



Julius Bär

Crunch Time – The Credit Cycle and Asset Class Returns

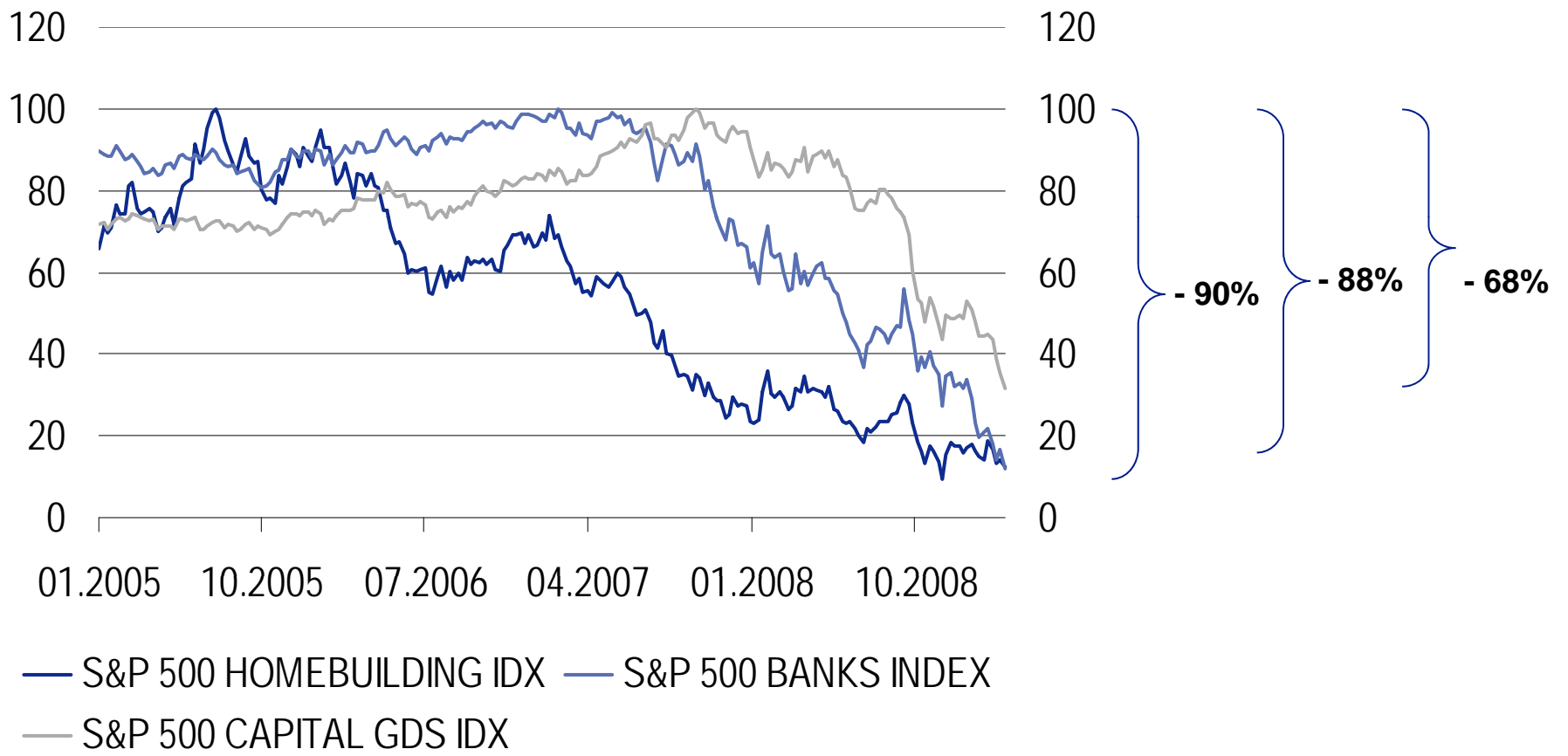
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Chief Strategist & Head of Research

CFA Institute Traveling Conference
Moscow / Warsaw / Munich / Frankfurt
October 2010

Contents

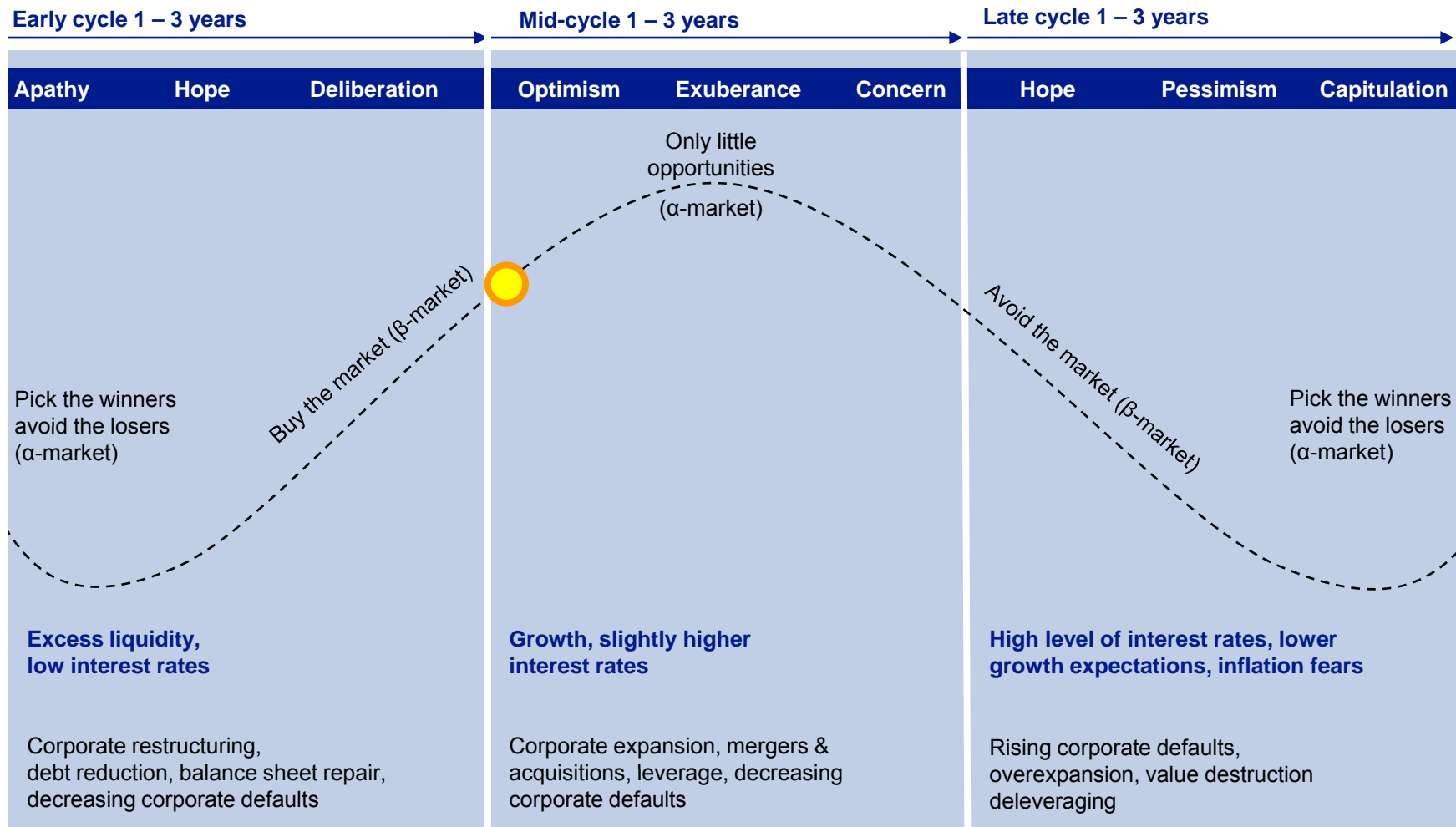
- Where we are in the deleveraging process, and how global asset prices and currencies are reflecting this
- Analysis of asset class sensitivities and the reduced correlation of emerging market equities
- Cross-asset relationships and how to identify when to make asset allocation shifts

