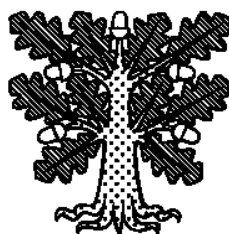


# Investment View

## 1<sup>st</sup> Quarter 2011



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**1. Summary**

The global economy is in recovery mode. Growth has reverted to the pre-crisis rates in nearly all major countries and economic blocs. Yet, significant policy challenges remain.

America’s sense of well-being is undermined by unemployment, keeping nearly one out of ten of the U.S. work force out of work.

The survival of the EMU is being challenged by the divergence between the core and periphery eurozone countries.

Meanwhile, many emerging markets, notably China, are fighting inflation, while making the transition from export-led growth to increased reliance on domestic demand.

Policies to address these and other issues are being pursued. The Fed’s easy money policies to support the U.S. economic recovery continue and Europe is implementing its €750bn European Financial Stability Facility (EFSF). China is tightening credit and allowing a (slow) currency revaluation to help rebalance its economy.

It remains to be seen if all this works. But let us imagine the following economic scenario in spring or summer this year: U.S. unemployment is drifting down, however modestly, while core inflation is still very benign. Europe secures its periphery, while the core EU economies continue to post solid growth; confidence in the European project should return, along with a stronger Euro.

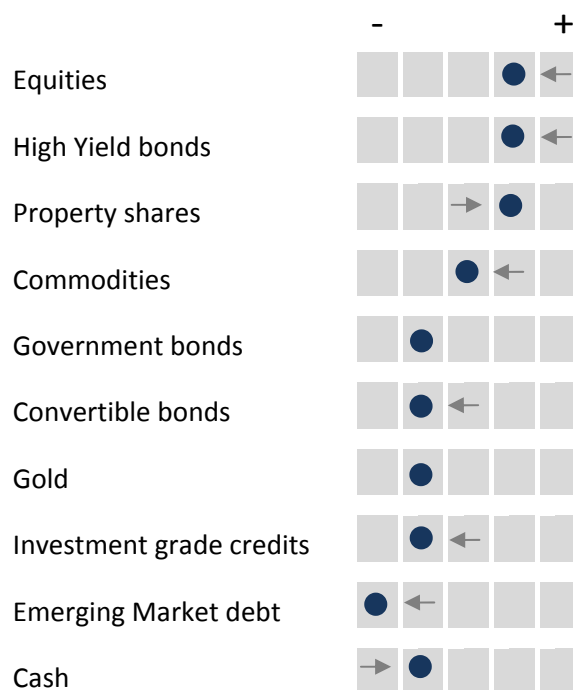
If the emerging markets manage to contain inflation, confidence in world trade will return.

Of course this scenario is optimistic and there will always be unexpected events (collapse US municipal bond market?), but at the moment the odds favour more optimism, justifying holding on to higher risk assets in investment portfolios.

Equities and High Yield are our preferred asset classes. We have become more neutral on investment grade bonds and more bearish on Sovereign bonds.

We like the following investment ideas: U.S. international banks, German small and mid cap industrials, oil exploration and services, mining equipment and businesses with emerging market exposure.

**Recommended asset allocation – balanced**



## 2. Economy

The world economy has probably grown around 5% in 2010 with momentum re-accelerating since the summer. Most economists expect 4% to 4.5% global GDP growth for 2011. Morgan Stanley forecasts that all regions, except Europe, will grow at or above trend in 2011.

Global growth is supported by;

1. Solid Production Manager Index numbers in the world
2. U.S. Corporations appear to be under-invested. Free Cash Flow (FCF) is at a record high, while Capital Expenditures' share of GDP is at a record low
3. U.S. employment should start to rise as Corporations may have overdone cuts in labour expenses
4. Half of global GDP (on a PPP basis) is now produced by emerging markets
5. Central banks still conduct very accommodative liquidity policies

Global growth remains uneven however. emerging market (EM) growth is expected to slow slightly from 7.4% to 6.4% this year. Similar to 2010, more than 70% of global output growth will be generated by EM. In developed markets (DM), we expect a kind of triple B recovery - bumpy, below par, brittle - to continue.

