SILVERHORN ALPINUM

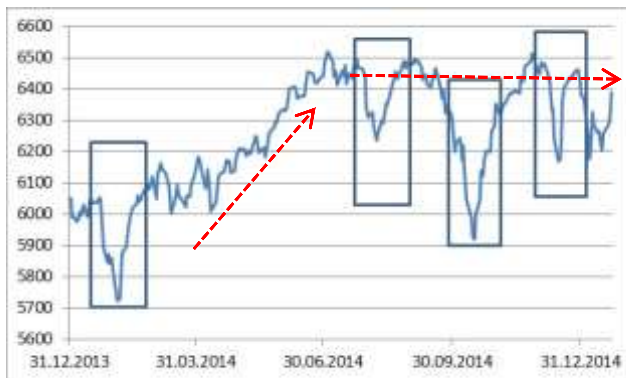
Quarterly Investment Letter

1st Quarter 2015

Investments at a Time of Deflation and Easy Monetary Policies

The final quarter of 2014 provided a roller coaster of price movements in the financial markets. After past corrections in January/ February and July/ August of last year, the investors had to face a further two drawdowns in the fourth quarter, namely in September/October and December, with strong rebounds in between and after mid-December (see Chart 1). Many analysts see the rapid oil price decline and its implications e.g. regarding oil producing countries as the main culprit.

Chart 1: In 2014 Global Equity Markets made most Gains early in the Year



Source: Bloomberg, MSCI

The clear winners for 2014 were the US whose economy had increasingly gained momentum that also inspired the US equity market which led global equities for the second year in a row. For example, the S&P 500 gained 11.4% in 2014 whereas the equity markets of Europe, Japan and emerging markets performed negatively. The MSCI World index achieved a performance of 5.5% for the year whilst the MSCI World ex US was closer to -4% in USD terms. BRIC countries had another bad year dragged down by an ailing Russian stock market and weak Brazil. According to MSCI they lost 2.6% after a previous loss of 3.3% in 2013.

Highlights for Investors

- Finally, the US will be in the lead to promote economic growth. The majority of other countries are lagging behind.
- This economic mismatch brings the synchronicity of expansive monetary policies amongst the big players to an end. The Fed will ceteris paribus finally increase its key interest rates later in 2015 to be "ahead of the curve".
- As the ECB has stepped up its quantitative stimulus measures, the world will not be short of liquidity. The weaker Euro will offer some windfall profits to exporters from the Eurozone while imported inflation will remain low thanks to low energy prices for the time being.
- Weak oil prices are rather a function of excess supply than a sign of an impending global recession. The deflationary impact of lower energy prices should act as an economic stimulus.
- As growth concerns abate investors should continue to focus on investment opportunities in the equity markets. European stocks will be more at the center of attention following ECB's recently launched stimulus program. Regarding fixed income, long duration exposure should be avoided. Corporate exposure remains still more attractive than investments in overbought sovereign bonds.

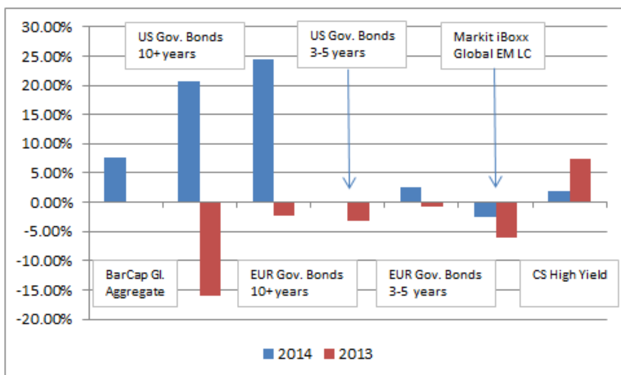
In hindsight, a purely long exposure in long duration bonds and equities would have yielded a return of about 7% for the year assuming the investor was truly willing to take the drawdown risk and willing to tolerate the significantly increased volatility. Regarding equities, for instance, in March/ April one would have witnessed a rotation regarding sectors, style, size and regions all at the same time that made some companies lose 20% or more while, for instance, the S&P 500 as an aggregate still posted positive numbers for the months, respectively. Likewise the reversal of US interest rates did not happen

as investors still bought highly overvalued, but seemingly safe, long-term government bonds. It is remarkable that the key gains for the equity and the bond markets were already made by late spring whereas in the second half both markets moved sideways with augmented volatility.

