Quarterly Investment Letter

4th Quarter 2014

Touché! – How some weak US data punctuated the Equity Market Momentum

The correction in September brought an abrupt end to the advances in the equity market environment investors had seen over the previous weeks. Although there was no significant new information available, the tipping point was some weak monthly US data, which all of a sudden put in question the recovery of the largest economy which had so far been taken for granted. Investors felt the urge to reassess their exposures and decided to sell positions across the main asset classes. Retail investors sold ETFs in droves - particularly on the bond side - with the result that equity markets tanked plummeted while credit spreads widened markedly. Thus, the MSCI World Index ended negative for the quarter with losses mainly in emerging and BRIC equity markets.

The same picture holds true for the global aggregates for fixed income. At aggregate level the sole exceptions were government bonds with maturities above 10 years for the US and the Eurozone which ended in the black despite a negative September. for the quarter US fixed income markets declined across the board in September with negative returns both for safe haven assets such as US Treasuries (UST 10 year yield increased from 2.34% to 2.49%) as well as for "risky" assets such as high yield. For example, the BoAML Global High Yield Index returned -2.64%, which is its worst month since June 2013. Different to earlier this summer, this correction was primarily driven by technicals, not fundamentals. The main reason for the technical weakness was an increased supply of bonds due to an active new issue calendar as well as negative retail fund flows. Global emerging markets local currency bonds lost 3.7% in September and about 4% for the quarter as a whole which showed once more the riskiness of such an exposure. Hard currency emerging market bonds fared much better. See the markets' overview table at the back of this edition for more information.

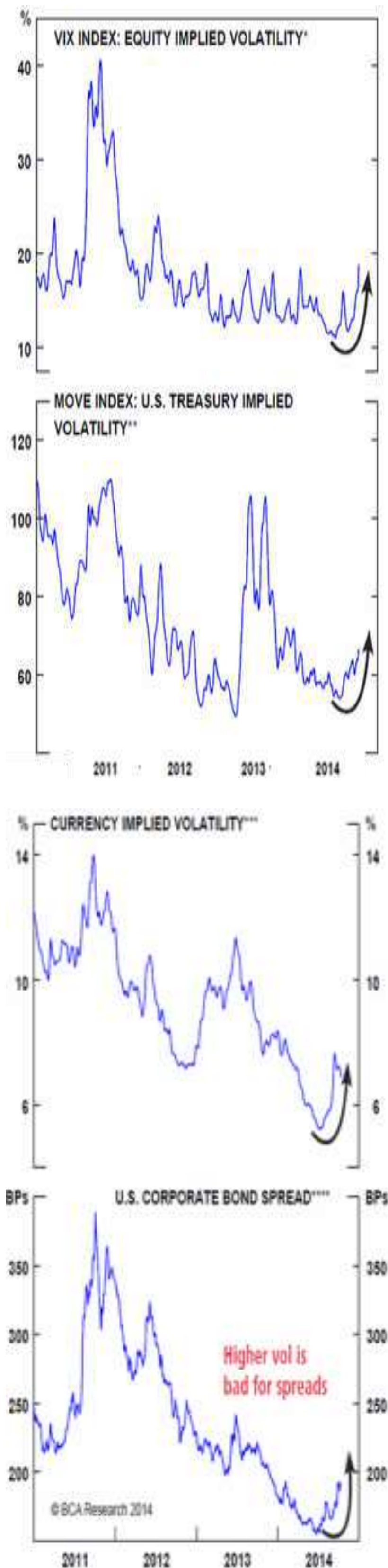
Highlights for Investors

- The key instrument to fix the current financial and economic crises is global growth. The hopes projected into the recovery of the economy were dented in September due to somewhat U.S. weak data. We believe, however, that the U.S. economy will continue to grow at its modest but steady pace.
- The disappointment regarding U.S. growth led to a significant correction in the financial markets. In fact, it was the tipping point for investors who had already growing macro-economic and geopolitical concerns.
- The correction affected particularly the stock markets and credit spreads – both attractive return sources in the current world of zero interest rate policies.
- Concerns regarding global growth and the absence of inflation will slow down the much anticipated monetary tightening. Thus, rates will be lower for longer. This is good news for credit spreads and equities. The former will provide investors with interesting cash flows while the latter will offer value based price appreciations and dividend payments. It is therefore recommended to rely on stock/ securities selection skills of active managers instead of buying just the market.

What are the Investors worried about?