Anatomy of a crisis – 1) bubble bursting, 2) intermediary gets hit, 3) impact on real economy



Evolution of the capital market cycle – Opportunities and risks

● Current position

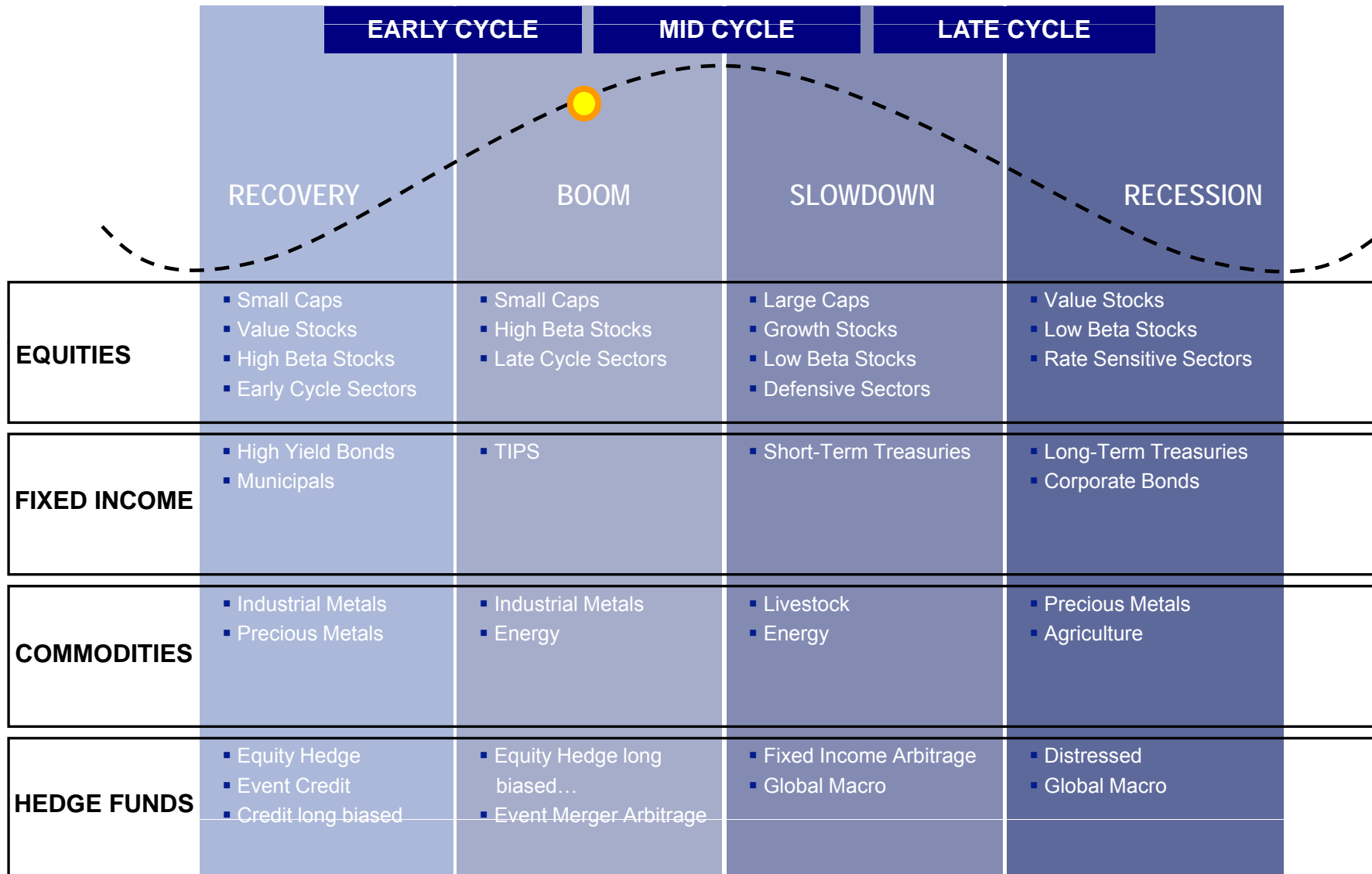


Source: Julius Baer

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Investing over the business cycle

