Friday, December 17th 2010

This is our last Newsletter for 2010. We will convey to you our thoughts for 2011 which we remind you may and most certainly will be modified and updated each Friday hereafter!

Overall we believe that much of the economic damage has been uncovered and this is priced in the markets, probably even “overpriced”. Time and governments' interventions have been supportive and we believe that the World is now well on its way to repairing itself.
The rate of capital reconstitution may be slow, but it is positive nonetheless. The “good-old-times” with predictable relative-value standards may be creeping back into the investment-scene.
With this observation as the backdrop, we will try and look through and over year-end for a glimpse of 2011.
With the immortal words of Yogi Bera “making predictions is very difficult, especially about the future…” to be kept in mind, we offer herewith our thoughts and outlook;

- Core economics: World GDP will grow at a fair clip, say 3.50% with the EM economies gaining “market share” as their growth will run well ahead.
- Short-dated interest rates: In the industrialized world will remain as they are, at zero % or thereabouts, as inflation remains invisible and economic growth remains slow with a heavy burden of unemployment across Europe and the USA. At the same time the Emerging World lead by China and India will likely pursue increases in short term rates to fight rising inflation.
- Equity indices Expected to rise into 2011, driven by corporate earnings. With the S&P 500 likely to earn about $90.00 per unit of the index, a P/E of 15X would suggest a 1'350 for end 2011 (up 8% or so from here). With the S&P as a base, it is likely that higher Beta markets may rise by more. Arguably some of the larger Emerging Markets equity indices have lagged in 2010 and might outperform in 2011.
- Oil: Global growth, even at a moderate 3.50% rate will generate increased demand for energy and therefore will likely pressure oil prices upwards as supply is more or less set in the short run. We expect to see the commodity trade towards if not through the $100 mark in 2011. This is also a reflection of the decline in the US$ purchasing power.
- Bond yields are likely to rise, at least on the longer side of the maturity curve. The 10 year Treasury-Note already at about 3.50% may trade towards 4% where we would be buyers again, as the yield is unlikely to stay there with the Fed holding short rates anchored at zero. Spreads on lower grade corporate borrowers and sovereign debt of emerging countries may further tighten-in as the Global economics improve, possibly producing sufficient gains to offset the risk of losses from the expected curve move. We would remain on the shorter side of the maturities in the higher credit risk paper.
- Currencies: We are confident that the Euro will not fall apart, if for no other reason than the fact that the cost of dismantling the single currency would far exceed the cost of bailing out the few sick members. The Yuan will strengthen, not because the

Chinese are pressured by the West but because it is the most effective way in which to reduce domestic inflation. The US$ in itself remains fragile as investors are concerned about the enduring double deficit and the Fed's intent of reintroducing inflation.

- Gold: It is historically high and as we know of mines producing the metal at $150/Oz., there is a risk that even a small reduction in fear-driven demand could result in nasty downside. Rising interest rates introduce an opportunity cost to holding the metal. Upside may be limited, if any. Hold a minimum?
- Hedge Funds: In 2010 the industry produced a small return of about 4-5%. Disappointing? Yes, but at the same time quite fair as it represents 500BP over money. The "wrong part" here is the expectations. Let's not forget that Hedge Funds manage volatility at the expense of up-side. In 2008 we were all upset with perception of poor returns (down say 20%) whilst these were the best or "least bad" asset class. In 2009 they gave fair, positive and yet again disappointing returns (equities did better). We believe that in 2011 this asset class will not disappoint if we adjust our expectations to reality, looking for an 8% or so net returns.

Major risks into 2011:

The risks we enumerate herein are neither listed by their possible effects on markets nor by their probability of occurrence. We are equally concerned by each and the effects each occurrence might have on the others:

1. North Korea actually ventures in conflict.
2. Iran makes further nuclear advances or even initiates aggressions.
3. China experiences social unrest in its rural areas.
4. European unions join forces to counter austerity programs disrupting life and GDP growth.
5. The USA embarks on its own austerity measures to curb either or both deficits with resulting economic slowdown, rising unemployment and political moves to protectionism.
6. Demand from India and China drives agricultural commodities beyond affordability.

Overall Portfolio allocation could be tilted further towards equities and lower credit-grade debt, raising overall volatility with an expectation for commensurate rewards. A reasonable allocation into next year at 40% in Hedge Funds, 30% global equities, 10% in commodities (agricultural & oil) and 20% in corporate and emerging debt should provide a 5-10% return with reasonably low overall volatility.

For currency allocation we would hold at least 60% in the portfolio's reference currency, underweight exposure to the Euro and the US$. We will maintain our 5-10% exposure to the Yuan and HKD against the US$ for all accounts.

Whilst we believe that 2011 can afford us reasonable returns (in the context of close to zero inflation) with improving clarity, by no means do we suggest that the World has overcome all its past excesses and that we will have clear sailing hence. If nothing else, the industrialized economies have a huge and hardly resolved

unemployment problem, trade imbalances are not adjusting and governments are not finding balance.

We have read other analysts predicting quite a different future- Us 10 year rates over 4.50% with the S&P to lose 15% or so, yet agreeing with us on oil at $100 and commodities in general up quite a ways. These “other analysts” target Gold at $1’700 and a huge 11% Euro rally.

We do note these divergences in views and promise to adjust our thinking as truths are uncovered into the year!

Happy New Year and may you have a very nice and profitable 2011.
And for those of you who will shortly be on vacation, we wish you excellent holidays.

Since this is our last newsletter of the year, we thought it would be useful to do a “bigger picture” year in review by asset class rather than our usual week in review for the second part of this letter. We hope you find it useful!

