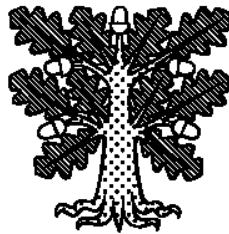


# Investment View

## 4<sup>TH</sup> Quarter 2010



Hoving & Partners S.A.  
Wealth Management

30A Route de Chêne  
1208 Genève

+41-22-544 12 90

### **1. Summary of recommendations 4th Quarter**

World economic growth is expected to slow somewhat in 2011 according to IMF. It seems that the risk of a double-dip scenario has been addressed in time.

We have become more optimistic about the outlook for the world economy returning back to normal between now and 2012.

In our opinion this “back to normal” should be reflected in the asset allocation for 2011 and we recommend making the first changes in this allocation in this quarter.

We would recommend investors with balanced portfolios to generally increase their risk appetite.

With the world economy returning back to normal in mind, we should expect interest rates to increase rather than to go down during the course of 2011. We may even see the first changes during this quarter.

We believe that government bonds and investment grade credits have become expensive. As interest rates may rise, bonds may even, depending on the duration, lose value. This would be a shock to most investors as they have been used to a roller coaster bond market.

We believe the asset allocation of most investors still reflect an “underweight” in risk assets, such as equities and preferring bonds.

We think there is a good opportunity to start switching low yielding bonds into equities at this stage of the economic cycle.

Currently, equities are less expensive than investment grade bonds based on the earnings yield ratio (company earnings divided by bond yields).

The long-term prospects of emerging markets remain positive. These countries are predicted to outgrow western economies by 4-5% annually during the next 10 years. Portfolio exposure to emerging markets is therefore important to enhance long-term investment performance.

This is true for emerging market currencies and emerging stock markets in general. But, we do not favour emerging market debt as interest rates are poised to rise to contain inflation, which is the major risk in these markets and huge inflows of capital seeking higher yields.

We recommend investing in Western companies that have a good exposure to emerging markets as well. Companies that are focused on western home markets remain less attractive as the low growth environment in the U.S. and Europe should prevail for some time to come.

Other more risky investments such as in natural resources companies must be envisaged.

Emerging economies, like China, India and Brazil will increasingly need steel, copper, aluminium and energy. Most of these resources are still controlled by Western conglomerates.

Technology companies, also pre-dominantly controlled by Western companies, should be envisaged as they represent the core value added competence of the West. Most of these companies are cash rich and they can still show true growth.

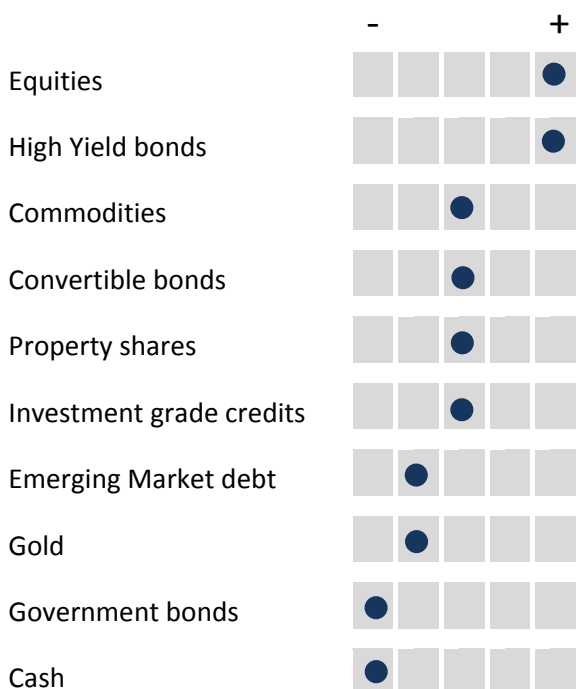
Financials, an important asset class, will continue to be subject to more government controls, making investments in banks and insurance companies complicated.

Nevertheless, stock market rally's without Financials are rare. We recommend to selectively investing in mostly U.S. banks, especially those with good exposures to emerging markets.

