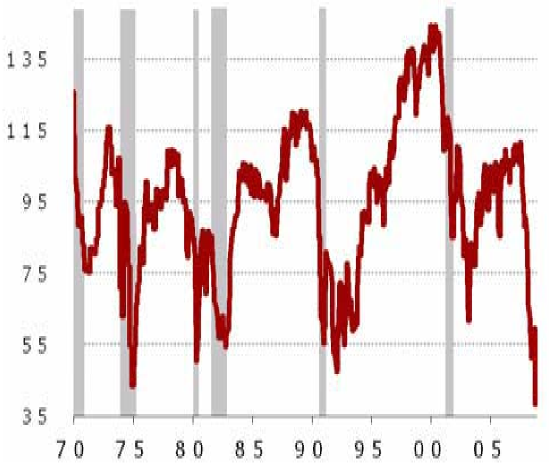
Quarterly Report 31 of December 2008

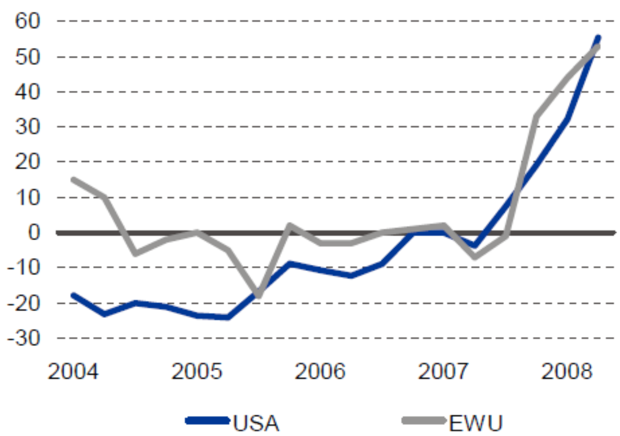
Economic Environment



picture 1: consumer confidence

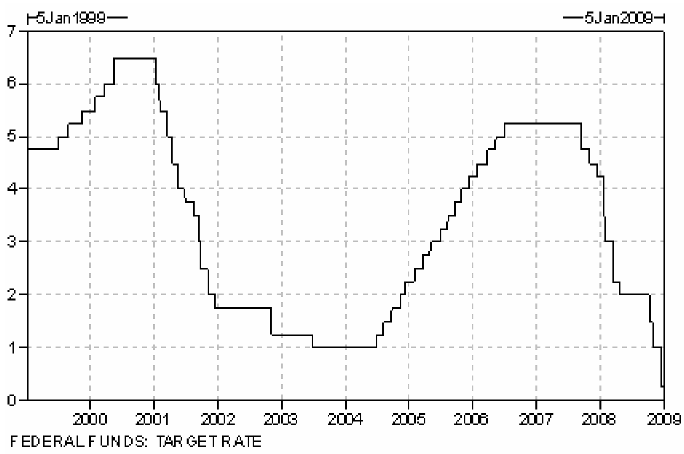
Review

The most important US economic data sank to their lowest levels for many decades, and reflect the current weak state of the US economy. In November, for example, the sentiment barometer for the service sector compiled by Supply Management fell to the lowest level recorded since data was first collected in 1997. The sentiment within the manufacturing sector, as measured by the Chicago Purchasing Manager Index, also recorded its sharpest decline in November since April 1982. Consumer sentiment in the USA presents a similar picture. This fell to a level last seen in 1975. The number of US citizens claiming unemployment benefit rose to 6.7 % at the end of November. The global economy posted a similarly gloomy performance; all indicators point towards recession, with some of the most important falling to the lowest level recorded in decades. In addition, the economies of the emerging markets were not immune to these developments, being also hit by the ongoing financial crisis.



