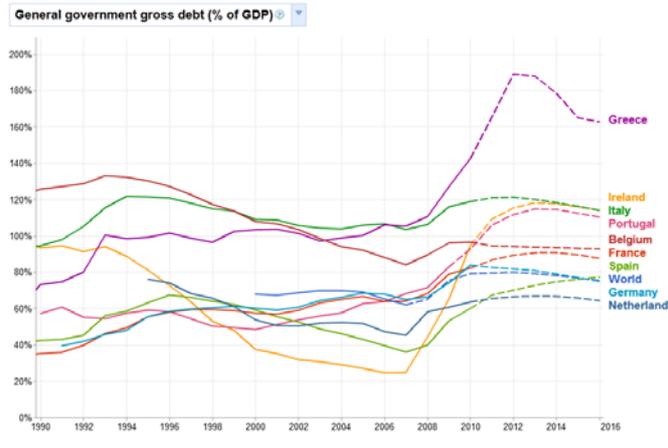
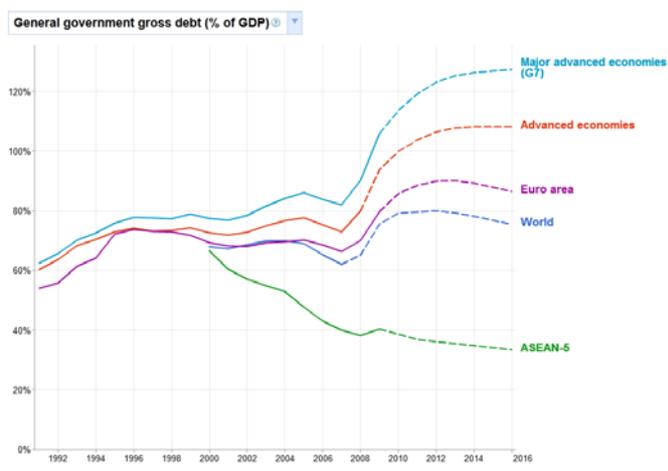




Musical Chairs.....

December 2011

"Playing musical chairs" is also a metaphorical way of describing any activity where items or people are repeatedly and usually pointlessly shuffled among various locations. It is also used to refer to political situations where one leader replaces another, only to be rapidly replaced in turn due to the instability of the governing system. Today, the game is not just in full action locally but even more so in the Eurozone as a whole. I was attending an investment summit this week in Montreux, Switzerland with many participants from all over the globe. At the opening speech Todd Benjamin asked the audience if they believe that a country would leave the Eurozone. Guess what; roughly 70% thought this will not happen. Since humans do not like change and the unexpected this is probably not surprising. But since all participants were investment professionals I really wonder if they do not read markets anymore. The current Eurozone's sustainability is in question and academic discursions about if and when and maybe does not help any longer! **Markets give us the answer: a complete disbelief in the European institutions and its political willingness to**



adapt to change. With every round of musical chairs you lose a teammate. Surprisingly to me it is Italy being the last victim despite the fact that the odds for Spain were definitely higher. But then the order is not that important. However important is, that the winner acknowledges that a new round can only be played when there are some players left. Unfortunately Misses Merkel does not recognize that and comes up with rather dubious harmonization plans of fiscal union for the Eurozone i.e. **Germany controlling the weak member states budgets in order to keep its strong trade surpluses.** In any country this only works when the weaker states are proportionally overrepresented in the respective upper houses. But there is no such thing for Europe. Eurozone members have already abandoned its sovereignty over their national banks and the result is more than obvious. Does Germany honestly believe to rule Europe on their terms? Well, it seems so but this

will certainly not happen. **In contrary, bond markets have started to price in a break-up of the Eurozone.** Bond auctions went terribly in Spain, Italy and as a matter of fact for the fifth time in a row in Germany. Not only is Germany still strongly opposed to proposals for Euro bonds, but the fall in the Euro exchange rate also suggests that there is no believe in a successful rescue plan for the Union. Italian 10 year bonds trade around 7.2%, while the most recent 2 year auction yielded about 7.8% - near what Zimbabwe has to pay! Can markets be that wrong? I don't think so. **Just look at the spreads between Germany and the United Kingdom. The 10 year bonds trade now more or less at the same level, despite the fact that inflation in the UK is much higher.** This means that the market is pricing in

1. 10-Year Government Bond Nominal Yields (%)



significantly higher credit risk for German bonds than from UK bonds. This is an interesting development and as such consistent with the policy actions of each country. The Bank of England has aggressively monetized debt, while the Germans do firmly oppose it. In the German context investors should prefer their bonds due to its discipline and anti-inflation culture. **They miss the point however those international investors see Germany without a captive**

