HOVING & PARTNERS S.A.

WEALTH MANAGEMENT

Quarterly Investment View

Issue No. 4/4 October 2011

1. Summary

Earlier in the year, we believed that the right policy responses would inject confidence into the financial markets of advanced economies. Instead, the effectiveness of most policy responses in the US and Euro-zone has been at its lowest level in decades. Will this change soon?

It must be obvious to most political leaders that further delays in finding solutions to the current debt and Euro crisis will be extremely costly. The risks of the EMU economies entering into a vicious recession cycle are very great indeed. The most likely scenario is that ratio will prevail to avoid chaos and that a step by step solution will take place in the coming months.

Despite the fact that current global growth is below its long-term average, we are not seeing signs of a 2008-style collapse. The main causes of the Post-Lehman contraction are not present today. At that time, major banks stopped lending to each other (still the case in the Euro-zone today), trade finance stopped, inventories were high, capital investments were high and in general there was a great deal of counterparty distrust. Today's picture is more benign, but that may change abruptly if European events spin out of control.

Even if politicians act in time, the Euro-zone and the US will probably skirt recession, but we anticipate it to be a short and mild affair (muddling through scenario).

We believe that the EMU banking sector will be capitalized adequately soon, backed by EFSF, Euro-zone governments and the IMF. It is reported that the IMF works on a plan to involve emerging economies in setting up a global EFSF increasing resources to address the Eurozone-crisis.

Longer term, we believe the Euro has a good chance to survive. Down the road, we believe that EU leaders will agree to more fiscal integration, one independent Central Bank with full powers, a Treasury Ministry and more issuance of a large pool of EFSF bonds as a proxy to Euro-zone government bonds.

Our views on the Asset Mix – going into 2012

Government bond yields of the stronger EMU countries are currently at historic lows and relatively unattractive, unless a severe recession was to occur in Europe.

Investment grade credits do give some yield pickup, but are equally at historic lows.

We believe more in holding high dividend yielding companies as the better solution to earn income. Moreover, dividends paid by companies tend to increase over time.

The Q3 earning cycle and its outlook will probably cause a few negative surprises, but overall earnings should be in line as the real economy has held up relatively well.

Market timing will again make the difference when to pick up interesting candidates.

Prices of high yield debt instruments have come down quite a bit this year. Valuations have become more attractive and we therefore have taken a long position in this asset class to benefit from higher yields.

Emerging market debt also suffered following higher interest rates (to fight inflation) and lower exchange rates. Valuations have also in this asset class become more attractive and the risk/reward justifies a long position.

Recommended asset allocation – balanced

	-				+
Bunds		●			
Credits			●		
High Yield		→	●		
EM credits	→	●			
US equities		→	●		
European equities			→	●	
EM equities		●			
Commodities		●			
Gold		→	●		

2. Economy

The global economic recovery, which started in 2009 driven by temporary monetary and fiscal stimuli, has clearly not been sustainable. Instead, global imbalances have been rising.

Pimco, the large California based bond investor, expects the global economy to expand at a very modest real rate (the rate after inflation) of 1% to 1.5%. Current real global growth forecasts are well below the long term average of 3%.

In Europe the Production Manager Index (PMI) surveys are consistent with zero to minus 1% GDP growth, i.e. a mild recession. This is happening at a time when there is further fiscal tightening, a mild credit crunch and still a strong Euro.

Meanwhile, the US leading indicators are consistent with just 0.7% US GDP growth. The US will probably not enter into a recession.

The US non-manufacturing ISM actually surprised on the upside in September, with the new orders subcomponent moving up four points to 56 (ISM manufacturing new orders has also advanced slightly). US retail sales seem to have stopped falling contrary to what could have been expected following US consumer confidence numbers.

On the other hand, the probability of a recession in the US next year would increase significantly if all the fiscal tightening scheduled for 2012 were to be implemented (2.5% of GDP, compared to fiscal easing of 0.5% this year). Fiscal tightening in the US is unavoidable, which would hamper growth.

This year's events have sunk consumer confidence to recession lows which may induce a vicious economic cycle downturn.

China

Chinese growth has relied heavily in the past on investments in fixed assets financed through easy available credit. This seems to have come to a slow down.

The People's Bank of China has raised the reserve requirement ratio by 600bps since January 2010, draining about RMB4.2trn of liquidity from the banking system. Many smaller firms (SME's) have been cut from banks' lending lists.

