



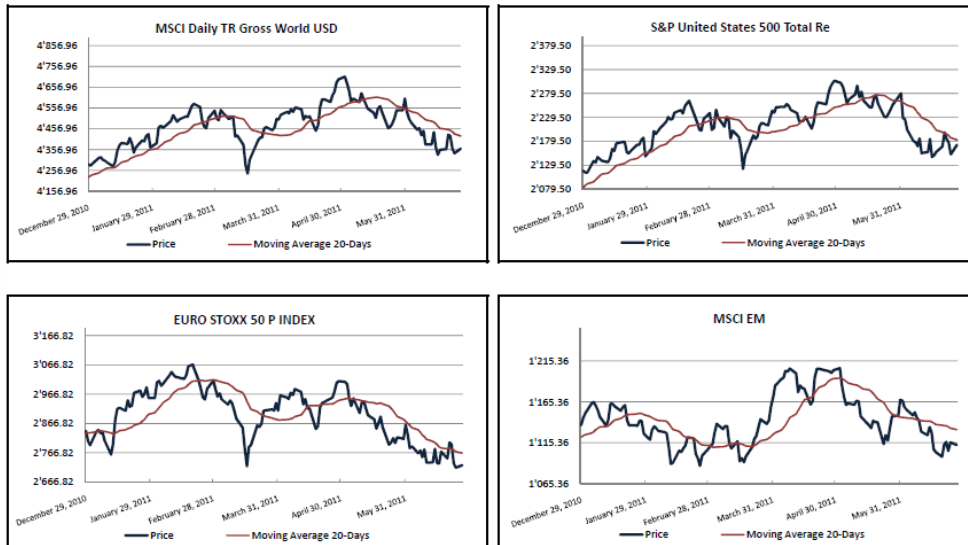
## Marcuard Heritage: Quarterly Asset Allocation Outlook

### 3<sup>rd</sup> Quarter 2011

#### A retrospective view on 2011 Q2

The second quarter of 2011 saw the return of risk awareness in the market. During the first quarter, equity markets seemed unimpressed, no matter what bad news on economic growth, Euro zone debt issues and belligerent actions were made public. It took a few weeks after the Japanese earthquake disaster before the outlook on global growth and equities was re-evaluated. Since then, the equity markets retreated from previous highs in a solid pattern. The MSCI World declined quarter-to-date by over 3% though it is still slightly up year-to-date. The S&P 500 retreated by almost 4% quarter-to-date while the Euro Stoxx 50 index retreated by more than 5% during the same period. The sole exception amongst the Euro Stoxx 50 countries is Germany that is up for the year as its exports are still thriving. As financials suffered so did value stock indices as compared to growth stock indices.

**Chart 1: Equity Markets in troubled Waters**

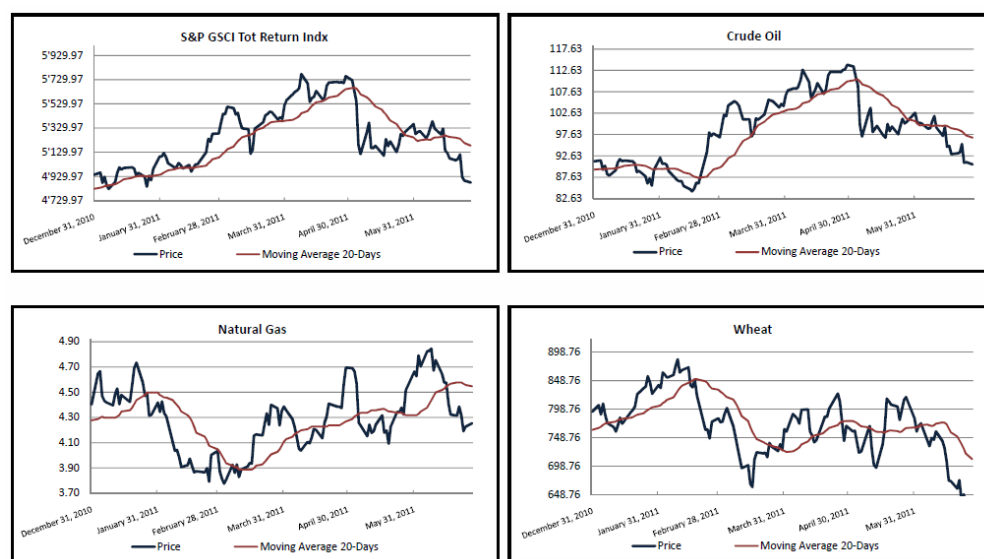


Source: Bloomberg

The string of bad indicators for the global economy led to a reassessment with respect to the perception on future growth. This impacted commodity prices across the board in a negative way. The GSCI index declined more than 10% quarter-to-date. Crude oil and wheat lost more than 15% in this period. But not surprisingly gold succeeded in advancing quarter-to-date by around 4.5% after having paused during the first quarter.

