

Editorial



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As we step into the second half of 2017, the global economy's increasingly strong vital signs appear to provide us with firm ground moving forward. Economic recovery has broadened and we see a synchronized and sustained economic expansion globally.

The positive readings propelling this return to growth are varied and relatively widespread, coming from labor markets, Central Bank monetary policies, improved financial conditions and an overall positive investor sentiment. The combination and the geographic broadness of these factors suggest that the global expansion is likely to persist.

In the US, investors' optimism is still strong, while the Eurozone's political and economic troubles have largely faded away and the valuation gap keeps closing. Overall, Europe, emerging markets and Japan seem primed to offer very good opportunities for international diversification.

It is also possible that we could soon see the emergence of another reason that makes the case for international diversification even more compelling, this time from the foreign exchange front. In this InSights,

we are taking a closer look at the long-term U.S. dollar cycle, a topic especially relevant for U.S. investors. As we are approaching what we see as a potential turning point for the USD, it is important to examine the background of the currency's past performance, as well as the implications that a potential downturn could have for investors.

We'll also dig deeper into the persistent low volatility trend, which has left many investors and analysts struggling to find explanations for what appears to be complete complacency in the markets. Understanding the factors and the dynamics behind this "paradox" is essential, as a potential upcoming reversal of the VIX downtrend could significantly affect risk management decisions.

Even though the positive climate in the global economy and the markets seems to persist, at BFI Infinity we remain vigilant of potential risks and relevant political and economic developments that could call for an appropriate strategic response. Overall, while we share in the optimism of the global economy getting back to a solid growth path, we still see more risks than the market currently prices in. In our experience, a well-weighted and tempered risk management strategy, with an emphasis on the bigger picture rather than short-term gains, is the best approach for growing and protecting our clients' investments over the long haul.

In the Limelight: U.S. dollar: Rough waters ahead?

After an almost decade-long uptrend, the USD stands at what appears to be a potentially critical turning point. We examine the background, the dynamics, and the investment implications of such a reversal.

The Volatility Paradox

A closer look at the persistent calmness in the markets, in defiance of recent troubling events on the economic and geopolitical arena, and our strategic analysis of the corresponding risk management response.

Our Perspective

Cycles and long-term trends



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Cycles can be found in almost every aspect of our lives and they form the very fundament of crucial systems that we use and rely upon, knowingly or not. We find cyclical patterns in nature and in science, but we also find them in the form of business

cycles in the economy, or in the boom and bust in financial markets. Such cycles create strong trends and some can manifest over the long-term. All too often, we can become too focused on short-term events and fail to identify the long-term cyclical patterns that are at play, especially in financial markets. Successful long-term investing requires us to be aware of these cycles and understand our position in them at any given time.

A pertinent example could be the long-term U.S. dollar cycle, as its nearing what seems to be a crucial turning point. Being able to identify this cycle could prove of critical importance, especially for U.S. investors, as the value of the dollar has a sizable impact on investment performance.

Markets' defiance in the face of global risks

So far, 2017 has been a good year, at least in terms of financial market returns. While U.S. markets have reached new highs, European and most emerging markets have outperformed their U.S. counterparts and are starting to close the valuation gap that we discussed in our last InSights.

However, there is one thing that makes some investors feel uneasy: equity markets are showing solid gains, while the global geopolitical situation seems to have gotten worse. Tensions in the Gulf, renewed concerns over the relationship between Russia and the West, and provocations by North Korea seem increasingly at odds with the positive

picture we are seeing in the markets. Volatility also remains close to all-time lows, despite the series of worrying developments in recent months. This picture of apparent complacency is indeed troubling and the persistently low VIX values is an important factor to consider in one's risk management strategy.

Interest rate expectations

Despite the recent hikes in the U.S. and the talk from other central banks about normalizing money supply, it still seems unrealistic that policies are going to change much and that we'll see interest rates rise (at least not significantly). That's good news for the markets, at least at this point in time, as the world today depends on low rates and cheap money. There is no doubt that sharply higher interest rates would cause some serious damage, especially as equity markets could come under considerable pressure. Of the G-20 countries, only two are currently having a budget surplus and most of them are accumulating more debt. It seems clear that solving the debt problem is going to involve inflating asset prices and we believe we are in the middle of this process already; a process that might last much longer, with far-reaching implications on asset markets.

