BLUE HORIZON
Wealth Partner AG

Editorial

We are pleased to present the first issue of "Wealth Management Review". Our objective is to share our views on current macro-economic and financial market developments, as well as on interesting wealth management topics.

We hope you enjoy it and welcome your feedback.

Thomas Trauth
Managing Partner

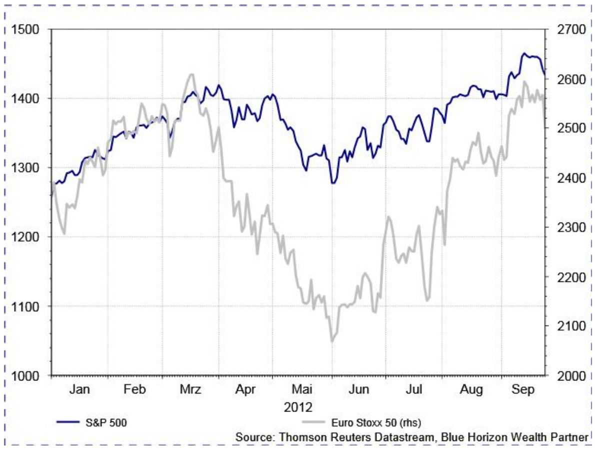
Macro-economic environment

Despite a weak global economy, mounting uncertainties, and political tensions, equity and credit markets rallied since the beginning of the year. We believe that central banks' monetary stimulus has been the major cause for the bull market in risky assets.

2012 has been a remarkable year. While the global economy weakened, market participants were worried about the European sovereign debt crisis, a potential Euro-zone break-up and political tensions in the Middle East (Arabic spring and the conflict around Iran). On top of all that, just recently, we have to add the political tensions between Japan, China, and Taiwan. Who of us, considering the above mentioned factors, would have guessed that since the beginning of the year the S&P500 has gained 14%, the DAX 23%, and even the EuroStoxx 50 – including our troubled southern EMU member countries – has advanced almost 8%. High yield as well as emerging market bonds even outperformed equity markets and returned 13.8% and 16.5%, respectively.

Fig. 1: Leading indicators suggest soft patch

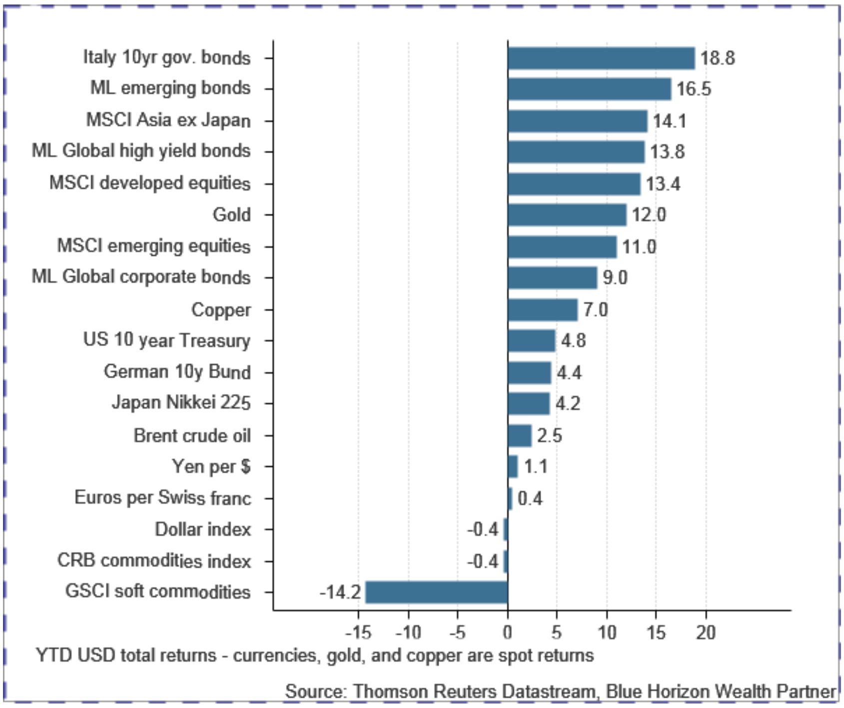
Fig 2: Equity markets performed well in 2012



Why did risky assets do so well? Let's have a look at the global economy, first. We are currently going through a soft patch. Leading indicators for almost all major economies have weakened and suggest that GDP growth will soften, compare Fig. 1. Most economists, however, expect only a mild fall of GDP figures. Looking a bit further into 2013 and 2014, growth will pick up again. However, the most likely scenario is that growth will not reach full potential during in the next couple of years. The public sector, banks, and, in countries with imploded real estate bubbles, private households need more time to repair their balance sheets. We expect this deleveraging process to take years, which will prevent GDP growth to run at full speed. While times of slow growth are certainly better than outright recession, corporate and household spending will stay depressed, capital utilization low and unemployment high. Since 2009 we have been experiencing, how low GDP growth failed to create enough jobs to reduce unemployment rates in any meaningful way.

