Quarterly Investment Letter

1/ 2016

Most Risky Assets drew a Blank in 2015

The year 2015 concluded with another volatile quarter which showed strong upwards movement for global equities and some tailwind for EUR bonds and emerging market local currency bonds in October. Unfortunately, most assets faced then heavy headwinds in November and December (see the market table in the appendix for details). To summarize the year for risky assets: With the exception of European equities (+5.5% according to MSCI Europe) and Japanese equities (Nikkei: +5.2%) they achieved at best flat returns with elevated volatility in the second half of the year. See chart 1 regarding the choppy performance of the MSCI World index.

Chart 1: MSCI World: A choppy performance

Source: Bloomberg

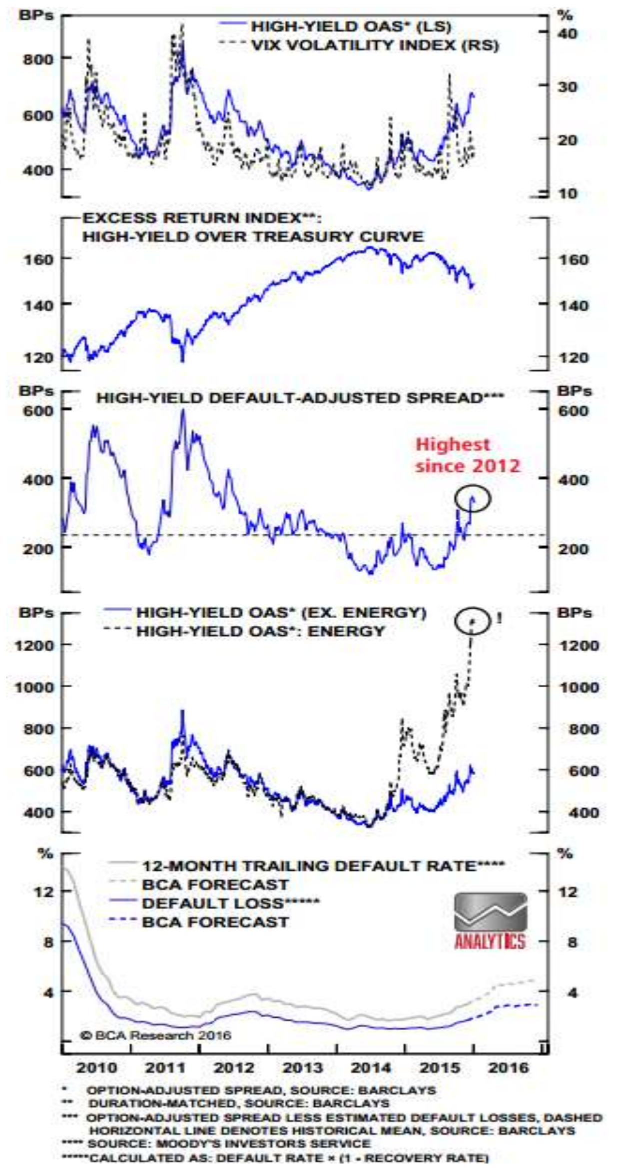
The free-fall of fossil energy prices accelerated the overall decline of commodities. The GSCI index lost 41% and the DJ Commodity index gave up 24.7% for the year. Over the same period BRIC equities lost 13.3% whereas emerging market bonds in local currencies and gold lost around 10.5%.

US Treasury yields rose in December to 2.27% after the Fed rate hike. Falling oil prices and investor outflows put US high yield under pressure again. The Barclays index declined 2.5% in December (2015: -4.5%) as fund outflows of USD 9.8bn occurred due to negative news that some funds limited investor withdrawals.