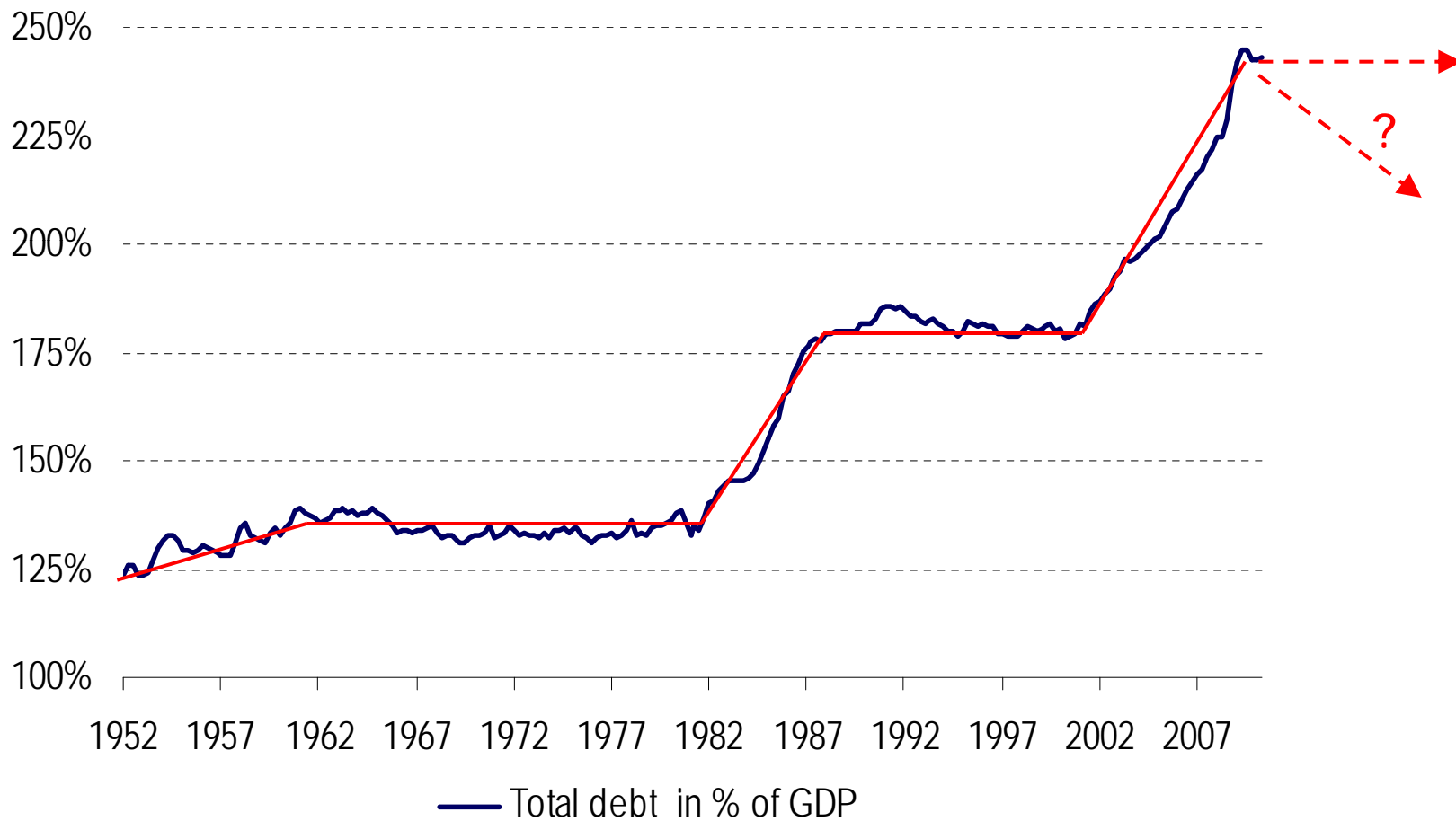
● Current position



Where are we in the deleveraging process?

