

Green shoots – how green?

Green is the colour of hope and (accordingly?) hopeful is how equity markets presented themselves at the year-end, as is the outlook into the new year. With the exception of Japan, all major equity indices regained ground during the fourth quarter. Leading the pack in a festive mood were Asian markets. The DJ Stoxx AP 600 (Asia ex Japan) was top of the league with a plus of 5.2% during the fourth quarter. In our table, the region also took the gold medal for the whole year. On 31st December 2009, prices were a breathtaking 62.9% higher than 12 months ago. Europe, with +28% and the USA, with +23.5% came in second and third.

Change in Equity Markets 2009:

| | | <u>Dec.2008</u> | <u>Dec. 2009</u> | <u>Change</u> ¹ |
|---------------|------------------|-----------------|------------------|----------------------------|
| Asia ex Japan | DJ STOXX A/P | 268.1 | 436.7 | 62.9% |
| Germany | DAX | 4'810.2 | 5'957.4 | 23.8% |
| Europe | DJ STOXX 600 | 198.4 | 253.9 | 28.0% |
| Japan | TOPIX | 859.2 | 907.6 | 5.6% |
| Switzerland | SPI | 4'567.6 | 5'626.4 | 23.2% |
| USA | S & P 500 | 903.3 | 1'115.1 | 23.5% |
| World | MSCI World Index | 227.7 | 299.4 | 31.5% |

Looking further afield, certain peripheral markets display even larger gains. Brazil, Russia, China as well as Indonesia rose between 142% and 114% (for the sake of comparison, measured in US Dollars) and as such managed to recoup a large part of the previous year's losses. However, the previous highs have not yet been reached in these markets either. Japan, for some time now the problem child of equity investors, did not live up to its name as the Land Of The Rising Sun on the exchanges. Its major indices (Nikkei 225: +21.5%, Topix: +7.9%, all in US Dollars) feature at the bottom of the 52 markets followed by „The Economist“.

Though a twelve-month comparison of these figures is per se quite impressive, it does not give observers any indication of the wild rollercoaster ride experienced during the period. Nothing pointed towards such a miracle in the first quarter of 2009, quite the contrary. Until March, most markets were slithering downhill into the valley. All the more fulminant was the ensuing recovery of stocks during the following nine

months. For example, the gauge for Swiss Blue Chips, the SMI, rose by 52% from its low in March 2009 to its high year-end. The S&P-500-Index of the American exchanges shot up by 65% and between March and November the Hong Kong Hang Seng Index doubled outright.

Hectic Equities – Composed Hedge Funds

Hedge funds, on the other hand, had a rather composed year. The HFRX Global Hedge Fund Index rose 7.2% in US Dollars or 12.9% in Euros during the period. This development shows once again how important it is to keep your nerve and act systematically in the investment business. Anyone who was caught by panic and sold during the first quarter crystallised losses and gave away the chance of recovery. On the other hand, those who stuck with it because of the low valuations or, in view of the contraction in the equity allocation, added to the portfolio were richly rewarded.

The **equity funds employed by us** achieved the following returns in 2009, with one exception all beating their reference indices:²

| | |
|---|--------------|
| Aberdeen Asia Pacific (USD) | 69.2% |
| CIIM European Stock Portfolio (EUR) | 49.4% |
| Performa Fund - Asian Equities (USD) | 57.8% |
| Performa Fund - European Equities (EUR) | 32.6% |
| Neuberger Berman US Equity Value (USD) | 35.4% |
| Performa Fund - US Equities (USD) | 26.2% |

Other funds employed by us developed as follows:

| | <u>USD</u> | <u>EUR</u> | <u>CHF</u> |
|---------------------------------------|-------------|--------------|-------------|
| Thalmann & V. Fund of HF ³ | 3.6% | 3.3% | 1.6% |
| BlueBay High Yield Bond Fd. | | 49.7% | |

Active Bond Issuance

A frenzy of activity drove underwriting departments at banks, not least at those active in the Swiss Franc market. According to the business paper “Finanz und Wirtschaft” (FuW) never before has such a large volume of new issues been placed as in the past year. In excess of 96bn Swiss Francs of fixed interest securities have been issued in

¹ Development of index in local currency. Exceptions DJ STOXX Asia/Pacific ex Japan and World in USD.

² Performance in currency of fund. Source: Bloomberg.

³ Performance since beginning of the year until end of November 2009.

the market. Net of redemption of bonds due, the Swiss Franc bond market totalled a record 534bn Swiss Francs at the end of 2009 (+3% year-on-year, +34% since 1999).

