SILVERHORN ALPINUM

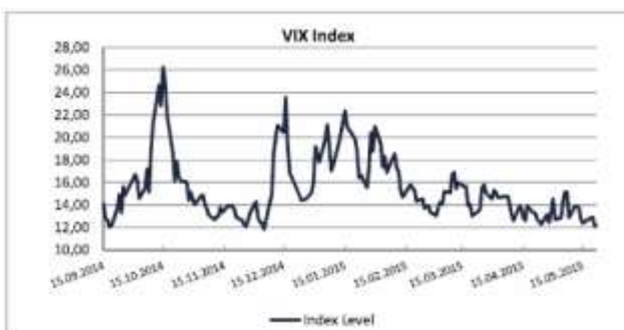
Quarterly Investment Letter

2nd Quarter 2015

For now, Developed Economies outpace the rest of the World

In the first quarter of this year, equity markets continued to rally. First and foremost, the German equity market was on fire across all market capital levels. MSCI Europe delivered 15.9% while e.g. the DAX jumped by more than 22%! The drivers are obvious; quantitative easing and a weaker EUR provided an opportunity for investors to benefit from the anticipated stronger growth scenario in Europe. Given the strong performance in 2014, it came as no surprise that the US equity markets moved sideways (0.4% YTD) although with big swings in both directions. In addition, the uncertainty of an impending Fed rate hike added to the headwind. Thus, the MSCI World index moved up by only 2.5% in the first quarter of the year. Despite doubts about "Abenomics", the Japanese equity market gained pace (about 10% YTD), too, while China's stock market continued to recover also.

Chart 1: Stock Market Volatility remained elevated during the first Months of the Year but subsequently moved back down …



Source: Bloomberg

There was a clear divide in the fixed income markets regarding short and longer maturities. The longer maturities could profit from declining interest rates while the shorter maturities were subject to more volatility. Long German Bunds (10+ years) gained by more than 11% whereas emerging markets local currency bonds suffered by -2.5% in the first quarter.

Increased volatilities of risky assets and emerging trends helped to propel hedge funds as well. Thus, the broad aggregate of the HFRX was up by 2.1% which was the highest performance for the last two years. Interestingly, stock market volatility as measured by the VIX for the S&P 500 has declined suc-

Highlights for Investors

- Global growth is happening but it remains sluggish. The economic impact of the gigantic QE measures, at global level, remain underwhelming. Please note that in Q1 2015 alone, more than 20 central banks lowered their interest rates!
- At present, the Fed also behaves more dovish than anticipated. Market expectations for a rate hike have shifted towards 2016 but a good deal of uncertainty remains. Nevertheless, the bond markets faced a correction in early Q2 after e.g. yields of German 10 year bunds were close to zero in early April.
- Revived geopolitical concerns regarding the Middle East and the Gulf region have stopped the trend of weakening oil prices although the current excess supply situation prevails unless also the U.S. considers to play a buffer producer to global supply. The anticipated economic stimulus due to lower energy prices failed to materialize so far.
- Despite a strong performance in core European equity markets we continue to favor European equities. However, we expect some sector rotation and a shift from exporters to domestic consumption. The Japanese stock market offers also investment opportunities.

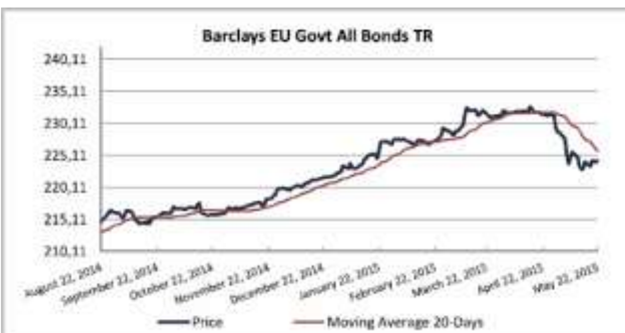
cessively since its temporary highs in January/ February (see Chart 1). In contrast, interest rate volatility as measured by MOVE remains elevated (see chart 2). Commodities continued their downward slide, driven clearly by soft oil prices and generally ample supply effects. Despite an ongoing debate about fiat money, at times of global quantitative easing, the gold price was not able to profit and was flat for the first quarter despite a strong start in January.

Chart 2: ...whereas Interest Rate Volatility stays elevated

Source: Bloomberg

This picture started changing in the first half of the second quarter. After further gains in the bond market prices, particularly in Europe, the yield curves at the longer end snapped back due to the increased probability of a Fed hike. Quarter-to-date the Barclays EU Government All Bonds lost 3.3% as compared to -0.2% of the segment under 5 years. Increased geopolitical risk (Yemen) also made the oil prices rebound (approx. +25%) at the same time. This injected also insecurity in the equity markets where European markets started to lag behind the rest of the world in aggregate.