SME's have had to turn to the informal financial markets for funding. In this market, the average lending rate is about 6% per month. There are no hard statistics on the total amount of informal lending by illegitimate financiers. While the size of such lending is not that large, this wild wave of nationwide informal lending could cause major problems to the property market, if it is not handled carefully and proactively by the Chinese government.

Despite slowing economic activity in China, most monthly economic data still seem at respectable levels. Credit Suisse still expects a respectable China GDP growth of around 8% in 2011 and 2012.

However, inflation is still substantially above the desired level. As such, we do not anticipate any meaningful easing of monetary or fiscal policy, at least for the rest of 2011.

The difference between now and 2008-09 is that private consumption in China seems quite solid, reinforced by salary increases and tax cuts.

The Euro-zone: ECB and EFSF

The Euro-zone needs to address its three main problems: a vulnerable banking sector, the lack of fiscal union and weak EU institutions. Addressing such solutions, takes time; a quick fix is not in the cards.

However, markets will not give much respite to EU leaders. Further delays would have the potential to trigger a bank run. So, for the time being, we are stuck in a waiting game.

The EU summit in October or the next G20 summit early November 2011 should be the turning point markets are waiting for.

It is important that EFSF II has been approved. The markets are already looking beyond to EFSF III, which could be armed with yet more firepower than the proposed €440bn for EFSF II. However, there are huge political, legal and maybe even constitutional hurdles.

Part of the "final" solution for the peripheral Euro-zone situation has to be leveraging up the EFSF, unlimited use of ECB funds and a move towards Euro-zone bonds (to allow the ECB to buy peripheral European debt on the scale required). The debt of peripheral Europe – including Italy – is now €3.2trn.

It is reported that the IMF is in talks with non-Euro-zone economies and in particular with emerging market economies to set up a global EFSF. This would aim at increasing resources available to address the Euro-zone crisis.

3. Fixed income investments

Government bond yields of the stronger EMU countries are currently at historic lows and relatively unattractive, unless a severe recession was to occur.

Allocation wise, we continue to prefer safety in credits from "core" Euro-zone countries and we generally would avoid peripheral credits.

Year to date, Euro-zone credit has shown that country risk, rather than sector risk, is the largest determinant of performance.

High yield credit spreads have increased in 2011 to around 800bps, effectively pricing in a recession. This seems an attractive entry point. Should the US economy slip back into recession, high yield companies are better prepared than last time, as the biggest default risks were wiped out in the previous cycle. Furthermore, because such a short period of time has passed since the last default cycle, high yield companies have remained in credit quality enhancing deleveraging mode and kept balance sheets very liquid. Thus any upcoming default cycle should be fairly benign.

We would like to reinitiate a long position in emerging market debt given better valuations, stronger government balance sheets and a healthier growth outlook. There is also scope for currency appreciations.

With inflation expectations fading in the world amid growth concerns, emerging market interest rate curves have started to change.

In fact, countries like Brazil, Turkey and Indonesia have shrugged off inflation concerns in their own economies and have already embarked on a monetary easing path, cutting rates by 50bps each. Others could follow their lead over the next few months. This rapid shift in interest rate expectations in emerging markets has quickly translated into broad-based emerging market currency weakness in just a few weeks. We do not see this weakness as a long term trend.

4. Equities

We became more positive on global equities at the start of Q3 based on higher global economic growth forecasts. This scenario has clearly not played out.

On the basis of the lack of effective policy responses resulting in further negative economic data it is difficult to get excited about global equities in the short term.

However, the global risk appetite indicator of Credit Suisse is at historical trough levels, which is usually a good indicator for turning points.

The current level of correlations across risk assets are at high levels not seen since the last financial crisis. High correlations usually indicate that investors do not discriminate between good and bad investments. When correlations ease, stock picking should create significant outperformance, similar to what happened after the financial crisis 2008-2009 and after recent summer’s Euro-zone dramatic price drop.

US Equities are not expensive. At an estimated EPS 2011 of $97, the S&P 500 currently trades at a P/E of 12. Historic normalized P/E of the S&P500 is 14-16. The US equity risk premium (ERP) is 7.6% (versus a historic ERP of 4.2%), at a time when the state of corporate balance sheets relative to government balance sheets has never been this good. EPS growth is only likely to turn negative if US GDP is sub 1.5%.

The US earnings yield is now seven percentage points above the 10-year bond yield. Equities also sit at 130-year lows in terms of rolling 10-year real returns.

