Mont Blanc Funds

Q1 2010 Outlook

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Peak Partners SA Q1 2010 Outlook

The Decade

While we must rejoice in having survived the past twelve or, rather, eighteen months, there is a risk that we might forget that a decade has come to an end. Indeed, events in the past ten years have challenged most conventional investment wisdom, in particular the notion that equity risk is rewarded over the - relatively- long term.

It is, at this stage, worth reminding readers that, over the past ten years, the SP500 has returned an average minus 3% per annum. Was it any better over eleven years or twelve? In both instances, the returns were disappointing (respectively minus and plus 1% without dividends).Over the past five years, the outcome is similar (down 2%). Equities have been a miserable investment as the Dow remains down 26.4% from its all time high and is down 9.3% from 10 years ago. For the Dow it was the worst decade since the 1930s, when it dropped 39.5%. Was global diversification an alternative? Barely, since the MSCI world lost roughly the same amounts.

Government bonds were the place to be, with 1-10 year Treasuries returning 5.5% annually over ten years, and 4.8% over the past five.

This is an incredible endorsement of socialism. Basically, it means that the people to trust with one's money have not been wealth creating entrepreneurs but rather, profligate vote-buyers with no other intention than rolling debt into the end of time whilst reserving the right to engage in competitive devaluations and other forms of currency debasing.

This, of course, is too cynical a conclusion. Hard work was indeed rewarded over the period; both when the arduous toil was performed by active managers (6.3%) and emerging markets (9.7% pa). Given that active management (aka Hedge Funds) have often been corrupted by exposure to emerging market beta, we can conclude that this was indeed the decade of emerging investing.

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Review 2009

Before we move on to discussing the outlook for 2010, let us reminisce what 2009 brought.

Equities

Equities did well over the year, with the Dow Jones rising 18.8% (23.5% for the SP500). This, however, was not achieved in a straight line as indices were losing around 25% in March. The Dow's low point on March 9, when it was down 53.8% from its all-time high in October 2007, turned out to be the start of a powerful rally. Although the gains slowed in December the Dow finished 2009 up 59.3% from its March low, the fastest climb since 1933. The rally was helped by a combination of zero interest rates – which prompted a massive exodus from money-market funds – and blanket government intervention.

Investors also bid up European stocks. The pan-European Dow Jones Stoxx 600 index rose 28.6%, its biggest annual percentage gain since 1999 . (This index lost 46% in 2008, however.)

The prospect of sustainable growth in emerging markets helped Russia's RTS Index to increase 129%, India's Sensex by 81%, and China's Shanghai Composite by 80%, though all remain significantly off their all-time highs touched in 2008 or 2007.

Brazil's Bovespa gained 83%, which puts it within 7% of its 2008 record.

In Japan, the Nikkei Stock Average of 225 companies finished the year up just 19%.

Bonds

Treasury bonds fell in price in 2009, sending their yields higher as investors sought out riskier returns.
Losses on Treasury notes and bonds varied between 3% and 13% depending on their maturity, while the U.S. government sold a record-breaking USD2.1 trillion of new debt into the marketplace to fund its programmes and budget deficit. The losses suffered by Treasury Bond holders are thus derived from a combination of:

- Reduction of the 'flight to quality' appeal
- Moderate Increase in inflation expectations,
- Substantial supply,
- Downgrade risk

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Inflation indexed bonds beat nominals in the US as the curve went from grossly oversold to marginally overbought. In Europe, French OATis are now expensive, particularly at the short end. Talk about CDS costs for US and UK debt seem far-fetched, the real test will be on foreign currency debt. Since there is no talk of imminent issuance of 'Carter Bonds' (US Treasuries denominated in other currencies than the US Dollar), the acid test could be a relative cheapening of TIPs.

High-yield and low-rated corporate junk bonds returned 57.5%. As investors grew more comfortable with risk and bid up their prices, the gap between their yields and yields on risk-free Treasury bonds fell from more than 20 percentage points in December 2008 to 6.4 a year later.

Bonds with the weakest, triple-C, credit ratings returned more than 100% for the year. As prices rose, the yields on junk bonds fell in half, from about 24% a year ago to about 10% now. High-quality, investment-grade companies can borrow at about 5%.

Investment-grade bonds also logged impressive gains, returning about 20% in 2009. The average highly rated corporate bond now yields about two percentage points more than comparable Treasury bonds, compared with 6.25 points higher a year ago,

The improvements in the credit markets were achieved thanks to massive government intervention which took numerous forms (TALF et al), including the very substantial absorption of the Fannie Mae and Freddie Mac risk which will eventually take its toll.

However, bank lending remains scarce and asset-backed markets are still down 23% in volume over the previous year.

Commodities

Having performed dismally in 2008, a year when there was, indeed, a risk of systemic bank failure, gold only barely beat developed equities in 2009, rising 24%. Base metals, being marginally more useful than the barbarous relic, led the way, with copper up 139% followed by lead and aluminum.

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Agricultural commodities reacted to excess rainfall in the US; as well as to a serious drought in South America. Overall, weather extremes are becoming a greater factor that will contribute to increasing volatility while global grain consumption is expected to have increased by 1.7%, on the back of demand from diet-changing emerging economies. Corn was up 2%, wheat down 11% and soybeans up 7% while rough rice lost 5%. More weather-sensitive crops such as cocoa, and orange juice, soared alongside sugar which reached a 28-year high in August.

Hedge Funds

As of the end of November, Hedge Funds returned an average of 19%, thanks to unique opportunities in credit, in particular. The demise of many proprietary bank desks helped returns. Towards the end of the year, directional (macro & CTA) strategies lost ground, having been substantial contributors during the crisis. Emerging and equity managers´ best efforts at capturing beta were relatively unimpressive.