Chart 3: The EU Bond Market Rally reversed abruptly in Q2

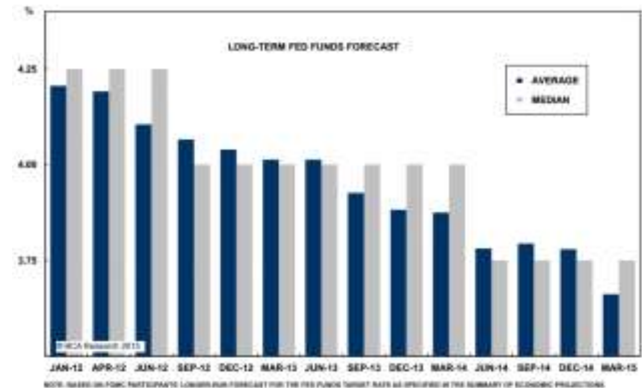


Source: Bloomberg

Despite a disappointing first quarter result, U.S. economic growth is trending upwards. Particularly, private consumption should be propelled by rising payrolls and lower oil prices. With it, the unemployment rate has fallen below the critical point of 6.5% set by the Fed while the inflation rate has started to trend at and above 2% as Chart 2 indicates. Unless, the Fed changes its stance, the economy seems to be entering a stage which would justify an increase of the Fed rates in the not so distant future. However, U.S. economic growth will be moderate as compared to other post crisis/ recession periods in the past. On the one hand, there is no full household re-leveraging cycle in sight and there will be less public spending for budgetary reasons. On the other hand, there is a tendency towards less investments due to slower population growth and towards a more capital-lie (?) economy as BCA put it.

It is not surprising that the Fed's estimate of the neutral rate is declining as it adjusts to the new reality as chart 4 reveals.

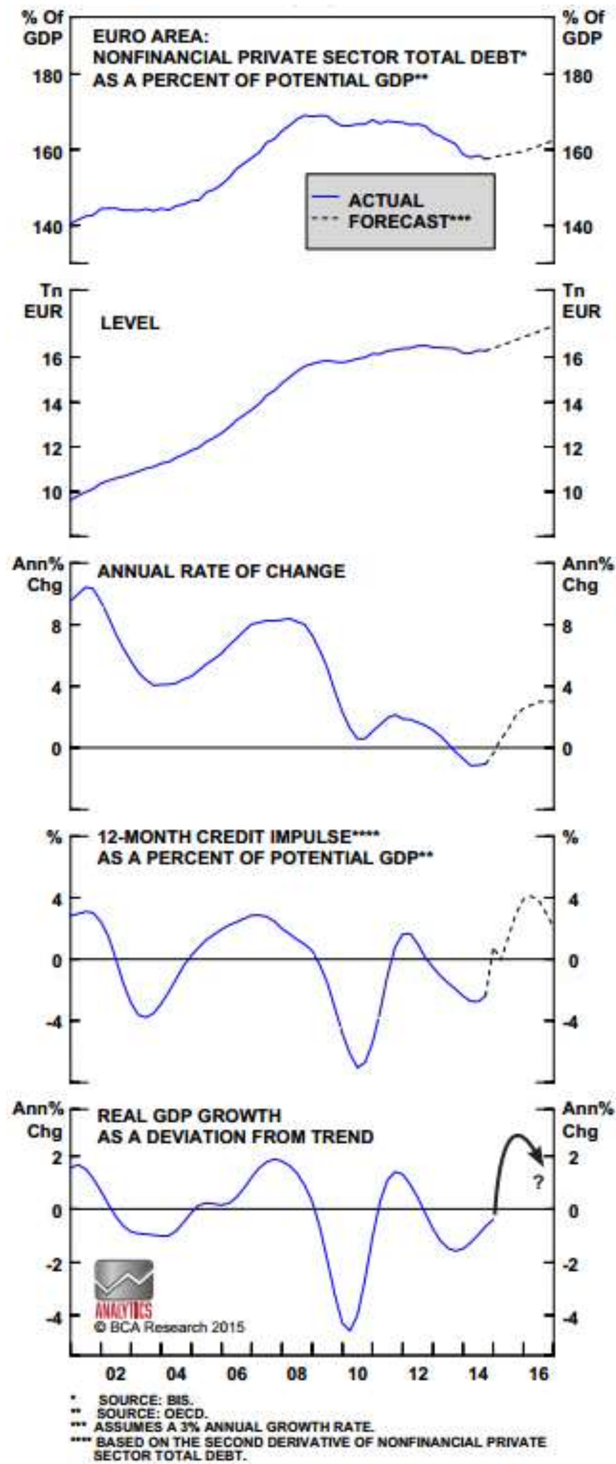
Chart 4: Fed's Estimate of the Neutral Rate