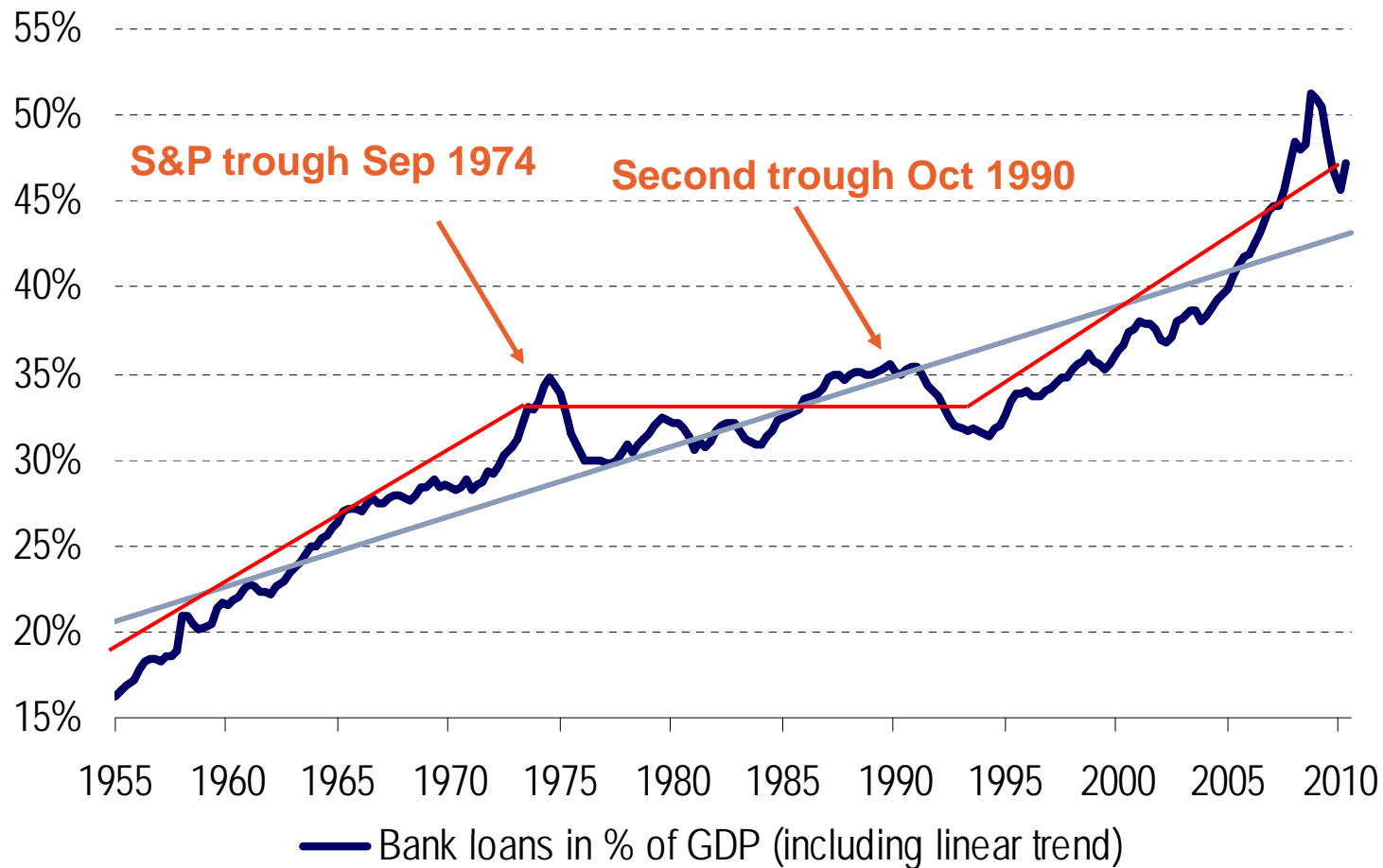


The U.S. debt supercycle: In place since after WWII



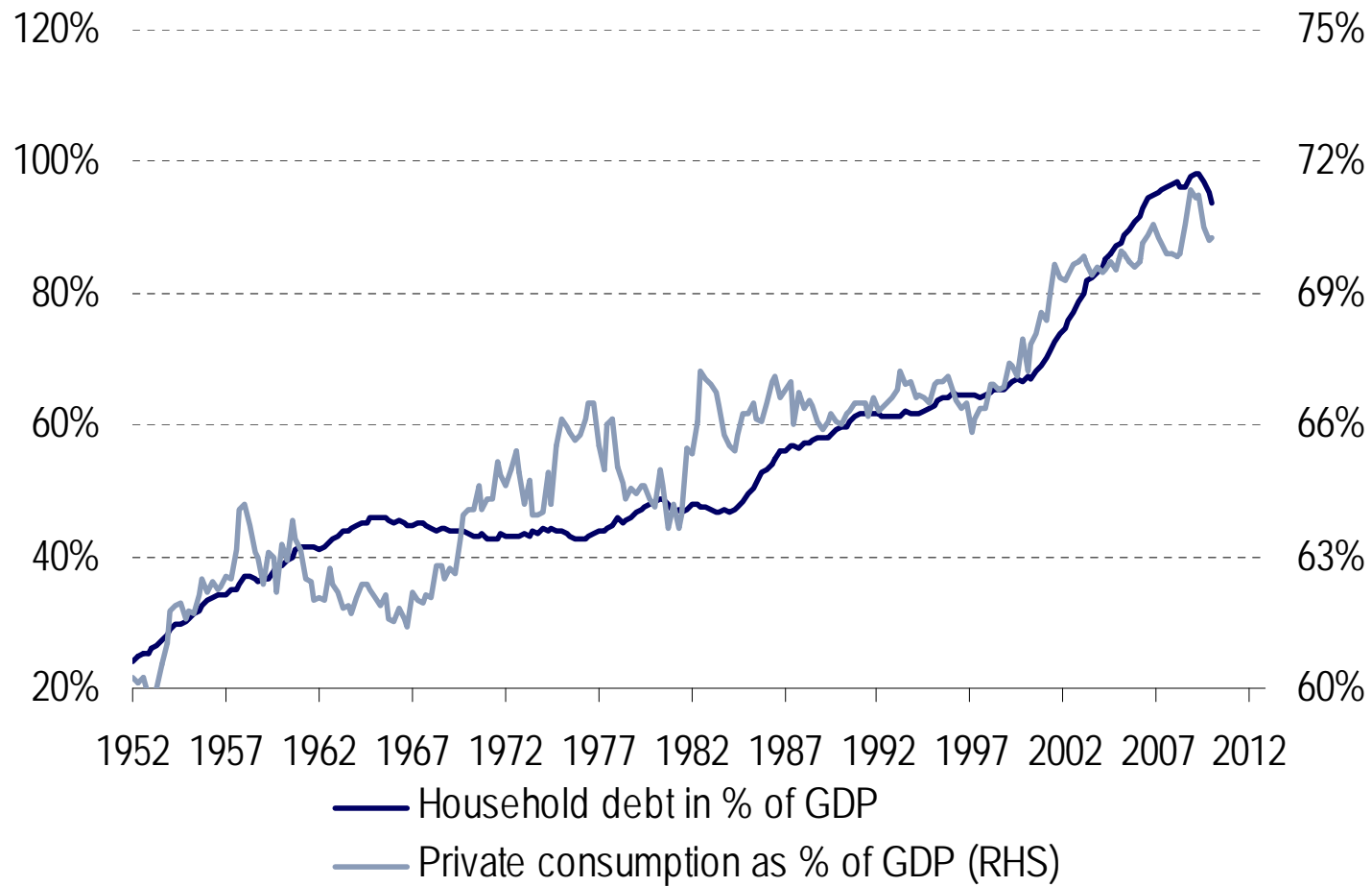
Source: Bloomberg, Julius Baer

U.S. bank loans still above long term trend



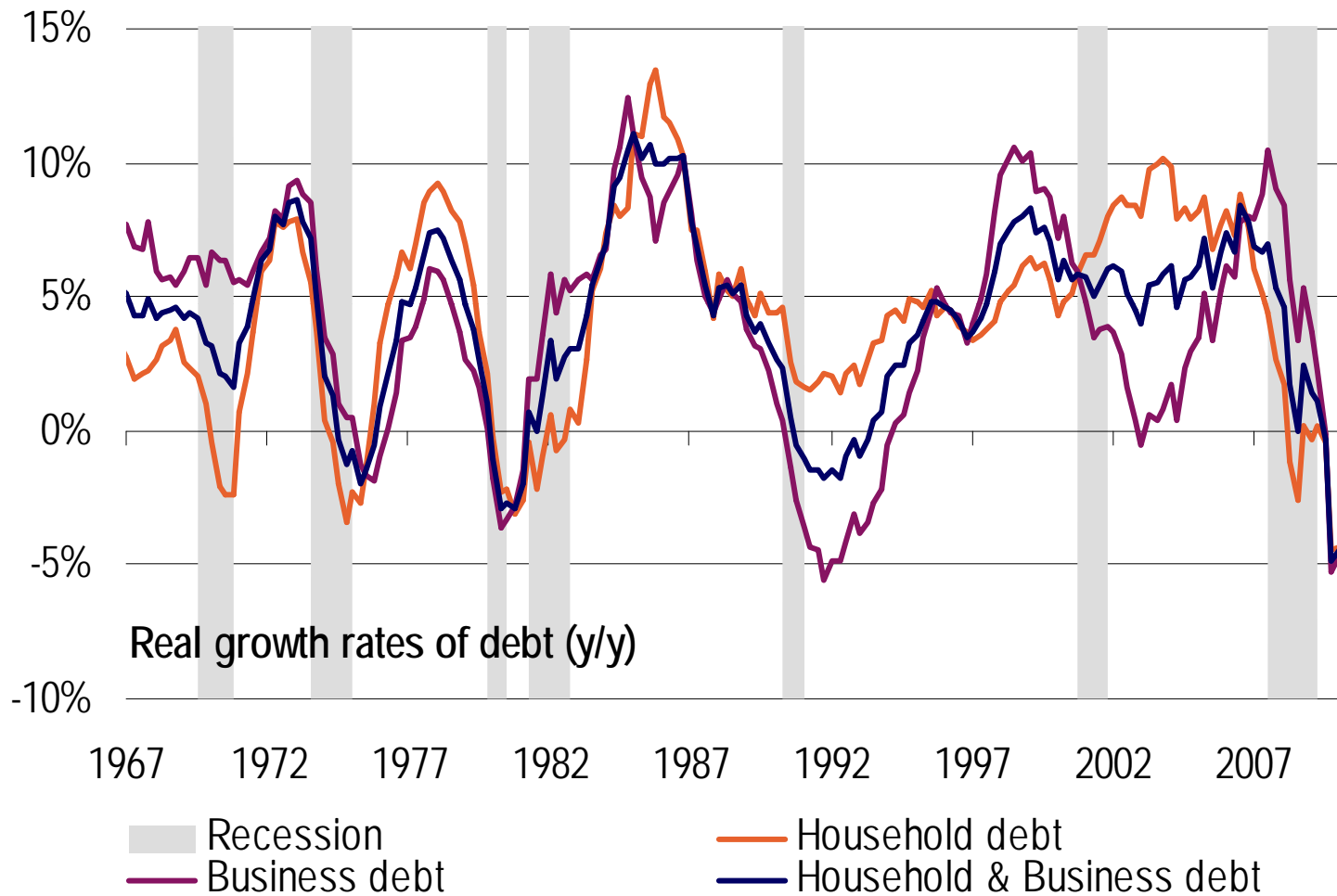
Source: Fixed Income Research Julius Baer