Firstly, it is about global growth. Growth could provide earnings, disposable income and higher tax revenues that could alleviate the governmental and private households' debt burden. But despite the combined efforts of the Fed, the Bank of England, the Bank of Japan and to an extent by the ECB the ample money supply that keeps oozing into the economies seems to fall short of any sustainable results. Growth remains lacklustre and there are no traces of inflation in the real economy at a global level. By the same token the zero interest rate

Chart 1: Uncertainty impacts Volatility



Source: BCA

policy deprives investors of reliable price indications to make proper rational decisions.

Secondly, investors seem to struggle with a "Rubic's cube" of seemingly non compatible signals from the markets. A strengthened USD might be an indicator for the US recovery story or just a confirmation of its safe haven status in uncertain times. If the U.S. economy grows as expected the Fed will tighten, which will presumably strengthen the USD even more with unknown impact on U.S. exports, corporate earnings and risky assets in general. If global growth slows further the Fed might not act but the implication is that earnings growth worldwide will be in decline with once again more negative impact on risky assets over time. The low price levels for the majority of commodities are signals of supply exceeding demand. Partially, this is due to secular supply increases but how much is due to less demand? What is the net effect of lower economic activities while disposable incomes rise, e.g. thanks to lower energy bills?

Finally, it is about an increase of geopolitical risks. Unfortunately, the "peace dividend" of the post-cold war era has disappeared as the world has moved from a unipolar power, i.e. the USA, to a multipolar one that will make international political processes much more complex again. Take the case of Syria as an example. In addition, globalization has intensified the exchange between nations. Unfortunately, it might also facilitate epidemics unless the world community could agree to act in a coordinated fashion. The outbreak of Ebola has touched upon such primal fears.

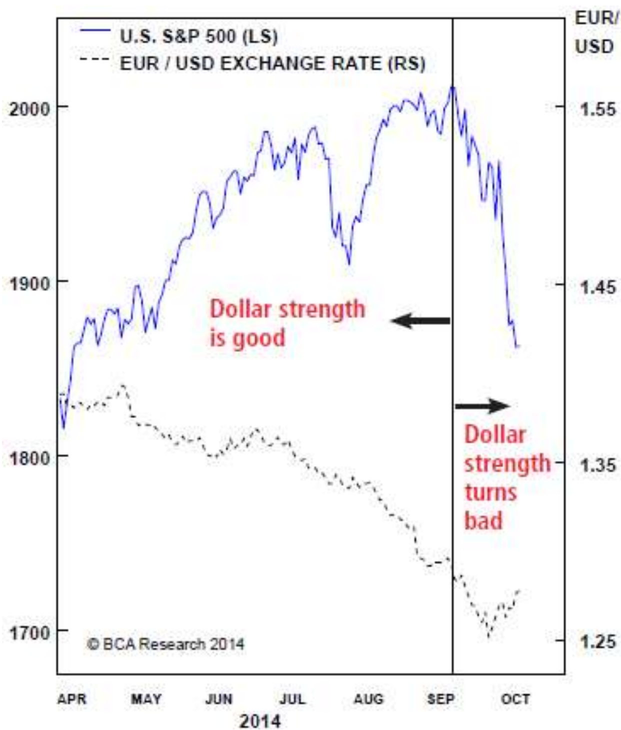
Chart 1 illustrates nicely how market volatility has markedly increased lately for equities, interest rates, currencies and credit spreads.

U.S. Economic Growth continues

Despite some negative macroeconomic numbers, the U.S. recovery stays on track. Maybe the pattern might be somewhat slower but key numbers such as unemployment rates look promising. The economy reflects indeed cyclical strength particularly from the home market. It is quite telling that credit spreads of corporations with a link to global growth widened more than those of more domestic market oriented credits. The deflation scare, i.e. a stagnation of global growth and no inflation, which shook the finance world over the last weeks, will quite likely lead to a postponement of the first rate hike if this impression should remain. As the researchers of BCA pointed out recently, the impact

of lower yields (=credit costs) is likely to outweigh any negative impact of a stronger U.S. dollar[7]. Therefore, further U.S. dollar appreciation could well be compensated by an ongoing lower USD yield curve. See also chart 2.

Chart 2: Has the USD Appreciation reached already a Tipping Point?