While these observations refer to the major economies, we should not forget the severe pain and deep recessions some Southern European countries have been experiencing as a result of Austerity measures, capital flight, and extremely high corporate funding costs.

Fig 3: Asset class returns in 2012



Central banks

Central banks were very busy in September to implement additional extraordinary monetary measures. We expect those measures to be more effective to lift prices of risky assets, but unfortunately less so to stimulate economic growth and employment.

The month of September was very remarkable as central banks within a couple of days started an additional round of unprecedented monetary easing measures. On 6 September the ECB announced to purchase sovereign bonds, on 13 September the FOMC followed with an extended bond purchasing program, at the same day the SNB reiterated its commitment to buy Euro in order to prevent the EUR/CHF exchange rate to fall below 1.20, and on 19 September the Bank of Japan enhanced its monetary easing program significantly.

The reasoning for the decisions varied: The US Fed has been disappointed with job creation and wants to stimulate growth and employment. The ECB – against the vote of the German committee member – intends to address severe distortions in the government bond markets, which prevent the monetary transmission mechanism to work efficiently. The Bank of Japan tries to overcome deflation and to steer the economy towards a sustainable growth path. And finally, the SNB fears the deflationary impact of a strong Swiss Franc, coupled with negative consequences for the Swiss export sector.

Not only did major central banks announce further quantitative easing measures in a very short period of time, but the policy measures were very remarkable in their own right. The ECB announced unlimited sovereign bond purchases. The Fed committed to buy, in addition to the existing asset purchase program, USD 45 bn of mortgage backed bonds per months as long as it sees no clear signs for a recovery.

What were the market reactions? Equity markets rallied (see Fig. 2) immediately after the announcements, however, gave part of their gains back in recent days. A variety of risk indicators fell, e.g., implied equity volatility declined (compare Fig. 4), i.e., the price of insurance against falling equity markets became cheaper. European sovereign credit spreads fell as well (see Fig. 5). At the same time, inflation expectations, as priced by the inflation-linked bond markets, rose.

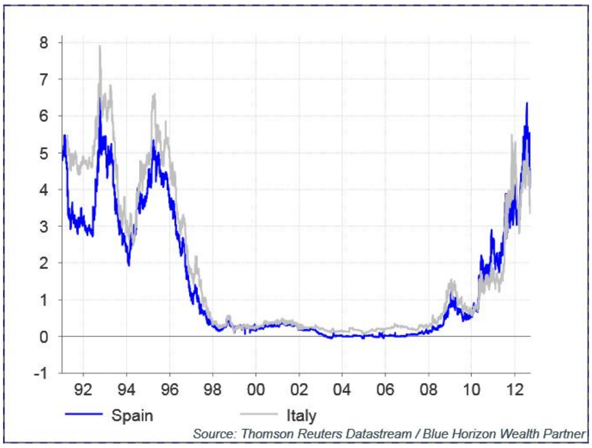
Why do central banks like these market reactions? The monetary transmission mechanism has not been worked well during the current crisis. Major reasons are that corporates and households still feel uncertain about the future and hold back on spending plans, and that banks are still very busy to (risk) manage their balance sheets and to comply with increasing capital adequacy requirements. Central banks address this in a number of different ways. They drive real cash returns into negative territory to punish cash holders. They take off risk from bank balance sheets by buying mortgage-backed securities (Fed) and bonds of weaker sovereigns (ECB). They drive up risky assets to induce a so-called wealth effect – households feel richer when their assets are worth more. And they drive down funding costs for corporates

Outlook

While we continue to be concerned about slow global economic activity, the risks associated with sovereign debt, and a number of political risks, we do think that amble liquidity and the commitment of central banks will continue to provide a cushion for risky assets. With real (inflation-adjusted) interest rates often below zero, valuations of equities and credits not overly expensive, and most risk indicators improving, we feel comfortable that risky assets will continue to perform well.

Fig. 4: VIX implied equity volatility

Fig 5: Sovereign credit spreads vs Bunds



Euro crisis – what crisis?

In contrast to many commentators, we think that the recent crisis in Europe is mislabeled. We do not regard the current situation as a "Euro" crisis, i.e., a crisis of the European Monetary Union.

