Highlights 2012

The year 2012 started in the shadow of negative investor sentiment, low expectations, overwhelming European debt problems, and weak macro-economic conditions. Nevertheless markets managed to start the year with a rally, followed, however, by a strong sell-off between March and May. Since June, markets have recovered, pushing equity indices to annual highs in December and double-digit annual returns, despite fiscal cliff concerns. We see the major reasons for the good performance in more credible policy measures to tackle the European debt problem in recent months, unprecedented monetary easing measures, and somewhat better US and Chinese macro data.

2012 was a year of surprises. Back in January the economic outlook was bleak and a majority of market participants shared a very pessimistic outlook. However, as experience has shown, including to some extent events of 2009, pessimistic sentiments on the part of the many can paradoxically lay the ground for a rally of risky assets. Usually, in such circumstances, we observe low trading volumes, so that only a few courageous buyers can deliver sufficient marginal demand to drive prices up. The rally early in 2012, however, lasted only two months and in March concerns grew so high and the debt problem in Europe seemed so difficult to solve that markets started to sell off and had lost more than 20% by the End of May. The first days of June marked the trough and gave way to a remarkable bull run with markets reaching their annual highs in December, albeit with highly volatile and nervous market movements in the intervening months.

Fig. 1: Major equity markets in 2012

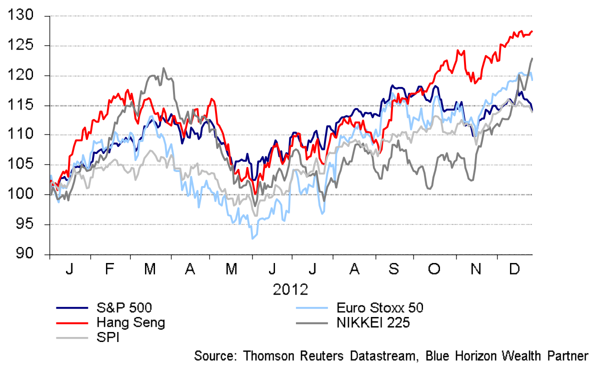

Fig 2: EUR-USD exchange rate

After early June, financial markets gained strong support as a result of very aggressive central bank measures. Mario Draghi's famous speech on 26 July in London surprised us all, stating:

> *"Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."*

We also remember September, when ECB, US Fed, and the BoJ announced very substantial quantitative easing measures within the span of a couple of days.

For many there was another surprise in 2012: US equity underperformed most other major equity markets. While the S&P500 index gained 11.5% YTD (as of 28 December), the DAX rose by 29.1%, the Nikkei by 22.9%, the Hang Seng by 23.0%, and even the EuroStoxx50 advanced 13.4%. Similarly, the USD weakened by about 2% versus the Euro.

Risk landscape 2013

As we enter a new year, we would also like to state which risks we think are significant and important enough to warrant close monitoring in 2013, though such a list will never be complete. First, there is certainly an element of personal judgment involved when choosing the relevant risks. Second, the probability of certain events occurring may be underestimated or they may be completely unforeseeable.

Recent research labels such unforeseen but significant events "Black Swan events". Examples are the rise of the Internet, World War I, and the September 11 attacks. Nassim Nicholas Taleb wrote about such events in his 2004 book "Fooled By Randomness" and later in his 2007 book "The Black Swan" (second edition published in 2010). As such events are characterized by being very hard or impossible to predict, it is not worth making a major effort to detect them. Instead, in the second edition of "The Black Swan", Taleb provides "Ten Principles for a Black-Swan-Robust Society".

But let's get back to the more ordinary, known risk areas. Monitoring those developments helps to establish an early warning system for portfolio management and helps us to stay focused on crucial developments. Among other sources, we consulted a report by the Economist Intelligence Unit, commissioned by State Street Global Advisors, "Managing investments in volatile markets". This is a survey among important investors to find out which major tail risks they fear and how they prepare for such risks. Another source, which we found useful, is the Risk Watchdog report (www.riskwatchdog.com) of Business Monitor International. In the following we present our summary of risks.

