

In our quarterly report published at the end of September we made the following comment: "There will be several meetings and summits of European leaders during the month of October at which they hope to reach consensus on important details regarding the use of ESM funds and possible European Banking supervision by the ECB etc. All of these events make October a month when volatility could rise again. We have therefore reserved some cash in all client portfolios to take advantage of this volatility. We are not expecting a major setback but believe that after the very strong rally some consolidation is inevitable."

The consolidation we were expecting started in the middle of October and resulted in a setback of about 8% in the US markets and 6% in the European and emerging market indices. As mentioned above, we had retained higher cash positions in client portfolios and have used the recent set backs to buyback positions we had sold at higher levels in September or to increase cyclical exposure in portfolios as we believed that cyclical stocks and emerging market equities looked attractively valued and the more defensive sectors with which our clients profited for the first half of the year looked relatively expensive.



Fig 1: Emerging markets (Orange) MSCI World Index (White) since October 2012 (source Bloomberg)

We were also of the opinion that emerging markets would start to perform better in the fourth quarter. Our comment in the last quarterly report was "Equities in emerging markets have been underperforming all year. However, their bonds have done very well and now their currencies are beginning to appreciate as well. We had increased positions in emerging market bonds for our client portfolios at the end of last year. The reason we did this is because emerging markets had been raising interest rates for the bulk of 2011 and their currencies had also depreciated substantially. We were therefore positioning ourselves in advance of a rate reduction cycle with possible currency appreciation (after a severe correction) as an extra bonus. This positioning has paid off very well for our clients this year. *We now believe that it is time to start increasing the emerging market equity exposure in client portfolios. The emerging markets have reduced interest rates and announced infrastructure, reform and stimulus packages over the past six to nine months. It usually takes about three to six months for such measures to show results. Therefore, a positive trend for growth in these markets should become evident in the fourth quarter of 2012. We have gradually increased exposure to emerging markets, commodities and related themes during the third quarter and will continue to do so on dips.*"

As Fig 1 shows, emerging markets have outperformed in the recent market consolidation. We expect this outperformance to continue, especially in light of the recent positive numbers from China. Chinese PMI (Purchasing Managers Index) is indicated to be above 50 (economic expansion) for the first time in over a year. Industrial profits were up sharply in October after seven straight quarters of slowing economic growth. Therefore it appears that as we mentioned in our last report, the stimulus measures of the last six to nine months are starting to bear fruit.

OPPORTUNITIES

Among the cyclical sectors in developed markets we find the technology sector particularly attractive after the recent setback. These are stocks with dominant market shares, growth opportunities in developed and

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emerging markets, excellent balance sheets and the ability to raise dividends, pay extraordinary dividends and buy back shares without any adverse effect on working capital or capital expenditure. The commodity stocks as well as some industrial stocks should also benefit from the improvement in the emerging markets, especially China. Recently housing and employment numbers as well as capital goods sales in the US have shown consistent signs of improvement and this should be supportive as well.

We believe that the mountain of cash being hoarded in company balance sheets will only start to be employed when there is more clarity in the European debt crisis and the US fiscal cliff. However we believe that capital expenditure will most likely be forced on companies due to the age of their infrastructure or the inability to continue working efficiently without updating technology.

RISKS

Even though there is a slowdown in Europe due to all the uncertainty and austerity measures, we believe that this is priced into markets to a large extent and is not a major risk at current levels. The US and China seem to be at more steady levels of growth even if these levels are lower than market participants would like. Globally this more favourable backdrop in the US and China should help equity markets move higher. However, the key risks are a new and unexpected development in the European debt situation, an unfavourable resolution to the fiscal cliff in the US and the possibility of renewed unrest in the Middle East.

We believe that the US fiscal cliff issue will be resolved before it becomes a major risk for the market. However, the prevailing uncertainty with regard to this very important decision is causing volatility to increase. It is not unusual at the current stage of negotiations to have vastly differing announcements from day to day which can influence market sentiment radically in one direction or the other. It is therefore important to build positions slowly. In our opinion the worst news flow with regard to the European debt situation is behind us but it is always possible that some previously unknown risk emerges. Though we do not expect this, we cannot rule it out.

As far as the Middle East unrest is concerned, this is an on-going situation which could either subside or break out at any time. The way to protect portfolios from excessive volatility in such a situation would be to increase exposure to oil and gold. While there is no way of completely avoiding this risk, these measures should reduce volatility.

OUR CLIENT PORTFOLIOS

In September we reduced risk in client portfolios as we were expecting some market consolidation due to the political uncertainties on both sides of the Atlantic. We have used recent setbacks to increase our exposure to emerging markets and related themes. As we had reduced our exposure to the US in September this year, we were able to use the current volatility to increase exposure to the technology sector in the US which we find particularly attractive at current levels.

We have moved our equity exposure closer to neutral and have remained underweight bonds while adding to gold on dips. We expect equity markets to end the year higher than they are now. Possibly near the highs for the year. We also expect favourable equity markets going into 2013 as signs of improvement in the US and China and stabilisation in Europe become more evident.

Bond markets should continue to underperform and even though we do not expect an extreme rise in yields in the near future, even a moderate rise from these levels would impact bonds substantially. We remain underweight developed market bonds and overweight emerging market bonds.

We believe that even though the best years for commodity performance may be behind us, there is good support at current levels which should be especially favourable for commodity producers. In our opinion gold will move higher from current levels attempting to breach its previous high of USD 1'900 achieved in September 2011. We have therefore increased gold positions in client portfolios to an average of about 10%. Brazil has been increasing its gold reserves as a way of diversifying its dollar exposure; they have recently been joined by Mexico, Colombia, Paraguay and Argentina. As a group, central banks will buy 500 tonnes of gold this year, the most in more than four decades.

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OUR ASSUMPTIONS

We are assuming that even though the whole European debt crisis situation continues to be a source of great concern, a compromise will be found which eases the path to eventual fiscal union. The process will be nerve wracking nevertheless. We also assume that though the fiscal cliff in the United States is causing a lot of short term volatility, this situation too will be resolved with a compromise which is acceptable to the Democrats, Republicans and the rating agencies.

We are of the opinion that China will continue to grow at a healthy pace of about 8% and this level will be enough to avoid social unrest and stave off inflation. It may turn out that this is a more favourable scenario than having 10% growth and the constant threat of high inflation. The recent economic figures indicate that a hard landing has been avoided and inflation is under control.

CONCLUSION

Therefore, though we accept that we are experiencing a time of great uncertainty, we believe that we should not completely ignore valuation. Investor sentiment is at low levels and we believe that as even small bits of good news trickle through, the positive effect on equity markets could be substantial as most market participants are underexposed to equities and overexposed to bonds. Even with the current uncertainties there has been some progress in the move away from bonds and towards equities at least for new money allocations. According to the UK's Investment Managers Association the flow of money into equities was over £500million which was the second month in a row that equities were the leading asset class and indicated that the tide was turning in favour of equities.

We hope that the thoughts and opinions expressed in this report are of help and look forward to the continuation of the favourable performance we have delivered so far. We are particularly pleased that the performance has been based on asset allocation, stock picking and rebalancing on a regular basis and we have managed to achieve this result for clients while maintaining moderate risk levels in portfolios.

Gillian Hollenstein

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