The “nuts and bold” industrial companies, especially in the mid cap size, are our preferred choice as these companies will profit from the world economy picking up steam. Generally, smaller companies seem to have more growth potential than the large cap industries, which were a stable investment in volatile periods.

Gold is a separate asset class. Gold has played an important role to preserve capital in uncertain times and Gold was a good currency hedge. With the world economy expected to return to more stability, the role of Gold should diminish over time.

**Recommended asset allocation – balanced**



**2. Economy**

Going into 2011, the extent of economic recovery differs importantly across regions, with Asia in the lead. The U.S. and Japan experienced a noticeable slowdown during the second quarter of 2010, while growth accelerated in Europe, mainly caused by robust growth in Germany.

The most recent IMF forecasts (October) are that global economic growth will expand by 4.8% in 2010 and 4.2% in 2011,

It also expects that output of emerging and developing economies will expand at rates of 7.1% and 6.4%, respectively in 2010 and 2011. In advanced economies, however, growth is projected at only 2.7% and 2.2%, respectively, with some economies slowing noticeably during the second half of 2010 and the first half of 2011, followed by a reacceleration of activity later into 2011.

The probability of a double-dip scenario in Western economies seems now lower as economic data continue to show moderation instead of negative growth.

**3. Quantitative Easing**

The Fed's November 3 monetary policy decision is a major event with important implications for interest rates, the U.S. Dollar, and the U.S. economy in general.

The October Employment Report (due November 5) will help shape the near-term economic outlook and set expectations for future Fed policy moves. The Fed is generally expected to start with Quantitative Easing (QE2) after the Nov. 3 FOMC meeting.

With slow growth and plenty of spare capacity, U.S. measures of core inflation continued to track lower in September. Both U.S. wage and core CPI inflation are

near all-time lows. With this backdrop, Bernanke's speeches affirm that the Fed is drifting closer to a second round of QE. Bernanke wants proactive – not reactive policies, targeting inflation, considered to be dangerously low (thus targeting wage growth and, hence, unemployment).

As the Fed approaches a new asset buying program, critics are warning that the downside risks of such a policy exceed the benefits. Critics believe that, long-term, the result of QE will be a roaring comeback of inflation.

Critics doubting the positive effects on the economy have a point: clearly parts of the markets are awash in liquidity. Banks have over a trillion U.S. Dollars in excess reserves, corporations have plenty of cash and easy access to capital markets, and interest rates are extremely low for most borrowers. However, two of the most important sectors of the economy - bank lending and the housing market - remain in depression.

A lack of confidence by the consumer, not liquidity, seems to be the main problem holding back growth.

Is QE therefore really necessary and does it not boost a bubble in asset prices?

The U.S. Federal Reserve Bank aims to achieve the following effects with QE:

1. The artificial demand for Treasuries (the Fed buys outstanding Treasury stock) keeps a lid on the long-end of the Treasury yield curve.

2. Low government bond yields are key to keep mortgage rates low. This is vital to support the U.S. housing market.

3. Low real rates help the Treasury with cheap financing of Government debt, thereby improving the U.S. fiscal situation.

4. Low interest rates force investors to seek higher yielding assets, increasing investments in higher risk, thereby boosting asset prices. It is not surprising that stock markets almost doubled since QE 1 was put in place.

5. The Fed buys assets that banks do not want to hold or cannot sell because of illiquidity. This frees up capital that banks can spend or can use to bolster their balance sheets. This should ultimately inject money into the economy and security markets.

The anticipation of QE2, announced at the end of August, probably explains the recent and significant rally in the stock markets, but it pushed the U.S. Dollar lower. If the Fed ratifies QE2 in November, we anticipate an extension of the recent market moves. However, markets could be disappointed about the size of total package and may as a result correct. We would view this as a "buy on the dip" opportunity.

The effects on the economy depend on the size of QE2, but as a second injection and if it is big enough, we expect that QE2 has more impact than QE1.

On the other hand, if the Fed would decide to delay or withdraw from the next round of QE, we would expect stock and bond markets to reverse strongly. This is a true risk to the current positive momentum of the stock markets.

