Silverhorn Alpinum

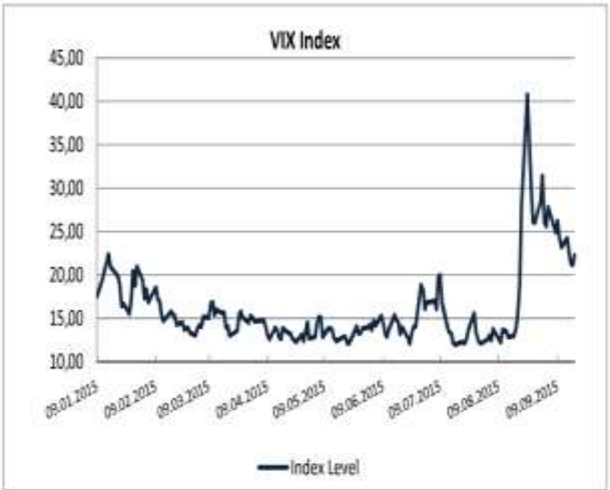
Quarterly Investment Letter

Quarter 4/ 2015

Chopping and Changing

The third quarter was challenging for all asset classes. It was negative for equity markets as worries on China, particularly after the devaluation of the yuan in August and the Fed's decision to leave the key rates untouched in September topped over any positive market sentiment. The MSCI World Index declined by more than 8% as the S&P 500 lost about 7% and the MSCI Europe gave back 9.2% (see the Market Table in the appendix for details). Asia Pacific and BRIC fared even worse with losses of approximately 16% and 22%, respectively. The quarter started benign for Western markets in July before the share prices dropped in August and September. Particularly September looked like a bull market correction when long positions were sold aggressively to take profit and short positions were closed equally. Or to put it more simply: Fear made many investors throw the towel. The loss of global equity market cap amounted to USD 10 trillion which is supposedly the largest drop ever within a quarter.

Chart 1: Volatility Spiked in Q3



Source: Bloomberg

Highlights for Investors

- As stated in the previous letter, global growth remains heavily affected by the antagonistic forces of deflationary impulses (energy, commodities), announced monetary tightening (the Fed and Bank of England) and continued monetary stimulus (ECB, Bank of Japan,...). Given limited potential output growth of the developed countries and ailing emerging economies, expect global growth to be moderate.
- The future Fed policy and Chinese economic growth will remain the key drivers of macro concerns and market sentiment.
- It looks likely that the Fed will undertake a modest liftoff in the fourth quarter to regain credibility and to lower the level of uncertainties as perceived in the markets.
- As the EU is increasingly dragged into the Middle East conflict, be it by military involvement or by the strong influx of refugees, the domestic debt and economic reform issues seem to have moved to the backburner as fast increasing concerns put stress on the political landscape.
- The continuously low oil prices will provide additional disposable income for the households which should help consumption.
- We remain confident that a cautious investment approach in risky assets, will be the most rewarding for risk conscious investors, with a long-term investment horizon. In short, we favor Equity L/S managers with lower net exposures, short duration credit and loans, amongst our broad range of long-only and alternative instruments universe. Regarding equities prefer Europe, Japan/ Asia over the US.

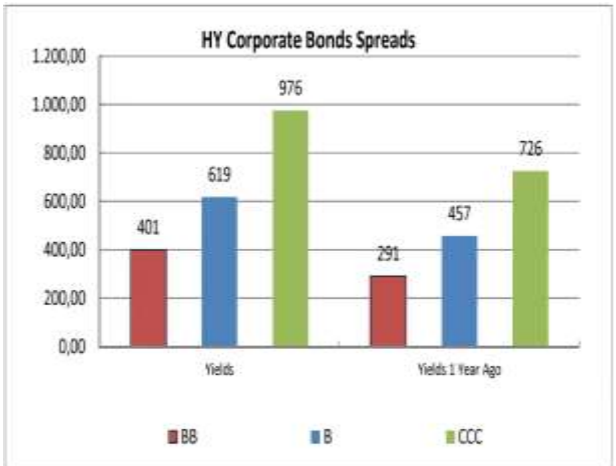
Not surprisingly, equity market volatility spiked as illustrated by the VIX in Chart 1 which leaped temporarily from values around 15 to 40.