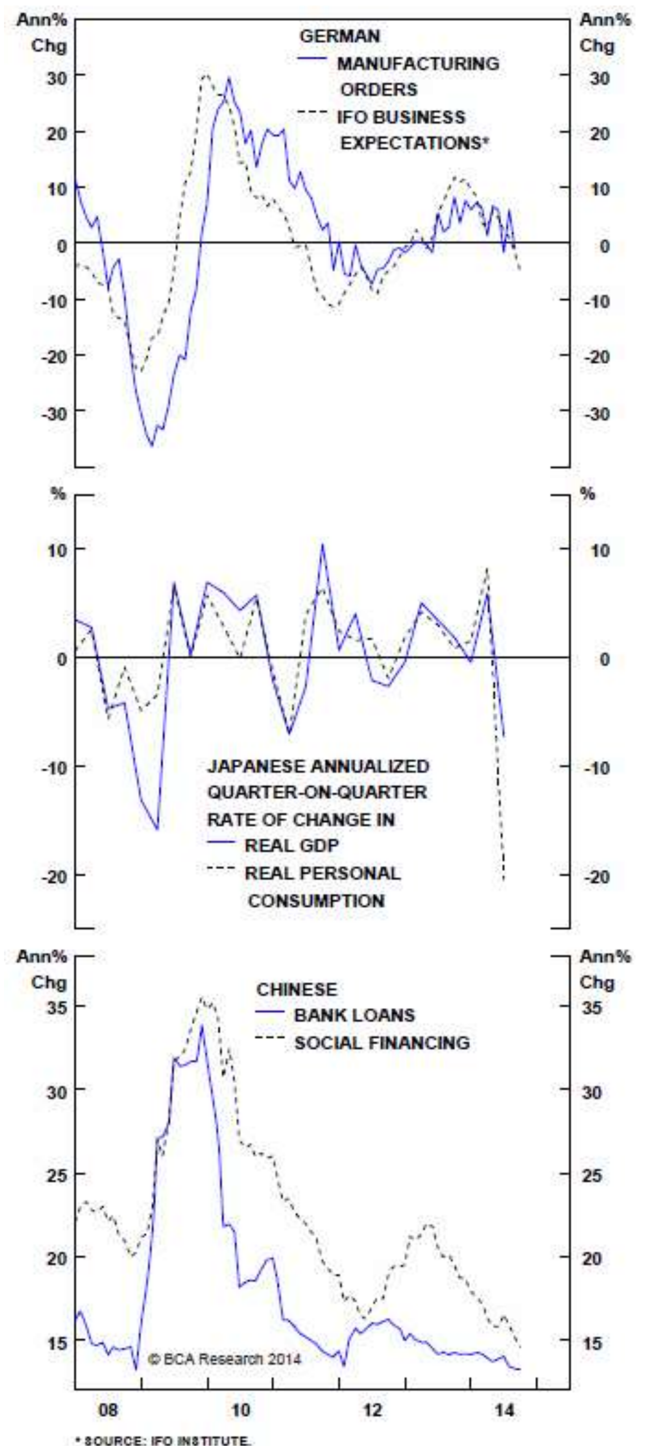
Source: BCA

The World ex USA: Stories from the Greenside Bunker

Chart 3 reflects the difficult macroeconomic condition of major economies. It is fair to state that particularly Europe and Japan resemble a golfer who tries to find the appropriate shot to escape the greenside bunker. Most countries in Europe and Japan face little to no sales' and profits' growth. They face further high unemployment, growing debt and adverse demographic headwinds. So far Germany had been seen as the locomotive that could pull the other ailing economies. However, as the graphic at the top indicates Germany also faces issues of a weakening economy.

Investors got used to the fact that Japan seems to be in permanent recession over the last 25 years – and technically Japan is in recession now - and they reluctantly concluded that this might be also the way Europe goes. The way out could be decisive ECB action or more expansive fiscal policies. The former might happen after the bank stress test (Asset Quality Review) by the end of October. This is overdue as the ECB runs currently a restrictive policy as Chart 4 illustrates. If the TLTROs (=Targeted longer-term Refinancing

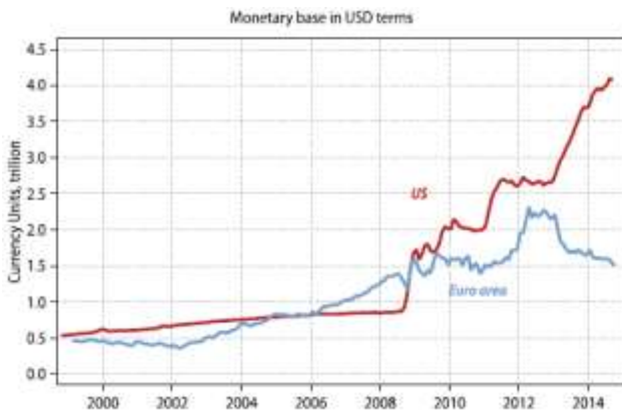
Chart 3: Bad Economic News for the Rest of the World



Source: BCA

Operations) will be ultimately successful, i.e. whether the EU countries in need will take up more credit, has to be seen. So far the results have been meagre. If fiscal stimulus will work it will depend very much on the condition that it is accompanied by structural reforms e.g. in France and in Italy. In the absence of these reforms investors and consumers will be reluctant to invest and consume, respectively, as they would anticipate new hardship to come in the near future.

