THE BIG PICTURE

January 2011

Shifting sands – looking into 2011

We have increased equity allocation in two steps since late summer. Our *guidance for balanced portfolios* is now as follows: 50% global stocks, 10% corporate bonds including a sizeable and growing share of convertible bonds, no or only a minimum of long-term bonds, 15% precious metals including gold mining shares, 25% cash in the home currency of the client. As to our forex strategy we favour being in dollars and Swiss francs, recommending to hedge euro and yen exposure for non-euro denominated portfolios. We have not changed our equity strategy meaningfully, still favouring developed markets to emerging markets, technology to financials and Germany, the UK and Switzerland to the highly indebted peripheral European economies. The great trade of the past few years – bonds as a deflation hedge combined with emerging equity markets as a performance driver – no longer looks appealing to us. Within the equity space we see no reason to change our strategy as delineated in the September 3 paper.

After less than two years in operation Bellecapital is already recognised as one of the leading independent fund managers in the country. A few weeks ago we received a mandate from Pictet & Cie, one of the largest private banks in the world, to manage a strategy fund for them. The fund is managed along the lines of our investment strategy but geared to smaller investors. It is also open to our clients.

Why have we raised equity allocation? And what do we see for 2011?

1. *The mid-cycle slowdown should end in the first half of 2011.* Leading economic indicators are stabilising or turning up, commodity markets are booming and deflation fears subsiding. Monetary policy works after all, but only after a long time lag! The result: Short-term global growth is likely to slow, but economic activity may nevertheless prove stronger than is generally expected. It promises to be driven by robust business spending all over the world, by healthy, albeit somewhat slower growth in emerging economies and by the US recovery broadening to encompass the consumer as the labour market improves. The last two US business cycles started unusually slowly too but eventually employment growth accelerated. We are still in the early part of the business cycle and may have to

wait for 2012 to see global growth pick up again. The signs are on the wall: Cyclical stocks, commodity prices and commodity producers have rallied in the past few weeks. Yes, we remain overweight US stocks – the economy appears far more balanced than the economies of other regions of the world and unit labour costs are falling while they are rising in most emerging countries and even in parts of Europe.

2. *Global bonds have probably entered a long bear market*. The risks of a "double-dip" in the US and of a "hard landing" in China have receded, prompting investors to reassess. It's important to realise that the sharp increase in bond yields is a *global* phenomenon. It has little to do with America's QE2 or its tax cuts and, therefore, does *not* reflect materially higher inflation expectations. Ongoing deleveraging remains a powerful anti-inflation force. Rather the "real" component of bond yields increased from a multi-decade low triggered by the improved cyclical outlook, monetary tightening not only in China but also in countries such as Australia and Sweden, and possibly also by an increase in the credit risk (default risk) premium for government bonds, including German Bunds which do not fully reflect Germany's burden of shouldering much of Euroland's public debt. I'm relieved that we've experienced a big correction but not a crash, and that equity markets have been amazingly resilient. The implications:
3. *We are in an early stage of a major shift out of bonds into stocks*. Valuations across these two main asset classes are now normalising – bond yields are beginning to narrow the huge gap to corporate earnings' yields, a development that is most unlikely to go smoothly. Bond yields may well retreat again before the uptrend continues. That would be a positive sign. I would begin worrying if the 10-year Treasury yield crosses the 4% threshold in an environment of near zero inflation. Other bond markets would probably follow; there is no place to hide! To diversify the source of cash flow receipts we advise investing in high-yielding defensive stocks, an old theme of ours. But beware; some regions are riskier than other!
4. *China is losing the war against inflation and overheating while Euroland ex Germany is losing the war against deflation and recession*. China's borrowing costs are far too low; it's currency far too cheap. The central bank has waited too long before tightening *monetary* policy while Euroland has waited too long before tightening *fiscal* policy and easing monetary policy (Germany is the big and important exception). In brief: The American economy is managed more professionally. Policy is pro-growth by preventing deflation at all costs (easy fiscal and easy money policies), whereas Europe now risks falling into a debt trap. The ECB has no option but to start purchasing Spanish and Italian debt too, but it is unlikely to ease *monetary* policy sufficiently. And Germany is unlikely to ease *fiscal* policy to stimulate its large domestic economy for the benefit of its EU partners struggling with large current account deficits. Austerity risks Japanese-style deflation and stagnation for many years combined with European-style social unrest. 2011 may be the crucial year and turning point of the crisis – if Madrid

falls and subsequently also Rome the banking industry would hit the wall (Portugal, Ireland, Italy, Greece and Spain owe over $2tr to European and US banks) and we would all be in trouble. If, however, Spain manages to struggle through we may be presented with a big opportunity to make money in Southern Europe. My take and my hope: Worst will not come to worst. But it's close...keep your fingers crossed! What about the euro?