Alternatively, it is possible that the Fed is trying to steer market sentiment by talking

about easing, but effectively try to do as little as possible.

Clearly, policy makers need to remain vigilant against unintended consequences of QE. Cheap capital caused a large over-expansion in the tech sector in the late 1990s and an ugly four-year adjustment thereafter. Cheap credit in housing from 2004 to 2007 caused an even bigger misallocation of capital that continues to hurt the economy to this day.

Another criticism is that easy policy may be creating bubbles in stock and bond markets. Indeed, we believe that this is partly true. Credit and Government bond markets in particular show signs of a bubble. Flights to safety concerns are such that investors even accept negative real U.S. Treasury returns (return after inflation).

It is also true that the price of Gold has risen dramatically, but is this due to low interest rates or more an expression of U.S. Dollar weakness? Commodity prices, such as copper, have surged, but this was more demand driven by China.

Stock markets are practically always driven by liquidity and interest rates (therefore, bond prices often move in the same direction as prices of stocks). This year, Western stock market prices have not yet moved very much.

In conclusion, what the Fed is doing today is an extreme version of what it does in every recession: it cuts interest rates dramatically and floods the economy with liquidity. The only difference this time is that the very deep recession is forcing the Fed to go beyond cutting interest rates to zero. Without that super-easy policy, we believe

the economy would have slipped into a depression.

Fortunately, today's credit boom is healing, not hurting, the underlying economy. The access to easy corporate credits today is allowing firms to rebuild their balance sheets and stay viable until the real economy picks up. There is no irrational exuberance in the corporate sector: they have plenty of cash and are operating their businesses in a very conservative manner despite cheap credit. This is clearly nothing like the recent tech or housing bubble.

#### **4. Fixed income**

Favourable liquidity conditions should continue to dominate the bond markets for a while into early 2011.

Nevertheless, we see little room for lower bond yields (or upside potential for bond prices) in the current cycle, especially for Government bonds or investment grade Credits. Current U.S. Treasury Yields are even lower than in the Great Recession of 1929-33, which saw GDP contract for four consecutive years and unemployment reaching 25%.

In general, with the Western economies expected to return to normal conditions, higher demand for loans and credits should come back driving interest rates higher.

We believe we are at the beginning of a new cycle of higher interest rates and this is exactly what the Fed is trying to achieve.

Reasons are:

1. Economic growth of Western economies, although anemic, has turned positive in 2010 and should remain positive in 2011 according to recent IMF data. Growth leads to more demand for credit and bank loans in general.

2. Demand for consumer credit will increase with consumer confidence returning.

3. The U.S. saving ratio as a % of GDP should reach 6% in the first half 2011 and beyond that point, consumers are expected to spend more money.

4. The U.S. housing market is close to the point where it has reached its low.

5. Demand for new housing loans should increase.

Inflation

Another aspect is inflation. The bond market is always first in anticipating the return of inflation. Recent down moves in bond prices have been quite strong in the U.S. sparking the inflation debate. We believe that these price moves were more the result of institutional investors taking profits on their huge bond positions.

However, with the introduction of QE2 liquidity will rise further on top of already huge cash piles, forcing the markets “to do something”.

There is a risk that bond markets may react unfavourably because of the increased perceived risk of inflation and it is possible that inflation scares may return in the 2nd half 2011.

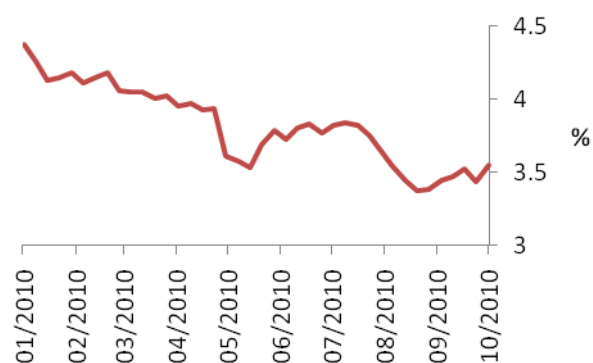
We anticipate bond price volatility to increase in the coming months and it may even end with an unpleasant bond crisis in the 2nd half 2011 when the smaller bond investors will try to find their exit.