The Western economies face an unfamiliar crisis. Job growth has been moving to developing economies because they are more competitive (Chinese labour works for 10% or less than its American counterparts). What is new is that EM economies have become able to innovate as quickly as the Western economies or

replicate what the West does. Jobs, in other words, will not come back if Western competitiveness is not restored.

Unless developed economies learn to compete the old-fashioned way – by making more goods at lower costs and making them better (like the German industry) – the smart money will continue to move offshore to Asia, Brazil and other developing economies.

### Reflation

We expect the major Western central banks to continue asset reflation policies in 2011. Monetary policies in the G3 should remain expansionary. With inflation continuing to be modest, neither the Fed nor the ECB nor the Bank of Japan is expected to hike rates this year.

The situation in EM is the opposite. Inflation is pushed up by higher cost of labour and higher food prices. EM central banks are expected to be in a tightening mode this year, proceeding cautiously, as they do not want to kill growth or risk excessive exchange rate appreciation, although the latter is not an issue if exchange rates are compared to pre-Lehman levels. Higher inflation in EM countries may have an adverse effect on EM stock markets. The biggest risk would be a further rise in China's inflation.

### Sovereign risks

The Sovereign debt crisis, which started with Greece in April 2010, has not been contained. On the contrary, the size of the Sovereign debt of the small periphery economies is destabilizing the whole eurozone. Interest rates of the weaker periphery countries have risen to pre-Euro levels, hindering their capabilities to grow or service debt. But, also Bunds and Dutch

government debt have seen their interest rates rise since August 2010.

Will the current Sovereign crisis lead to the end of the EMU and the Euro? Although this cannot be excluded, we anticipate that the stronger core countries will give their support to stabilize the situation, giving more time to renegotiate the Maastricht Treaty rules.

In our scenario, we assume that the leaders of the EU will continue to support the Euro. Letting the Euro go under after only ten years of existence is not only very expensive to Germany's banks and exporters, but there are solid economic reasons to fight for the Euro's survival. The world needs an additional reserve currency next to the USD and the Japanese Yen. Europe needs one currency to protect its free trading zone.

The economic differences between the core and periphery have been an issue since the start of the Maastricht Treaty. Ignored by politicians, the ECB has often called for more strict observance of deficit and budget rules and structural changes in employment laws. It is the current crisis that probably makes it possible to introduce the necessary changes.

Although Germany is "officially" against a European bond guaranteed by all member states, this seems the ultimate solution to the EU Sovereign crisis. But this will take time (not expected before 2013) and requires more pressure from Germany on the periphery countries to bring their debt under control.

In the meantime, the ECB is working hard to avoid a debt restructuring event when large portions of Spain's and Portugal's Sovereign debt mature in April 2011.

### **3. Fixed income**

We expect that interest rates of 10-Y Bunds and 10-Y U.S. Treasuries will move higher in 2011 led by higher economic growth. In the eurozone we may see a worsening inflation outlook.

The credit recovery is generally still slow and, above all, uneven among economic regions. In Asia ex-Japan it is already back at its long-term trend. In Europe, Sovereign volatility and a more leveraged banking system allow for less flexibility to extend new loans. The U.S. currently occupies a benign middle ground and further progress is needed on the housing and employment front.

We expect Credits (corporate bonds) in the Euro and USD zones to post only modest returns in 2011, marking a significant downturn in performance from the past two years. We may see further divergence in rates between "core" and "peripheral" Euro Credits; to avoid risks, we favor debt issues from "core-based" companies with relatively short durations.

High yield debt continues to look attractive. The risks of defaults of companies has diminished, while higher yields continue to attract investors, further compressing spreads.

We favour debt issued by U.S. financials offering some of the widest spreads. This sector benefits most from the turn in the U.S. credit cycle, mandated deleveraging, financial regulatory reform and Basel III.

