



WEALTH MANAGEMENT

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## Marcuard Heritage: Quarterly Asset Allocation Outlook

4<sup>th</sup> Quarter 2011

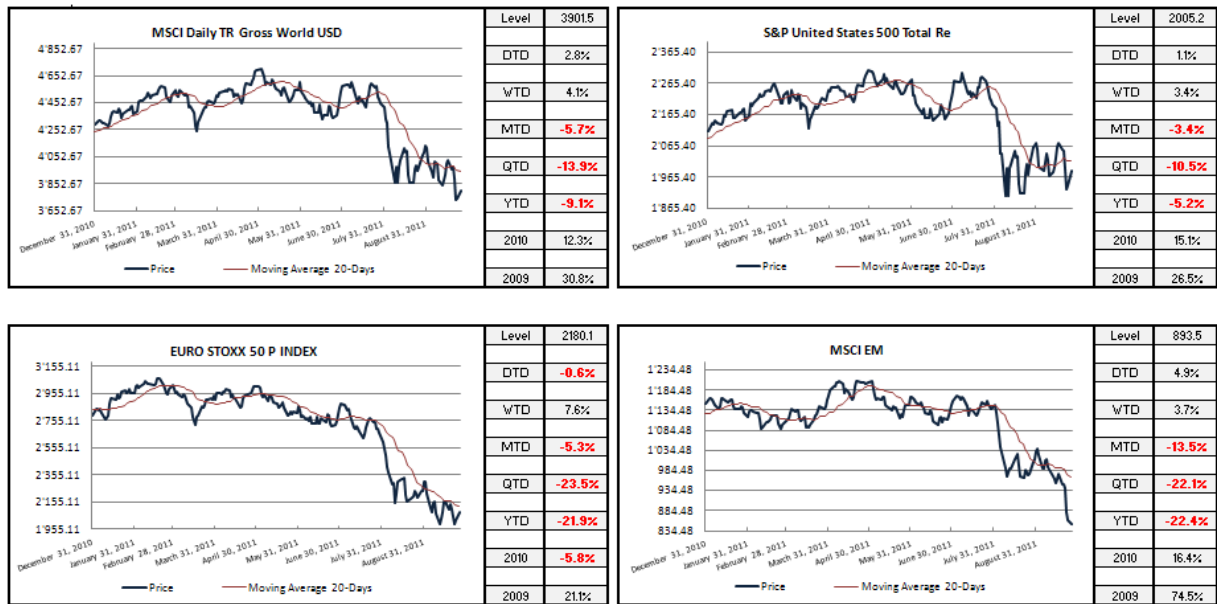
### A retrospective view on 2011 Q3

The third quarter was a stress test to all investors as confidence evaporated and equity and commodity markets collapsed as fearful market participants factored in the string of bad economic figures for the US and the Eurozone. In addition, fears grew that China would step up its fight against imminent inflation at the cost of economic growth contraction. Thus, in hindsight the second quarter of 2011 was solely a prelude to what the third quarter had to offer. In August equity markets lost up to 25% from peak to trough. The flight to safety skyrocketed safe haven investments such as the Swiss franc, the yen and gold. The carelessly provoked stalemate of US politics regarding the debt ceiling debate accelerated the decision process of rating agencies to downgrade the US. Contrary to popular expectations this helped to propel US treasuries and German bunds to new highs. Investors seemingly concluded that after all, the US and, to an extent, Germany are the most stable nations of the developed world where the money may be the “least unsafe”. Thus, ten year yields of both bonds dropped, for instance, below 2% to new record lows.

By the end of the third quarter, the MSCI World index had lost 14% during the quarter (year to date: -9%). The Euro-Stoxx was the loss leader with -23.5% for the quarter and -22% for the year to date, closely followed by the Emerging Markets with a loss of 22% (year to date: -22.4%). It is amazing to see that the emerging countries have not decoupled after all. After a period of resistance they corrected with a vengeance. Solely the US as measured by the S&P 500 could get away less damaged with a loss of 10.5% for the quarter and a year to date return of -5.2%. See Chart 1 for the respective graphs.