Currencies

- What a roller coaster of a year! In the first part of the year the Euro tumbled on the back of its lingering sovereign debt crisis. The Euro dropped to a low of 1.1923 versus the US Dollar, only to move back up as high as 1.42 as the Greek debacle abated. But then Ireland popped up and the Euro went back down to 1.30 versus the Greenback but has since recovered slightly and is now around 1.33.
- The US Dollar appreciated in the first part of the year but then declined as the European sovereign debt crisis subsided somewhat and concerns started propping up over the strength of the US economy given lingering high unemployment. The Dollar declined further as anticipations that the Fed would embark on another round of quantitative easing. But over the last 2 months the US Dollar has strengthened as risk aversion rose on renewed concerns in the Euro zone and Chinese tightening fears.
- The Japanese Yen and Swiss Franc strengthened versus most major currencies for the year on the back of their “safe haven” status. The Swiss Franc went from 1.48 in the start of the year to 1.2775 versus the Euro currently and is at 0.96 versus the US Dollar having started the year at around 1.04. The Japanese Yen went up from 94 versus the Greenback to almost 80, and is now at around 84 as the Japanese Central Bank and government undertake various measures to stimulate its economy.
- High yielding currencies such as the Australian and Canadian Dollar saw sharp gains this year, both reaching parity with the US Dollar in late October. These currencies benefited from interest-rates differentials, improving growth prospects and higher commodity prices.

Fixed Income

- Government bond yields dropped to historic lows this year as major central banks indicated that they would keep benchmark rates lower for longer, Europe’s sovereign debt crisis roiled sentiment and as economic data, especially in the US disappointed. Yields on 10 year and 2 year US bonds reached a low of 2.38% in October and of 0.327% in November respectively.
- However since early November we have seen a dramatic pullback in government bonds, with yields jumping back up on improved growth prospects and inflation fears as the Fed embarks on another round of quantitative easing. Yields on 10 yr US bonds are now at 3.41% and on 2 years bonds are at 0.64
- In Europe, spreads on the PIIGS (Portugal, Ireland, Italy, Greece and Spain) reached dramatic levels as the sovereign debt crisis lingers on. Despite some solution with Greece, in the middle of the year, Ireland was forced to accept a bailout package and Portugal may be next in line…
- Credit markets were strong this year despite the many concerns discussed previously. Corporate bonds benefited from massive inflows and companies took advantage by issuing massive amount of debt! Investment grade securities did especially well in the first part of the year, but now lower quality securities are outperforming as investors search for higher yields. As of today, investment grade corporate bonds are up 5.4% for the year to date while high yield corporate are up 14.1% for the period as shown by the Barclays Capital indices.

Equities

- As of today global stock markets are well into positive territory for the year to date. The S&P 500 is up 11.5% and the MSCI World is up by 7.8%. However it was a rocky ride, with most equity markets down by 10% for the first half of the year, and with sharp moves up in the last few months of the year.
- There have been also wide disparities between regions, with American stocks outperforming European ones sharply as these were hampered by sovereign debt concerns. Indeed, the EuroStoxx 50 is down by -4%.
- In Europe, equity markets belonging to the “crisis” countries are down sharply. Spain’s Ibex 35 index for example is down -16.3% for the year to date. Conversely, Germany, the European country to have best performed during the turmoil, is up nearly 18%!
- Performance across sectors has also been very different. The three best performing sectors are Materials, Industrials and Consumer Discretionary which are up between 15-20% for the year to date. Financials, Healthcare and Telecoms lagged, with these roughly flat for the year.
- Financials moved sharply back and forth throughout the year, being sold because of regulation, Goldman’s lawsuit and the European debt crisis while Healthcare was also in the limelight because of new US regulations.
- Equity prices were supported throughout the year from strong corporate results but were hampered by various government regulatory overhauls, a mixed economic picture, the European sovereign debt issue and the Korean crisis. Equities have benefited over the last few months given their attractive valuations and also because of higher M&A activity, with cash sitting on historic high levels of cash.

Emerging Markets

- Emerging Market equities are outperforming their developed counterparts for the year to date, with the MSCI EM Index up by 12.4% versus 7.8% for the MSCI world index. However, performance varied by region, with Brazil and China especially lagging.
- The Shanghai composite index is down by -11.7% for the year to date. Chinese stocks have performed poorly on growing inflationary risks and concerns as to how the Chinese government will respond to these. Brazilian stocks are flat for the year, with political uncertainty (now resolved) and some inflationary concerns weighing on equities. However one should remember that Petrobras and Vale are a significant part of the benchmark, and Petrobras vastly underperformed this year. Other EM stock markets did very well, benefiting from stronger growth prospects.
- EM currencies appreciated broadly on stronger economic prospects and interest rate differentials. EM bonds also did well.

Commodities

- Commodities are up by roughly 15% for the year. It was also a rocky ride for commodities this year (except for precious metals) and performance varied amongst the many different types of commodities.
- Precious metals did especially well this year, rising in the many different market environments we experienced over the course of the year. Gold is up by 25% for the year, benefiting mainly from the perceived erosion in value of the major currencies. It is now at 1370$ an ounce, having reached a high of 1423$ for the year.
- But Silver was the clear winner (not only in the precious metals category but in all assets category!) climbing 77% this year. Silver had traded at 16.90$ on the first day of 2010, to overcome the $30 level a few days ago. This move was nothing short of stunning!
- Energy is up roughly 10% for the year. Energy prices were lower in the first part of the year on global growth concerns but sharply turned around as the global economic picture improved. Energy reached a low of $68 a barrel this year in May but is now at $87, having come close to $90.
- Industrial metals are also up around 10% for the year, weakening in the first part of the year but then staging a bounce back on improving economic picture. Agriculture performed even better, on supply concerns in the second half of the year. Agriculture for the year is up by over 30%!

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