Fixed income investors continued to search for yield and safety to the benefit for long duration US treasuries, e.g. +20.7% for 10+ years bonds, and Euro government bonds (10+ years) with a positive performance of 24.5% for the year. In contrast, high yield bonds and emerging market bonds faced setbacks. The high yield market faced increased volatility following a deterioration of macro conditions including the oil price related impact and adverse technical dynamics due to fund flows. See also Chart 2 for more details.

The growing strength of the US economy supported also the US dollar that seems to have overcome its relative weakness against the other currencies. Furthermore, the Fed's moves to prepare the world for US rate increase accentuated this development.

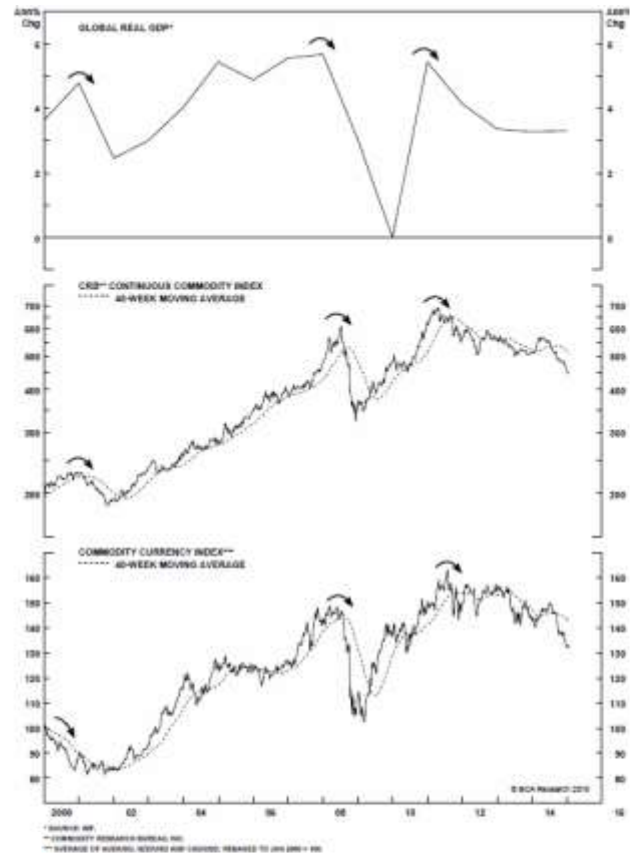
Chart 2: Against the Odds: In 2014 Long Duration would have paid off in Local Currency!



Source: Bloomberg

Commodities continue to have a difficult time, aside from exceptions such as coffee, as excess supply coincides with foot-dragging global growth. Hereby, China as a major consumer will continue to play a crucial part regarding the development of commodity prices. Chart 3 shows the close relationship between Global GDP and its influence on commodity prices and commodity-related currencies. It is obvious, how the ongoing weak economic growth environment takes its toll on the commodities market. With respect to gold, geopolitical concerns were not strong enough to overcome the negative impact of the prevailing dominating deflationary environment. Thus, the gold price declined by 1.7% for 2014.

Chart 3: Commodities - Impacted by the weak Global Economy



Source: BCA

Where do we go from here?

In the last edition we spoke about three concerns of the market participants. The first two, i.e. global growth outlook and seemingly incompatible market signals, are obviously interconnected. It is fair to say that the massively lower oil price will have immediately a net positive impact on the world economy as it instantly increases purchasing power of energy consumers. Estimates for the US by BCA indicate an impact of about USD 180bn, for instance, which is equivalent to 1% of GDP. Increased consumption will ultimately push up growth rates worldwide.