Household debt has spurred economic growth



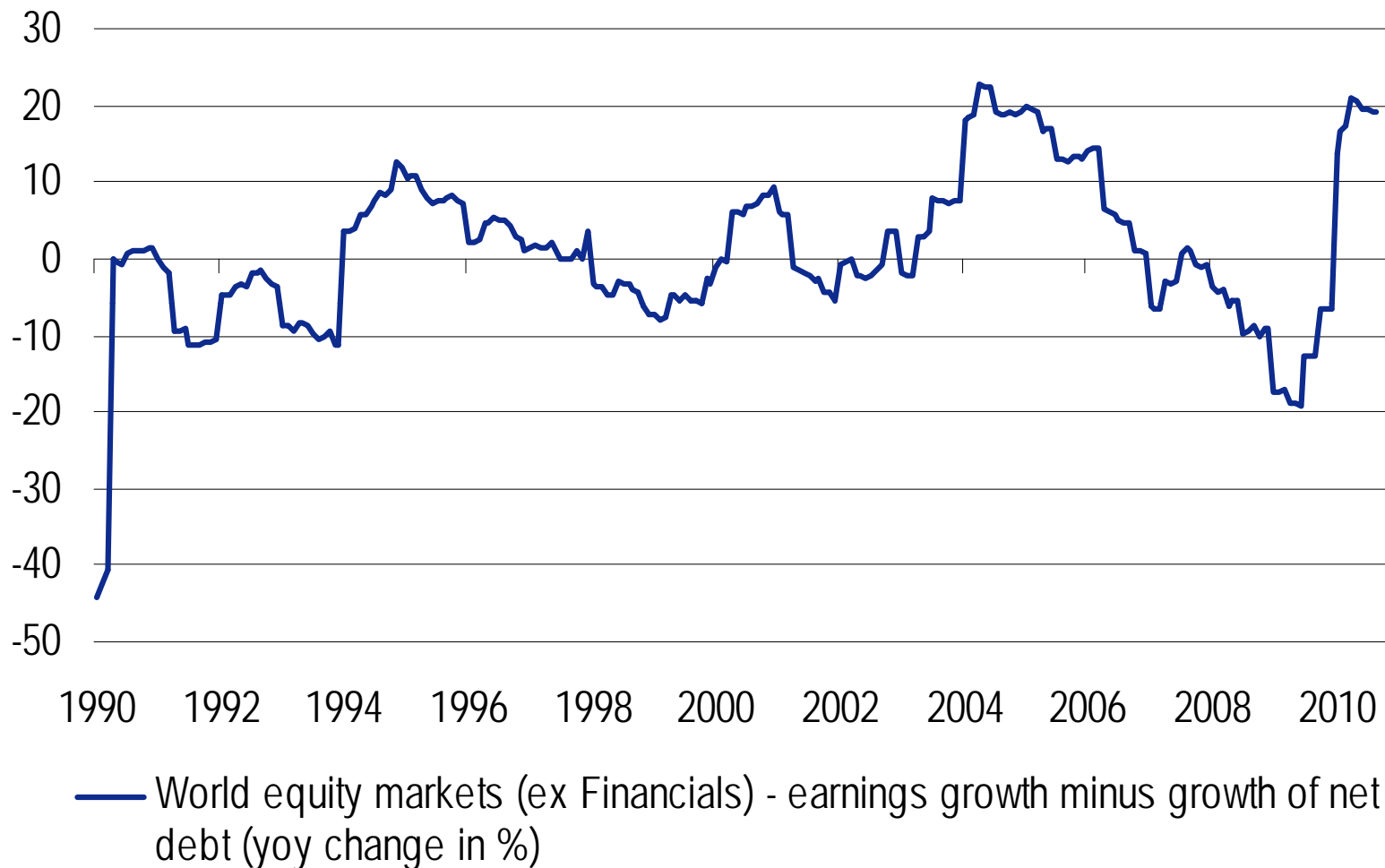
Source: Bloomberg, Julius Baer

It is the consumers *and* corporates this time around



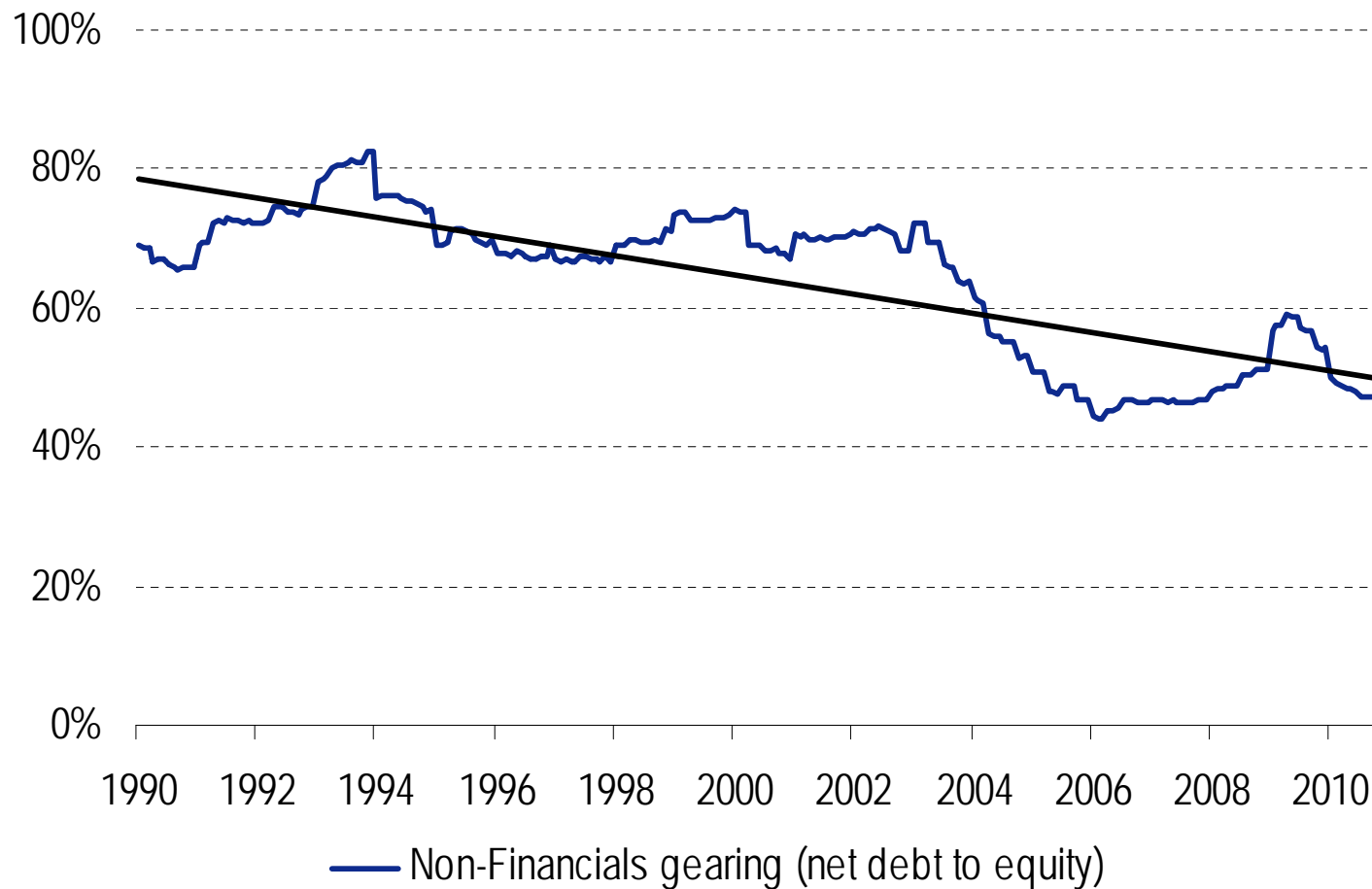
Source: Datastream, Julius Baer

De-leveraging outside the financial sector at extremes (earnings growth exceeds debt growth by 20% currently)