Furthermore, in the view of FuW it is remarkable that during 2009 not a single issue went into default, in other words, suffered from non-payment. In spite of the flood of new issues, investors did not tire of putting these into their portfolios en masse. New issue volume is likely to increase again this year. One reason for this is large government finance requirements but corporates will also continue to be forced to use bonds for their financing requirements rather than bank loans. The same also applies to international markets. Even though new issue volume there rose by about one third in 2009, further growth in volume is expected for 2010.

The US Treasury alone may issue bonds to the tune of 2.45 trillion US Dollars compared to about 2.1 trillion in the past year. In light of the low coupons, the question of how far investors are prepared to go along with this is quite another matter. We, in any case, shall not.

Strong undercurrents in bond markets

Below the relatively quiet surface of government debt, strong currents caused ripples in the lower echelons of bond markets. In the lower-quality credits segment, an impressive rally ensued during the course of which gains were made otherwise only available to equity investors i.e. during „normal years“. The annual performance of the BlueBay High Yield Bond Fund employed by us speaks volumes, +49.7%. Good money was also to be made in the area of medium to higher-quality corporate debt. You will find more on this interesting subject in the special report „Debt Is The New Equity“ written by our Chief Investment Officer, Teja von Holzschuher, in December.

During the course of the year, the **yields on 10-year government bonds** rose in all countries except Switzerland. Whereas benchmark yields in December were also lower than three months earlier, those of the US, Continental Europe and the U.K. rose during the three-month period. Benchmark yields in Japan did not change during the fourth quarter:

| | <u>Dec. 2008</u> | <u>Dec. 2009</u> |
|----------------|------------------|------------------|
| USA | 2.1% | 3.8% |
| Europe | 2.9% | 3.4% |
| Switzerland | 2.1% | 1.9% |
| United Kingdom | 3.1% | 4.0% |
| Japan | 1.2% | 1.3% |

Changes in Asset Allocation

At its meetings, the investment committee decided upon the following changes to the asset allocation for medium-risk balanced portfolios not subject to client's restrictions:

Liquidity: As a consequence of the below-mentioned reduction in the US equity allocation, the money market share has increased. Liquidity currently amounts to about 15% and is usually held in the client's reference currency.

Bonds: We continue unchanged to hold primarily corporate bonds of mid-to-high quality plus an addition of high-yield bonds. In contrast, we consider government bonds of developed industrial nations to be unattractive. The target size for the entire bond allocation of a balanced portfolio remains unchanged to the last report at about 37%. Equally unchanged is the maximum term at five years.

US Equities: Following the striking rally of American equities (+65% since the March lows), we reduced their weighting by about 5% early in December to currently about 8% of portfolios. Compared to stocks in other countries, US equities appear fully valued, which is why we reduced their weighting.

European Equities remain unchanged at about 25% of the portfolio, those of **Asia** (equally unchanged) at around 11.5%.

Non-traditional Investments: 2009 was not the year for non-traditionals. We adhere to our decision taken in the third quarter to avoid, respectively, sell existing positions in this asset class.

Summary of our current asset allocation:

Investment Category

| | |
|------------------------|------------------------------|
| Money Market | overweight |
| Bonds | underweight / short duration |
| Equities USA | underweight |
| Equities Europe | overweight |
| Equities Switzerland | neutral |
| Equities Japan | underweight |
| Equities Asia | overweight |
| Non-traditional assets | underweight |

Measured on the **price/earnings ratio**⁴ using the latest 12 months' profit figures, all equity markets have become dearer (red):

| | <u>Dec. 2008</u> | <u>Dec. 2009</u> | <u>Change</u> |
|-----------------------|------------------|------------------|---------------|
| MSCI World Index | 14.3 | 32.1 | +125% |
| DAX Index/DE | 1.4 | 60.2 | +479% |
| DJ STOXX 600 Index/EU | 19.7 | 58.2 | +195% |
| S & P 500 Index/USA | 14.9 | 24.3 | +63% |
| SPI Index/CH | 28.1 | 37.8 | +35% |
| TOPIX Index/JPN | 13.0 | n.a. | n.a. |

Price / Book and **Dividend Yield** of major equity markets:

| | <u>Price / Book</u> | <u>Div. Yield</u> |
|-----------------------|---------------------|-------------------|
| MSCI World Index | 1.8 | 2.4% |
| DAX Index/DE | 1.5 | 3.5% |
| DJ STOXX 600 Index/EU | 1.7 | 3.3% |
| S & P 500 Index/USA | 2.2 | 2.1% |
| SPI Index/CH | 2.1 | 2.2% |
| TOPIX Index/JPN | 1.1 | 1.8% |

