asset's market value. Consequently, there are certain conditions for a long-term "bearish" trend to emerge across government bond markets as ECB and BoJ are ready to start tapering next year and support the Federal Reserve.

As of Q3 2017, the ECB's balance sheet was EUR 4.2 trillion, and the volume of asset purchases has doubled since 2015. We believe the ECB will be the first to tighten monetary policy following the Federal Reserve. It is not excluded that Mr. Draghi will make an announcement with regard to the reduction of the balance sheet and an increase in the interest rates for 2018 after the October-November ECB meetings. At the moment, we do not see any favourable factors driving the growth of the U.S. dollar against the single European currency, while the probability of the EUR/USD currency pair reaching 1.30 is estimated at 30% in 2018. It is safe to assume that the EUR/USD currency pair will trade between 1.17 and 1.20 till the end of this year.

Chart 5:
ECB Balance Sheet, EUR Trillion, 2010-2017

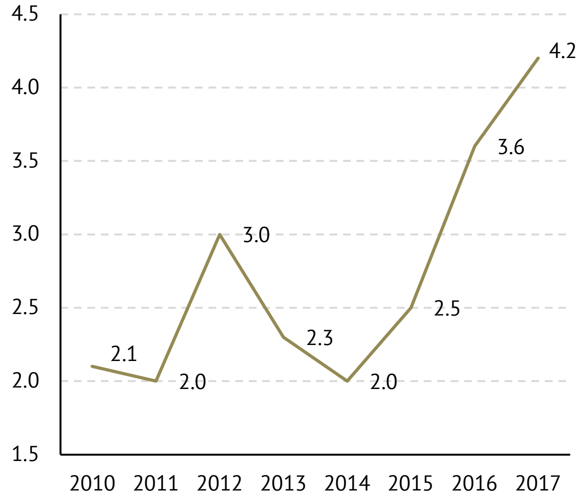
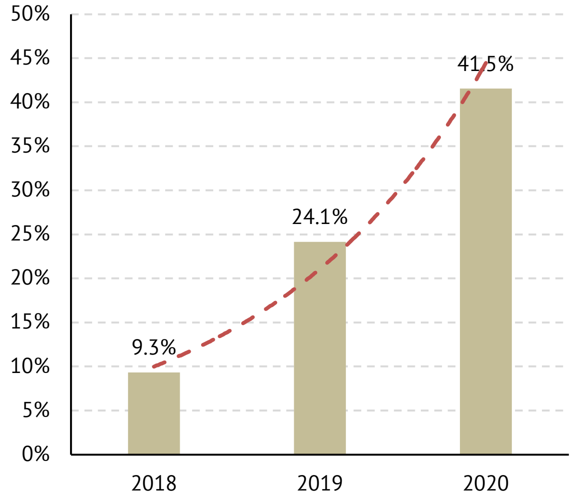


Chart 6:
FED Balance Sheet Reduction, %



Source: ECB, FED

RUB Strengthens for Second Year in a Row. Is the Trend Here to Stay?

Vladimir Mikhailov
Executive Director
GL Financial Group

This year the Russian currency has appreciated about 7% against the U.S. dollar due to various factors including the stabilisation of the Russian economy, the investors' expectations of an EU/US-sanction softening, and large open positions from traders and hedge funds on carry trade operations. In addition, a reduced rate of capital outflows from the country supported the Russian rouble and the control over crude oil prices thanks to the joint efforts of OPEC countries and Russia and to the skilled actions of Elvira Nabiullina, Governor of the Russian Central Bank. Her efforts aimed at mitigating the monetary policy and financial aid offered to commercial banks given additional liquidity, potential.

But, where is the acceptable exchange rate between the USD and the RUB? The one suitable for Russia's exports of commodities, domestic industrial companies, and importers? And above all, what are the chances for Russia's economy to experience another currency shocks in the near future?