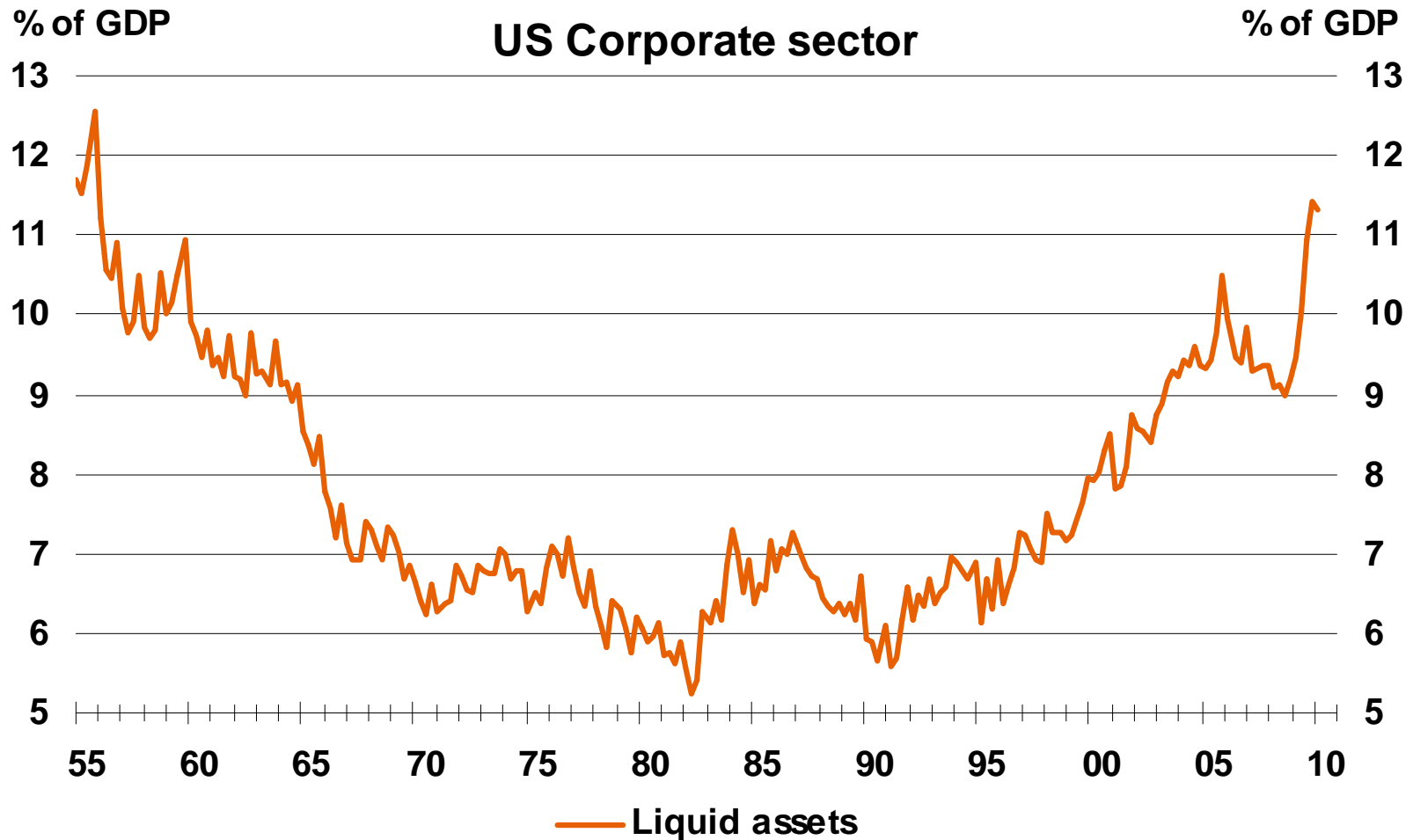
Source: Strategy Research Julius Baer

This leaves world non-financials at conservative leverage levels that are excessive in historical terms