Highlights for Investors

- Ignoring unpredictable exogenous shocks we expect that economic growth will be positive but moderate. Although market sentiment is negatively biased we do not see the typical signals of an impending recession. For instance there is currently no widespread over-leverage and no inventory build-up to witness.
- We foresee that global economic growth will be consumption-led. The US economy will profit from increased disposable income thanks to lower oil prices. Europe might surprise on the positive side as Quantitative Easing continues and consumer confidence seems to pick up. In fact, some Southern countries, i.e. Italy and Spain, show indications of an economic recovery.
- Key macro themes for 2016 remain the fragility of global growth particularly with respect to China's slowdown, the free-fall of many commodity prices and its impact on the respective economies and (geo-)politics of commodity-related countries, the Fed's next steps and their impact on the U.S. economy ,the USD and risky assets and finally the stability of the EU given the economic and political challenges the union faces including the upcoming UK referendum ("Brexit").
- We remain confident that a cautious investment approach in risky assets, will be the most rewarding for risk conscious investors, with a long-term investment horizon. In short, we favor Equity L/S managers with lower net exposures, short duration credit and loans. Regarding equities we prefer Europe, Japan/ Asia over the US.

Chart 2: US High Yield Market Overview

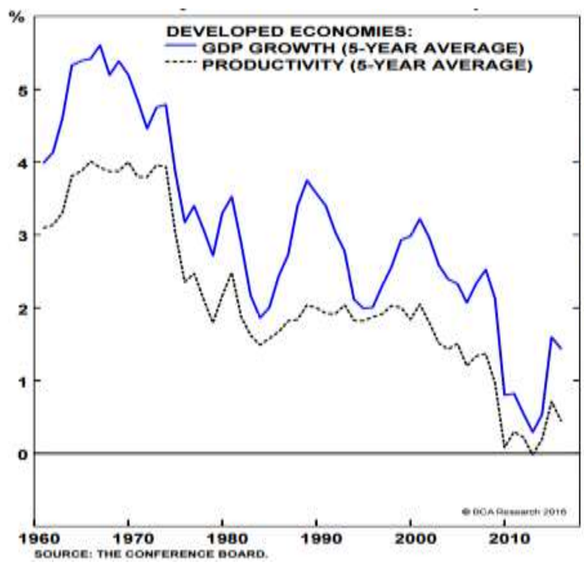


Source: BCA

Chart 2 shows that the default-adjusted spread is back to the levels of 2012. Further, spreads in the energy sector increased to new heights in 2015 while default rates have started to rise again.

It has to be noted that absolute return strategies were better suited to navigate through the recent market turbulences as compared to more traditional strategies.

Chart 3: Trends in GDP Growth and Productivitypoint to lower levels



Source: BCA

What is the Roadmap for 2016?

Since the financial crisis in 2008 developed economies have de-leveraged to rebalance their excessive indebtedness. Thus, it is no longer credit growth that drives economic growth. It has to be genuine demand based on income growth instead. Globalization, pent-up demand by emerging markets and technical progress could fill this gap in the past. However, research indicates that this phenomenon has been exhausted. The growth rates of trade volumes no longer exceed global economic growth rates as recently analyzed by BCA.

Thus, economic growth is likely to stabilize at a lower level than witnessed over the last 50 years (see chart 3).

The current transition of the Chinese economy towards a domestic demand driven set-up is the most obvious example about the changes to come. Chart 4 shows how much the transition has advanced over the recent years as import volumes have come down significantly since 2010. The chart also shows that the government has stepped up its efforts to contain credit growth. Despite the various sell-offs in the Chinese equity markets, we expect that the slowdown of the economy will be managed by the government that still has "dry powder" to stimulate the economy be it by money injections, by lowering interest rates or by devaluing the renminbi further. China's growth rate is expected to hover between 5% and 6% for 2016.

Chart 4: China's Cold Shower for the Rest of the World

Source: BCA

For developed countries, the options for reducing debt levels and putting the house in order were to restructure (politically difficult), to encourage genuine growth (long- term development) and/or to reflate. Their central banks stepped to support obtaining these goals. However seven years into this process, e.g. for the U.S., the law of diminishing marginal returns of low interest rates have become evident: modest real growth and no inflation except for highly elevated asset prices.