5. *The European currency will survive, even if a large EU country is forced to restructure its debt.* Yes, there is a cloud hanging over the euro. However, the crisis is the result of fiscal profligacy ending with dangerously overleveraged *countries*. The common *currency* is not the source of the problem. Yes, the euro has become a fundamentally weak currency because the ECB will be forced to support the highly indebted countries by monetising their debt. But this is a temporary measure. The currency is part of the solution, not the main problem.
6. *It is questionable whether sovereign debt restructuring can be avoided*. A big step towards a common fiscal policy, a debt crisis resolution mechanism and a serious attempt to establish a political union of some sort may follow. A lot can happen – and will happen – until the European crisis is solved. Avoid banks if you can! *Use the safest short-term paper as cash substitutes*, as I've been arguing for years. A large bank used to be as good as gold when I was young. No longer in a world of counterparty risk, of countries on the brink of default, of a troubling lack of sound judgement and in a world of regulators who don't really understand risk and who even rely on the risk models of the institutions they supervise. Europe is not struggling with a fiscal crisis only, but also with a constitutional crisis, a crisis of public governance and a banking crisis in disguise – the main reason why the ECB suddenly and unexpectedly agreed to take some sovereign junk off French and German banks' balance sheets. Can a full-fledged political crisis followed by a currency crisis be avoided? No one knows, but we can be sure that uncertainty will remain high, something investors hate! It's too early to raise exposure to the European stock markets. This brings me to Japan, a country of remarkable stability.
7. *We have begun investing in Japan for the first time in many years.* We are not alone. Capital is flowing back into Japanese stocks for some good reasons. Why start accumulating Japanese shares in a diversified portfolio? First and foremost, monetary policy is being eased while taxes are being cut. Second, stocks are cheap by almost any measure, as cheap as the peripheral European equity markets, but without their problems. Third, Japan has adjusted and learned to live with deflation. Unemployment rates are below Germany's and the economy has expanded at a faster rate than the US or Europe this year. Fourth, cash flows at large companies are growing strongly, even more strongly than at many large American or European firms. The result: Japanese stocks could well surprise by outperforming Chinese shares next year though investor sentiment remains totally at odds with this assessment. Understandably given that emerging equity markets have returned an average of around 13% p.a. since 1988.

However, growth is now taken for granted and priced in while valuations have caught up with the more mature markets. Thus, it makes sense to start investing in a market hat has been virtually ignored for years and begin accumulating the likes of Canon, Asahi Glass, Hitachi, Nomura, Sapporo Holdings and Komatsu (the stocks we own in the above-mentioned fund). In general we prefer playing the "BRIC story" by investing in the great multinational companies of the world.

8. *The developed world's corporate sector in general continues to shine, showing outstanding profitability and more often than not ultra-solid balance sheets.* It's the place to be! How will the estimated $2000bn cash be used? Tentative answer: A multi-year M&A cycle and a new business spending cycle have probably started. The capital stock not only in America is depleting fast partly due to the rapid change in technology. Replacement demand is likely to rise strongly in the years ahead – a new capex cycle. Investment spending/infrastructure spending is one of our core investment themes. In the US, investment spending hovers at a 60-year low as a share of GDP; in Europe, it has probably fallen below its replacement rate. Nevertheless, payout ratios are likely to continue rising. Contrast the Chinese corporate sector with its meagre profit margins of only 2% in some large export industries. Manufacturers are vulnerable to rising commodity prices, rising interest rates and increasingly to the upward pressure on wages. We are taking profits. A last word on the dollar:
9. *The dollar is in a stealth bull market against the euro.* It should continue next year as it becomes clear that the euro zone debt crisis is far from being contained by the measures taken. One country after another is coming under pressure for essentially the same reasons – debt-servicing costs far exceed nominal GDP growth. More importantly, we expect to see both the interest rate gap vis-à-vis Euroland and the current account deficit continue narrowing in favour of the dollar. Generally, the dollar has shown remarkable resilience in light of the nearly unanimous bearish views at the start of 2010. On a trade-weighted basis the dollar was steady, losing only 5% against the Swiss franc, a currency that has benefited greatly from its safe-haven status. Gold, another safe haven quasi currency, soared more than 30%. We don't see gold or the franc peaking anytime soon. Gold is an age-old hedge against the risk of inconvertible paper money being debased by the printing press while the franc is likely to appreciate further given Switzerland's huge current account surplus (11% of GDP), its strong economy and low debt ratio (below 40% of GDP). As to other commodities we would wait before taking positions, favouring agro over industrial commodities. Overcapacity looms in e.g. aluminium and iron ore.

I have rarely encountered such as large discrepancy between macro and micro! Macro-risks appear to kill any thought of investing – in America it's the real estate and unemployment crisis, in Europe the sovereign debt crisis, in Japan deflation and very poor demographics, in China economic overheating and bubbly real estate. Nevertheless, when we look deeper into the economy, the picture no longer looks as dark.

The world's major companies are doing very well. In the US corporate earnings soared 27% in 2010. Earnings may grow another 10% or so in 2011. And profit margins are close to record levels. Even US households are not doing as poorly as we might think given all the bad news. Disposable income increased nearly 4% in 2010 and is likely to increase further in 2011. What does this mean for investors? Macro anxiety is keeping investors in bonds, cash and gold – and equity valuations down! The biggest opportunity today is in the large-cap growth segment of global equity markets. The valuation gap vis-à-vis the respective indices have rarely been slimmer, if ever. In other words: Investors don't pay up for growth. One reason why we've raised equity allocation!

Conclusion: We have decided to ride the liquidity wave and to make a bet that bond yields are rising for a good reason. Still, we are not investing aggressively, favouring big caps over small economic sensitive stocks and, of course, holding a mix of great companies from all over the world, many of which offer both attractive dividends and appreciation potential. Our caution derives from the unusually large macroeconomic imbalances that make forecasting more difficult than usual. The global economy remains fragile, sovereign defaults loom, profit margins are very high, interest rates have no way to go but up and the rich world is still struggling with excessively high levels of debt. The four d's – **d**ebt, **d**eleveraging, **d**eflation and **d**emographics are the main macro-headwinds today. It's too early to invest for the long-term. We are playing a *cyclical* recovery orchestrated by panic-stricken central bankers in the middle of a long *structural* bear market that began in 2000.

A fair amount of cash and some reasonably safe short-term bonds offer most welcome protection – with leverage, open economies and integrated capital markets, a disturbance anywhere immediately becomes a problem everywhere. As Mark Twain famously warned: "There are two times in a man's life when he should not speculate: when he can afford it, and when he can't."

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