Interest rates will likely stay low over a longer period, but central bank intervention is only one of the factors behind this. For more than 40 years, rates have been dropping, even during times when central banks were less aggressive. It thus seems clear that globalization, technological advances and increased productivity have played a major part. While these factors have had a major disinflationary impact, inflation now seems to be created in the form of asset inflation. While most debt is nominal, increasing asset inflation will help to deal with the debt problem.

New trends are started and cycles repeat: this needs to be properly understood and considered in any long-term investment strategy. We are happy to help you with this process and to be your partner in creating and protecting your wealth over the long haul.

In the Limelight

U.S. dollar: Rough waters ahead?

The benefits of diversification have been clear to seasoned investors for decades. That also includes currency diversification. The avoidance of over-reliance on any single currency is the Foreign Exchange equivalent of the traditional concept of investment diversification. Much like spreading out risk among a number of different investments, with exposure to different regions and sectors, currency diversification also offers its own investment opportunities and risk management potential.

For example, there are a number of strong contenders for those wishing to risk-adjust and look beyond the USD. “Hard” currencies, such as the Swiss franc, which are backed by governments with relatively sound monetary policy and a record of stability, can help not only manage the overall risk of a portfolio, but also open a wider opportunity horizon that can boost performance. And let us not forget the EUR either, which has been pronounced dead many times, yet may remain longer with us than some would expect and could even surprise to the upside.

The importance of foreign currencies in a portfolio might not be breaking news in and of itself, but it is perhaps becoming increasingly relevant. As the USD appears to stand at a potential turning point, now might be the time to reconsider and re-adjust one’s foreign currency strategy.

The U.S. dollar: A king amongst currencies

Without a doubt, the U.S. dollar is the most important and influential currency. This monetary heavyweight is a part of currency pairs that account for over 85% of trading volume. Its place as the world reserve currency means that it’s being held in significant quantities by most governments or central banks globally. In fact, it commands a share of over 60% of the total global currency reserves, while the Euro comes second with only 28% of world reserves. Furthermore, around \$580 billion in U.S. bills, or 65% of all dollars, are used outside the country. More than one-third of the world’s GDP comes from countries that have pegged their own currencies to

the USD, while 39% of the world’s debt is issued in dollars.

In a historical context, the dollar’s rise was quite meteoric. It began with the Bretton Woods Agreement, in July 1944, when it was decided that currencies would be linked to the U.S. dollar, which at that time was still pegged to gold. Central banks would be able to have fixed exchange rates between their currencies and the dollar, while the US would have to redeem dollars for gold on demand. As the US held the world’s largest gold reserves, for the following years the USD was the one of world’s most stable and preferred currencies. As a result, most countries began to increase their dollar reserves instead of their gold reserves. However, geopolitical and economic challenges that came with the Vietnam War and increased deficit spending in domestic policies, along with other factors, gave rise to concerns over the stability of the USD, which in turn caused the demand for dollar-to-gold conversions to surge. Thus, in 1971, President Nixon announced that the US would unilaterally unpeg its currency from gold, in what became known as the Nixon Shock.

Nevertheless, the USD remains to this day the king amongst currencies and retains its status as the world reserve currency, as well as the designated reserve currency involved in the purchase of key commodities like gold and oil. Its continued prominence is largely due to the size and relative robustness of the U.S. economy, the dominance of its financial markets, and the international markets’ trust that the US can pay its bills.

In recent years, there have also been additional factors that contributed to the USD’s strength. The Federal Reserve helped boost the currency by putting an end to the expansive monetary policy that followed the 2008 crisis and by raising interest rates. Non-US-related developments also played an important role. The European Central Bank (ECB) hampered the competitiveness of its own currency, the Euro, by “doubling down” on its Quantitative Easing program, while the political uncertainty, the

banking crisis, the high unemployment rates, and the weak economic performance of the past years in the Euro area also took a heavy toll. As the closest “challenger” to the dollar, the Euro’s woes benefited and supported the USD’s uptrend over the last years.