It was also a pretty bad quarter for fossil energy prices and associated economies. As oil prices kept falling by about 24% in the third quarter alone it is not surprising that some oil-producing countries have started to sell risky asset as well which added to the pressure on the equity markets.

And if that was not already bad enough, it did not help that prestigious companies such as carmaker Volkswagen and commodity trader Glencore hit the headlines as well: the former due to fraudulent behavior regarding published diesel exhaust emission reports and the latter due to a ferocious meltdown of its valuation.

Fixed Income offered a mixed picture in the third quarter. Despite low interest rate and yield levels government bonds of developed countries offered positive returns across all maturities. Hereby, longer maturities were able to profit most, e.g. US and EUR bonds with 10+ years maturities gained around 5%. In contrast emerging market bonds (local currencies) and also High Yield bonds lost more than 7% and 5%, respectively.

Chart 2: High Yield Bond Spreads have widened year-on-year

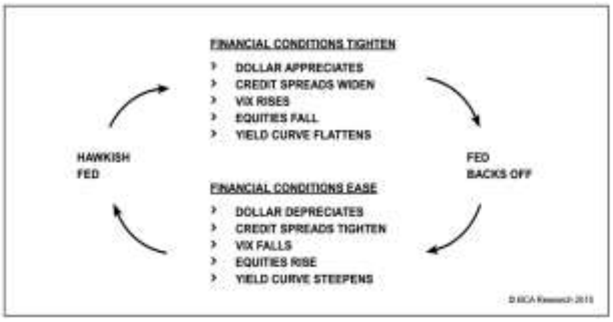


Source: Bloomberg / Silverhorn Alpinum

Chart 2 indicates how much corporate bond spreads have widened within one year, e.g. BB spreads moved up by more than 120 bps while CCC spreads moved up by around 270 bps. Concerns on deteriorating growth expectations and currency volatility put continuous pressure on the valuation of corporations and their credit quality. For instance, at the end of September, the yield to worst (YTW) and option adjusted spread (OAS) for the BAML 0-5 Year Index as provided by Bank of America Merrill Lynch was 8.59% and 7.68%, respectively.

Despite the growing uncertainty amongst investors, gold lost again ground as its price gave up almost 5% in the third quarter. As stated in the previous letter, we believe that gold is sidetracked as there is no imminent inflation in sight and it is otherwise rather associated with unattractive commodities in general.

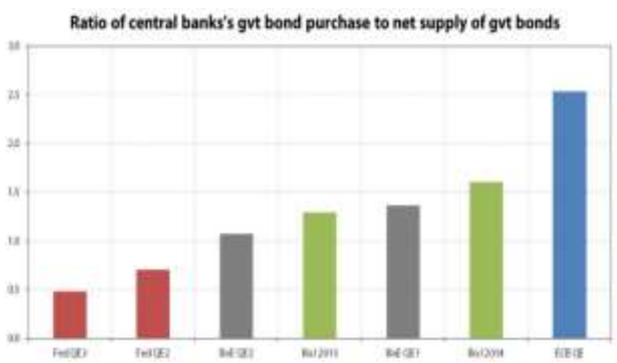
Chart 3: The Fed Policy Loop



Source: BCA

The Fed's contribution to these developments was Mrs. Yellen's decision to not raise the rates in September which the markets interpreted that the US economy might be not as strong as previously believed. Mrs. Yellen's more hawkish speech a week later alleviated the situation a bit. However, it also brought concerns about a strengthening USD to the forefront. BCA published recently a description of the Fed Policy Loop which at present determines the path of the markets as shown in Chart 3.