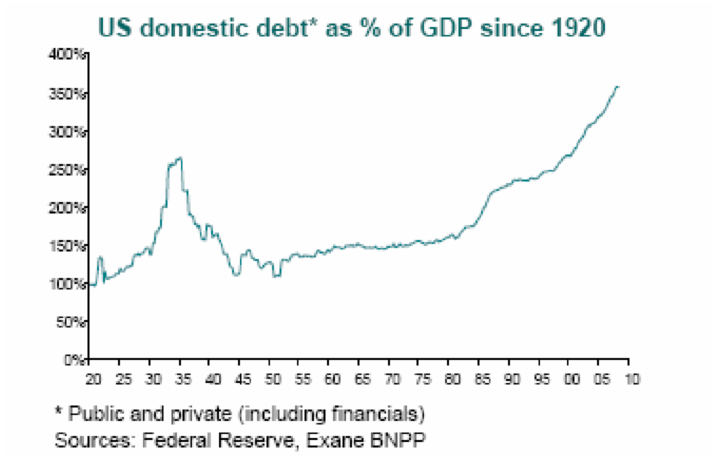
picture 2: numbers of banks, which increased credit conditions

Despite the worldwide interest rate cuts and the massive support for banks provided by governments, commercial banks remain reluctant to pass on the flow of liquidity. Instead of using the money to ease the credit crunch, banks have been depositing the money with the Federal Reserve or have been investing in safe Treasury Bills. This is having dramatic consequences on the real economy. In November alone, US commercial banks bought treasury bills worth $100 billion. In comparison to 2007, this represents a rise of over 60%.The difference between the return on three-month Libor and the return on US three-month Treasury Bills (T-Bills) is called the TED spread, and is a good mood indicator for the level of trust amongst banks. The higher the TED spread, the less the banks trust each other The TED spread eased slightly in recent days. This indicates that confidence has improved slightly amongst banks. However, the TED spread remains at a high level.



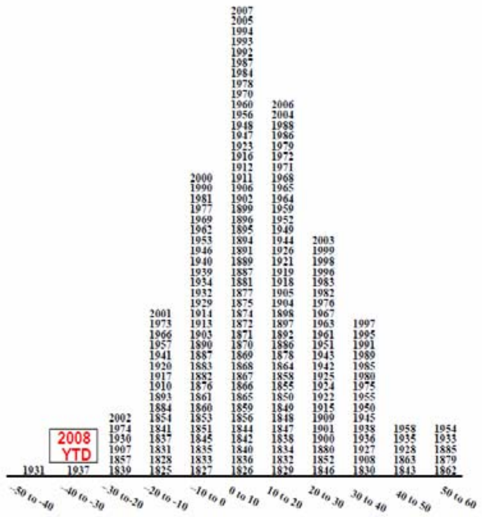
Outlook

Going Japanese? With increasing signs of deflationary conditions in the US, and following the US Federal Reserve's decision to cut its prime rate to 0.25% in December, market-watchers are beginning to wonder whether the Fed is simply following in the footsteps of the Bank of Japan. Despite the Bank of Japan's zero interest rate policy in the late nineties, commercial banks remained reluctant to provide loans to companies and consumers. For this reason, the Bank of Japan began buying up securities of all kinds ("quantitative easing"), in order to supply the markets with fresh capital. As Bernanke takes a very positive view of the Bank of Japan's approach, we have reached the FED's last and most likely response, so-called "quantitative easing". It is conceivable that the FED will soon break the Bank of Japan's record. Following the collapse of Lehman Brothers in mid September 2008, the Fed's balance sheet total has more than doubled from $924 billion to $2,200 billion. Further problems are looming for the US economy in the form of defaults in the credit card and automobile leasing fields. This could easily push the FED's balance sheet total from $2 trillion to $5 trillion.



At the beginning of October, the US House of Representatives approved the sum of $700 billion to rescue the US financial sector. The designated US president Barack Obama is planning to create three million new jobs within two years, and for this purpose will increase state spending to bolster the US economy by up to $650 billion. However, it is questionable whether these stimulus packages can actually be financed. By the end of December 2008 government debt had risen to $10 trillion, equivalent to 74% of GDP. Historically, state stimulus programmes (Keynesian demand stimulus), such as those pursued by the US in the thirties or Japan in the nineties, were not sustainable. In the short to medium term, government stimulus programmes have had a positive impact on the economy and stock markets. In the longer term, however, these programmes failed to produce the desired effects. (A description of the economic crisis of the thirties and the Japanese crisis around the Millennium is enclosed in the appendix.) If the rescue measures of the Fed and government prove unsuccessful and if excessive losses pile up, then the Fed would have to "print" more money, triggering hyperinflation.

