

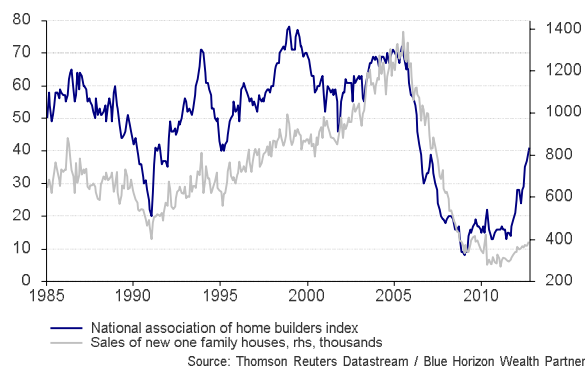
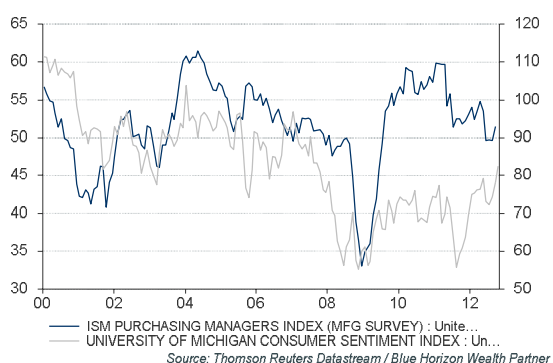
Macro-economic environment

The euphoria setting in after central banks applied major monetary easing measures in September was followed by a period of disillusion, retrenchment of equity markets, and very high market volatility. Macro-economic indicators were likewise very mixed. There are nevertheless early signs of improving economic conditions, especially in the US. The EU took initial steps to encourage structural reforms, but has left many questions unanswered. In the US the presidential election turned into a tight race, with the country barely a step away from the fiscal cliff.

Equity markets continued to be very volatile, giving back part or all of the gains made in the September rally. From the end of August, the S&P500 index remained more or less flat, European indices continued in the positive range, EuroStoxx50 gained 1.6% and the DAX 3.3%. The Chinese Hang Seng equity index even rallied 10.4%, suggesting market prices reflecting a Chinese economic recovery. Spreads of peripheral European government bonds remained relatively well behaved, and corporate credit markets continued to perform well. Commodities declined, in general, on the back of weaker growth data, and even gold gave back some of its gains of August and September.

In our view, there are four factors weighing on capital markets. First, the Q3 earnings season started with disappointing results, and the outlook for the coming weeks is likewise not rosy.

Fig. 1: US leading indicators improved somewhat Fig 2: Signs for US housing market bottoming

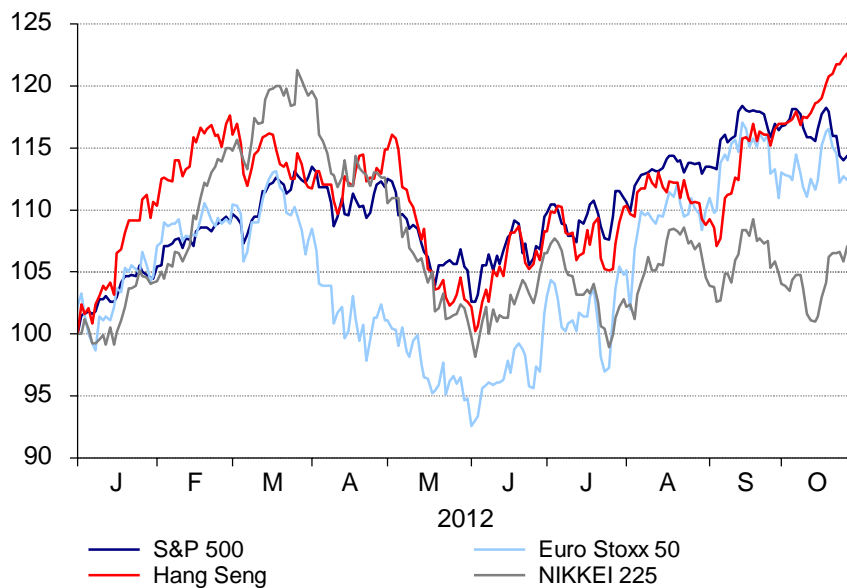




Secondly, many macro-economic indicators came in weaker than expected. While indicators continue to be consistent with the global picture of a shallow dip in Q4 2012 and Q1 2013, followed by weak growth, it seems that negative sentiment has taken over. We would like, however, to highlight some positive developments, most noticeably in the US. For example, the ISM manufacturing survey index rose to 51.5 (for September) from 49.6 in the previous month, and the Michigan consumer sentiment index even jumped 9 points to 70.3 from 61.3 (see Fig. 1). Furthermore, the US housing market shows some signs of bottoming. While sales of existing homes continued to decline, inventories of unsold new homes reached their lowest levels for 45 years and inventories of unsold existing homes are as low as in 2005, i.e. before the housing bubble burst. At the same time the National Association of Homebuilders/Wells Fargo builder sentiment index has improved significantly (see Fig. 2).

