

Marcuard Heritage: Quarterly Asset Allocation Outlook

4th Quarter 2010

The current Status

Concerns of sluggish global economic growth and ongoing stress in the EMU Sovereign countries have gripped the financial markets over the last quarters. Both themes being somehow inter-related as the financial austerity of many EMU countries, the US and the UK combined with the overall deleveraging of governments, banks and household balance sheets will have significant impacts on the future economic growth across the Developed Countries. Taxes have already started to be raised, affecting the disposable income of millions of people who are also not going to resume consumption through easily accessible credit anymore. The recessionary environment will also affect tax revenues and thereby will complicate balancing the governmental financial households. The effects of the different financial governmental stimulus have faded or failed to trickle through the financial system as banks preferred to repair their impaired balance sheets. Also, the extremely low nominal interest rate environment does not leave much room to central banks to effectively provide supplementary monetary impulses in the developed economies. The recent Fed announcement of further Treasury purchases highlights that the economy is still lacking the necessary strength to stand on its own without further government help although there are some signs of improvements in the US and also in some European countries.

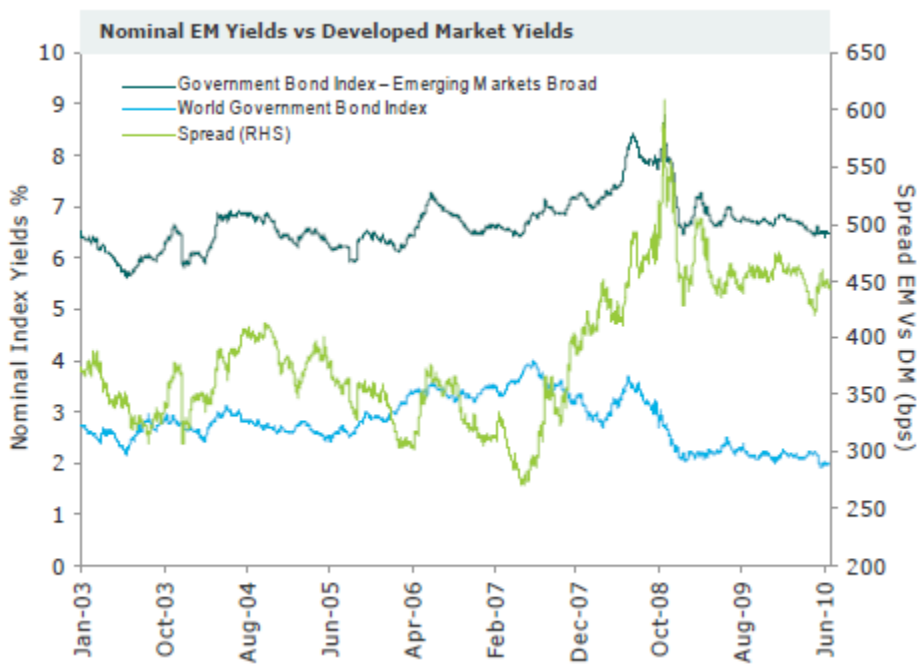
Overall we should see continuing dispersion in economic growth between the countries of the Developed Markets as illustrated by the Northern European countries vis-à-vis the Southern European countries. Further, there will be growth dispersion between the Developed Markets block versus the Emerging Markets block. Finally, there will be continuous performance dispersion across the various asset classes. In the absence of clear and lasting trends, disciplined asset picking, market timing and risk management will be the key success drivers for money managers in the coming quarters. With all the headwind and uncertainties in the different markets, return expectations on risky assets will stay under pressure.

Dispersion across Asset Prices

Performance of the various asset classes year to date has been extremely dispersed. Generally, market prices seem to have consisted of a series of short-lived and very often macro-driven (“risk on / risk off”) trends which were hard to exploit for most managers.

Global equity markets have been mostly indecisive so far this year, with the exception of Europe which had to deal with its own sovereign crisis and Southeast Asia, which has been posting continued economic growth parallel to rising asset prices. Until September, stock prices seemed to have moved range-bound with a slight negative tilt apart from a few positive exceptions such as Germany and cyclical markets like Sweden. Only in September did the S&P 500 move back into positive territory for the year.

Thus far in 2010, government bond of perceived stable governments such as the US and Germany were the big winners as the peripheral EC countries’ debt crisis triggered a flight to safety. At peak, German 10-year bunds yielded below 2.15% in summer 2010. The following chart illustrates the differences in yields between the developed countries and the emerging markets. Despite widespread concerns investors are willing to buy government bonds of the established reserve currencies as they still offer great liquidity and safety. With respect to the US, GaveKal Research speaks of the “Bernanke put” as the market seems to believe to be able to sell back these bonds at a higher price despite indications that the Fed would tolerate higher inflation rates in the future.