Obviously, low oil prices will harm the previously booming US oil and gas industry as well as offshore drilling projects in the Arctic Sea, off the shores of Brazil and elsewhere. But to put it into perspective: the US energy industry employs merely 600'000 people with investments that contribute about 1% to US GDP. According to research, in the worst case,

about a third of jobs will disappear which is undoubtedly bad but we need to acknowledge that the US economy creates currently about 200'000 to 250'000 new jobs per month as well. Thus, the US economy will be in the lead whilst other economies will most likely lag behind. China will struggle to achieve the targeted growth rate of 7% though it has enough "dry powder" to stimulate growth.

Chart 4: A Weaker Euro And Lower Oil Prices Should Support Growth

Source: BCA

And there is still geopolitical risk as there will be little chance that it will disappear in the near future. So far investors have coped well but e.g. open warfare in the Ukraine or more terrorist attacks in developed countries will seriously test the market sentiments. Needless to say that timing of this is practically impossible.

Equities remain attractive after all

Despite the good progress equities have made over the last years, we are still convinced that this asset class offers still value to investors. Good companies can offer real asset values, ideally, plus attractive cash flow yields. In addition, the de-leveraging cycle helped to prop up their cash balances. This allows them to buy back shares but as a side-effect it reduces the amount of equities to be purchased in the markets. The current monetary policies which are still predominately expansive will contribute additional tailwind despite some doubts about their efficacy.

The Eurozone might be in for a (positive) Surprise

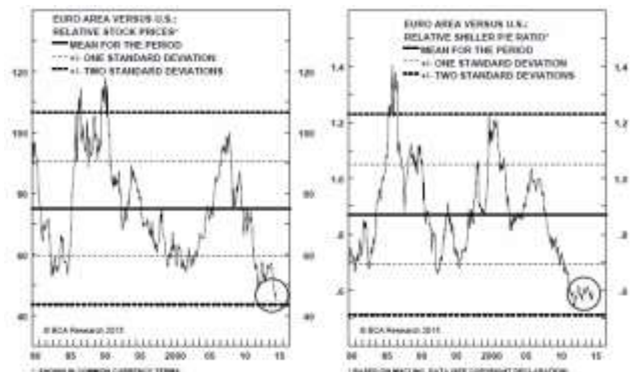
Contrary to popular belief the monetary policy of the Eurozone was less expansive as compared to the official statements and general perception over the last years. Some say that the ECB even underdelivered given the little impact the targeted longer-term refinancing operations and other initiatives (e.g. regarding ABS) seem to have had so far.

This will change as Mr. Draghi announced the ECB's bond buying program with a targeted volume of EUR 60bn per month from March 2015 until September 2016 including the option to extend the measures if needed. This should help to improve credit flows also in the private sectors of the Eurozone. This coincides with a significantly lower EUR and the currently low oil prices. Hence, investors could be surprised by a pick-up of GDP growth later this year above the anemic growth expectation around 1.2% for the region.

It is also worth noting that European companies' balance sheets are close to record levels while the net debt/equity ratios have reached a low point when compared to the last two decades.

Thus, it is obvious that continental European stocks should benefit from this current environment, maybe except for Switzerland which faced a strong appreciation of the CHF after the Swiss National Bank lifted its peg against the EUR. According to BCA the EUR area stock market is relatively attractive as compared to the US (see Chart 5).

Chart 5: European Equities are attractive as compared to the US'



Source: BCA

So what could derail this positive outlook? We mentioned geopolitical risks already. In addition, the new

Greek government seems to be on collision course with the EU at it tries to shake off the requested austerity policies to cure its economy and to reduce its debt. However, we believe that after some noise both parties will end up with a renegotiated agreement.