The European stock markets are cheaper than the US trading at P/E’s of 9-10.

We recommend big cap stocks in Europe and the US with a strong credit profile, dividend yields above investment grade credit yields and international earnings.

We would use fire sales by the markets to reposition the equity portfolio looking further out into 2012 to benefit from any increase in visibility and potential economic pickup.

5. Currencies

The EUR should weaken, as all forces that have been supporting it early this year are losing steam or have reversed course.

The Euro-zone area badly needs a shift to reflationary policies to help reduce credit market stress. A lower EU exchange rate is badly needed.

Against this background, we expect the US Dollar and the JPY to firm and view the AUD as vulnerable.

Has the Swiss National Bank won? They certainly have to use all tools available to keep the CHF around the desired 1.20 level against the EUR. It depends on the outcome of policy decisions by EU leaders if the Swiss are able to persist.

Finally, we expect UK economic growth to remain poor, inflation to remain stubbornly high and see a high chance of renewed QE making GBP less favourable versus the USD but maybe not versus the EUR.

6. Commodities

As with most risk assets, recent pricing in commodity markets has been driven overwhelmingly by macro sentiments.

Although the outlook is murkier than normal, continued solid Chinese demand (restocking) should provide long term support for many commodities.

The short-term risks are on the downside, with prices likely to remain highly volatile. However, once the panic subsides (hopefully, the G20 meeting on 3-4 November will provide some clarity), the key "fundamental" consideration will be the extent to which the financial meltdown has contaminated the real economy.

The first two months of panic look to have had surprisingly little impact on the economic data from China and the US, although the Euro-zone has weakened noticeably. This suggests that if, as we expect, EU leaders eventually act to shore up the financial system and the global economy stabilizes, many commodity prices are likely to trough in 4Q 2011, before resuming their decade-long upward trend in 2012.

Given continued debt issues in advanced nations and both structural and cyclical headwinds to growth with all the implications these have for foreign exchange and interest rates, we are looking to renew our long position in physical Gold.

7. Conclusion

The main risk is that the real economy will fall into a severe recession driven by a negative and vicious self-fulfilling cycle. Our base case scenario is for the advanced economies to muddle through and emerging market growth to outperform.

Large international corporations with growing dividends look compelling relative to bonds and credits.

High yield and local emerging market bonds look attractive as they trade near 2008-2009 lows.

Gold is attractive again after the recent correction and should provide a safe haven were turbulent times to stay.

The Investment Committee

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

Ranked YTD Performance of Various Indices Q1, Q2, Q3 2011	Q1	Q2	Q3
Gold $ per Ounce in €	-5.04%	-2.72%	+13.60%
Barrel of Oil in €	+16.67%	+9.35%	+8.45%
JP Morgan Global Gvt. Bonds in €	-0.88%	+0.86%	+5.50%
Investment grade Credits in €	-0.73%	+0.61%	+1.38%
JP Morgan Cash Index 1M in €	+0.18%	+0.45%	+0.79%
JP Morgan High Yield bonds in €	+3.16%	+3.62%	-1.47%
BB CTA Index	-5.66%	-9.11%	-3.39%
HFRX Global Hedge Fund Index €	-5.43%	-9.83%	-8.24%
Convertible Bonds in €	+0.66%	-1.24%	-8.73%
MSCI USA in €	-0.66%	-3.12%	-10.62%
Rogers International Commodity Index in €	+3.35%	-6.82%	-11.68%
MSCI Daily Net TR World Free €	-0.93%	-2.58%	-12.21%
MSCI Japan in €	-13.00%	-11.29%	-13.20%
MSCI Europe	+0.09%	-1.26%	-17.84%
MSCI Emerging Markets in €	-4.21%	-8.30%	-24.00%
MSCI China Free in €	-3.05%	-8.45%	-26.63%
MSCI Latin America in €	-5.43%	-10.88%	-28.01%
Copper in $ per Lb. in €	-7.24%	-10.48%	-29.60%

Negative Quarterly performance

Positive Quarterly performance

Hoving & Partners S.A.

30A Route de Chêne

1208 Geneva

Switzerland

Authors

Jan-Paul Menke

Michael Hoving

Michiel van Wulfften Palthe

Editing

Jan IJff

Enquiries

Website
www.hovingpartners.ch

E-mail
jpm@hovingpartners.ch

Telephone
+41-22-544 12 90