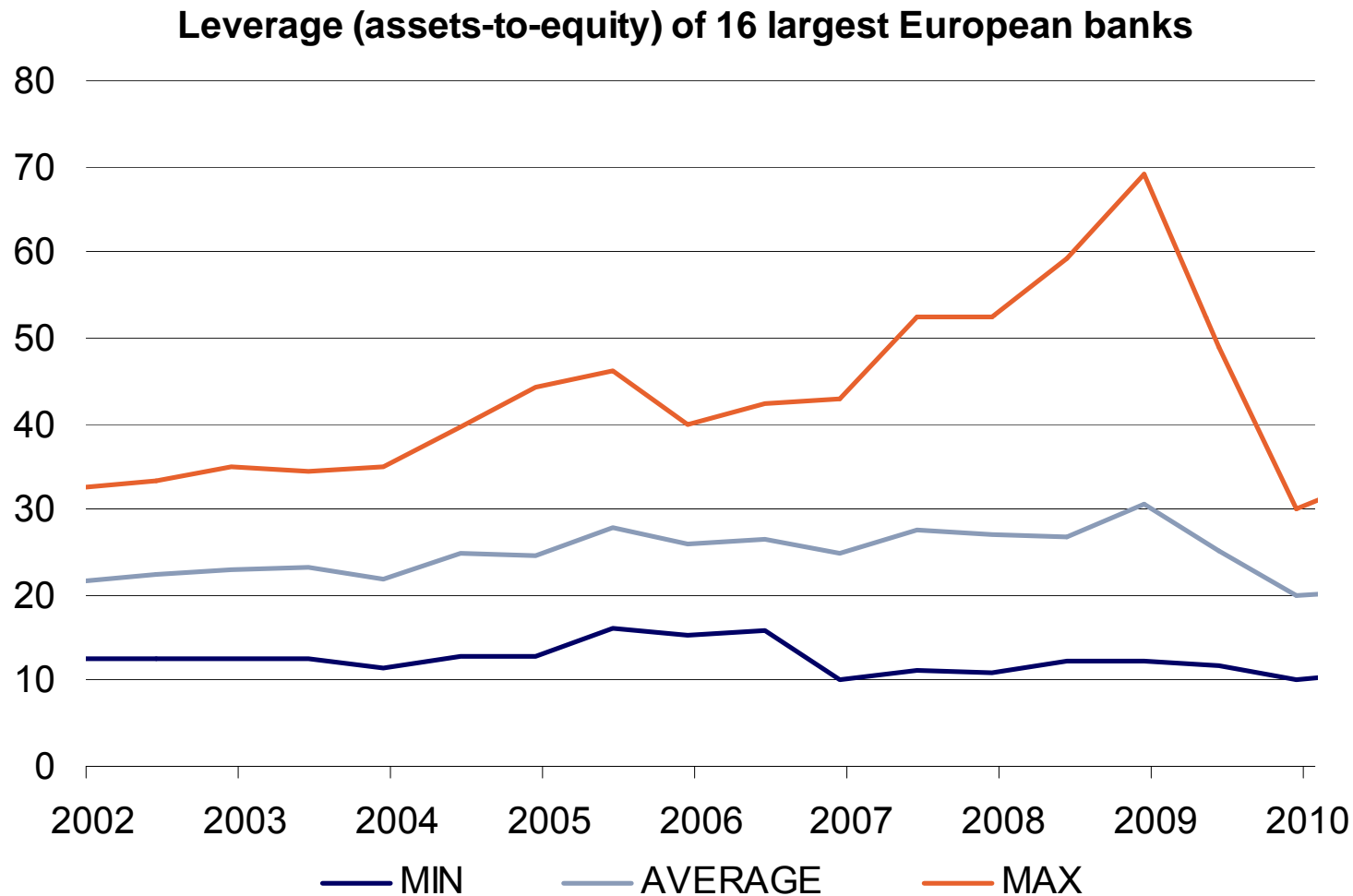
Source: Datastream, Julius Baer

Cash holdings with U.S. non-financial corporates close to all-time highs



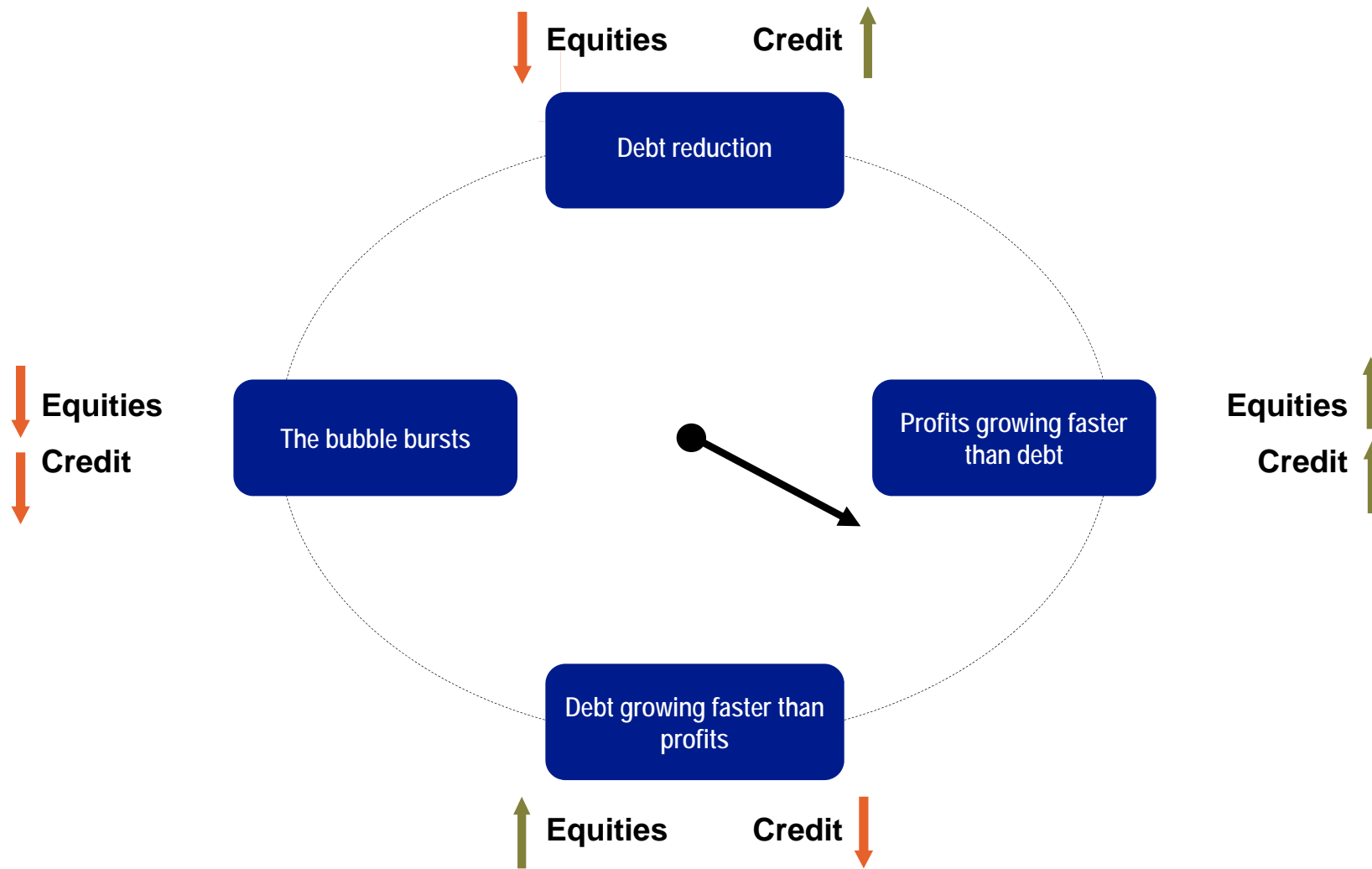
Source: Fed, Julius Baer

De-risking in European banks



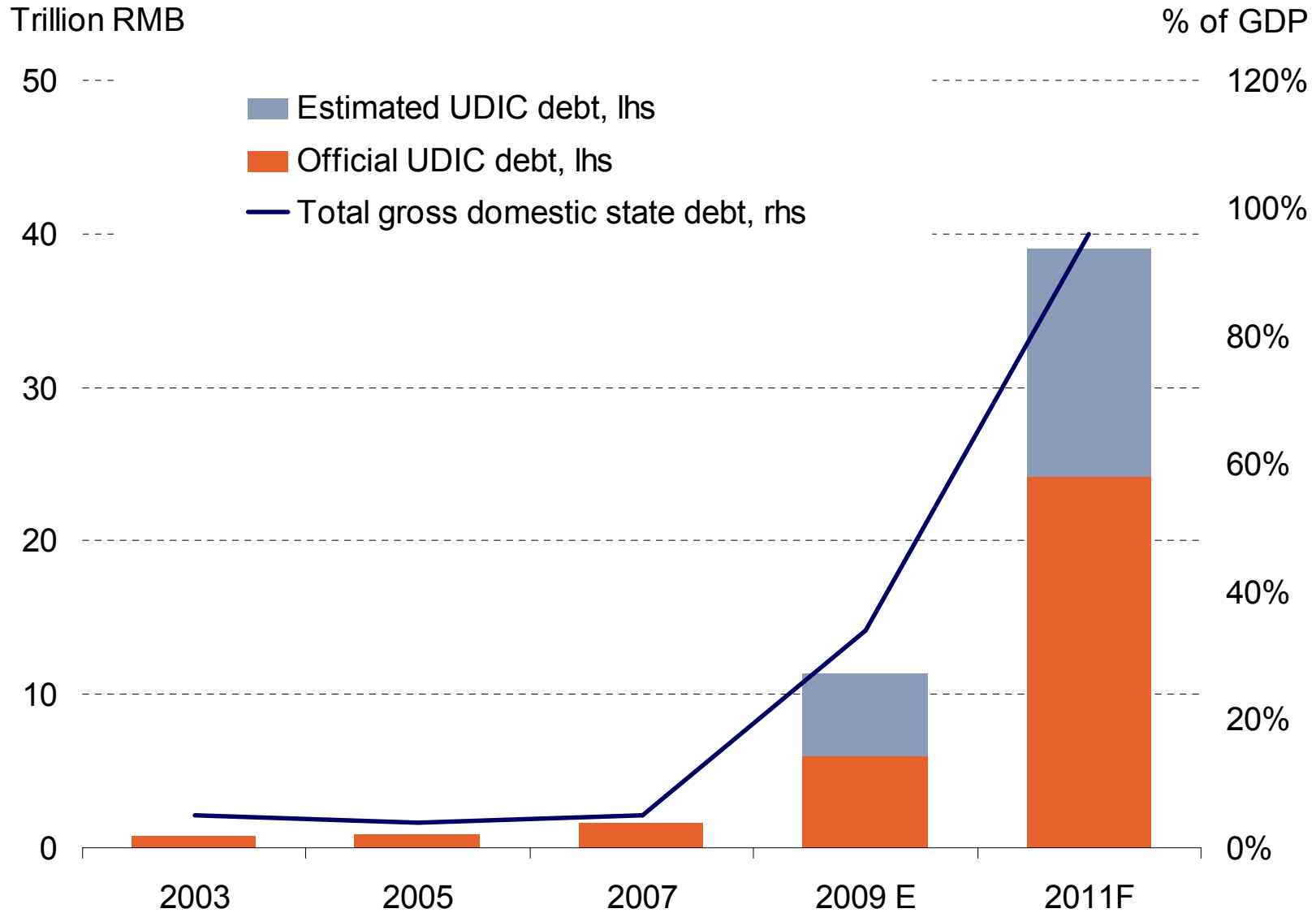
Source: Fixed Income Research Julius Baer