Chart 4: The ECB offers the most expansive Monetary Policy



Source: Gavekal

BCA explains: "Whenever Fed rhetoric becomes more hawkish, financial conditions will tighten. This means a stronger dollar, wider credit spreads, lower equities and a flatter yield curve. However, a sharp tightening in financial conditions will then cause the Fed to back away from its hawkish stance. This will cause financial conditions to ease, entailing a weaker dollar, tighter credit spreads, higher equities and a steeper yield curve."

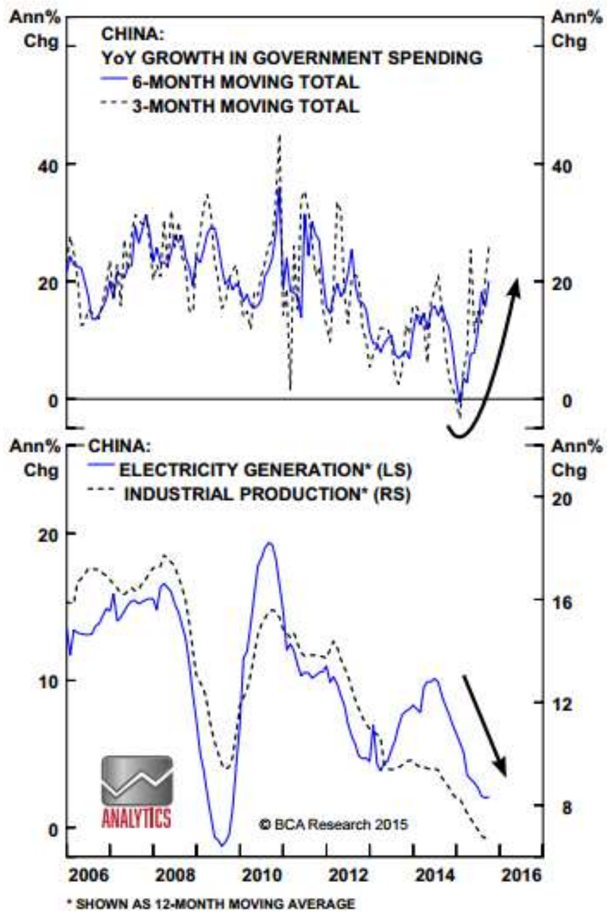
Chart 5: The Global Economy remains fragile but it will stay on a modest Growth Pattern

Source: BCA

Obviously, there is no easy way out of the era of massive accommodation of the financial system through expansive monetary policies as practiced during the global financial crisis in 2008 to October 2014 by the Fed. Although nobody disputes the stabilizing impact of massive Fed intervention during the global financial crisis, it is also all too clear that the markets have developed a dependence regarding the Fed and to all the other central banks which joined in offering quantitative easing programs. Hence, markets nowadays expect that central banks act "as a suppressor of financial volatility" (Bloomberg) and as "booster of financial asset prices" (Bloomberg). Therefore, much will depend how well Mrs. Yellen will guide the markets over the next months when she will eventually have to raise interest rates.

Chart 4 illustrates nicely how comparatively aggressive the ECB has put Mr. Draghi's announcement to do "whatever it takes" into action. The Fed, the Bank of England and even the Bank of Japan are clearly lagging behind. Obviously, the heterogeneous state of the EU increases the complexity of the task for Mr. Draghi enormously.