Expensive Government Bonds

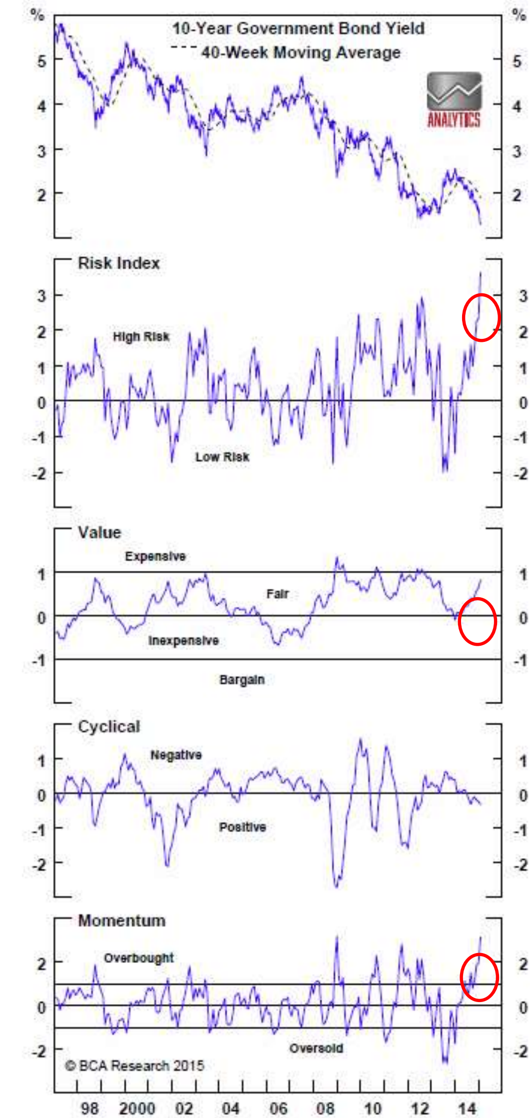
The rally of global sovereign bond yields in 2014 continued into January of 2015. The 10 year German bund yield is now close to 30bps while yield of the 10 year US Treasury is currently below 1.7%. Therefore our assessment remains very cautious regarding such long duration exposures.

Chart 6 makes use of the 10 year government bond yields to illustrate these points nicely. The top of the chart shows how yields came down over the last 15+ years. At present the risk index as calculated by BCA has increased significantly due to negative momentum (i.e. increased probability of rising yields in the future) which signals "overbought" and cyclical factors that imply a more positive economic environment that implies future rate increases. Nevertheless, valuation is still in the "fair" region according to the chart although it is also approaching the upper border towards becoming expensive.

In contrast, corporate credit fundamentals outside the energy sector remain solid as interest coverage ratios continue to improve due to the low interest rate environment and leverage ratios remain largely unchanged. We believe also that the pressure of the oil price decline on energy related bond prices has diminished at current levels.

After a strong depreciation of the EUR we would foresee a likely trading range vis-à-vis the USD between 1.10 and 1.20 in the coming months as long as there are no additional ECB actions or other news that will affect the value of the EUR. The strength of the USD and the absence of inflation might very well influence the FED's decision with respect to its announced interest rate increase. Timing and sizing are subject to a lot of ongoing speculation amongst analysts. Weighing the arguments, the probability of a rate hike over the next months is rather low, unless there were clear signals of re-emerging inflation whilst US growth continues in strength.

Chart 6: Global Sovereign Bonds are Expensive



Source: BCA

However, we cannot rule out that the Fed might be tempted to make a point and to re-establish its street credibility by a symbolic move of, say, 25 to 50bps only during the year to demonstrate that it is "ahead of the curve". It would not be the first central bank this year to surprise the markets…

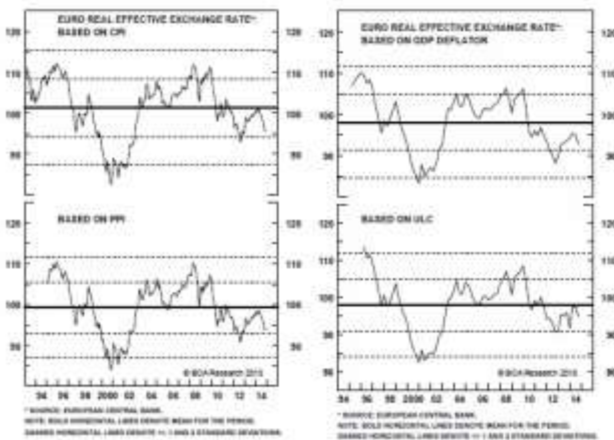
In any case, we expect that the USD will stay relatively strong versus the other currencies as compared to the recent past.