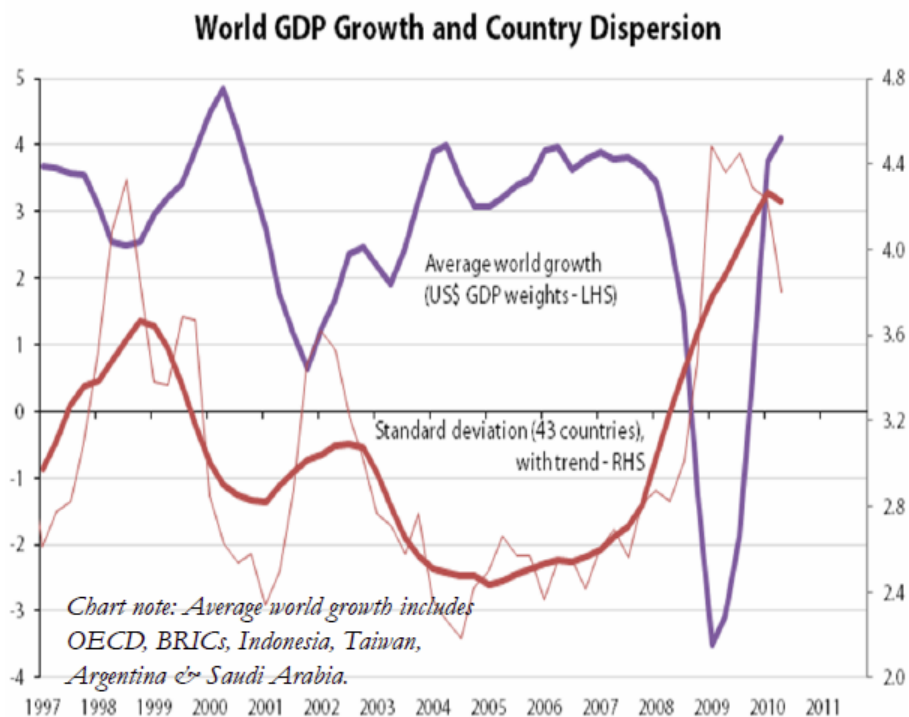
Source: BlueBay Asset Management

Dispersion in Economic Growth

Next to the EMU sovereign crisis, investors have to cope with the plausible scenario of lasting sub-par economic growth in the developed world including the fear of a US double dip. Furthermore, unknown consequences of a surplus of interventionism of many governments to react to the financial crisis and the massive stretch of government debt have caused a high degree of uncertainty. To make matters worse, there are doubts that the Asian growth locomotive China, too, could be prone to a severe correction triggered by an overheated property market, rising inflation and an appreciation of the renmimbi.

As implied above all these events have lead to an investment environment with high uncertainty and little conviction. Most investors seem to prefer the sideline. It is no surprise that the velocity of money has slowed down significantly which neutralized the enormous money injections by the central banks.

Obviously, the sovereign default risk of peripheral EMU countries prevails while the respective countries will still have to demonstrate a serious commitment to consolidate their finances. As much as the developed markets seem to be at the brink of a deflation, most emerging countries have currently had a good run with some countries such as India facing even at rather high inflation rates. In fact, Asian countries might have entered the transition phase shifting focus from production to consumption. The growth dispersion across the Developed Markets and Emerging Markets should therefore continue.



Source: GaveKal Research

The overall economic strength of the Asian countries is also reflected in their currencies versus the USD and EUR. This effect is amplified as global investors are aggressively chasing yields. This has led to ongoing strong capital transfers into these emerging market regions with negative effect on the main currencies. It goes without saying that worries of a US double dip and the EMU sovereign financial stress have also undermined both currencies, respectively.

Thus, it is also not surprising that gold is in heavy demand. It has become temporarily the ultimate currency and a real asset hedge. At the same token, investments in shares of gold mining companies have picked up strongly as their margins are very attractive at current gold price levels.

What to expect in Q4 and beyond?

In contrast to governments most corporates are on average in good shape with healthy balance sheets providing the floor to a classic investment-led recovery once capital spending will start picking up again. This is true for the US but also for European companies. The chart below shows increasing sales growth coupled with margin improvements for Europe. In the past such improvements triggered investment activities and propelled growth.



Source: GaveKal Research

Classic events that could derail global growth such as monetary shocks, commodity shocks or bursting asset bubbles do not seem to be in the offing. At current levels, it is unlikely that the interest rates at the short end will rise anytime soon. This is supported by the recent decision by the Fed to extend Treasury repurchases and by the comment of Mr. Bernanke that some level of inflation is a key target of his mandate. The risk remains that if the US can avoid a double-dip recession medium to long-dated fixed-income instruments might greatly suffer from increasing interest rates as investors would reallocate back to riskier assets. The recent rally in treasuries might offer poor return expectations if the continuing rounds of QE eventually translates into increasing inflation expectations. Obviously, overbought markets like the German bunds would also suffer at the long end once adjustments to inflationary expectations would kick in.

Equity markets might not be able to translate the relatively robust condition of the corporate world into share price appreciation. This may have various causes. Overall, risk aversion is still a key factor based on general uncertainty and lack of trust in the economic recovery. For instance, there are concerns that corporations which were very pro-active cutting cost during the downturn might be unable to react again on possible future revenue contractions.

Nevertheless, there is a good chance that investors will move back into equities once they realize that earnings yields and even dividend yields are more attractive than current bond yields. It might be worth taking the risk. Particularly, global corporations should be able to profit from the strong economic development in Asia and in other emerging market regions. Finally, should growth in the developed countries positively surprise the markets we would expect to see an emerging trend favoring equities.

The Marcuard Heritage Model Portfolio Positioning

We continue to be cautious regarding equity beta exposure and generally reduce the exposure in long-only instruments with broad coverage in the equity markets. Subsequently, we have increased further our exposure with respect to Equity L/S as we prefer active management able to generate alpha from the long and short book. In addition, we favor increased selected exposure in the high dividend yielding equity universe.

On the fixed income side, we reduced the government bond exposure to move further into the liquid and high quality credit space. In addition, we increased the weights for fixed income enhanced instruments with emphasis on less correlated investments such as insurance-linked offerings.

Generally, we increased our exposure to emerging market assets through local sovereign and high quality corporate debt and equity investments.

We increased also the exposure in one single hedge fund manager with a sizable allocation in gold and gold stocks. Should gold prices dip, we will add to the existing physical position to the portfolio.

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