

S U C C E S S I O N

Platform based Discretionary Model Portfolios

Managed by Evercore Pan Asset

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Model Portfolio Update

Yesterday was another very bad day in stock markets. Investors and investment managers let out a great cry for help. It was the day they decided the west's political leaders had no easy answers. To make things worse, China announced a slightly weaker industrial production survey.

Markets have continued to fall today, albeit in a more controlled fashion. There is a high degree of correlation between all assets as investors begin to fear a comprehensive range of negative outcomes. If the market is a balance of fear and greed, fear unquestionably dominates at the moment.

Irrational price movements are taking place: For example, the Euribor rate at which European banks lend to each other has risen as fears of bank collapses proliferate, but the price of gold is down. This is not logical as gold is normally seen as the principal reserve of value when all else fails. Euroland is apparently on the verge of collapse, but the Euro is surprisingly strong. In the UK, another half a trillion pounds of borrowing is likely to be added during this parliament, so worse public borrowing numbers should mean weaker UK government bond prices. Not a bit of it. Gilt prices are actually up (yields are down), but corporate bonds are weaker, despite higher yields and the companies backing them being awash with cash.

There is plenty to worry about, but we cannot say whether we are heading for a global recession any better than other commentators. However, looking at recent downgraded growth forecasts, world GDP growth will be around 4% in 2012, with both the UK and the US growing by more than 1%. Things could be worse. If the Eurozone sorts out the debt crisis and possibly reduces rates, it may also have some growth. China is expected to grow at 9%. This may fall, but the Chinese central bank has many levers it can pull to stimulate the economy if it wishes. The falls in commodity prices should be seen as very positive for the Developing markets as it will help bring their inflation under control.

The global markets are clearly in a dangerous place, but the panicky sell-offs we have seen in recent days and weeks look to be discounting events which may not happen. Things seldom turn out to be either as good or as bad as the market expects.

So what have we done with the model portfolios and what do we plan to do?

- We advised against all investment in the Euro zone for many weeks and have avoided all direct exposures for clients. We see the Eurozone as the eye of the storm and will continue to avoid the region until the debt crisis is resolved. The Euro is surprisingly strong in light of its problems and may weaken over the coming months.
- We have built up substantial liquidity in portfolios so that all now have a defensive stance. This has not helped as much as it should because some of the risk assets we retained, such as the Asian equities, have been hit even harder than Western equities.
- Developing market assets now look very attractively valued, are backed by good growth and are not affected by the same financial problems as the west. In many Developing markets there is scope and political will to take off the brakes and get economies moving again to combat weakness elsewhere in the world.
- Japan features in some of the portfolios. It has been a resilient investment, helped by the strong Japanese yen. We expect Japan to have decent growth in 2012.
- The higher risk rated portfolios now contain some exposure to gold via gold mining share ETFs. Gold miners normally outperform the gold price, but have lagged substantially this year. Most current valuations are based on historic gold prices so over time the mining shares should catch up. Even if the gold price doesn't rise or falls a little, there is scope for gold mining share prices to rise.

Overall, there are some reasons to be positive. The portfolios have suffered from the current market irrationality, but are well-positioned to benefit as markets settle. It is not a time to make big changes to portfolios, but the high liquidity will provide firepower and scope to take advantage of opportunities. It is still three months to the end of the 2011 and better things may happen during that time than the market is currently discounting!

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Below, John Redwood has written an analysis of the underlying causes of the current market crisis:

The immediate cause was the results of the two day Fed meeting to consider the crisis and what to do next. The Fed decided to do very little and announced no new great money printing scheme. There are to be no fistfuls of extra dollars to push up asset values. Instead they said they would sell short term bonds and buy longer bonds, using the proceeds from repayments of mortgages they own to buy some more mortgages. They also said the economic outlook was poor. Clearly it was not enough for the optimists still left in the market. They had been hoping that the Fed would have a new magic bullet which would puff up the economy again.

Markets have come to realise the US President cannot deliver his package to boost the economy if it involves spending more, taxing more and borrowing more. Nor do they think such a package would work anyway. They also know the Republican package of spending less and taxing less is stillborn. The balance of the US constitution has delivered a logjam at the top, when people want decisive leadership.

The biggest falls took place in Euroland. There no-one speaks convincingly for the Central Bank. The leading politicians of Euroland are in disagreement with one another. They cannot decide whether to print more or borrow more to tackle the heavy debt problems of Greece and Portugal, Italy and Spain. They say they want to keep all the problem countries in the zone, but do not communicate a vision on how that is possible. The Euro remains an orphan currency. It is in search of political parents to love it and take care of it. It needs a sovereign to tell it what to do. It needs a grown up Central Bank that has clear views on how much to print and how much support to offer the commercial banking system.

At the heart of the crisis unfolding is too much debt. In the first phase of the crisis in 2007-8 the problem was too much private sector debt. Banks had borrowed too much. Banks had lent too much, especially against property in the US, UK, Ireland, and Spain. Governments eventually got over the worst of this by taking many of the debts of the banks onto their own balance sheets one way or another. They also decided on a reckless expansion of their own borrowing, to stave off the full adjustment.

Now, the second phase of the crisis is on us. In this phase weakened banks lend money to heavily over borrowed governments, and spendthrift governments lend or spend money on propping up the weakened banks. We have often talked here of the dangers of this arrangement. The Regulators have made the banks lend more to governments, claiming this is risk free. The governments have often propped up the banks, without demanding action to sort them out. So what should be done? The governments and banks both have to get their houses into order. For the governments, that does mean spending less. You cannot get out of a debt crisis by borrowing more. For the banks, that should mean quicker action to sell assets, write off liabilities, break up weak conglomerates, and raise new capital until each main bank is trusted by the market.

None of this is easy. The sooner the adjustments are made, the sooner we can resume decent growth. There is no safe way left to kick the can down the road. Print more cash and you will get more inflation. Borrow more, and you will undermine markets further. Pretend and extend more credit, and you continue the gnawing erosion of confidence.

Yesterday the World Bank, the IMF and some of the leaders of the west made statements telling us things are bad, but saying that someone else needed to take action. The US Treasury Secretary has urged Euroland to sort itself out, but has to admit the US can't settle on a single policy either. Euroland keeps delaying decisions, as individual countries make heavy weather of even implementing what the zone agreed last July. There is a lot riding on the G20. In the end it will come down to individual countries sorting out their own budgets and tackling the problems of their own distressed banks.

Regards,
Evercore Pan-Asset Investment Committee

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