Fixed income alternatives

Since we think that current returns on government bonds or investment grade Credits have become too low, what is left for the fixed income investor to invest in?

High yield bonds with short durations still offer value. Longer durations would be too risky in the current cycle. High yield bonds prices correlate with default rates of companies. In an environment with default rates coming down, high yield bond prices tend to rise. We expect that default rates, especially for the smaller companies, to come down in the coming months due to the low interest environment, easier credit conditions and in general improving economic fundamentals.

European Corporate Bonds - average yield



We think it is too early to invest in inflation linked bonds. Moreover, inflation linked bonds already trade at a premium.

In the emerging markets central banks are trying to get ahead of the curve: China hikes rates, Singapore seeks faster currency appreciation and Thailand and Brazil introduced withholding taxes on coupons.

Of course emerging markets are worried about the making of a bubble, with real interest rates in Singapore at -3% and Chinese vegetable prices up 18% in September. Shanghai will raise its retail sugar price by 13%. Although official Chinese inflation is only 3.6%, we believe the actual number is much higher. India’s inflation is also too high, running at 10%.

However, worrisome is that the yield on 10-year government bonds issued by Indonesia is only trading at a 1% premium over U.S. Treasuries.

### **5. Equities**

Post the 2008 crisis, investors have shifted their portfolios towards debt and away from equities. The record pace of inflows into bond funds well into 2010 illustrates this past trend.

This has led to the following situation:

1. The gap between earnings yields and (after tax) debt yields have never been larger. Said differently, investors up to now have overvalued debt and undervalued equity.
2. The smart corporate world makes use of this valuation gap by issuing cheap debt and buying back equity.
3. Some companies even pay dividends that are higher than what the same companies have to pay for debt. This does not make sense.
4. The gap between the FCF (free cash flow) yield and the corporate bond yield is at an all-time high.
5. Equities have under-performed bonds for an amazing 30.5 years – the longest period for almost 80 years. Is this normal?

It is our conclusion that equities are cheap relative to bonds. However, there are some worries about earnings 2011 that may cause headwinds.

#### Earnings

Profits of most companies have been very good, but headline growth is still slow, with the exception of luxury, high tech and commodity related companies. Also, most

sales growth went to inventory replenishing.

Next year will be a big test to see if sales growth comes from another source. If not, sales margins must increase which is difficult in a low growth environment. To counteract, companies must continue to improve cost cutting and finding solutions for foreign exchange fluctuations.

2010 profits should end on excellent notes. Credit Suisse forecasts 34% EPS growth in the U.S. and 36% in Europe for 2010 – but a lower than consensus 11% in 2011 in the U.S. Profits in 2011 could be lower than 2010, but still targeted at between 5-10%. While this is a risk, we think the market is already pricing in lower future earnings growth.

#### Valuations

Valuations of Western companies are fair, particularly in Europe, that are trading at approximately 10.5x 2011 IBES P/E with 5-10% earnings growth. Emerging market equities are still attractive, but less so after the 30% return of MSCI Emerging market index since May. Valuations are still reasonable with a P/E of 11.7, which is in line with the long-run average.

#### Momentum

Sovereign risk in Europe appears contained for the moment and we expect little news. Longer-term, European Sovereign risk remains a challenge and an overhang for both equity and bond investors.

In general, investors are still shy of equity investments and still favouring fixed income securities. With improving confidence and economic recovery, we expect money to be shifted from fixed income to equities. The VIX (volatility) index is currently at a low

level, indicating that investors are less worried.

#### Emerging markets

There is a growing concern that a bubble in emerging markets is in the make. After all, emerging markets are small relative to the overall global capital markets.

Investors seem to enter with large inflows in Emerging Markets equity funds. For example, last week saw \$5.7bn of inflows into EM equity funds, the 4th largest inflow ever. The last three weeks in October have seen the strongest three week streak of new funds ever (\$16bn). The Banc of America Merrill Lynch Fund Manager survey shows that 49% of investors are now overweight the region vs. 39% last month.