Equity Markets



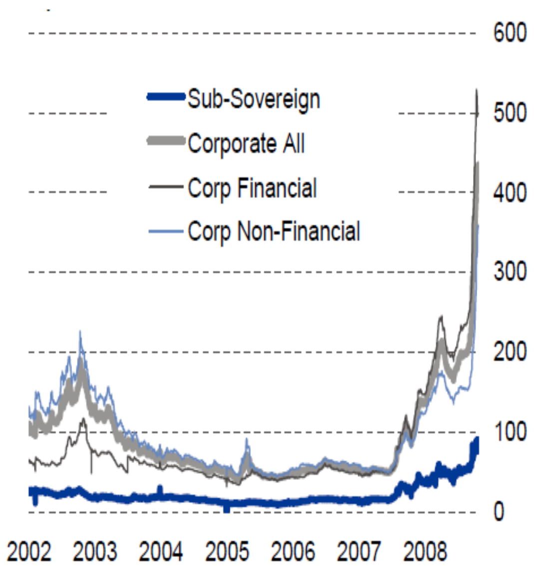
Review

2008 was a stock market year we are not likely to forget. Three out of five American investment banks, two mortgage giants, the world's largest insurance group as well as the state finances of a number of countries collapsed. At times, the financial system stood on the verge of the abyss, and states around the world intervened to prevent the global economy from collapsing. Global equity markets posted losses not seen since the thirties. Measured against the MSCI World Index, equity prices shed an average of up to 40% of their value. The biggest losers were the emerging markets, which were once again unable to decouple themselves from the industrialised states. The Shanghai Index in China, for example, lost 60.3% of its value. Due to the collapse in commodity prices, Russia has been hit the hardest, recording a fall of 71.78%. Equity markets in the G3 states also came under considerable pressure. The S&P500 (USA), for example, lost around 37%, the Euro Stoxx600 (Europe) dropped 43.33% and the Topix (Japan) posted a negative return of 40.74%. Since 1886, the losses recorded in 2008 were topped only by the slump of 1931. However, that is hardly comforting. Over the course of the past quarter it has become increasingly clear that the financial crisis has crossed over into the real economy. The first to feel the effects of the crisis were automobile manufacturers, followed by companies in other sectors who have been forced to slash their earnings forecasts.

Outlook

The valuation of the S&P 500 based upon the calculated 10-year average price/earnings ratio has reached a P/E figure of less than 15. This is below the historical average of 16. In past recessions, however, the P/E ratio has fallen to between 7 and 9. This would suggest the S&P 500 still has a downside potential of 30%. It is difficult to analyse equity markets on the basis of the P/E ratio, though, because the state is likely to intervene massively in economic affairs during Obama's presidency. We are expecting corporate profits to remain under pressure until into Q2. In fact, these are only likely to begin recovering during the second half of the year – as a result of the stimulus packages. In historical terms, economic crises tend to peak four months after the highest level of state intervention has been reached. Equity markets respond 4 to 6 months more quickly, and tend to correct around the time of the highest level of state intervention. The past has also shown, however, that such equity market rises brought about by state intervention have rarely been sustainable.

Bonds



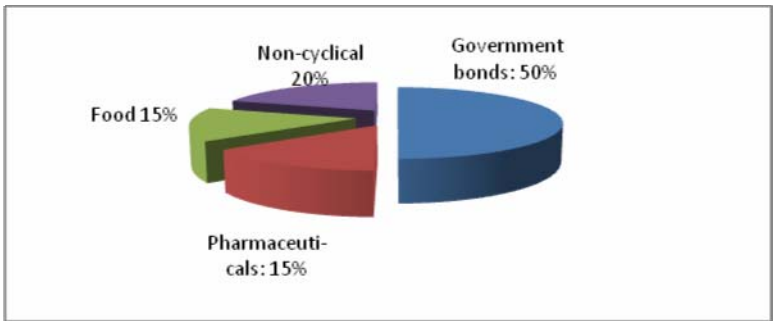
picture 3: Corp. Spreads

Review

While 2008 was the year of government bonds, which recorded very high gains, bonds of all other types suffered dramatically. Following the collapse of Lehman Brothers, investors expected the level of bond defaults to rise above those seen during the Great Depression. For this reason, they demanded high returns, which pushed the price of bonds downwards. In November, the interest premium (credit spread) for the bonds of issuers with good credit ratings reached a level, relative to government bonds, last seen during the Great Depression of the thirties. For example, CDS spreads for companies within the automobile industry imply a default likelihood of between 19% (VW) and 48% (Fiat). This is also the case for high-yield bonds, whose risk premiums have reached new record levels.