Chart 1:
RUB-USD, 2014-2017, YTD, %

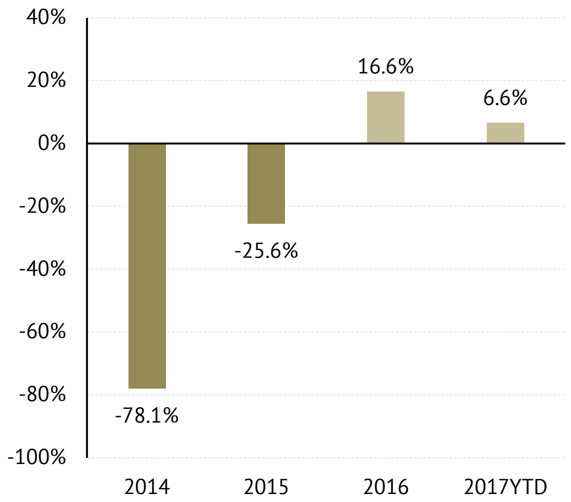
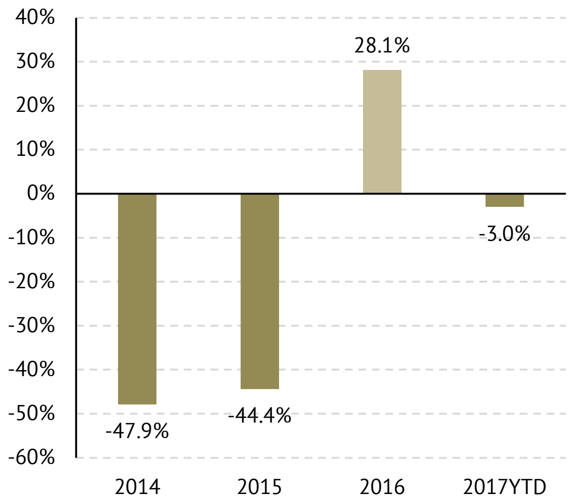


Chart 2:
Oil Prices, Brent %



Source: Bloomberg, 2017 YTD, as of 10/13/2017

A reasonable estimation of the USD/RUB exchange rate would be in the range of RUB 60–63 per USD, with no margin for force majeure and unpredictable political events. The Central Bank of Russia should keep easing its monetary policy and reducing its refinancing rate further. Currently, the central bank's key rate is 8.5% as compared to 11% in 2016 and 17% in 2015. Currency analysts at Bank of America Merrill Lynch predicted the Russian Central Bank key rate will go down by 25 bps in 2017 and by another 125 bps in 2018. At the last board meeting in September Russia's Central Bank decided to trim the key rate by 50 basis points, to 8.5%. On the one hand, the regulator could be concerned by a rouble rallying in a mid-term horizon; on the other hand, the Central Bank of the Russian Federation has repeatedly claimed it has plans to replenish its currency and gold reserves through the purchase of foreign currency. This, along with other factors, let us believe that a further strengthening of the rouble is unlikely before the end of the year.

Another and important factor is the "carry trade", performed by foreign investors, traders, and hedge funds on the USD vs RUB. Essentially, traders borrow funds in U.S. dollars at a low interest rate to convert them into a high-interest rate currency, in our case the Russian rouble; then invest the latter in local assets, for instance RUB domestic government bonds. The current yield of 10-year RUB government bonds is 7.7%, down from 16% in 2015, compared to 2.45% for the 10-year T-bonds. Thus, carry trades can be very profitable in market conditions where differences between two currencies' interest rates are significant and consistent.

For 2018 markets are expecting the Russian Central Bank to cut down its rate to 6.5%–7% and the US Fed's monetary policy to toughen. Therefore, the price of borrowing USD should go up. It is likely that carry trade returns could go down. Next year investors and traders should start unwinding their positions after having accumulated considerable profits. This should have a noticeable and positive impact on the USD/RUB exchange rate on the medium term. Conversely, there are still expectations the EU and the US will ease their sanctions or drop them altogether as soon as 2018. Russian government officials have repeatedly stated that Russia should be prepared for the lifting of sanctions later in this year. However, the prerequisites for the lifting of sanctions against Russia are extremely vague and unpredictable.

Chart 3:
Capital Outflows from Russia, USD Billion

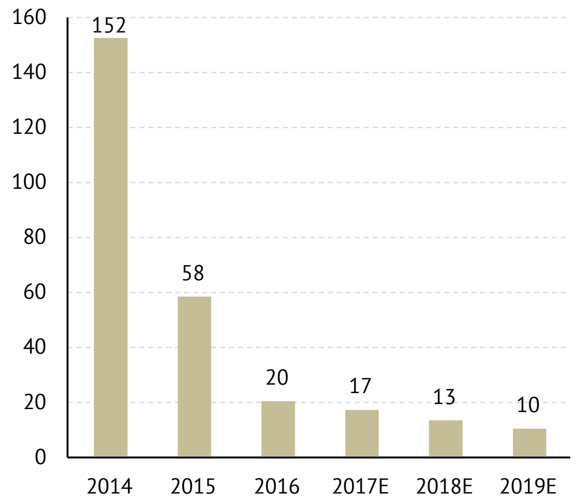
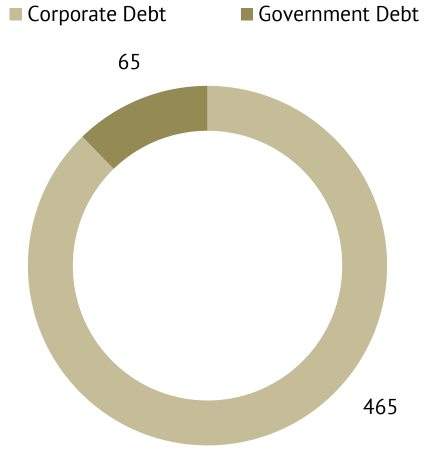