The Fed did finally raise the rate by 25 bps in December and Mrs. Yellen managed to guide the market participants in a sensitive way during her public statement to avoid further speculation and second guessing about the rate hike and its size. It is quite likely that this time the pattern of the interest rate cycle will not mimic the ones of the past where the Fed decidedly raised rates a couple of times in a rather short time frame. Given the current fragile state of the global economy we could well face an irregular path of rate increases and, possibly, occasional policy reversals.

Chart 5: European Growth seems to gain Traction

Source: BCA

Fired up by quantitative easing, the European economies have lately started to develop steadily with no inflation in sight as chart 5 suggests. Despite the awareness that the EU faces deep structural problems and massive internal imbalances consumer confidence has picked up lately and, for instance, the economies of Spain and Italy may be in for a positive surprise in 2016.

Chart 6: Modest Japanese Growth despite Stimulation

Source: BCA

Another popular attempt to inject growth into the economy was to forcibly depreciate the currency beyond the already weakening effect by quantitative easing. Obviously, such measure serves more the redistribution of trading shares than to provide net growth. It is, in fact, a zero sum game if everybody does it. Depreciation was an important "arrow" for Mr. Abe to stimulate growth in Japan, so far with a modest outcome, though.

How to deal with Exposure to Risky Assets?

In the current environment we still see equities as an attractive investment as compared to other assets. We agree with BCA that global stocks are far from cheap and that careful selection is required. As profit margins have been atypically high over the last years for the U.S. we can fairly assume that they will revert back towards the mean. As this implies lower earnings, valuations are and will remain stretched as indicated in Chart 7.

Chart 7: Richly Valued U.S. Stocks

Source: BCA

While the U.S. stock market seems to be richly valued, there is still scope regarding the European and the Japanese stock markets. European stocks trade currently at a Shiller PE of 14 as compared to 24.4 by U.S. stocks. In contrast, emerging markets are still in the process of cyclical adjustments. Thus, despite market corrections in the past it might still be too early to build up long exposure again (see chart 8).

So what about fixed income? As the Fed raised rates in December, it is fair to assume that Treasury yields should rise as well in the short run. However, as economic growth will remain modest it is likely that yields will have a ceiling that will not be much higher than current levels.

The dramatic drop of oil prices triggered a massive decline in the high yield bond area in 2015 as mentioned above. This sell-off might offer attractive investment opportunities in competition with equities. But this has to be done selectively as the default-adjusted spreads are still way below the levels of 2010/ 2011. Even outside the troubled energy sector, companies face headwinds as profit margins and rates of return on capital are expected to decline. Also, defaults will continue to rise in the coming months.

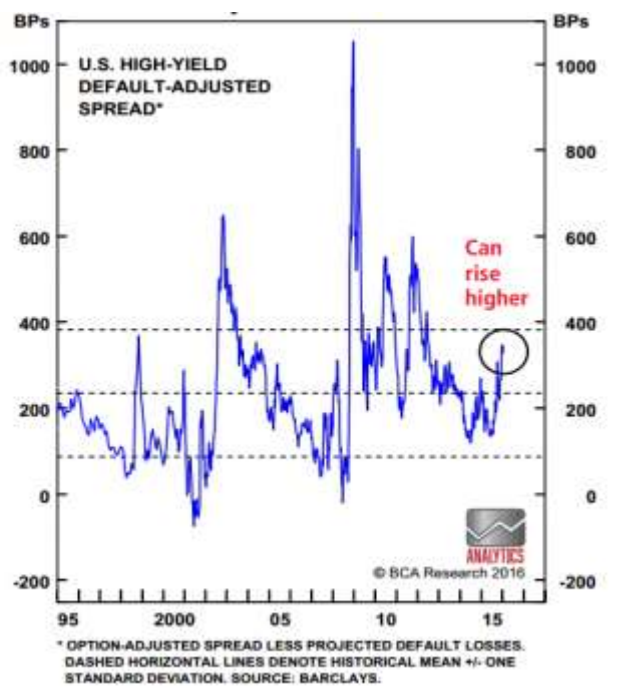
Chart 8: Emerging Markets are not that attractive