Source: BCA

There are indications that the Eurozone might be back on a growth pattern. Strong stock market performances might be early indicators. Some input clearly stems from windfall effects of a declining oil price and a weaker EUR. But there might be also less pressure regarding deleveraging and regarding austerity measures. A modest increase in credit growth will have a positive impact on economic activity. As BCA points out in chart 5, " if nominal credit growth recovers to a mere 3%, this alone could boost growth by more than two percentage points over the next 18 months. Having stated this, it has also to be clear that the Eurozone has similar if not worse issues regarding future growth trends than described above for the U.S. economy.

Chart 5: Euro Area: Easing Deleveraging Pressure



Source: BCA

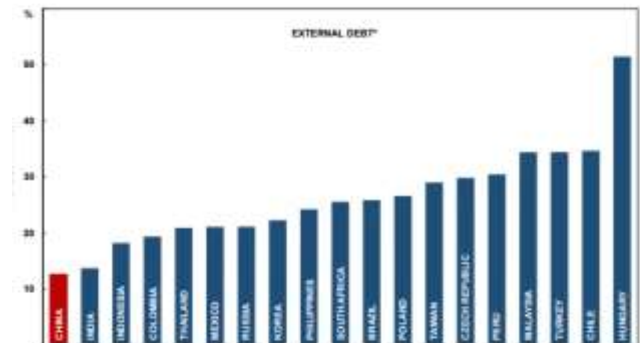
Despite the stimulus injected by "Abenomics" and the Bank of Japan, the Japanese economy has not truly reshaped itself. The most evident consequence of these measures is the strong devaluation of the yen which should help to price Japanese goods back into the goods markets as chart 6 shows.

Chart 6: Euro Area: Easing Deleveraging Pressure

Source: BCA

We expect that the Bank of Japan will continue with its fierce expansive monetary policy just like the ECB in Europe.

Chart 7: Chinese external Debt is benign



Source: BCA

As the Chinese economy is in a state of transformation from an export oriented economy towards a domestically driven one, we have to expect slower growth. The declared war on corruption and the governmental fight against excessive uncontrolled credit growth will lead to additional interferences that could lead at times to the conclusion that the economy is close to crisis mode. However, China is in a strong position with plenty of currency reserves, great economic strength and still elevated interest rate levels which provide room for manoeuver for the Chinese leaders. Chart 7 shows, for instance, the low level of

external debt of China as compared to other countries.

The View on Risky Assets

The U.S. equity market is not cheap as chart 8 reveals. All shown common indicators lie currently significantly above the average value with respect to PE ration, price-to-sales ratio and price-to-book ratio and, logically, below average regarding the dividend yield. After a formidable run in the past it is highly likely that earnings will have to slow down. A strengthening USD and more importantly an imminent Fed rate rise will have an adverse impact on the financial markets.

In contrast, European stock markets are lagging behind. Particularly European earnings have been far weaker than U.S. earnings. As BCA points out, Euro area stocks trade at a price-to-book and price-to-sales ratio of 1.8 and 1.1, respectively, versus 2.9 and 1.8 for U.S. stocks. Likewise the average dividend yield compares favorably for the Euro stocks given a value of 2.8% versus 1.9%.

Likewise, Japanese equities have gained attractiveness. E.g. on a cash flow basis, Japanese stocks trade at 8.8-times trailing 12-month cash flow as compared to 12.6-times in the case of the U.S. and 9.8-times for Euro area stocks. Chart 9 provides further insights how U.S. stock valuation compares less favorably vis-à-vis the Euro area, Japan and emerging markets.

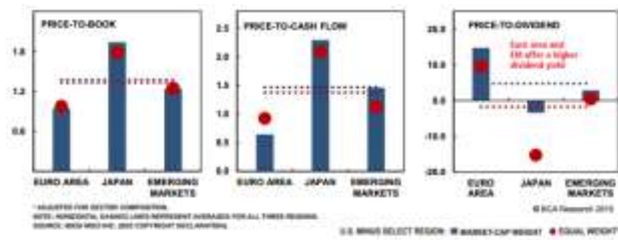
As stated in previous letters, regarding emerging markets it is important to remember that careful selection at country and stock level will be of outmost importance given the wide divergence of quality amongst countries and stocks.

Regarding fixed income, there is reason for caution with respect to long duration exposure in the short run, given the expected Fed lift-off even when there is reason to believe that in the long run long-term yields will not move back to heights we witnessed over the last 50 years. As the low to negative levels of government bonds yields will prevail with the implication that such bonds are expensive (see chart 10), investments in the corporate credit and loans area will remain comparatively attractive.