Nevertheless, investors often failed to capture these returns as fund of funds had limited leeway to invest as they struggled with redemptions and illiquidity. Overall, fund of funds returned 10.6% to November.

Outlook 2010

Fundamentals remain dire and, whilst we expect the US to recover first, this is a very relative blessing, since the nation still displays all the signs of depression. Broad unemployment is above 17% and home foreclosures are being stalled in various ways that may lead to the same type of moratorium that was introduced in the 1930s. Commercial real estate loans and securities are severely impaired and this particular trend is not abating. CRE as a total amounted to USD3.1 Trillion in 2007 (Residential was USD12 Tn) and it is unlikely that creative accounting will be helped by the political measures that came to the rescue of home-owners. In Residential, there is USD134bn of Option ARMs that will reset upwards later this year. Expect more pain on these fronts.

Equities.

A very respectable strategist just wrote “it is too early to be cautious”. This would be a strong negative signal if it were a consensus view. Indeed, the herd is not far from sharing this view and we would thus recommend to underweight holdings. Equities are generally richly valued, with P/Es around 18 times expected earnings both in Europe and the US; a level that is above historical averages. Fundamentals will have to surprise by more than the year-on-year effect implies (for the next six months, this will generally be an undemanding comparison, except for

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inflation metrics). Against this, there is the backdrop of high unemployment, rising taxes, and, in certain countries such as the UK, political uncertainty. Further risks loom in the very ignitors of the crisis, such as real estate pricing and valuations of related securities and loans. It is difficult to imagine that we have reached a stable level for real estate when 25% of US homeowners are equity-negative and thus have an incentive, at least in some states, to walk away from their obligations.

Banking stocks, which have been among the index drivers in last year's rally will face strong headwinds. While government help, a steep yield curve and accounting denial have helped restore profitability, earnings now face dilution among a greater equity base and nominal decline since the deposit base does not support increased lending activities. Also, it is hoped that regulators will eventually rein in investment banking activities, all of which will return banks to their former status of quasi-utilities with low P/Es.

Pricing markets for perfection is therefore somewhat exuberant, considering that consumers become savers, that government spending will have to be curtailed and that export markets will remain muted. There is, as always, the wildcard of quantum-leap innovation but there are no signs of this happening yet even though 'green' themes are strong candidates.

Nevertheless, money will be made in selective trading of equities, particularly due to the specific mechanics that drove last year's rally and favoured certain sectors over others. Dividend quality, in particular when linked to pricing power, will tempt investors seeking purchasing power protection when inflation fears are warranted.

Emerging equities indeed reflect higher growth potential but they equally price in perfection. Furthermore, there is a clear risk that IPO supply will put a lid on prices. In China alone, the expected offerings would be more than two times the USD40 to USD50 billion earmarked in the USA.

Still, one of the cheapest assets at this stage is equity volatility (observed / historical volatility is not an asset, unlike tradeable implied volatility). The VIX, having also retreated to pre-crisis levels (below 19/20) is prone to any challenge to the 'perfection'.

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Bonds

Corporate bonds will remain a core portfolio component, yet it has to be absolutely clear that this decision cannot be based on substantial price appreciation. Spreads, whilst reasonably generous in some cases, do not support substantial tightening. Substantial price risk arises from duration effects, as was the case in last December. Therefore, there will need to be active in hedging strategies, which will reduce the carry component. There is substantial risk in investors, who are overweight in corporate bonds, brutally waking up to duration risk and exiting their positions. Exogenous risks remain, as illustrated by Dubai and, more recently, Iceland's attempt to work itself into a formal default.

Government bonds will be shunned as a strategic investment. However, the increase in volatility will offer trading opportunities over and beyond hedging purposes, particularly as inflation fears will pick up well ahead of actual price pressures, so long as unemployment remains high. Indeed, there seems little cause for imminent increases in inflation as money velocity is still low. The Fed's Monetary Multiplier measure crashed to an all-time low of 0.809 in December while MZM is contracting at 3% annually. Manufacturing capacity use (67.2%) would endorse this view.

Commodities

Agriculturals remain attractive and the market is likely to be sounder as outright speculative purchases wane. The folly of ethanol production is likely to continue to absorb up to one-third of US corn supply and there is no reason to believe that weather patterns will generally be more clement than last year. Emerging market demand is bound to remain strong, and only the extreme overboughts (sugar, cocoa) should be avoided.

Oil seems overbought and the overhang of moored tankers used as storage will soon be felt once seasonal heating oil demand declines.

We believe that the rally in industrial metals will remain as speculative as the move up in equity prices. Still, we shall be watching the Baltic index. So far, dry bulk is still 71% below its peak of mid-2008, which does not bode well, though there seems to be a – muted – uptrend.

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Currencies.

This will probably be one of the most active theatres of war this year. Markets are finally realizing that the EUR is no proxy for the DEM, in spite of the ECB's attempt to mimic the Bundesbank. Investors will soon understand why history did not let any currency union be a success, unless the EU quickly federalizes and appoints comptrollers in Greece, Portugal, Spain and Ireland.

Hedge Funds.

Broad based rallies in equities and credit set an ideal stage for Long / Short managers exploiting dispersion and selectivity. Most of the easy money has been made in stressed credit and emerging markets. CTAs and macro funds may well stage a comeback as conventional wisdom and consensus trades are challenged. Some potential remains for distressed debt managers.

Overall, 2010 will be about safeguarding the gains made in 2009. It is expected that mid- to high single digit gains will be within reach but it would be irrational to expect much more.

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