Chart 7: The USD strengthened to a Point where it may hurt…

Source: BCA

Meanwhile, the JPY seems to have clearly undershot in the wake of "Abenomics" and excessive quantitative easing by the Bank of Japan. The Chinese might be tempted to devalue their currency to stimulate their economy which would challenge the rest of the world. As the Chinese economy seems to grow less rapidly the pressure on commodity currencies will continue due to excess supply that meets lower demand. In a recent BCA presentation on currencies, the speaker indicated that growing concerns regarding "fiat currencies" might support gold in the medium term.

Chart 8: …whereas the EUR is not Overvalued



Source: BCA

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. The normalization process for interest rates seems currently stalled but it will continue once the Fed will start tightening later this year.

We keep our exposure to fixed-income instruments mainly in USD, EUR and GBP (FX hedged) credits and loans. So far there have been no changes regarding low default rates which support our case. The lower oil prices will affect the US energy sector but its impact on overall default rates will be negligible for our investments. We continue to stick to our preference for short-dated portfolio duration. As before we have a preference for money managers with focus on high quality businesses and who run portfolios with positive asymmetric pay-off.

We lowered our exposure to emerging markets as the current environment is increasingly difficult for these countries.

We are about to build up positions in insurance linked securities (ILS) again. In contrast to the past we emphasize more the exposure in private transactions as they do offer more attractive risk-return ratios. We dampen the impact of increased illiquidity through careful management of the allocation for the respective portfolios.

The second pillar is our exposure to Equity Long/Short and Event Driven managers which we prefer over direct Beta Long-Only equity managers. We continue to prefer the versatility of active hedge fund managers in this current environment with increased volatility.

Gold stays at a low weight in our conservative portfolios: Our fundamental view that gold is, per se, a helpful tool to diversify, has not changed; but the current deflationary environment has 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: December was another difficult Month in 2014 across the Asset Classes.

Equity Markets	Dec	Nov	Oct	YTD	2013
MSCI World Daily TR with Dividends USD	-1.6%	2.1%	0.7%	5.5%	27.4%
S&P 500 INDEX	-0.4%	2.5%	2.3%	11.4%	29.6%
MSCI Europe Gross	-1.4%	3.0%	-1.9%	4.1%	16.4%
MSCI AC Asia Pacific	-2.0%	-0.8%	1.1%	-2.5%	9.3%
MSCI Daily TR Gross EM BRIC US	-5.3%	-1.3%	2.6%	-2.6%	-3.3%
Fixed Income & Credit					
BarCap Global Aggregate (USD Hedged) Index	0.5%	0.9%	0.7%	7.6%	-0.1%
JPM GBI EMU AAA TR USD	-1.7%	0.4%	-0.2%	-3.0%	2.2%
Global Gov Bond Index All Maturities (USD)	-0.5%	-0.5%	-0.6%	-1.8%	-6.8%
Bloomberg EFFAS US Gov Bond 3-5 Years	-0.7%	0.5%	0.6%	0.2%	-3.1%
Bloomberg EFFAS US Gov Bond 10+ Years	2.2%	2.8%	2.1%	20.7%	-15.9%
Bloomberg EFFAS EURO Gov Bond 3-5 Years	-0.3%	0.1%	-0.5%	2.5%	-0.8%
Bloomberg EFFAS EURO Gov Bond 10+ Years	2.1%	2.9%	0.5%	24.5%	-2.2%
Bloomberg EFFAS German Bonds 1+ Years	0.9%	0.7%	0.5%	7.8%	-4.6%
Markit iBoxx Global EM LC Bond Index	-4.6%	-1.6%	2.3%	-2.5%	-6.1%
CS High Yield Index value	-1.7%	-0.8%	0.9%	2.0%	7.4%
Alternatives & Commodities					
HFRX Global Index	-0.8%	0.3%	-1.3%	-0.6%	6.7%
DJUBS Commodity TR	-7.6%	-4.1%	-0.8%	-17.0%	-9.5%
Gold 1 OZ	1.5%	-0.5%	-2.9%	-1.7%	-28.0%

Source: Bloomberg data

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