Economic climate - partially sunny, partially cloudy

Are all the lights for 2010 on green as it would appear at present? Obviously, the decisive factor is to what extent the global economy will manage to steer onto a growth course again. On the one hand, we have the many government stimulus measures, some of which will only develop their full impact during the new year. In China, for example, 590bn Yuan (about 88bn CHF) will impact in 2010, surpassing the 488 billion Yuan already spent in the past year. The USA pins its hopes on the early repayment of government support to the financial sector, freeing these monies up for other measures or rather to avoid a further ballooning of the governmental support apparatus. On the other hand, the unchanged huge public financing requirement is casting a shadow over markets. Government deficits everywhere are rising, reaching a critical size in some countries such as the U.K. and the USA. Further shocks from this quarter, as we have seen recently from Greece and Dubai, cannot be ruled out.

Consumers under pressure from all sides

Unemployment in the industrialised nations, led by the USA, remains high. In Europe the summit has not yet been reached. This is unlikely to put consumers on either side of the Atlantic in an exuberant shopping mood. Even for those still in employment, some will have to tighten their belts, such as Ireland's civil servants who have to digest across-the-board salary cuts. Such incisive measures could also be seen in other countries and weigh on sentiment.

Average **growth and inflationary forecasts** from „The Economist“'s December poll of economists:

| | <u>Real GDP Growth</u> | | <u>Inflation</u> | |
|----------------|------------------------|-------------|------------------|-------------|
| | <u>2009</u> | <u>2010</u> | <u>2009</u> | <u>2010</u> |
| Germany | -4.9% | 1.6% | 0.3% | 1.0% |
| Euroland | -3.8% | 1.2% | 0.4% | 1.2% |
| United Kingdom | -4.5% | 1.3% | 2.1% | 2.2% |
| Japan | -5.4% | 1.5% | -1.3% | -0.9% |
| Switzerland | -1.7% | 1.0% | -0.5% | 0.6% |
| USA | -2.5% | 2.7% | -0.4% | 1.8% |

Naturally, nobody is saying it out loud but ultimately tax increases will be unavoidable. In Switzerland, whose position is rather comfortable by global comparison (the gov-

⁴ Source: Bloomberg

ernment deficit 2009 is likely to come in at about 1.3% of GDP⁵), VAT will be increased slightly in the coming year. In the canton of Zurich, the government has dealt with this by imposing an inconspicuous increase in the notional rental value (deemed taxable income on owner-occupied properties). Though other reasons are being put forward in order to avoid the political taboo word, ultimately however, both are tax increases.

In Germany, the economy-driven tax reductions are likely to be of temporary character. In countries where, as a percentage of GDP, the government deficit already reached double digits in 2009, it is difficult to imagine a future without tax increases. The U.K., Spain and USA are in this group. The dilemma cannot be overlooked: A turn at the fiscal screw is badly needed to stabilise government finances. These tax increases, however, could stall the burgeoning recovery immediately, which is in no way desirable.

Lean times for banks not over yet

Equally, the financial sector has not yet turned the corner. In the US, particularly small and regional banks are now grappling with their lending engagements to the commercial real estate sector. To make matters worse, most of these institutions do not fall into the category “too big to fail”, doing little to ease concerns. In Europe, the weakness of certain Eastern European economies is casting a shadow over the lending business.

From this combination of factors, rather sluggish consumption and investment activity may be deduced which could throw a spanner in the works of exchanges. Astonishingly, consumers recently appear rather sanguine, as a number of surveys in various countries suggest. On average, economists have also increased their expectations. Hence, central banks are starting to think about how and when to switch the “excessive monetary supply” lever to a more “neutral monetary supply” position. As observers largely agree, in the Eurozone and the USA this is unlikely to happen before mid-year. The burgeoning recovery appears very fragile and no-one wants to risk nipping it prematurely in the bud.

Overall forecast bright? - Bright!

All in all, we expect 2010 to be a challenging year from an investment point of view. Returns are unlikely to reach those of 2009 again, in other words, a shift down to a more normal gear is on the cards. Equities are likely to develop very individually, in other words, selectivity is the order of the day. Bottom line indications for real assets are positive. Bonds are unlikely to be able to repeat their 2009 dreamlike performance, but remain a safe harbour for the time being and contribute to overall performance. Inflation is unlikely to pose a threat in the coming months, in the longer term however, it is important for investors to keep it in view.

Alfred Ernst

Vaduz/Zurich, 31st December 2009

⁵ Source: The Economist