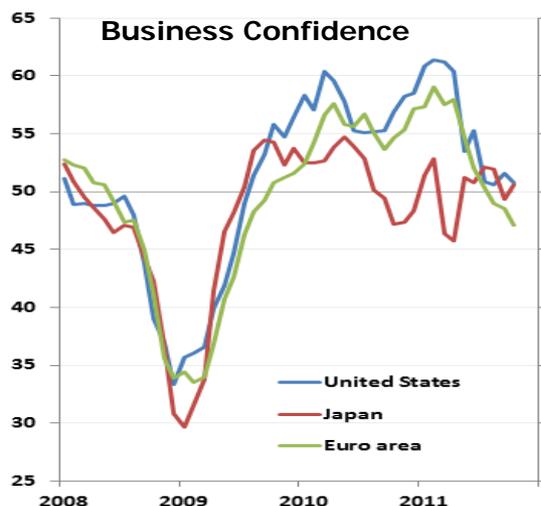
national bank that can act as lender of last resort. Therefore it's nothing but logical to value also Germany with a higher credit risk. Thus, the "Eurobond" discussions are just rubbish. German interest rates would spike higher and the Eurobonds cannot be backed by the ECB as they are prohibited from financing government budgets.

With the sovereign debt crisis moving forward the banking system is once more under severe pressure. The reason is not that they have learned nothing from the past but the fact that they hold ever more of their countries sovereign debt. **Rather than dispersing risk by spreading their holdings of government debt over several countries, banks are raising the chances of a vicious circle developing between the health of the sovereign and the country's financial system – a phenomenon that lies at the heart of the Eurozone crisis.** Naturally for the banks, the higher the stakes the higher the chances of a secure government bail-out. According to Dealogic European banks face this year a funding gap of USD 241 Billion. **It's the first time since the financial crisis hit the markets that the banks are collectively unable to replace their maturing debt with new bonds.** As a result banks will be forced to sell assets even if it means to take big losses. The funding freeze has raised fears about the knock-on effects for companies reliant on bank funding and the broader economy. **A study by Morgan Stanley estimates that banks worldwide will have to shed assets in region of USD 3'300'000'000'000.- over the next few years in order to meet new regulations on the amount of capital buffers they hold and to address the funding shortfall.**

So far European authorities have just kicked the can down road and markets quitted the actions with a heavy sell-off. Refinancing levels for many European member states are now near or in danger zone. **As a result the rating agency Moody's stated that multiple defaults in Europe are not unthinkable anymore while the FSA (Financial Services Authority) officially requests UK banks to prepare for an eventual end of the current monetary union!** I guess there is no other solution than to rework the European monetary framework altogether. What is true in the kitchen is definitely true for Europe: "too many cooks spoil the broth".

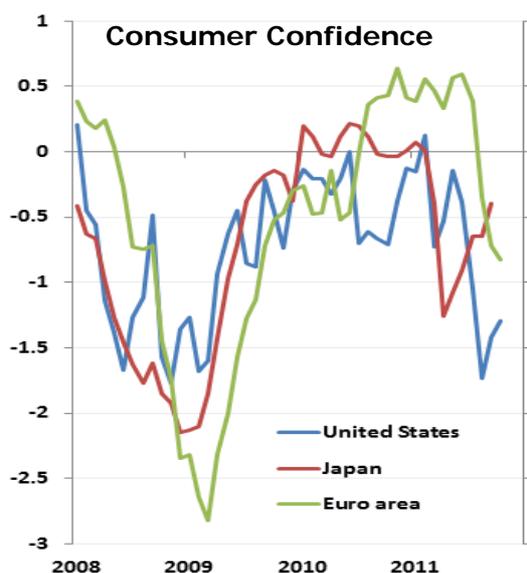
The Economy

The global economy has weekend this year and entered a new dangerous zone. World Economic Outlook (WEO) projections indicate that global growth will moderate further to about 4 percent through 2012, from over 5 percent in 2010. Real GDP in



the advanced economies is projected to expand at an anemic pace of about 1½ percent in 2011 and 2 percent in 2012, helped by a gradual unwinding of the temporary forces that have held back activity during much of the second quarter of 2011. However, this assumes that European policymakers contain the crisis in the Euro area periphery, that U.S. policymakers strike a judicious balance between support for the economy and medium-term fiscal consolidation, and that volatility in global financial markets does not escalate. In my opinion the chances for a renewed European recession are higher than a slow growth scenario. Further a break-

up of the currency union will most likely come sooner than later with Greece departing next year followed by one or two other countries in 2013. **As a result OECD and IMF growth forecasts for the Eurozone are probably much too high. According to Capital Economics Eurozone GDP will contract 1% in 2012 and 2.5% in 2013.**