Finally, two safe havens cracked in September. The Swiss National Bank practically pegged the CHF to the EUR at 1.20 to protect the Swiss economy at the (temporary?) price of its independence after the EUR was close to par in August. As the USD appreciated, gold price started to crack by the end of September, ending the month by -9% though the return for the quarter equaled still a positive 10.4%. Solely, the yen remained a strong key currency.

**Chart 1: Where is the floor for Equity Markets?**

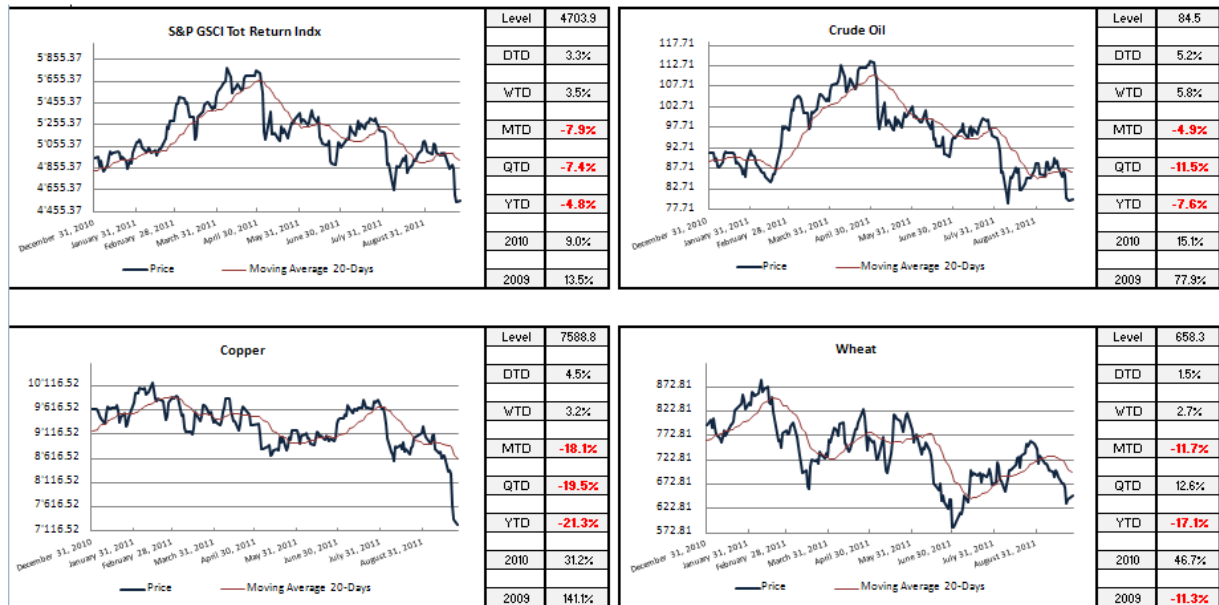


Source: Bloomberg

The continuously bad news on global economic growth during the quarter intensified the pressure on commodities as forecasted demand faced downward corrections. Thus, after a soft recovery of the prices at the beginning of the quarter, the trend reversed again severely (see Chart 2). The GSCI index declined by more than 7.4% quarter to date. Crude oil and copper fell by 11.5% and 19.5%, respectively. Only wheat managed to remain robust with a positive quarter (12.6%) that disguises the high volatility of its price development during the quarter. In any case, all mentioned commodity prices lost territory for the year by quarter's end.

Thus, by the end of the third quarter, markets are beaten up but none of the macro challenges has been resolved. The piecemeal approaches of EU and US policies that helped to lift the markets repeatedly for short periods of time face a significant shortening of the half-life of their various announcements on policy actions. The market experts are eagerly expecting clear signals from the political decision makers.

**Chart 2: Commodity Prices in Decline**



Source: Bloomberg

**The Fourth Quarter: The final Chapter of the Challenging Year 2011**

At the danger of sounding like a broken record, the key issues that put a spell on the financial world are not resolved. Investors have to position themselves vis-à-vis the unsolved Euro-zone sovereign debt problem including the lack of recapitalization of certain European banks, the uncertainty regarding a double dip of the US economy and an economic slowdown of Asian economies.