Outlook

We continue to recommend a core exposure to first-class government-associated bonds with short maturities. In the event of an extended and serious recession, these should help stabilise the performance of the portfolio, as the correlation with equities is low. At the same time, we would recommend building up selected corporate bond holdings from defensive sectors which have been undeservedly punished by the market and which show historically attractive returns. We take a particularly positive view of companies in the health and food sectors, along with other non-cyclical companies which show solid cash-flows as well as low levels of indebtedness. These corporate bonds should prove to be relatively robust in an economic depression as well as in a recovery scenario. Due to the risk of inflation, we favour bonds with short maturities.



picture 4: model portfolio

Returns on 30-year and 10-year US treasuries fell below 3% in the past quarter – the lowest they have been for 50 years. At the same time, price gains have been very high (the next bubble?). If inflation picks up as the result of the expansive monetary and fiscal policies, we would consider short selling 30-year bonds.

Commodities

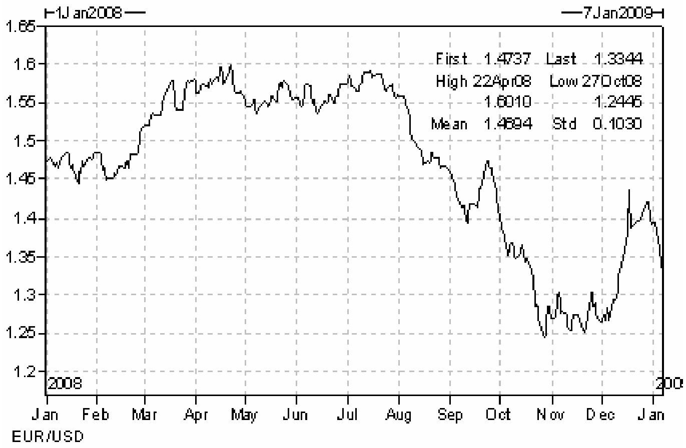
Review

The bull market in commodities overheated and the bubble burst last summer, as the adjacent chart shows. Commodities are extremely cyclical, and respond particularly sensitively to economic downturns. The global slowdown in growth caused demand for commodities to collapse. The second cause of the bear market was the credit crunch. Investors such as hedge funds, for example, became over-indebted and were unable to extend their maturing loans because they ceased to be able to obtain money from banks in the capital market. In order to prevent liquidity bottlenecks, institutional investors such as hedge funds sold tradable assets, including commodity assets. The collapse in the price of gold took investors by surprise, not least because gold assets have traditionally been safe havens during times of crisis. For investors with the reference currency euro, pound sterling, Canadian dollar or Swiss franc, such investments have at least broadly retained their value, above all in comparison to other asset classes such as equities, corporate bonds or commodities.

Outlook

The outlook for commodity prices is strongly dependent upon the state of the economy as a whole. In a global depression scenario, commodity prices would remain under pressure. In the event of an economic recovery, or in a highly inflationary environment, commodity prices would begin to rise once again. Lower interest rates, ballooning government debt and strong inflation would be likely to give gold a strong boost. By contrast, perspectives within a scenario involving a sustained economic depression and deflation are less positive. Even then, however, thanks to its status as a safe haven, gold is still likely to perform better than other asset classes.