The US economy has shown some resilience during the last quarters, although the most recent data suggest that the Q4 GDP growth may be lower than previously anticipated. **The fact that the congressional super committee failed to cut a deal on federal deficit spending will most likely lead to an end of the extension of the payroll tax cut, which is due to expire at the end of the year.**

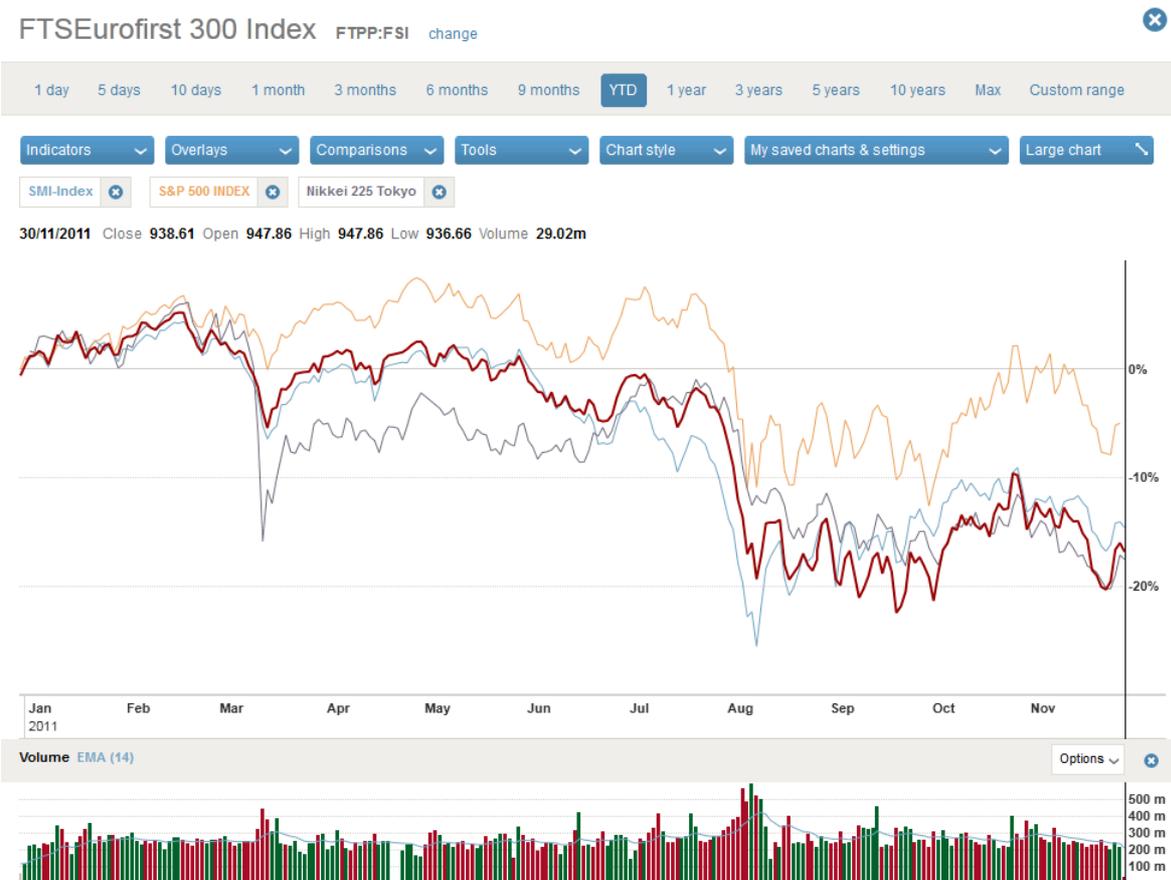
Weak consumer confidence readings coupled with disappointing durable goods orders for October do not brighten the outlook either. Although the ISM data show that the US economy and the manufacturing sector are still expanding, the growth trend has slowed significantly and the overall trend is down. **While the US economy is stronger than that in Europe it continues to face pressure from high unemployment and a weak housing market.**

A continued high rate of foreclosures is likely to keep the housing market weak. Despite historically low mortgage rates, many households are not in a position to take advantage of favorable financing or are reluctant to buy while pricing is uncertain.