Valuation approaches

An accurate determination of the actual value of a currency at any given time is an onerous and complex task. There is a multitude of economic factors at work, while there are also “softer” elements to consider, like geopolitical concerns, on top of the fundamental analysis. One might look at a currency as a country’s stock: much like the performance of a company’s stock reflects the market’s outlook and confidence (or lack thereof) in the company’s value and prospects, the currency of a country also tends to reflect the assessment and expectations of the economic prospects and the future of the issuing country, in relation to others.

Thus, similar to the considerations one would bear in mind when valuing a company, a currency valuation would include factors that could determine or influence the current worth and the potential of the issuing nation, like budget balance, trade balance, economic performance, credit rating, money supply, interest rates, etc. All of these elements influence

the exchange rate of currency pairs, while different weights are also assigned to each factor.

There are different economic theories and approaches on how to determine what a “fair” exchange rate should be, which factors should be included in the overall valuation process, and how to weigh them accordingly. The purchasing power parity theory (PPP), along with all its sub-theories, like the Big Mac index and the Interest Rate Parity theory, are among the most prevalent. Currently, most of them show an overvaluation of the USD, all to varying degrees.

Historical performance and long-term cycles of the USD

Moving past the theories and into the actual historical data, when one looks at the performance of the USD over the last 9 years, the strong upward trend that the currency demonstrated could suffice to boost confidence and expectations as to its continuous rise. As can be seen in the following chart, the dollar rose by a remarkable 42% from 2008 to 2016, as measured against a basket of international currencies.

From the point of view of a US investor, even though this period has provided fertile ground for US investments, it has taken a toll on international

U.S. Dollar Index

strong for the last 9 years



ones. Irrespective of the actual performance of the underlying investment, there was always a loss to be borne on the foreign exchange side. Therefore, during this time, the foreign investments were consistently underperforming their US counterparts.

The bigger picture, however, is far more interesting.

Once we expand the timeline of the USD's performance and look beyond the last 9 years, a very different trend emerges. Going back to the currency's peak in 1984, the dollar is, in fact, 35% down. During these 32 years, we can see a steady decline and long-term downward trend, which puts its recent gains into a more contextualized frame.

U.S. Dollar Index

still weak for the last 32 years



Digging deeper into the historical performance figures, there is a pattern that quickly becomes apparent. Over the last 40 years, 5 to 8-year periods

of a strong USD are consistently followed by an approximately 9-year period of weakness. During the strong years, the highs stay below the last strong

U.S. Dollar Index

long-term pattern



period's highs, and reversely, during the weak periods, each time the lows drop below the previous lows.

At this moment, it would appear that we could be standing on the precipice of a turning point. As the USD seems to be near its high for the current 9-year period of strength, concerns over an upcoming down-cycle are on the rise.

There are a number of factors that could force the currency on to such a downward path, as it is possible that we could see changes or trend reversals in the factors outlined above, the same that had so far boosted the USD. The US economy, for example, could find increased competition for growth and performance from other regions, especially as the Eurozone economy slowly but surely "acquiesces" from the economic and political troubles of the past years. Directional changes in the Federal Reserve's interest rate policy also pose a risk, while both geopolitical and domestic policy issues in the US still seem somewhat unpredictable.

Investment implications

Considering all the factors mentioned, and bearing in mind the dollar's long-term cycles and performance patterns, a move to diversify out of the USD could be timely and attractive to investors.

It is worth highlighting, however, that at BFI Infinity we do not advocate going to extremes or resorting to radical shifts in one's strategy. A more tempered and long-term view would still carefully consider diversifying out of the USD for an US investor and to reduce USD exposure for non-US investors, since the exact timing of its uptrend reversal cannot be accurately pre-determined. On the other hand, the dollar has the potential to exhibit significant resilience during recession and crisis periods, as it has historically proved, a factor that earns the USD always some place in long-term wealth preservation planning.