Currencies / Hedge Funds

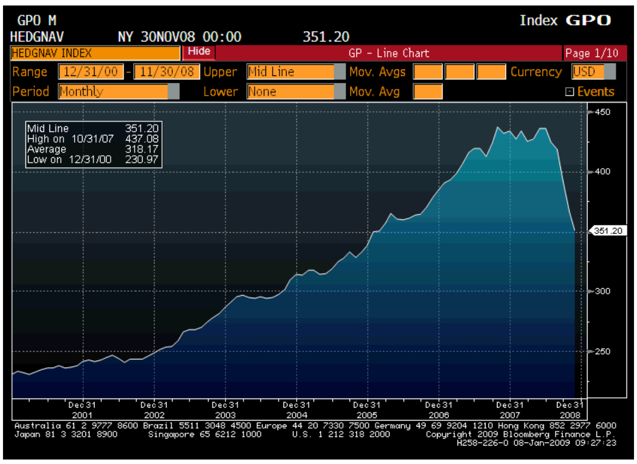


Review

Despite the sharp deterioration in US economic data and the very low US interest rates, the value of the US dollar rose during the period to the beginning of December 2008. Historically the US dollar has proven to be a safe haven during times of crisis. Investors sold their foreign assets and fled to US Treasuries. On this occasion too, the US dollar profited from the further accentuation of the crisis at the beginning of October 2008. At the same time, returns on 10-year US treasuries fell below 3% - which is the lowest level seen in 50 years.

Outlook

In the short term, the US dollar could continue to profit from the uncertain state of the markets. Due to the deteriorating economic environment within the Eurozone, the ECB will be obliged to cut its key lending rates still further. The interest spread on the euro relative to the dollar, Swiss franc, yen and pound sterling will narrow, and for this reason the euro is likely to find itself coming under pressure. If the rescue measures taken by the Fed and the US government fail to produce the desired result, and if the losses become too great, then the Fed will need to “print” more money. This would trigger hyperinflation, and the value of the dollar could collapse. In addition, a lower dollar would be in the interest of the US. This is because a low dollar would ease pressure on the export sector, thus promoting growth. For these reasons, it is our assumption that the US dollar will weaken in the long term.



picture 5: CS Tremont Hedge Fund Index

Hedge funds (review/outlook)

Following a prolonged boom, the hedge fund sector has plunged into the most serious crisis in its history. In 2008, hedge funds still produced better returns than equity markets. However, they singularly failed to meet the expectations of the oft-propagated “absolute return strategy”. Hedge funds are currently being squeezed not just by their own losses, but also by the deleveraging process and tighter government regulations. Lending constraints and tighter regulations means hedge funds face new challenges. For this reason there is likely to be massive consolidation within the sector. The only hedge funds to survive this process will be those that are able to generate positive returns in this new environment.

Appendix

Historically, state stimulus programmes (Keynesian demand stimulus), such as those pursued by the US in the thirties or Japan in the nineties, were not sustainable. In the short to medium term, government stimulus programmes have had a positive impact on the economy and stock markets. In the longer term, however, these programmes failed to produce the desired effects. An equity bull market developed in the twenties, which was driven by the Fed's expansive monetary policies. In order to prevent a stock market bubble, in 1928 the Fed decided to tighten its interest policy. Four weeks before the stock market peaked, interest rates were raised. The economy began to weaken from the beginning of 1929. Following the crash on 24 October 1929, the Fed responded and dramatically reversed its monetary policies. The government under US President Hoover however failed to take any measures, putting their faith in the "healing forces of the market" instead. It was only with the electoral victory of the Democrat Franklin D. Roosevelt that US policy changed. With the "New Deal" he introduced wide-ranging economic reforms and stimulus programmes. By 1937, however, it had become apparent that the stimulus programmes were not working. The economy emerged from the Great Depression only when the US entered the Second World War in 1941, which brought about an expansion in the production of armament.

picture5: US stock market from 1929-1944

The picture in Japan was similar. In the early eighties Japan was in a boom phase, and a real estate and equity bull market developed. This boom was promoted by expansive monetary policies. To prevent the economy overheating any further, the Bank of Japan began raising interest rates. This caused equity prices to collapse, and resulted in a decline in real estate and property prices. Banks which had specialised in mortgage-based securities were forced to ration their lending – resulting in a credit crunch. This had a very negative impact on gross social product. In the years 1991 to 1995 the Bank of Japan was forced to slash its official discount rate of 6% to just 0.5% in an attempt to stimulate the economy. Notwithstanding state stimulus packages, the country entered a deflationary spiral.

picture6: Japanese stock market

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