Thirdly, while politicians celebrated a break-through EU summit on 18 and 19 October, many questions remain unanswered amid uncertainties about the medium-term outcome. Progress was made at the EU summit, though, towards an EU-wide banking supervisory body, the "Single Supervisory Mechanism" (SSM), including an EU bank rescue mechanism due to come into effect in the course of 2013. Furthermore, national governments agreed to mandate Her-

Fig 3: Major equity markets in 2012



Source: Thomson Reuters Datastream, Blue Horizon Wealth Partner



man Van Rompuy, President of the European Council, to come up with a “road map” for what was termed a “fiscal capacity”, i.e. some sort of Eurozone budget. History tells us that such far-reaching reforms of the EU system take time and generate major political power struggles. The reservations expressed by British Prime Minister David Cameron, and the differing views of France and Germany give some indication of the discussions to come. With regard to banking regulation, it seems that Spain and Ireland will be excluded from the new rescue funds, which means that those countries will have to shoulder bank bailouts nationally. It is fair to assume that this question will also give rise to further discussion and quite possibly delay.

Fourthly, the US election has developed into a very tight race, creating increasing uncertainty about who will be next in office and how the new president, together with congress, will deal with the looming fiscal cliff. The fiscal cliff would push the US economy into recession in 2013 since several major budget items will expire at the end of 2012, reducing the federal budget deficit by up to 5.1% of GDP. Those budget items are the extension of the Bush tax cuts, an extension of the stimulus payroll tax cut, an extension of emergency unemployment benefits, and cuts to defense and health spending negotiated as part of last year's debt-ceiling compromise. Considering last year's confrontational discussions around the debt-ceiling, the last-minute compromise and the severe negative repercussions on financial markets, the fiscal cliff situation should not be taken lightly. However, with the experience of the last few years in mind and since no US politician will risk being blamed for the next major recession, we expect that, irrespective of the result of the election, those responsible will find a solution and prolong some of the fiscal stimulus measures. Nevertheless, the process may well involve intensive discussions and political rope pulling, which could cause considerable nervousness on the financial markets.

Outlook

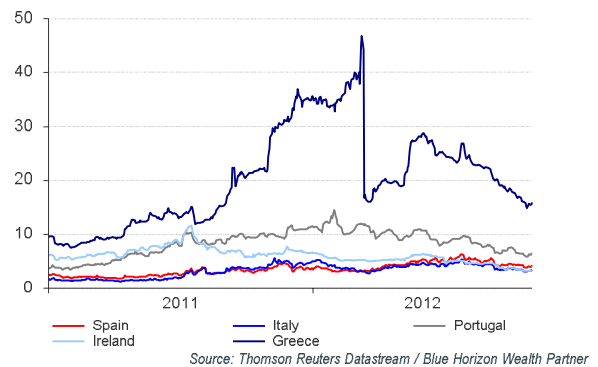
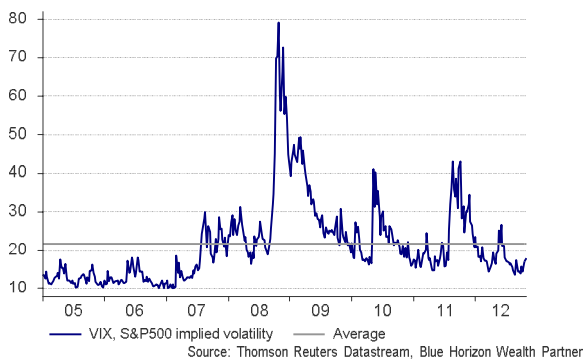
Fiscal policies in Europe and the US remain a burden for financial markets. While macro-economic factors seem to be stabilizing and even improving, an important prerequisite for unlocking the upside potential of equity markets is that politicians should make up their mind and give clear guidance on future fiscal policy. We admit that their task is by no means easy in view of soaring debt burdens and sluggish economies. But it is precisely under such circumstances that corporates and private individuals need clear guidance for basic planning and to break the vicious circle of uncertainty and postponed economic decisions.



Risk indicators have slightly worsened in October but, in our view, are not seriously worrying. Equity-related volatility has picked up somewhat but remains well below the long-term average (see fig. 4), and spreads of peripheral government bonds remain clearly below their highs (see fig. 5). Overall, we are keeping to our neutral position in risky assets, since we believe in the power of loose money to lift asset prices. However, the environment and a great number of risk factors warrant caution and careful monitoring.

Fig. 4: VIX implied equity volatility below average

Fig 5: European bond spreads





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