Nevertheless, from a risk management standpoint, diversification out of one's home currency always makes sense and plays an integral part in a balanced strategy. It is a matter of the degree and the way in which such a shift would be implemented, in accordance with the individual profile of each investor, and dependent upon their specific needs, aims and expectations.

The Volatility Paradox

Since the beginning of the year, we've seen a number of unsettling events unfold on the international geopolitical and economic stage: controversial legislation passed in the US, the French election and the Front National scare, and the U.K. election in which Theresa May barely snatched victory from the jaws of defeat. There were also concerns over North Korean missiles, tensions boiling over in the Persian Gulf, the G-20 clashes and the latest round of explosive tweets and press showdowns by President Trump. And yet, despite all indications and seemingly good reasons to the contrary, stock markets are experiencing a bout of tranquility we haven't seen in years. To the surprise and bewilderment of many investors and analysts, volatility has been increasingly at odds with real events, painting a picture of complete complacency. But where does this complacency stem from and what other factors may be involved in these perplexing volatility lows?

Measuring volatility: The underpinnings of the VIX

Volatility is a key statistical measure used to describe the rate and magnitude of current or expected price fluctuations relative to the average level of price swings. Historical (or "realized") volatility measures actual price fluctuations in the past, while there is

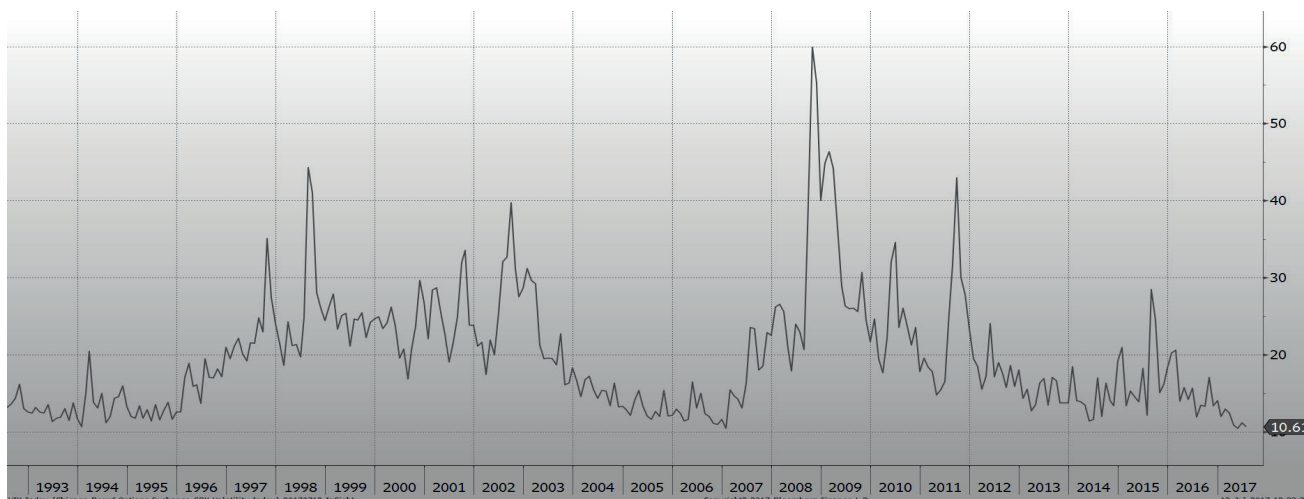
also a number of indices and tools used to measure future or expected volatility. Principal amongst those is the VIX, which is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index. Also known as the "Fear gauge", it shows the expected, or "implied", volatility based on calculations using the implied volatilities of a wide range of S&P 500 index options.

Overall, the underlying idea of the calculation rests on the premise that options, due to their hedging properties, become more valuable in times of increased market turbulence, as one is willing to pay a higher premium to hedge against the rapidly fluctuating price of the underlying S&P 500 stocks.

The VIX was first introduced in 1993 on a much narrower scale as the first successful effort to establish and implement a volatility index. In 2004, it significantly broadened its spectrum to the scale it encompasses today, thereby reflecting a more accurate snapshot of investors' expectations of future market volatility.