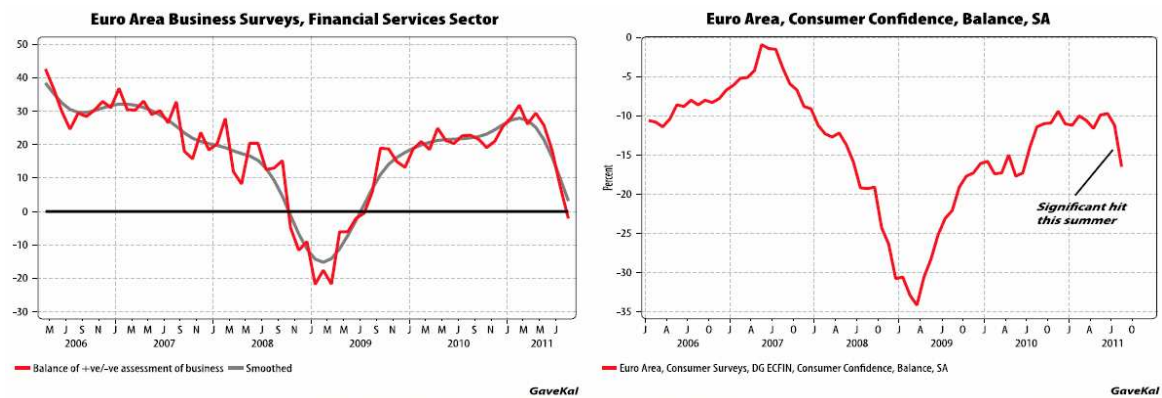
For the time being inflation, as a theme, remains on the shelf in the Developed Markets. It might, though, raise its ugly head within the next years.

The short-term trigger point for further global economic weakening is the US economy. Should the bad numbers on employment and growth continue, the stock markets would need to even further adjust to the lower expectations by the investors. Another fall in equity prices could be in the offing. It is generally anticipated that the Fed will do whatever it can to provide a floor for the US economy, should the measures of the current government (e.g. the announced USD 450bn jobs plan) prove to be insufficient. Indeed, the Fed started with Operation Twist (i.e.: an extension of the average maturity of its Treasury holdings by buying USD 400bn of securities that mature in more than 6 years. At the same time it is selling an equal amount of its existing holdings that mature between 3 months and 3 years from now) in September which will keep the long end of the yield curve flat. This should yield cheaper financing costs for corporations.

If the US economy muddles along with growth rates of 1% to 3% it will not be able to solve its structural budget and unemployment issues but it might at least generate enough demand that the Asian countries will not be derailed either. The Asian economies are facing some slowdown albeit from a high level of economic growth on average as they need to control inflation through tightening. However, with

a relatively healthy financial situation – both with respect to governments and the financial sector- these countries should have enough ammunition to stimulate their respective economies when needed. This is particularly true for China which has the means to run large internal stimulation programs (e.g. infrastructure spending, social housing, pension plans)