Chart 4: The ECB preferred mostly Rhetorics over Action so far



Source: GaveKal/ Macrobond

China continues its path to transform its economy, i.e. to reduce its dependency on exports in favor of a stronger domestically oriented economy. In addition, the government is eager to reduce the scale of credits in the economy. This has led to a slowdown of the economy that might undershoot the government's intention to let the economy grow by 7.5%. So far, there are no signs that fiscal stimulus or a more expansive monetary policy are in the offing. For the rest of the world this means less demand for their goods, notably regarding commodities.

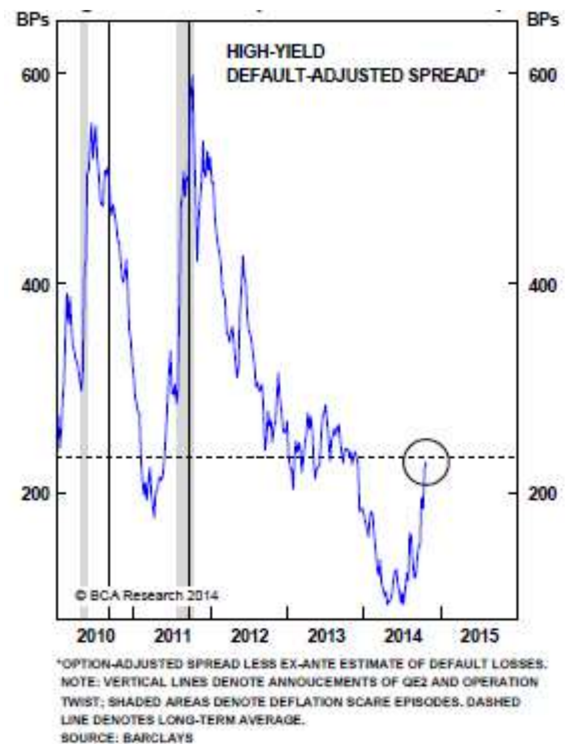
What does this mean for the G7 countries? As BCA recently pointed out: "In the absence of fiscal stimulus, most G7 countries will have to opt for the less-optimal choice of using more QE to stimulate economic activity. This is a recipe for rolling currency depreciation across the world."

Why It still makes sense to be invested in Credit

In our opinion the credit markets have overreacted over the last weeks. The expectation that there will be no imminent rate hike in the coming quarters will reduce interest rate volatility while default rates will stay low. Current valuations after the credit spread widening offer attractive investments both in US High Yield and Loan investments. On a risk adjusted basis, the USD short duration High Yield area offers a particularly attractive investment as it bears low interest rate and credit spread risk, but offers now a yield-to- worst of around 5% in early October.

As pointed out before segments of emerging market hard currency bonds also remain attractive as they offer a higher spread premium. They were not that much affected by the recent market turmoil as the duration effect was positive for the hard currency segment. After the credit spread widening the yield-to-worst has surpassed 5%.

Chart 5: US High Yield remains attractive



Source: BCA

Equities stay attrative but Selection remains Key

Given limited global growth expectations it is probably not a bad idea to reach out for quality stocks and dividend paying companies.

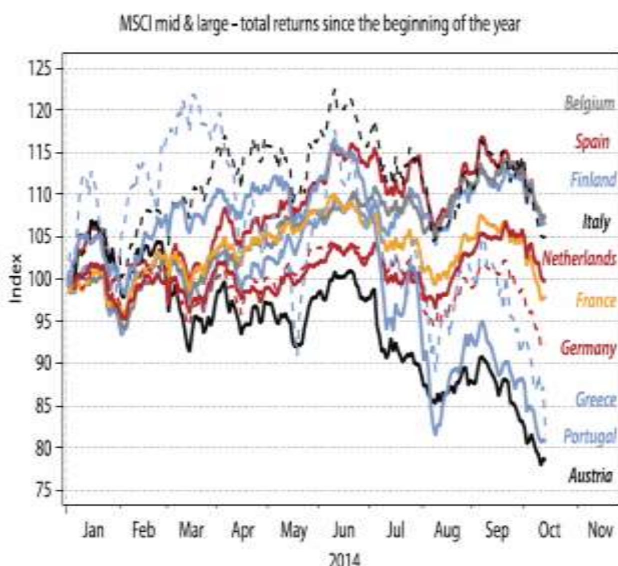
Against expectations, U.S. corporate earnings remain robust with top line growth of 5.5%. Thus, it is fair to state that the U.S. stocks were oversold during the recent correction. As the U.S. emerges

as the strongest G7 country exposure in the U.S. stock market seems to be an evident choice.