Chart 8: U.S. Stocks are not cheap on average

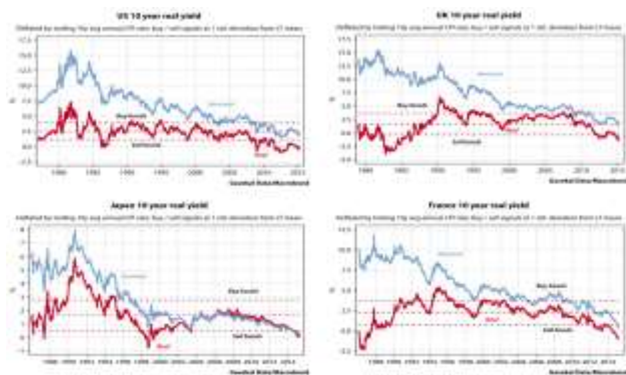
Source: BCA

Chart 9: U.S. Stocks are not cheap in Comparison



Source: BCA

Chart 10: Government Bonds are expensive



Source: BCA

The Model Portfolio Positioning

We continue to keep equity and credit exposure as key pillars in our asset allocation. The search for investment opportunities with attractive risk-adjusted returns and low correlation continues. But we will stay alert to instantly react to relevant changes in the markets.

We remain confident that equity markets and the credit space will be supported. The normalization process for interest rates has picked up lately at the long end of the yield curve and it will continue. Therefore, there is no imminent need to alter our strategy to favor low duration exposure and our focus on credit and loans.

Equity Long/Short and Event Driven managers are still our preferred choice over straight Beta Long-Only equity managers, as we expect more market volatility in the months to come, which lead us also to cut back on Equity Long/Short strategies with higher beta exposures. We maintain our general equity exposure with a focus on Europe's improved stock market environment.

We keep our exposure to fixed-income instruments mainly in USD and in European credits and corporate loans. Excess spreads have compressed further but yields are still comparatively attractive. In addition, default rates remain still very low. We maintain our preference for short-dated portfolio duration. We increased our exposure to emerging market debt in hard currency to profit from the unfolding recovery.

We invested recently again in insurance-linked securities as this type of instrument offers diversification benefits in the portfolio.

Gold stays at a low allocation: 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 lackluster outlook for commodities will not lead to a re-investment anytime soon in this asset class.

Appendix

Market Data Table: In 2015Q1 European Equities were "on Fire" and EUR Government Bonds with long Maturities performed well, too

Equity Markets	Mar	Feb	Jan	YTD	2014
MSCI World Daily TR with Dividends USD	-1.5%	5.9%	-1.8%	2.5%	5.5%
S&P 500 INDEX	-1.7%	5.5%	-3.1%	0.4%	11.4%
MSCI Europe Gross	1.3%	6.8%	7.2%	15.9%	4.1%
MSCI AC Asia Pacific	0.1%	4.2%	1.8%	6.1%	-2.5%
MSCI Daily TR Gross EM BRIC US	-1.9%	4.4%	1.1%	3.6%	-2.6%
Fixed Income & Credit					
BarCap Global Aggregate (USD Hedged) Index	0.6%	-0.6%	1.9%	1.8%	7.6%
JPM GBI EMU AAA TR USD	-2.8%	-0.8%	-4.6%	-7.9%	-3.0%
Global Gov Bond Index All Maturities (USD)	-1.1%	-1.4%	0.0%	-2.5%	-1.8%
Bloomberg EFFAS US Gov Bond 3-5 Years	0.5%	-1.2%	1.7%	1.0%	0.2%
Bloomberg EFFAS US Gov Bond 10+ Years	0.8%	-5.9%	8.7%	3.1%	20.7%
Bloomberg EFFAS EURO Gov Bond 3-5 Years	-0.2%	0.3%	0.4%	0.5%	2.5%
Bloomberg EFFAS EURO Gov Bond 10+ Years	3.3%	1.1%	6.5%	11.2%	24.5%
Bloomberg EFFAS German Bonds 1+ Years	1.5%	-0.4%	2.2%	3.3%	7.8%
Markit iBoxx Global EM LC Bond Index	-2.5%	-0.6%	0.6%	-2.5%	-2.5%
CS High Yield Index value	-0.4%	2.6%	0.4%	2.6%	2.0%
Alternatives & Commodities					
HFRX Global Index	0.3%	2.0%	-0.3%	2.1%	-0.6%
DJUBS Commodity TR	-5.1%	2.6%	-3.3%	-5.9%	-17.0%
Gold 1 OZ	-2.4%	-5.5%	8.3%	-0.1%	-1.7%

Source: Bloomberg Data

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