How do we judge the success or failure of a monetary union? In our view, this has to do with monetary stability and credibility, which we would like to subdivide in three separate factors. First, did the monetary union provide a stable currency, as measured by its inner value, i.e., a pre-defined inflation target? Second, did the currency maintain its value versus major other currencies? Third, how credible is the institution governing the currency, i.e., the ECB? Let's have a look at the above mentioned criteria. As Fig. 6 shows, headline inflation often exceeded the upper limit of 2%, but remained more or less in check. Core inflation, which excluded factors, which are either very volatile and/or not controlled by the central bank, remained well behaved. As Fig. 7 shows the EUR/USD exchange rate started in 1999 at about 1.18, fell than to about 0.82, and recovered to almost 1.60. Since 2004 the exchange rate has fluctuated between 1.20 and 1.60. During the debt crisis the Euro fell a bit but stayed relatively resilient above 1.20. This picture looks very similar if we would look at a trade-weighted EUR index. Third, the ECB as an institution enjoys a high degree of credibility world-wide and the Euro has become by far the second most important reserve currency and accounts for roughly 25% of world currency reserves.

In our view, the major cause of the crisis is not the monetary union but unsustainable sovereign debt levels, coupled with weak European leadership and poor decision making processes. We find it very disappointing that the European Union has not yet clearly defined when, how, and if at all an indebted country will be bailed out by the community. It is further unclear if and how fiscal policy should be coordinated and harmonized across the member states. In our view, this inability of European poltics to act swiftly and decisively is at the core of the so called "Euro crisis".

Markets by nature react to uncertainties by warranting higher risk premiums and by reduced liquidity. If we look at sovereign risk spreads (see Fig. 5), we observe that since 1995, already in the planning phase for the Euro zone, markets priced an implicit bail-out, since sovereign bond yields converged. During the crisis these spreads exploded as markets priced for higher default risks of the peripheral countries. Note, that part of the convergence can be explained by converging of inflation rates.

While we do not see the monetary unions as the cause of the crisis, it does have an impact. A country in control of fiscal and as well as monetary policy has additional options to reduce its debt and to distribute the debt burden. The EMU prevents individual governments from creating inflation and, thereby, from reducing the value of their bonds without an explicit default. In addition, EMU member countries cannot smooth the economic adjustment process by devaluating its currencies and, thereby, improving their international competitiveness. In the case of a monetary union, indebted countries have to increase taxes, cut spending, and in the worst case even restructure – a polite word for default – their debt.

Fig. 6: Euro land inflation

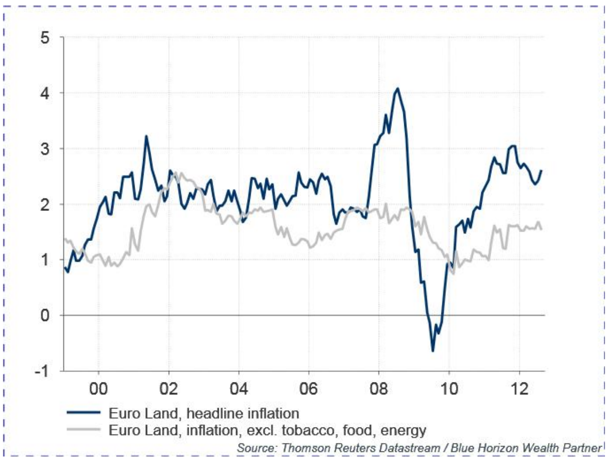
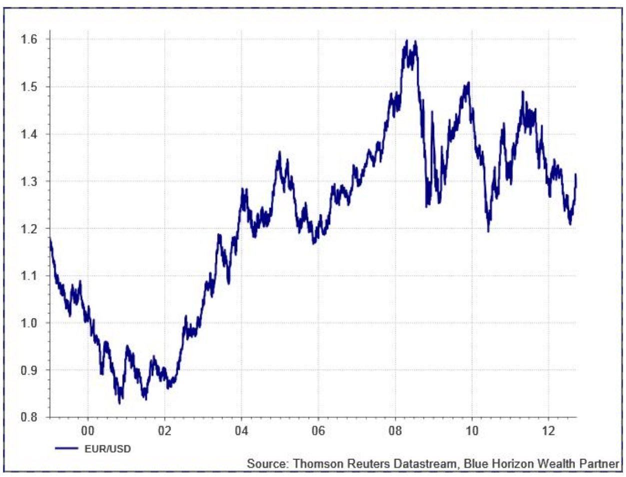


Fig 7: Development of the Euro



Blue Horizon Wealth Partner AG
Sihlhaldenstrasse 10
CH-8803 Rüschlikon / Zürich
info@bluehorizon-wp.com
www.bluehorizon-wp.com

Important Legal Notice