Although Asia as a region is outperforming the rest of the world in terms of growth, Japan still recovers from the devastating tsunami and China's policy makers are reluctant to keep the economy from falling in a severe growth recession. However, headline and core inflation are moving higher not just in Asia (ex Japan) but in Emerging and developing economies overall. Because food and energy account for a larger share of their consumption baskets second round effects of wages are likely.

To sum it up downside risks to activity have increased noticeably since the June 2011 WEO update. **Four types of risk deserve particular attention and revolve around weak sovereigns and banks in a number of advanced economies, insufficiently strong policies to address the legacy of the crisis in the major advanced economies, vulnerabilities in a number of emerging market economies, and volatile commodity prices and geopolitical tensions.** Various market indicators confirm the qualitative assessment that downside risks are now much higher than in June or April 2011. A downside scenario illustrates how the major advanced economies could fall back into recession and what damage this could inflict on emerging and developing economies.

The Markets

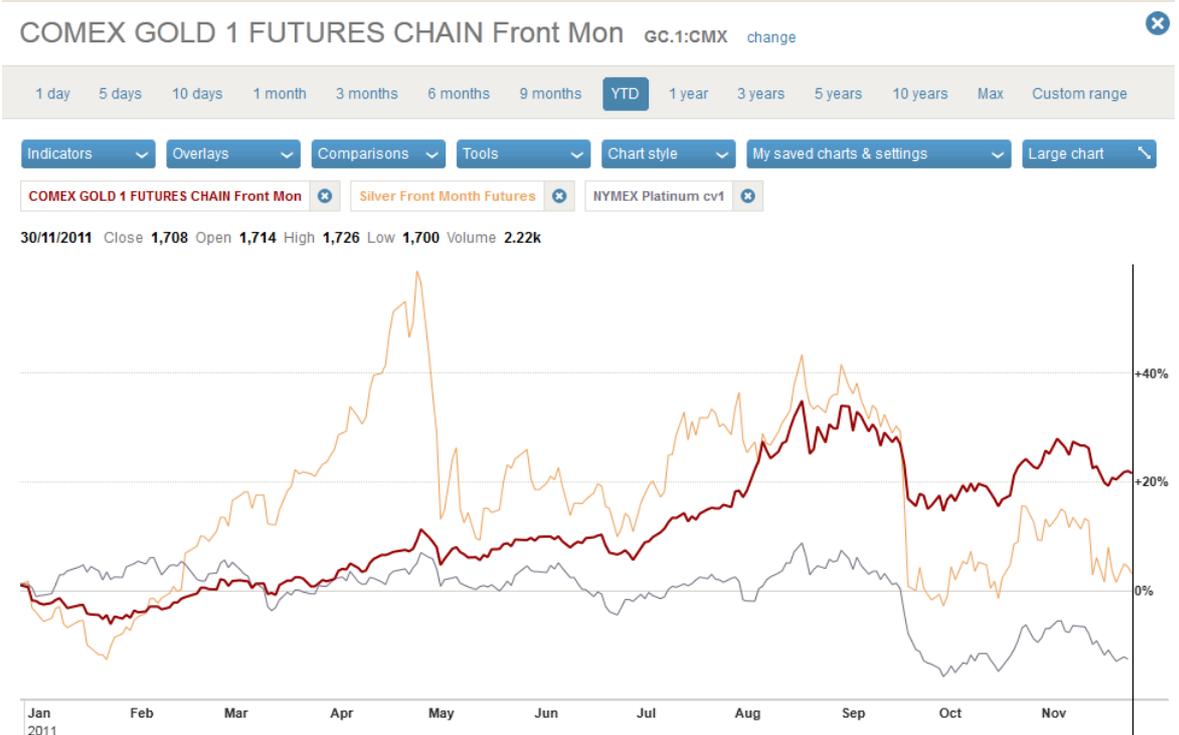


The dominant theme in November was risk off, independent of asset classes or markets. Only the most liquid and "safe havens" such as US Treasury, Bunds or interestingly enough UK Gilts produced positive returns, although at very low level. Equity markets however saw once mote a rather steep sell-off during the last weeks. Surprisingly strong earnings reports in the US and Europe led to a short lived rally (primarily short-covering) in October. **Trading volumes have never recovered since the first sell-off in August and volatility remains high - a sure sign that equity markets have not bottomed yet.** Money flows were negative for all markets. Also ETF's with outflows outnumbered those with inflows by a decent margin and continue to indicate a more defensive posture among investors. Given the strong earnings season most developed markets show inflation adjusted price / 10y average earnings ratios at the lower end of its range and are definitely not expensive anymore, but given the uncertain outlook, forward looking earnings look to me rather dubious. According to our equity screens, companies with cyclically adjusted price