While easy monetary policy in the developed countries may have speeded up the recent asset price rises in emerging markets, we believe the cause is more fundamental. The big Western economies have serious structural problems, while countries in Latin America and Asia are not only much healthier, but in many cases they are healthy relative to their own history.

The fundamental back drop:

-Many emerging markets have been much quicker to recover from the global recession and are likely to continue to grow significantly faster than developed markets economies.

-There is a growing split between the increasing government debt in the developed world and the relative low levels of debt in emerging markets.

- The Western economies have dangerously low inflation; emerging markets have hints

of high inflation, which is in line with a higher economic growth momentum.

- Emerging markets have built up enormous foreign exchange reserves and are running current account surpluses.

-Western countries including Japan have rapidly aging populations, accompanied by budget and potential growth challenges. China is expected to face similar imbalances in the near future as well.

In conclusion, we believe that equities are the more attractive asset class relative to bonds and cash. We like the high dividend yields of the S&P 500 and MSCI Europe. In Europe, we are overweight industrials and consumer staples as we regard it as a relatively cheaper way to access emerging market growth. We expect companies to start putting to work near-record cash holdings in increased dividends, buybacks and M&A.

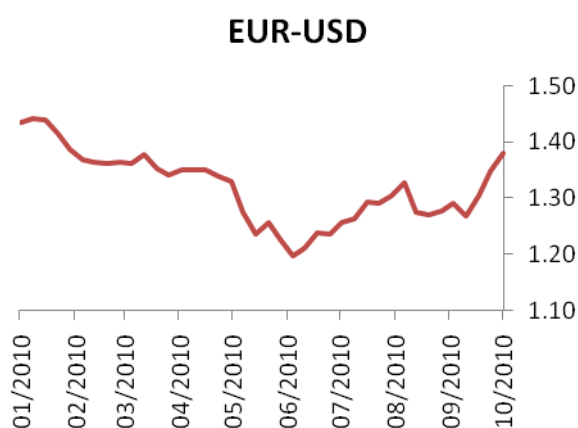
#### **6. Currencies**

At the moment, we are in the middle of a currency war between the Western and emerging market economies. This was also the main topic at the last G20 meeting. Western economies want to see emerging markets revaluing their currencies to support local buying power and to help Western economies to emerge faster from the economic crisis.

The main source of the conflict is the policy of China to keep its currency at low levels compared to the U.S. Dollar and the EURO. China claims that they need low exchange rates to maintain its high economic growth rate in order to satisfy 20 million new workers joining the workforce every year.

China can continue this policy, as their currency is not freely convertible, yet.

The announcement by the Fed of further quantitative easing at the end of August was bad news for the U.S. Dollar. In September alone, the U.S. Dollar dropped by 10% against a reborn EURO. The Fed takes every measure to save the U.S. economy; it is less concerned with the external U.S. Dollar value.



The reader may remember the famous policy statement of former Treasury Secretary John Connally in 1971: “the U.S. Dollar may be our currency, but it is your problem”.

The EURO continues to be the bystander of the fight between the two mega blocks, the U.S. and China. The announcement by China that it would help the EU by buying Greek Sovereign debt had the desired effect of a strengthening EURO (China exports more to Europe than to the U.S.).

The whole world seems to be a U.S. Dollar bear and there are good fundamental reasons for this. Most of all is the sheer size of the country’s debt and the ballooning deficits. The U.S. is the only Western economy that did not announce budget cuts, like the UK or Germany. The U.S. is in a debt spiral, which was manageable, when the country was growing faster, but this is no longer the case.

We anticipate that the U.S. economy will show real economic growth of around 2% per year in the next ten years. This is below its historic growth of 3% per year.

The long-term trend of the U.S. Dollar is expected to remain weak against the EURO.

However, Europe has its own problems and the EURO will not escape downward pressures from time to time, especially when Sovereign debt problems in the peripheral economies return. PIMCO, the large institutional bond investor, has predicted that Greece will enter into default in 2014. On the other hand, Jeffrey Sachs, a well known and much published American economist, is confident that Greece will overcome its challenges.