As volatility has re-entered the stock markets we would argue that investors would need to be cautious regarding buying the market. Instead success will depend on the selection skills amongst the companies. Particularly in Europe it will be interesting to watch the increased level of corporate actions as companies will reshape their activities to face a tougher environment. This means they will focus on what they ~~can~~ do best and will sell what they declare as irrelevant.

The recent market correction penalized all equity markets in Euroland indiscriminately and unrelated to the individual economic or corporate standing. This created opportunities to detect undervalued stocks in a still not cheaply priced equity environment.

Chart 6: EU Stock Markets reacted independently of individual Economic Strength.



Source: GaveKal

The Model Portfolio Positioning

We continue to keep equity and credit exposure as key pillars in our asset allocation. But we stay alert to instantly react to relevant changes in the markets.

We remain confident that asset prices will be supported. Although the normalization process for interest rates has somewhat slowed down it will continue and there is no imminent need to alter our strategy.

We keep our exposure to fixed-income instruments mainly in USD, EUR and GBP (EUR hedged) credits and loans. Spreads widened in September and early October. Thanks to ultimately more attractive yields we will be able to recuperate the recent setbacks quickly. So far there has been no changes regarding low default rates which supports our case. We continue to stick to our preference for short-dated portfolio duration.

We keep our exposure to emerging market debt in hard currency which – as an exception from our general view – has more longer duration risk as higher yield levels (i.e. above 5%) should compensate for the risk we take.

With respect to insurance linked securities (ILS) we evaluated that valuation and spread levels are still relatively stretched in the current "hunt for yield environment". Hence, we wait on the sidelines to re-enter the market as we like to diversify further our credit exposure within our fixed income allocation.

The second pillar is our exposure to Equity Long/Short and Event Driven managers which we prefer over straight Beta Long-Only equity managers. The recent correction might have provided some beta but we prefer the versatility of active hedge fund managers in this current environment with increased volatility.

Gold stays at a low weight: Our fundamental view that gold is, per se, a helpful tool to diversify, has not changed; but market sentiment and the absence of inflation 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 dim outlook for commodities will not lead to a re-investment anytime soon in this asset class.

Appendix

Market Data Table: September was an ugly Month across the Asset Classes

Equity Markets	Sep	Aug	Jul	YTD	2013
MSCI World Daily TR with Dividends USD	-2.7%	2.2%	-1.6%	4.3%	27.4%
S&P 500 INDEX	-1.6%	3.8%	-1.5%	6.7%	29.6%
MSCI Europe Gross	0.3%	1.7%	-1.6%	4.5%	16.4%
MSCI AC Asia Pacific	-5.1%	-0.6%	2.1%	-0.7%	9.3%
MSCI Daily TR Gross EM BRIC US	-9.1%	3.2%	3.2%	1.6%	-3.3%
Fixed Income & Credit					
BarCap Global Aggregate (USD Hedged) Index	-0.3%	1.2%	0.2%	5.3%	-0.1%
JPM GBI EMU AAA TR USD	-4.2%	0.3%	-1.7%	-1.5%	2.2%
Global Gov Bond Index All Maturities (USD)	-3.2%	0.5%	-1.0%	-0.3%	-6.8%
Bloomberg EFFAS US Gov Bond 3-5 Years	-0.4%	0.4%	-0.6%	-0.2%	-3.1%
Bloomberg EFFAS US Gov Bond 10+ Years	-2.0%	3.8%	0.5%	12.5%	-15.9%
Bloomberg EFFAS EURO Gov Bond 3-5 Years	0.1%	0.3%	0.1%	3.2%	-0.8%
Bloomberg EFFAS EURO Gov Bond 10+ Years	-0.6%	4.0%	1.8%	17.9%	-2.2%
Bloomberg EFFAS German Bonds 1+ Years	-0.3%	1.6%	0.5%	5.6%	-4.6%
Markit iBoxx Global EM LC Bond Index	-3.7%	0.3%	-0.6%	1.5%	-6.1%
CS High Yield Index value	-2.1%	1.5%	-1.3%	3.7%	7.4%
Alternatives & Commodities					
HFRX Global Index	-0.8%	1.1%	-0.9%	1.2%	6.7%
DJUBS Commodity TR	-6.2%	-1.0%	-5.0%	-5.6%	-9.5%
Gold 1 OZ	-6.2%	0.4%	-3.4%	0.2%	-28.0%

Source: Bloomberg data

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