Thus, the market sentiment became solidly bearish in the second quarter. Greece's decision to accept the austerity measures helped to lift the mood at the end of the quarter but the verdict is out whether the market sentiment will stay constructive during the summer.

## Chart 2: Commodity Prices in Decline



Source: Bloomberg

## What to expect from the Summer of 2011?

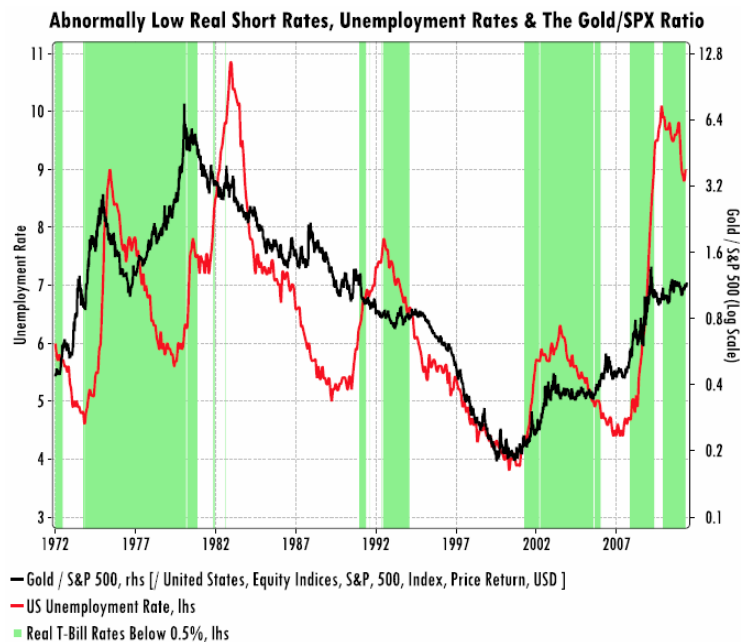
The key stories that might unfold over the next couple weeks will definitely shape the market environment for the year. The dominant theme for the time being is the unsolved Euro-zone sovereign debt problem, behind which, another banking crisis might be looming. Maybe Greece will be given further money injections and the Euro-zone may therefore buy some time but as long as the underlying issue is not tackled the concerns will re-emerge in the near future. A lot will depend on Greece's willingness to come up with, and execute, a credible austerity plan.

The other two stories are related to the theme of slowing global economic growth. Monetary tightening has finally slowed down China and other emerging markets. That will ultimately affect the developed market economies as well. In addition, the US monetary stimulus (i.e. QE II) will expire this quarter and it is unlikely at this stage that there will be a QE III.

Yes, global economic growth has become a key concern again. Weaker global economic figures in the last months led to a hefty correction in the commodity markets. Thus, they have shelved the recently much debated inflation scenarios for the time being. Particularly

the US economy seems to be in weaker shape than widely anticipated and the specter of a "double dip" has re-emerged as US GDP numbers are low while the unemployment rate is unduly high. It is agreed that the housing market and the lack of local credits are leaden weights with respect to any recovery in the US. It does not help either that the real short rates are negative as this does not stimulate capital accumulation and needed investments. Some voices suggested that the US government or the Fed should figure out a way to solve these issues directly instead of simply pumping more money into the overall system. Maybe it is time for an admittedly unpopular and untimely rate rise in the US to eliminate the distortions and to get the economy back to normal over time.