Chart 6: No Relief (yet) from China

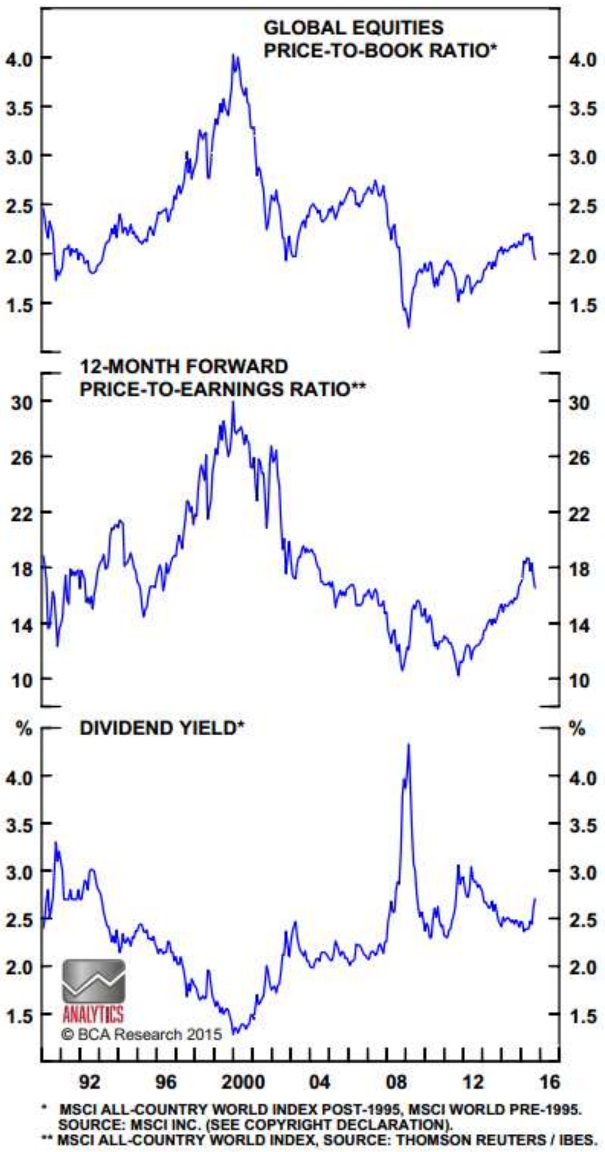


Source: BCA

Unfortunately, central banks do not operate in an isolated world and all their future actions, notably by the Fed, will have to be measured and judged against the other factors that are presently affecting the sentiment of the market participants. The list of global worries that feeds the current "macro angst" will stay the same in the near future. Ingredients are the fragility of global economic growth including worries regarding the pattern of Chinese economic development, (commodity related) emerging markets and growing concerns on High Yield credits.

Chart 5 shows that global economic growth remains fragile as measured by leading indicators, economic sentiment and the manufacturing PMI composite index. As the US will not be immune to weaker global demand, the Fed will have to monitor these developments carefully and factor them into their decisions.

Chart 7: Stocks are not as expensive



Source: BCA

Although we believe that China will ultimately master the transition towards a domestic demand driven economy, statistical data indicates that the slowdown in economic activity continues despite a much more stepped up stimulus program which includes interest rate cuts, reduced bank reserve requirements, infrastructure investments, tax cuts on car sales and lowered required down-payment for mortgages (see Chart 6).

So what about Equities?

Amongst risky assets, we remain convinced that equities provide good value despite their already elevated levels and a marked increase in volatility (see Chart 7). As pointed out in the previous edition, we believe that European and Japanese equities remain particularly attractive, followed by selected pockets in other Asian countries. Both areas continue to stimulate the markets with quantitative easing. In addition, we expect that domestic demand will pick up with significant impact on earnings. The strengthening of the US dollar (see Chart 8) will also increase competitiveness of companies outside the U.S.. In fact, the USD is now at the high-end of its post-1985 range which dates back to the period between 1998 and 2005 as Gavekal recently pointed out. Chart 8 uses hereby real effective exchange rates as provided by the Bank for International Settlement.

Chart 8: The US dollar is now uncompetitive

Source:Gavekal/ Macrobond

The Model Portfolio Positioning

We continue to keep equity and credit exposures as key pillars in our asset allocation. The search for investment opportunities with attractive risk-adjusted returns and low correlation continues. But we will stay alert to instantly react to relevant changes in the markets. In this context and given increased volatility, we keep equity beta low.