#### Fund flows

Bond inflows (4-week moving average) are negative for the first time since 2009, while equity inflows (3-month moving average)

are at their highest since 2006 and money market inflows have turned positive again. This pattern of fund flows suggest that investors remain somewhat cautious (hence money market inflows), but realise that bonds carry a risk and that, at the margin, some types of equities are safer than bonds.

#### 4. Equities

We maintain our positive stance on equities as our preferred asset class in 2011. Our arguments for holding more equities and increasing risks are:

1. Interest rates have reached the end of the long downturn cycle; the potential investment returns on Credits and government bonds have become unattractive.
2. Equities are among the cheapest inflation hedges at a time when the Fed takes measures that push up inflation. Equities only de-rate once inflation expectations rise above 4% (now 2.3%).
3. Equities offer better value than most assets classes. The equity risk premium (ERP) is 7.3% on IBES numbers. This compares to a long run average ERP of 3.6%.
4. Consensus forecasts 5% EPS growth in the U.S. and 15% in Europe, reason why most investment houses favor European equities.
5. The gap between the FCF (free cash flow) yield and the corporate bond yield is still at all-time highs.
6. U.S. Equities have under-performed bonds for an amazing thirty years – the longest period for almost eighty years. Is it time for a mean reversion?

7. The last time credit spreads were at current levels (December 2007), the S&P500 was at around 1,500.

8. Long term investors (retail, pension funds and insurance companies) are still cautiously positioned in equities.

Bonds yields have been rising since August last year. At some point, further rises may hurt equity valuations. On valuation grounds, such a problem would occur when the U.S. 10-Y Treasury yield reaches 4% (3.3% now). At that point the Equity Risk Premium (ERP) would fall below 5%.

We believe 2011 could be “The Year of the U.S. Banks”. Banks and Financials were one of the worst performing sectors in 2010. In the last few weeks this group is showing strong relative outperformance. Capital ratios of most U.S. banks look better than their European counterparts. Recently some U.S. banks have indicated that they may begin raising dividends in 2011.

One of the overlooked surprises for 2010 has been the faster than expected improvement in loan losses of U.S. banks.

Net charge-off rates have shown a steady decline after peaking in 4Q 2009, despite little improvement in unemployment and home prices. Bank of America forecasts loan loss provisioning to decline from 2.6% in 2010 to 1.8% in 2011 and to 1.4% in 2012.

#### Indicators

Some of the tactical indicators are extended, making us more cautious to increase equity positions at this stage.

Equity sentiment is at a 4-year high, the VIX index is at low levels and most stocks are currently far above their 200-days moving

average. On the other hand, the risk appetite index (Credit Suisse) is not extended relative to its norm.

#### Bears

Equities may at some stage enter negative territory should the Fed change its policies with regard to QE and providing liquidity in general. This would be good economic news, but it should not be good for stocks. Another trigger may be raising labor costs, driving up core inflation. However, we do not believe these are likely events in the near term.

Two other events would be harmful for equities: a hard landing in China and a European debt crisis. Our view is that the debt situation in Spain will turn out manageable. We are more worried about China.

#### Emerging markets

We see a potential bubble in EM caused by interventions of QE2-driven money inflows and real rates being below nominal GDP, especially in Asia. With inflation rising, there is a risk that central banks in emerging markets are getting behind the curve. To illustrate, Thailand has raised interest rates three times since July to pre-empt inflation. History tells us, that when interest rates go up, EM stock markets are vulnerable for corrections.

Fundamentals disagree, suggesting that global emerging markets (GEM) and Asia ex-Japan (NJ) should trade on a 20% to 30% P/E premium to global markets, compared to a 4% discount for GEM and a 5% premium for NJ at the moment.

Longer term, investors should overweight EM equities. Asia ex-Japan has delivered more than double the EPS and economic

growth compared to the world average, over the past 10 years. The region benefits from superior productivity growth, driven by labour migration from rural to manufacturing and growing school enrolment. Government debt, private sector debt and bank leverage are all in much better shape than the developed world. Their currencies are generally undervalued.