We believe the EURO will remain the base currency of the EU for quite some time; partial Sovereign defaults of peripheral economies should not change this outlook. The pain will come from interest differentials between EU countries. However, in the longer run, more fiscal and monetary discipline should favour the EURO to become a world currency next to the USD, the Remnibi and the Japanese Yen.

On the other hand, freely convertible currencies of emerging markets such Brazil have, unlike China, seen their currencies surge affecting exports. But this is a normal adjustment, expected to continue.

Short term, emerging markets will try to influence exchange rates stemming inflows of foreign capital by measures such as raising withholding taxes on foreigners holding local assets.

Despite such possible measures, we do not believe that money going to such regions will dry up. The steady appreciation of emerging market currencies is likely to continue.

### **7. Commodities**

Growth concerns have played a large role in crude oil price direction. But demand for oil is improving and inventories are going down. The macro environment is constructive for all commodities. The energy sector has lagged, but has been improving in relative performance the last few weeks. We believe at current levels the oil sector is an attractive long-term play on the structural bull market in commodities.

Agriculture prices have rallied and corn inventory is precariously tight. Prices will need to continue to move higher to ration demand given the limited availability.

In base metals, falling inventories due to signs of a soft landing in China are expected to be especially supportive of copper, tin and nickel prices.

### **8. Conclusion**

With the global economy normalizing and interest rates more likely to rise than to fall, we favour a shift to equities over bonds in general. Our preference is to participate in companies with exposure to emerging markets, as growth in those regions is likely to be higher and more sustainable in the coming years.

The current relatively low volatility index (VIX) indicates that risk appetite is already returning among equity investors. Going into 2011, careful and sound stock selection will determine future investment returns.

### *The Investment Committee*

Jan-Paul Menke, Chief Investment Officer  
Michael Hoving, CEO  
Michiel van Wulfften Palthe, Director

**Ranked Performance of Various Indices, YTD Q3, 2010**

Gold \$ per Ounce	+19.3%
High Yield bonds in \$	+9.3%
MSCI Emerging Markets in \$	+8.7%
Copper in \$ per Lb.	+8.0%
MSCI World in €	+7.8%
JP Morgan Global Gvt. Bonds in €	+7.3%
MSCI Latin America in \$	+6.4%
Investment grade Credits in €	+5.4%
Rogers International Commodity Index in \$	+2.7%
Convertible Bonds in €	+2.5%
MSCI USA in \$	+2.5%
MSCI Europe	+2.0%
HFRX Global Hedge Fund Index \$	+1.9%
MSCI China Free in \$	+1.5%
Barrel of Oil in \$	+0.8%
Barclays CTA Index	+0.6%
JP Morgan Cash Index 1M in €	+0.3%
MSCI Japan in JPY	-9.2%



*This document has been made by Hoving & Partners S.A. (H&P) and is offered solely for your information and is strictly confidential. This document has been made by staff of H&P using current public information that we consider reliable, but we do not represent it is accurate or complete, and it should not be relied on as such. H&P and staff of H&P cannot be held responsible for possible incorrectness of the assumptions in this document. No part of this document may be copied, photocopied or duplicated in any form by any means or redistributed without the prior written consent of H&P.*

*This document does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual investors and is meant for professional investors only. Investors should consider whether any advice or recommendation in this document is suitable for their particular circumstances, and if appropriate seek professional advice.*

*H&P is a professional wealth manager based in Geneva, Switzerland, and a member of the Swiss Association of Asset Managers.*

*The value of your investments may fluctuate. Past performance provides no guarantee for the future.*

#### **Hoving & Partners S.A.**

30A Route de Chêne

1208 Geneva

Switzerland

#### **Authors**

Jan-Paul Menke

Michael Hoving

Michiel van Wulfften Palthe

#### **Editing & Design**

Jan IJff

#### **Enquiries**

##### *Website*

[www.hovingpartners.ch](http://www.hovingpartners.ch)

##### *E-mail*

[jpm@hovingpartners.ch](mailto:jpm@hovingpartners.ch)

##### *Telephone*

+41-22-544 12 90