In general, VIX values over 30 are largely considered to be the result of heightened investor fear or uncertainty, while anything below 20 translates to investor confidence, or sometimes complacency.

CBOE's VIX Index of Implied Volatility at historically low level



Similar concepts and variations include the VXN, which is the VIX's equivalent for the NASDAQ 100, the Merrill Lynch Option Volatility Estimate (MOVE) Index for the bond market, and the VXD that tracks the Dow Jones Industrial Average (DJIA).

A rare lull in market fluctuation

On June 9, 2017, the VIX dropped to 9.37, its lowest point since December 27, 1993, after a year-long downward trend, concomitant with the S&P 500's rally. Despite the VIX suggesting that the market remains defiantly calm, recent political and economic developments provide an array of reasons to think otherwise.

Furthermore, there is historical evidence that feed into such concerns. Similar periods of persistently low volatility have traditionally been followed by sudden spikes and market turmoil. Alarming enough, the VIX's 23-year low in June saw the Index plummet below its previous record lows seen in 2007, just before the subprime crisis and the global recession.

Simple and not-so-simple explanations

As a rule, the VIX is technically characterized as "mean-reverting", meaning that when it reaches a level that is seen as too low, it tends to rise again. Conversely, when it moves higher than usual it tends to drop and revert back to its mean values. Nevertheless, the low levels we have witnessed during this period, are not necessarily a definite sign that such a "predestined" spike is upon us at any moment now. We are hearing several different explanations coming from analysts and industry experts trying to account for the current volatility levels that might inhibit such a reversal.

To begin with, there has been a significant and sustained flow into equities over the past years that has held strong since the beginning of the 2017. Some of the "imminent catastrophes", like Brexit and critical elections in the West, turned out to be false alarms, reaffirming investors' confidence in the market's resilience. As a result, the rally continued unimpeded, which in turn suppressed volatility.

Furthermore, there is the view that the rise in popularity of exchange-traded products (ETPs) linked to VIX

futures could play a role in influencing the Index to the downside and creating what appears to be a distortion. VIX ETPs, already a \$3 billion industry, have attracted \$700 million this year, with no sign of slowing down. Their increasing appeal to investors trying to profit from the low volatility environment might go some way into accounting for the lulled VIX. On the other hand, it is also important to highlight that the growing market of VIX ETPs could drastically exacerbate an increase in volatility.

Another argument that resonates with many analysts accounting for the VIX trend comes from the fundamentals. Years of extremely low interest rates and quantitative easing have helped keep volatility down. While the Fed is leading the way in putting an end to these policies, the Bank of Japan and the European Central Bank (ECB) are still engaged in monetary expansionism. In addition, low inflation, an encouraging return to economic growth and solid earnings are all positive readings. In other words, where some see a distortion in the VIX, or worry about investor complacency and overconfidence, others see an accurate representation of real economic indicators and signals.

Conclusions

In our view, low volatility alone does not provide solid enough ground to base an investment strategy shift upon. A period of relative tranquility in the markets is not all that unusual and it should not be seen as a reliable reassurance signal, nor as an omen of doom in and of itself. Most of the time, it develops as a response to positive macroeconomic conditions and rallying markets. Only the future will tell for sure if the current VIX is indeed an accurate monitoring instrument of today's market outlook or if its validity as a fear barometer is limited.

That being said, we are acutely cognizant of the risks of an abrupt reversal and we do share some of the concerns outlined above. It is inevitable that volatility will eventually pick up, especially as global economies are being weaned off the easing policies of the past years. As JPMorgan's Jamie Dimon put it, "We've never had QE like this before, we've never had unwinding like this before. Obviously, that should say something to you about the risk that might mean, because we've never lived with it before." In other words, we do see and seriously consider more risks than the market

apparently does and we thus remain vigilant in our observation of all relevant events as they unfold, both on the economic and on the political front.

Therefore, we would not advocate placing the weight of risk management and strategic decisions entirely on the VIX. In our view, it is merely one amongst a multitude of factors that one should carefully examine and consider, always in accordance with the specific structure and aims of an individual portfolio.



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