**Chart 3: The Deteriorating Sentiment in the Eurozone**



Source: GaveKal Research

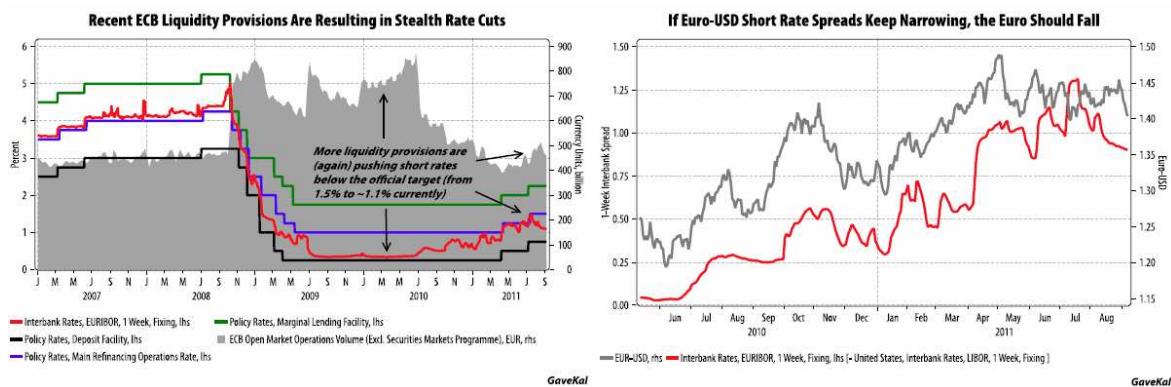
While the US seems to be an emergency case to fight its comatose status, the Euro zone will be “sick” for a longer period, some say up to three years, until the structural causes will be worked out. Maybe this helps the world to arrange itself much better with all the implications, e.g. a looming banking crisis, recession, a re-definition of the Euro zone, as it might have more time at hand to adapt gradually. Potential remedies within today’s definition of the Euro zone could be either debt monetization, i.e. printing money as some Southern countries might prefer, or further write-offs for bondholders or to involve the taxpayers even more in combination with austerity plans for particularly affected countries. Obviously, the presented solution could be a combination of the afore-mentioned measures as well. This will be flanked by measures as announced recently by the ECB to prop up European banks by buying bonds from them, to offer unlimited three-month liquidity at least until mid 2012, and perhaps most importantly to offer more long-term refinancing operations (LTRO) that should help banks to avoid liquidity shortages. The likelihood of an implosion of the Euro zone is currently very real. Therefore, as all EU members are aware of the severe consequences of a break-up of the currency union, the EU will ultimately present a work-out plan after taking some doing. In any case, the EU area will face low growth if not a recession. The lack of decision-making keeps undermining the confidence of consumers and investors (see Chart 3) with negative impact on economic growth while the financial markets will be caught in an alternating risk-on/risk-off loop along with an elevated level of market volatilities. However, once painful decisions will be made, the adaption efforts to restore the Euro zone economies to the cuts will most likely choke economic growth in the short run while, in contrast, financial markets will most likely be in for a strong recovery.

After the yields of sovereign bonds have lowered so much, the question is where they will head next? Near term price weakness in the major markets are possible but we do not expect an imminent correction of the low levels at the long end. Spreads amongst sovereigns within the Euro zone have opened up while treasuries and bunds trade in the same range. This offers opportunities for convergence trades, e.g. the French bonds (long) versus German bunds (short) where the spread is

about 80 bps. If Germany will continue to be part of the bail-out of ailing EU countries the spread should narrow.

We can also assume that spreads between corporate bonds versus sovereign bonds should globally narrow. At present yield-to-maturity of High Yield bonds are at 10% which is an attractive level that should compensate for credit risk. As stated above the corporate sector is generally healthy and default rates are around 1%.

**Chart 4: Currencies – the EUR under Pressure**



Source: GaveKal Research

We seem to be at the bifurcation point where the EUR might depreciate versus the USD after it has held up very strongly against the USD for an extended period of time (see Chart 4). At the time of writing this report the USD/EUR rate is below 1.35. As the Swiss National Bank practically pegged the CHF to 1.20, the Swiss franc has lost its safe haven status. In contrast, the yen remains strong.

The price for gold has dived in tandem with a rising USD. It might not even have bottomed out yet. However, as long as the structural issues of the developed world will prevail, gold will remain attractive for many investors and a potential rebound towards the USD 2000 level over the next quarters is not an implausible assumption at all.

**The Marcuard Heritage Model Portfolio Positioning**

In the current risk-on / risk-off environment we maintain an elevated cash level in the portfolio. However, we are ready to re-allocate the cash as soon as additional investment opportunities arise again.

Given the fears and the uncertainty in the markets we further reduced equity beta exposure on the long only and even on the long/short side with respect to long biased managers. Having stated that, we maintain significant exposures with respect to Equity L/S. We prefer active managers who are able to generate alpha from both the long and the short book.

On the fixed income side, we maintain lower government bond and corporate bond exposures, respectively. Generally, we stick to our shorter duration position at this stage and we continue to favor

exposure into fixed-income enhanced instruments whereas positions in convertibles are currently at a reduced level as well. We expect that our investments in Credit long/short will continue to pay off.

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

As the gold price seems to be in correction mode we are considering an increase of its exposure if otherwise the bearish environment will prevail.

We continue to use alternative investments such as CTAs and selected global macro funds to complement our exposures as they act as insurance components due to their favorable correlation qualities vis-à-vis the main asset classes.

However, positively perceived surprises like another US stimulation initiative or some resolute decisions from the EU could be the right signals to get back into the markets by increasing exposure to companies via investments in High Yield and by adding equity beta to the portfolios.

#### **Disclaimer**

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