Chart 4:
Russia's Total Debt Profile, USD Billion



Source: Central Bank of the Russian Federation, Central Bank of the Russian Federation forecast, E – Estimated

Also, crude oil prices influence the RUB exchange rate. But, the impact should not be so strong. According to the Russian energy minister, Alexander Novak, the global oil market should stabilise by the end of Q1 2018 with the Brent trading in the range of the 45-55 USD per barrel at least until the end of 2017. However, Venezuela's bankruptcy, for instance, is one of those crises which could reshape considerably the global energy landscape. In the event of its occurrence, the market will temporarily lose about 2 million barrels a day, but then the crude oil prices will be able to demonstrate fast upward short-term dynamics.

Another significant factor to add to the strengthening of the rouble is the fast recovering of the Russia's international reserves. They were at a low point in June 2015 with USD 350bn. They are now over USD 420bn, with gold accounting for USD 70bn. Concomitantly, the country's total foreign debt grew to USD 530bn, with USD 465bn generated by the corporate sector. Meanwhile, the government debt amounts to USD 65bn. In the event of an ongoing increase of the rouble, due to the inflows of "hot"[2] or speculative money, we will likely see the central bank starts purchasing currencies to increase their reserves. This might curb the growth of rouble. Given that, in 2011 Russia's international foreign reserves totalled USD 550bn, this is not an improbable scenario.

[2] "Hot" money: currency moving regularly, and quickly, between financial markets so investors are ensured they are getting the highest short-term interest rates available.

Most investors have still in mind the 2014 events. For a brief period of time we witnessed the over-100% depreciation of the rouble against the U.S. dollar. And we are all wondering if it can happen again. Many scenarios are possible amid the EU/US economic sanctions, i.e. toughened or additional sanctions against Russia but using other tools of influence.

As mentioned the aggregated corporate debt of Russia's industrial and financial companies is currently around the USD 465bn. The debt burden of the oil and banking sectors is heavy but manageable. Russia exports daily around 5 million barrels of oil. In addition, Europe is the largest buyer of Russia's pipeline natural gas. If the worst-case scenarii come true, the EU/US oil and gas trade embargo will have a strong negative impact on Russia's economy, banking sector, national currency, and budget, even though the amount of oil and gas revenues within the Russian budget has reached its seven-year low of 40%. Yet, it is unlikely to happen even though possible under some force majeure or extremely negative political or military landscape circumstances.

To conclude, the collapse of the barrel to a low USD 20-25 per could trigger another currency crisis. The most likely countries to be directly impacted by such crisis will be Saudi Arabia, Qatar, the UAE, Bahrain, and Oman. Unlike Iran, Russia and Kazakhstan, these countries did not depreciate their national currency value against the U.S. dollar in the midst of the 2014–2015 epic oil crash. For instance, Saudi Arabia international reserves dropped from USD 700bn in 2014 to USD 480bn in 2017, while their debt burden started growing at record pace. The ongoing political crisis around Qatar does not help stabilising the economic situation in the Middle East. Our estimates suggest that if crude oil prices stay at USD50 per barrel until mid-2018, the Central Banks of the Persian Gulf countries may launch the first stage of devaluation of their national currencies to support the budget balance, their economies, and especially national commodity exporters.

Cryptocurrencies. New Tulipomania or International Currency of the Future Without Control and Borders?

Vladimir Mikhailov
Executive Director
GL Financial Group

In 2014 Warren Buffett, the worldwide-renown visionary and billionaire, the «Oracle of Omaha» (Nebraska, US), said in his interview to the American television channel CNBC: "Stay away from it [cryptocurrencies]. It's a mirage basically. It's a method of transmitting money. It's a very effective way of transmitting money and you can do it anonymously and all that. A check is a way of transmitting money too. Are checks worth a whole lot of money? Just because they can transmit money? [...] I hope bitcoin becomes a better way to do it. But you can replicate it a bunch of different ways. The idea that it [bitcoin] has some huge intrinsic value is just a joke in my view". Since, the market value of bitcoin grew by seven times.

According to Deputy Minister of Finance Aleksey Moiseev, the Russian government plans to officially authorise transactions with bitcoins and other cryptocurrencies in 2018. The Central Bank of the Russian Federation is also in favour of legalising cryptocurrencies. The Russian authorities' stance on cryptocurrencies has changed dramatically over the last few years: from proposals to ban them altogether and impose criminal punishment for their use to the current legalisation plans. Japan was the first country to legalise bitcoin and recognise cryptocurrencies as a legal tender. Bitcoin is still not equivalent to money, but it was granted a similar status to securities and equities that can be used to pay for purchases or lease of property through electronic systems. In Russia, bitcoin may be granted the status of foreign currency, where banks will allow their customers to open current accounts in bitcoins. According to Inc. Russia, "cryptocurrencies have a real future in Russia. The government is pursuing a technology-based national development strategy. In that respect, blockchain and, in particular, cryptocurrencies fit naturally into the foundation of such strategy".