Source: BCA

In Europe ECB's expansive monetary policy by asset purchases remains a pillar to support the fixed income market. Government bond yields remain low, e.g. German 10 year bund yields are currently 0.6%. This is not attractive as the upside is limited and a correction could have a severe impact.

European credit remains attractive as corporations are generally still in a good shape with respect to liquidity and debt. Further, default rates will remain low due too low exposure to energy and metals regarding corporate issuances (high yield, corporate loans) in a mildly growing economic environment. Regarding exposure to European high yield there is the risk of contagion if further fund outflows should occur in the US given the strong involvement of the retail investors. By implication, European corporate loans, which are mainly the domain of institutionals investors, will stay rather immune to such dangers.

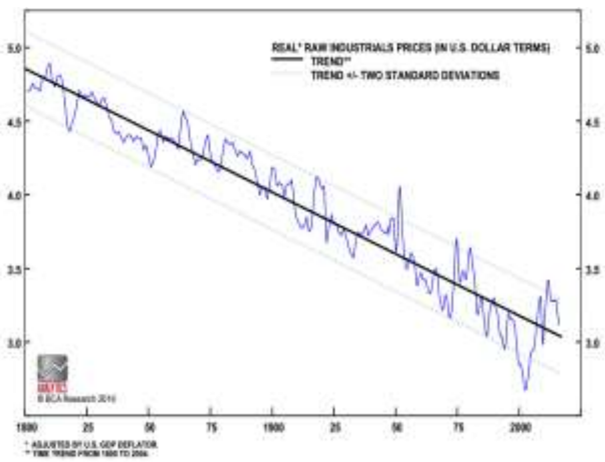
Chart 9: Spreads could widen further



Source: BCA

Finally, a word on commodities whose prices have been ferociously hammered for more than a year. We do not see them as attractive strategic positions unless there is a chance for exploiting spread trading.

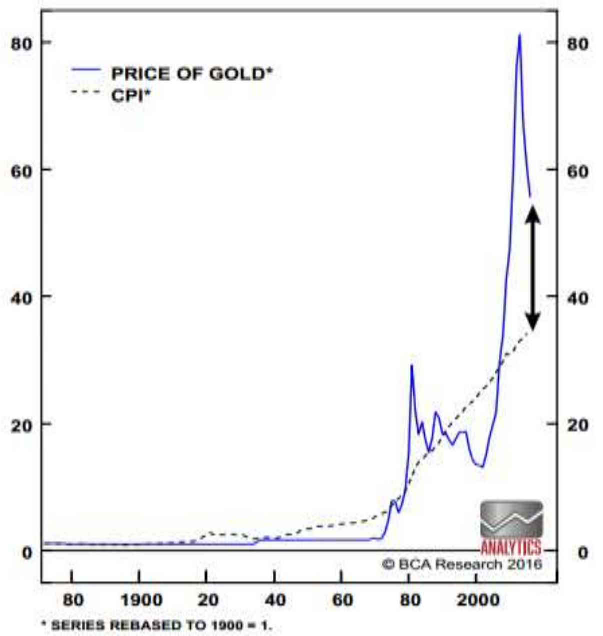
Chart 10: Downwards Trend of Raw Industrial Prices



Source: BCA

As chart 10 reveals, the long-term trend is southwards. Furthermore, precious metals do not look attractive as well as long as the economies are not out of the deflationary danger zone (see chart 11).

Chart 11: Gold Anyone?