**Chart 3: The Nominal Short-term US interest rates should go up to initiate the "Normalization"**



Source: GaveKal Research

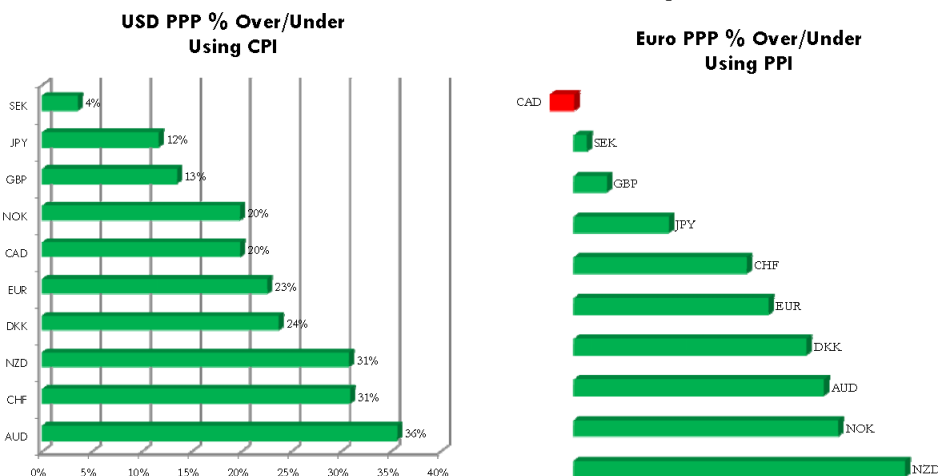
This theme of slower growth has also momentarily eclipsed the interest in the unrest in the Middle East for now, despite military action by NATO in Libya and quasi civil war in Yemen and Syria. The immediate impact of that shift in focus is that equity markets have trended south for the last couple of weeks. However, there are controversial views on how attractive the markets have become again. Prudent and fundamentally-oriented stock selection remains a key element for a successful equity management in the portfolios. Quality stocks will be assets to hold in the medium to long-term, as long as we are aware that during a risk-on/risk-off period it might be harder to generate sustained performance.

Likewise, the long end of the yield curve for bunds and treasuries softened significantly, e.g. 10 year rates hovering around 3% again. For the US, it is a reflection of a slower growth scenario whereas in the case of the bunds, it is a reflection of the few remaining perceived sovereign safe havens. Despite this the yield curves remain steep as the short end remains artificially low even after rate increases by the ECB.

Further investments in the fixed income space have to be handled with care. Safer spots might be at the short end and on the further out section (well beyond 10 years) on the yield

curve. There is continuous caution regarding exposure in EmMa bonds as levels are elevated.

#### Chart 4: Currencies – the US\$ Remains Very Undervalued



Source: GaveKal Research

All key currencies remain weak except for the CHF and the Yen. Slowing growth and the Euro-zone debt issue continue to put pressure on the USD and the EUR, respectively. However, the degree of undervaluation of the USD is at an untenable height vis-à-vis certain currencies. Particularly, certain commodity related currencies such as the AUD and the RND are due for further corrections. In the current period of uncertainty and fear, gold and, to an extent, the CHF may remain attractive for investors. Having said this, the CHF may still weaken somewhat against the USD. Emerging market currencies can still offer good value.

Overall risk awareness is high which reduces the risk appetite meaningfully. The next 6 to 12 months will be a difficult period with extended risk-on/risk-off phases. However, we would still expect some normalization in the medium term.

#### The Marcuard Heritage Model Portfolio Positioning

Given the various open issues that trouble the global economy we do not alter our conservative position regarding equity beta exposure despite the still overall healthy corporate situation. As discussed in the previous letter we favor selected exposure in the high dividend yielding large cap equity universe and maintain our exposure with respect to Equity L/S as we prefer active management able to generate alpha from both the long and the short book. Next to a preference in quality stocks at a global level we still see value in a selective exposure in emerging market stocks, especially in Asia. There, growth rates will still remain impressive even after the monetary tightening.

On the fixed income side, we maintain a lower government bond and corporate bond exposure. In the current risk-on / risk-off environment we maintain an augmented cash level in the portfolio. However, we are ready to re-deploy the cash as soon as additional investment opportunities arise again. Generally, we stick to our shorter duration position at

this stage and we continue to favor exposure into convertibles of investment grade quality and fixed-income enhanced instruments.

Our exposure in insurance-linked securities will continue to add to the diversification of the portfolio and remains a source of independent return generation.

At current prices of gold we would consider to add positions ceteris paribus only if the price should dip by more than 5% from the recent peak.

We continue to use alternative investments such as CTAs to complement our exposures with an insurance component due to their favorable correlation qualities vis-à-vis the main asset classes.

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