Equity Long/Short managers are still our preferred choice over straight Beta Long-Only equity managers as we expect continuously elevated market volatility in the months to come, which leads us to cut back on Equity Long/Short strategies with higher net exposures. Equity returns will be more modest. We maintain our general equity exposure with a focus on Europe's improved stock market environment.

The normalization process for interest rates has picked up lately at the long-end of the yield curve and it will continue. Therefore, there is no imminent need to alter our strategy, as we favor low duration exposure and our focus on credit and loans with mainly exposures in USD and in European credits/ corporate loans. Having stated that, we are, however, aware that we are already late in the business and credit cycle. Therefore, we will continue to apply prudent active credit selection as we are determined to avoid exposures in troubled sectors.

The spread widening offers an opportunity to add short-term High Yield particularly as default rates remain still contained for corporations outside the ailing energy, metals and mining sectors. Hence, we maintain our preference for short-dated portfolio duration. Further, we added convertibles after the recent correction and we keep our small exposure to emerging market debt in hard currency to profit from an unfolding recovery.

We remain invested in insurance-linked securities as this type of instrument continues to offer diversification benefits in the portfolio.

We keep gold at a low allocation: Our fundamental view that gold is, per se, a helpful tool to diversify, has not changed; but market sentiment and the absence of inflationary expectations have clearly turned against this precious metal for the time being. Hence, we keep gold exposure at a low level, as a hedge against unexpected macro and geopolitical risks and even inflation surprises.

The overall lackluster outlook for commodities will not lead to a re-investment anytime soon in this asset class.

Appendix:

Market Data Table: A painful Third Quarter of 2015

Equity Markets	Sep	Aug	Jul	YTD	2014
MSCI World Daily TR with Dividends USD	-3.6%	-6.6%	1.8%	-5.6%	5.5%
S&P 500 INDEX	-2.6%	-6.3%	2.0%	-6.7%	11.4%
MSCI Europe Gross	-4.4%	-8.7%	3.9%	0.5%	4.1%
MSCI AC Asia Pacific	-4.7%	-8.5%	-2.9%	-10.2%	-2.5%
MSCI Daily TR Gross EM BRIC US	-3.2%	-11.0%	-8.3%	-14.4%	-2.6%
Fixed Income & Credit					
BarCap Global Aggregate (USD Hedged) Index	0.6%	-0.3%	1.0%	0.9%	7.6%
JPM GBI EMU AAA TR USD	0.9%	0.5%	0.7%	-7.1%	-3.0%
Global Gov Bond Index All Maturities (USD)	0.6%	0.4%	0.4%	-3.1%	-1.8%
Bloomberg EFFAS US Gov Bond 3-5 Years	0.8%	-0.2%	0.3%	1.1%	0.2%
Bloomberg EFFAS US Gov Bond 10+ Years	2.1%	-1.1%	3.9%	-1.8%	20.7%
Bloomberg EFFAS EURO Gov Bond 3-5 Years	0.3%	-0.5%	0.7%	-0.8%	2.5%
Bloomberg EFFAS EURO Gov Bond 10+ Years	2.8%	-2.9%	5.2%	0.3%	24.5%
Bloomberg EFFAS German Bonds 1+ Years	1.2%	-1.2%	1.3%	-0.8%	7.8%
Markit iBoxx Global EM LC Bond Index	-1.8%	-3.5%	-2.0%	-10.4%	-2.5%
CS High Yield Index value	-2.5%	-2.0%	-0.7%	-2.4%	2.0%
Alternatives & Commodities					
HFRX Global Index	-2.1%	-2.2%	0.0%	-3.0%	-0.6%
DJUBS Commodity TR	-3.4%	-0.9%	-10.6%	-15.8%	-17.0%
Gold 1 OZ	-1.7%	3.6%	-6.5%	-5.9%	-1.7%

Source: Bloomberg data

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