Source: BCA

The Model Portfolio Positioning

We continue to keep equity and credit exposures as key pillars in our asset allocation. We expect that financial markets will be continuously volatile in 2016. We remain cautious regarding beta-dependent and long duration exposures. Thus, we keep equity beta low and favor shorter duration exposures.

Equity Long/Short managers are still our preferred choice over straight Beta Long-Only equity managers as we expect continuously elevated market volatility in the months to come, which leads us to cut back on Equity Long/Short strategies with higher net exposures. Equity returns will be more modest. We maintain our general equity exposure with a focus on Europe's improved stock market environment.

The normalization process for interest rates has picked up lately at the long-end of the yield curve. Therefore, there is no imminent need to alter our strategy. Next to short duration exposure we favor European credits/ corporate loans. Lately, we have added U.S. mortgage-backed securities and residential mortgage-backed securities as these bonds are supported by a robust U.S. housing market. We stay invested in insurance-linked securities for diversification reasons.

Having stated all that, we are, aware that we are already late in the business and credit cycle. Therefore, we will generally apply prudent active credit selection as we are determined to avoid exposures to troubled sectors.

Gold stays at a low allocation: Our fundamental view that gold is, per se, a helpful tool to diversify a portfolio, has not changed. However, market sentiment and the absence of inflationary expectations have clearly turned against this precious metal for the time being. Hence, we keep gold exposure at a low level, as a hedge against unexpected macro and geopolitical risks and even inflation surprises.

The overall lackluster outlook for commodities will not lead to a re-investment anytime soon in this asset class.

Appendix:

Market Data Table: 2015 was a tough Year for Investors

Equity Markets	Dec	Nov	Oct	YTD	2014
MSCI World Daily TR with Dividends USD	-1.7%	-0.4%	8.0%	-0.3%	5.5%
S&P 500 INDEX	-1.8%	0.1%	8.3%	-0.7%	11.4%
MSCI Europe Gross	-5.3%	2.5%	8.2%	5.5%	4.1%
MSCI AC Asia Pacific	0.1%	-2.0%	8.6%	-4.3%	-2.5%
MSCI Daily TR Gross EM BRIC US	-1.8%	-3.3%	6.7%	-13.3%	-2.6%
Fixed Income & Credit					
BarCap Global Aggregate (USD Hedged) Index	-0.3%	0.0%	0.3%	1.0%	7.6%
JPM GBI EMU AAA TR USD	1.8%	-4.2%	-0.6%	-9.8%	-3.0%
Global Gov Bond Index All Maturities (USD)	0.7%	-2.0%	-0.3%	-4.6%	-1.8%
Bloomberg EFFAS US Gov Bond 3-5 Years	-0.4%	-0.6%	-0.6%	-0.4%	0.2%
Bloomberg EFFAS US Gov Bond 10+ Years	-0.6%	-1.0%	-1.0%	-4.2%	20.7%
Bloomberg EFFAS EURO Gov Bond 3-5 Years	-0.6%	0.2%	0.3%	-0.9%	2.5%
Bloomberg EFFAS EURO Gov Bond 10+ Years	-2.5%	-0.1%	1.9%	-0.4%	24.5%
Bloomberg EFFAS German Bonds 1+ Years	-1.2%	-0.1%	0.4%	-1.6%	7.8%
Markit iBoxx Global EM LC Bond Index	-1.6%	-1.8%	3.1%	-10.7%	-2.5%
CS High Yield Index value	-3.0%	-2.1%	2.6%	-4.9%	2.0%
Alternatives & Commodities					
HFRX Global Index	-1.2%	-0.7%	1.5%	-3.5%	-0.6%
DJUBS Commodity TR	-3.1%	-7.3%	-0.4%	-24.7%	-17.0%
Gold 1 OZ	-0.3%	-6.8%	2.4%	-10.4%	-1.7%

Source: Bloomberg data

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