Recession

As the world economy remains weak, a global recession or recessions in one or more major economic areas is certainly high on the agenda. The much talked about fiscal cliff could by itself shave off 5% of US GDP growth in 2013 and would almost inevitably lead to a US recession. Also, the stronger countries in Europe could be subject to a more stringent and longer-lasting decline than many observers expect at present. We would especially also highlight the vulnerability of France, Spain, and Italy to potential political hiccups, or more severe budget or funding constraints, which could easily push the already anemic growth path into negative territory. Also China, after a soft patch in 2012, is not back on a full-speed growth path. Every growth rate below 5% would already disappoint massively and reduce global growth prospects substantially.

Sovereign debt

In many (major) countries sovereign debt exceeds sustainable levels and screams for austerity measures, while at the same time stagnation or even outright recessions prevent governments from tackling the problem head-on. There is much focus on the European debt situation, while we think that the US is not much better off. Especially on the sub-sovereign level, many US municipalities face very difficult funding situations.

Stronger austerity measures impair growth, with negative consequences for financial markets. Rising sovereign bond yields burden the public budget with higher interest payments and usually push funding costs for private companies and households up. Furthermore, bond defaults – or in more modern terms "debt restructurings" – leave bond-holders with significant losses. Major investors in sovereign debt are usually banks, insurers and pension funds.

Bank insolvencies

Especially after 2008 we are very aware of the massive adverse impact the failure of a major bank can have on the overall economy. Regulators and governments have been watching banks much more closely since then, and many banks have deleveraged and recapitalized their balance sheets. Still, a partial default of a sovereign or a further real estate crisis could wipe out banks' equity very rapidly.

Eurozone break-up

We continue to view a Eurozone break-up as an unlikely event, and the sovereign spread tightening in recent months seems to support this view. If at all, we see a certain probability that especially in those member states suffering from deep recessions and austerity measures, opposition against the Eurozone membership could grow strong. This may lead to an anti-EU majority pushing for an exit from the Eurozone.

Political risks

There are a number of geopolitical risks, which have the potential to unnerve financial markets, push up oil and other commodity prices, or by other means slow down economic growth. First and foremost, Israel could decide to launch an airstrike against Iran's nuclear program. In addition, the situations in Egypt, Syria, and Jordan remain very critical and could lead to a further destabilization in these countries and the region.

In East Asia, tensions between China, South Korea, and Japan could reemerge, especially as new leaders have come to power in Japan and China. And we should not forget about North Korea, which may launch new provocations, including potentially nuclear tests.

In Latin America, Hugo Chavez's illness may lead to a new presidential election and elevated political uncertainty. In Argentina, the government is under increasing pressure due to worsening economic conditions and legal claims by holders of bonds, which had been defaulted on in 2001. We would not exclude the likelihood of an economic and currency crisis in Argentina.

Elections in Kenya and Zimbabwe as well as a potential new conflict between Armenia and Azerbaijan may be less relevant for global financial markets, but are still worth mentioning.

Outlook 2013

It seems that there is a very broad consensus for a moderate economic recovery in 2013, which will not be strong enough to improve things fundamentally. Still monetary stimulus will be strong enough to offset investors' concerns about the economy and politicians' inability to come up with a clear and credible strategy to solve the debt problem. Overall we agree with the macro picture described.

As far as financial markets are concerned, we expect equity markets to deliver positive returns in 2013 and, based on relative valuations, we would favor European equity. Short-term, however, we expect a constructive compromise in the US fiscal cliff negotiations followed by a relief rally. Based on the macro environment, cautious investment and balance-sheet management by most companies, we still like credit. However, since upside for high-grade credit is rather limited, we prefer high-yield and emerging-markets credit, since absolute spread levels still provide enough cushion and carry to compensate for the risks taken. While bond yields may edge higher in 2013, we do not foresee a massive sell-off, since slow growth and wide output gaps are likely to keep inflation of the price of goods low.

As far as currencies are concerned we think that aggressive monetary easing by the Fed and BoJ will leave USD and JPY as the laggards in 2013. As far as the CHF is concerned we do not believe that there is a major upside for EUR/CHF, since the Eurozone problems are far from being solved and investors could easily get concerned about the situation in Portugal, Spain, Italy or even France. Still, we believe that the SNB has the will and the means to fight its lower EUR/CHF currency limit of 1.20 and, therefore, see no benefit for a Euro investor to hold Swiss francs.

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