On October, 8th Russian President Vladimir Putin reaffirmed this trend at the cryptocurrency conference in Sochi, Russia. He stated: “In a number of countries, cryptocurrencies are becoming or have already become a full-fledged means of payment, as well as a means of investment. Cryptocurrencies usage, at the same time, bears significant risks. I’m aware of the [Russian] Central Bank’s position.” Putin called on Russia’s central bank to create a regulatory framework for the adoption and usage of cryptocurrencies with “legal guarantees for working with innovative financial instruments.”

The primary threat many governments see in bitcoin and cryptocurrencies is the possible competition with real and so-called fiat currencies[3]. If cryptocurrency payments gain global use, the value of paper money will start dropping, which can create severe problems and headaches for central banks. Critics are pointing out that cryptocurrencies have no intrinsic value. However, the U.S. dollar has no such value since they abandoned the “gold standard” in 1971 and the US Federal Reserve literally started printing unlimited amount of money. People accept and pay with fiat currencies because governments and central banks act as their guarantors. In case of loss of trust in the governments and central banks, the share of bitcoins in circulation will only grow both among citizens and business all over the world.

Use of bitcoins for payments offers a variety of advantages. First of all, issuance of bitcoins is limited to 21 million digital coins, unlike fiat currencies that can be issued by central banks without any limits. All transactions and operations with bitcoins are recorded in a blockchain system. About 16.5 million digital bitcoins have already been issued or created, with a total capitalisation exceeding USD 90 billion. Due to the limited emission of bitcoins, the digital currency is not affected by inflation or decrease in purchasing power as compared, for instance, to regular or fiat currencies. They can drop in value over time or even become completely devalued as it has happened in Argentina in 2005 or recently in Venezuela. Secondly, cryptocurrencies are not controlled and regulated by central banks. They are free from any forms of currency control. If you think the government regulates cryptocurrencies, you have missed the idea behind cryptocurrencies.

[3] Fiat currency is currency that a government has declared to be legal tender, but it is not backed by a physical commodity. The value of fiat money is derived from the relationship between supply and demand rather than the value of the material that the money is made of.

Besides, all transactions between bitcoin holders are anonymous. In addition, bitcoin transactions are either commission free or are subject to a minimum transaction fee which is definitely much lower than the fees charged by commercial banks. However, cryptocurrencies still suffer from serious drawbacks such as high volatility of their market value (sometimes reaching up to +/- 30% within one week) as well as lack of legislation governing the use of this new type of currency in many countries. There are currently approximately 800 different cryptocurrencies in the world with a total market capitalisation of about USD 170 billion. The most recognised digital currencies are Bitcoin, Ethereum and Litecoin.

Source: Press Service of VEB Development Bank

Russian government controlled bank VEB has organised an open discussion about blockchain with Vitalik Buterin, founder of the Ethereum blockchain platform. The event took place at the Center of Competencies which will be launched soon jointly with NUST MISIS.

When talking about the perspectives of development different currency types, Vitalik Buterin said that “in 20-40 years we will have lots of different types of currencies. There used to be national currency and gold. In the future, companies will issue their own currency, so there will be global cryptocurrencies, and even cities will be able to issue their own currency. Everyone will have several types of currencies”, pondered the Ethereum founder.

One of the key issues raised during the discussion was volatility of the cryptocurrencies. “We are at the very early stage of our path and I think that cryptocurrencies will show crazy ups and downs. I believe that in a few years there will be a steady growth. Surely, if you are not expecting an immediate profit, it is promising to invest in this field. It is a mature technology already”, said Vladislav Martynov, member of the Ethereum Supervisory Council and representative of Ethereum in Russia.

Participants also noted that the blockchain technology is evolving and developing. People already know where and how to use it, and a number of governments are working on implementing it in public administration. The speakers also expressed their belief that Russia could become a global leader in the development of the blockchain technology, and called for wider application of that technology.

At the present time, VEB is developing methodology to implement blockchain technologies within the banking industry. Two prototyped technical solutions have been launched and are now being tested: trade finance transactions and management of investment projects “Digital Contract”. The first test transactions have already been registered. This solution can potentially have other applications in other fields too. VEB launched its e-wallet for the charity “The joy of old age”, and the first cryptocurrency contribution was made by a VEB employee.

Source: Press Service of VEB Development Bank

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