#### **5. Currencies**

Currency markets remain in the middle of an economic war between Western and emerging market economies. We expect 2011 to be another year of volatile trading.

The Swiss Franc and the Swedish Kroner should retain safe haven status in Europe. Emerging market currencies should continue to appreciate against the USD and the EURO.

We are sceptical that the recent rise of the USD against the EURO will continue in 2011. The Fed's monetary policies aim for a lower USD value. Also, the recent USD strength and the low USD interest rates should enhance the return of carry trade financing. The U.S. current account deficit suggests further long-term U.S. dollar weakness.

However, it will be difficult to predict the expected USD weakness while the stress situation around the EU Sovereign debt crisis continues to dominate. A large reduction in eurozone stress may occur by the end of April this year with successful refunding of Spain's and Portugal's Sovereign debt. It is our view that the ECB and the Core Euro area countries are committed to delivering this stabilization.

The EUR/USD could become attractive at that stage, as it was in June of last year.

## 6. Commodities

The year of 2010 provided strong returns to commodity investors. Precious metals steadily posted new highs on the back of extremely accommodative monetary policy within G3 and the rise of Sovereign debt risks in Europe.

Grains and soft commodities posted exceptional returns in the second half of 2010 due to supply concerns.

Energy, however, was mostly range-bound in the year, picking up in the second half in anticipation of QE2.

The top three performing commodity investments in 2010 were cotton at +104%, silver at +82% and coffee at +69%. Negative returns were seen for zinc at -8.55%, cocoa at -11.37% and natural gas down -38.04% due to lower spot prices.

We see commodity prices moving broadly higher in 2011 on the back of robust growth in emerging markets. We believe our outlook holds even as developed markets post relatively weak growth in 2011.

Headwinds for commodities are tighter money supply in emerging markets and fiscal austerity in developed markets.

We favour supply-constrained commodities such as oil, copper and coal. Increased demand and low inventories will likely set these commodities higher.

Gold currently seems to be in a pure momentum market. Momentum markets are exciting, but have a tendency to fall faster than they rose. The USD troughed in 2008, and inflation expectations are not rising in any meaningful way.

We anticipate that in 2011 Gold's current momentum market is likely to give way to more fundamentally-based assets like equities.

## 7. Conclusion

Our base case scenario for the 1<sup>st</sup> Quarter of 2011 is a relative positive one; the global economy recovers further, the Euro will survive and emerging markets remain strong.

This scenario is optimistic and there will always be unexpected events, but at the moment the odds favour more optimism, justifying holding on to more risks in investment portfolios.

Equities and High Yield are our preferred asset classes. We have become more neutral on investment grade bonds and more bearish on Sovereign bonds.

We like the following investment ideas: U.S. international banks, German small and mid cap industrials, oil exploration and services, mining equipment and businesses with emerging market exposure.

### *The Investment Committee*

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Michael Hoving, CEO  
Michiel van Wulfften Palthe, Director

**Ranked Performance of Various Indices, 2010**

Copper in \$ per Lb.	+31.37%
Gold \$ per Ounce	+29.52%
Rogers International Commodity Index in \$	+19.01%
MSCI Emerging Markets in \$	+15.87%
Barrel of Oil in \$	+15.15%
MSCI USA in \$	+13.18%
High Yield bonds in \$	+12.58%
MSCI Latin America in \$	+12.07%
MSCI World in €	+10.54%
MSCI Europe	+8.04%
Convertible Bonds in €	+7.76%
HFRX Global Hedge Fund Index \$	+4.76%
Investment grade Credits in €	+4.45%
JP Morgan Global Gvt. Bonds in €	+3.74%
Barclays CTA Index	+3.52%
MSCI China Free in \$	+1.98%
JP Morgan Cash Index 1M in €	+0.51%
MSCI Japan in JPY	-1.24%



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