earnings of less than 10 have performed better than the broad indices, although also suffering from the depraved market conditions. **As predicted, a couple of takeovers do at least confirm our view that despite all the gloom and doom cash rich companies will ultimately take the chance to buy topline revenue or synergies at reasonable prices.** Looking at our M&A portfolio Autonomy PLC was bought by HP and Yahoo will strike a deal with private equity groups. Despite the muted deal flows merger arbitrage held up well and generated positive returns. Here and then equity markets rally quiet strongly on unfounded hopes. **The recent coordinated central bank intervention cheered equity markets. Fact is, it just helped to prevent a couple of imminent bank failures and with it the inter-bank market.** The big question is - as always at the end of year - what are the prospects for 2012? The macro picture is getting worse, earnings although positive will be lower, the Eurozone will most likely break-up and China will not save the western world. **Consequently I do not see why equity markets should rally sustainably.** In relative terms US equities will probably do better, as well as the US dollar. European equity markets will test the lows of August once more. Look at individual companies, fallen angels and as pointed out before M&A candidates. The "food" theme will once more be present as the supply demand situation in Asia gets worse month by month.

We are in favor of the US Dollar, Canadian Dollar and Swedish Kroners, shun emerging market currencies and definitely don't like the Euro. Interestingly enough the Swiss National Bank is successful in weakening the Swiss Franc - the Japanese could only dream of. How long this will work is difficult to say, but at levels of 1.25 to the Euro I would certainly recommend to be long the Swiss.

Commodities markets were driven by heightened uncertainty surrounding the debt crisis and the worsening macro-economic outlook. Base metal prices remained volatile particularly for copper. Oil prices gained some upward momentum as extremely tight physical markets have sustained prices higher. US product inventories have moved below its 5 year average and deepening geopolitical tensions will most likely



support prices in the short-term. We remain skeptical however, that longer-term the global slowdown will support prices at current levels. Gold prices recovered at least during November some lost ground amid the seasonally strong period for demand as strong buying demand emerged across Asia. **Continuing negative interest rates, inflation concerns and the sovereign debt risks provide certainly a fertile ground for further gold investments.** As with other sectors, agriculture markets have been influenced by movements in the wider financial markets. The October WASDE report featured no big surprises. However, the El Nina phenomenon this winter has the potential for soybean production setbacks in South America.

Portfolio Strategy

As you would imagine we definitely prefer US Dollar assets, but see still no reason to increase equity holdings other than for short-term trading. Our focus remains on cash, quality corporate bonds, merger & acquisitions and real assets. In the alternative arena we lost confidence with a lot of long/short strategies, but acknowledge, **that systematic multi-strategy funds possess investment appeal.** The high market volatility still offers good opportunities for structured investments. **We remain focused on plain vanilla (simple) structures seeking high coupons or leveraged theme based baskets.** For the last decade equity returns were basically zero, well below the long-term average of 7%-10%. Nevertheless, certain sectors performed fairly well during this period. Energy, materials and consumer staples had all solid absolute returns. Naturally, the worst sector had been financials. Since asset class and sector correlations are still extremely high our models cannot calculate compelling allocations for the short-term. **Longer-term however, consumer discretionary, consumer staples in emerging markets, energy and materials i.e. agricultural demand and software (cloud computing) are our sectors of choice.**

China will experience a real baby boom next year as we enter the year of the dragon. Birth rate is expected to rise about 5%. There are a couple of "baby care" stocks listed in Hong Kong, certainly worthwhile a closer look as a sub-topic.

Portfolio Allocation			
		Main Focus	Sectors
Cash & equivalent	5	Base Currency	
Gov. Bonds	0		
Corp. Bonds	10	Single A	Industrial
Equity Developed	12	USA	Consumer Discr, Energy, Materials, Information Tech
Equity Emerging	8	BRIC	Market, ETFs
Alternative Hedge	10	Multi-Strategy	Single Managers
Structured	25	Coupon, Leverage	Theme based, M&A
Real Assets	30	Agriculture	Agriculture, Precious Metals, Sustainable Forestry Real Estate, Wine, Art

I wish you all a happy x-mas season and look forward to support you in a challenging 2012.

Jürg D. Zingg
Portfolio Strategist