The credit clock – passing quarter past: Corporate profit growth is strong

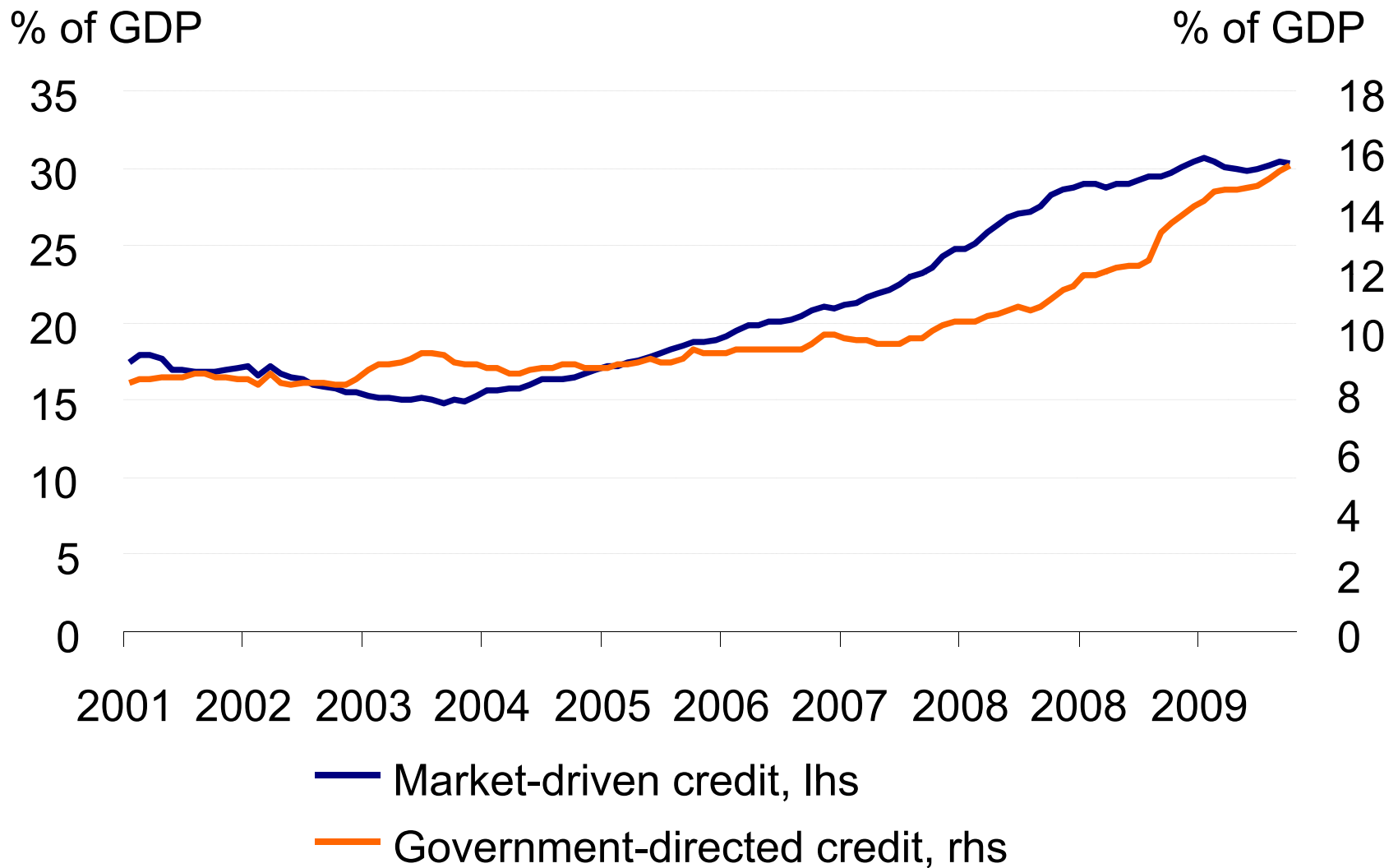


Source: Citi, ML, Julius Baer

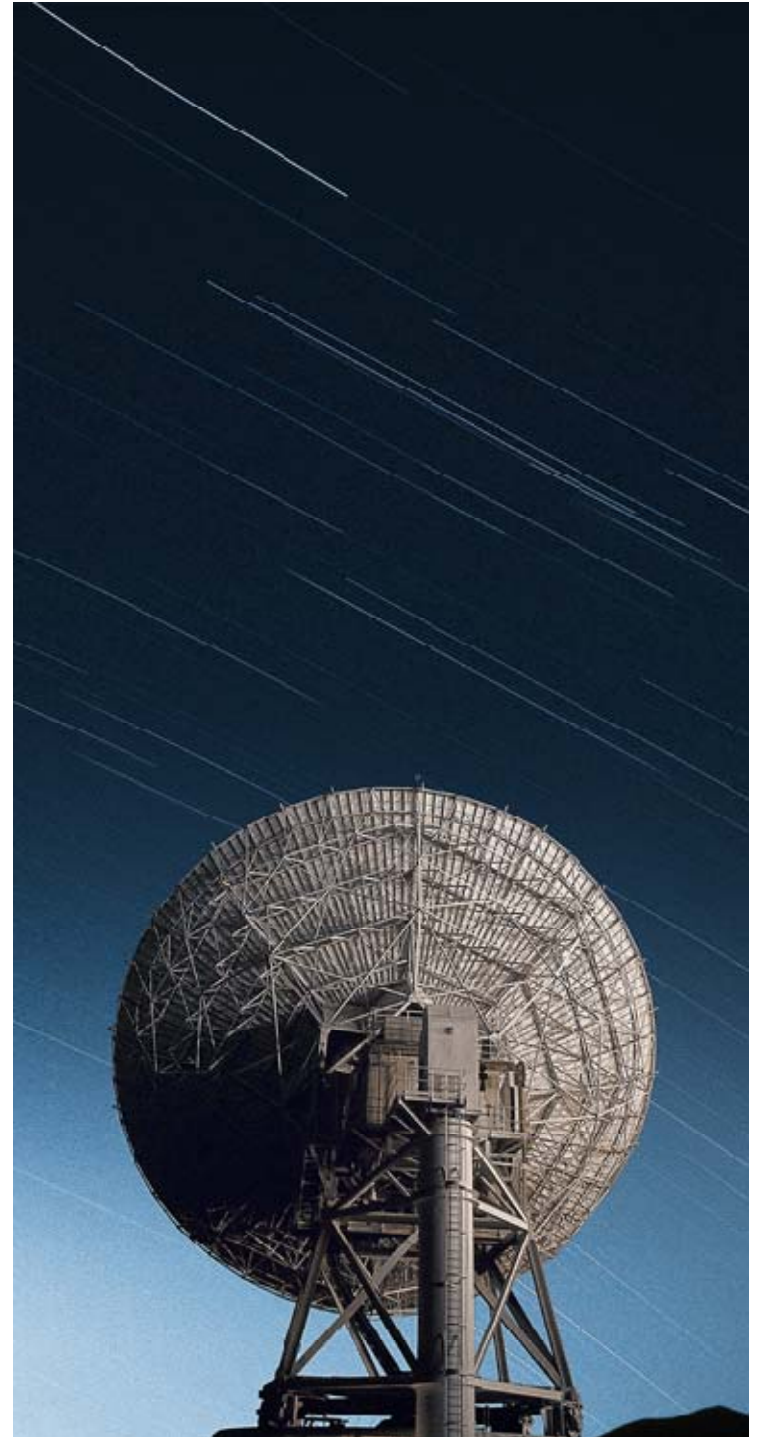
De-leveraging? Not here!



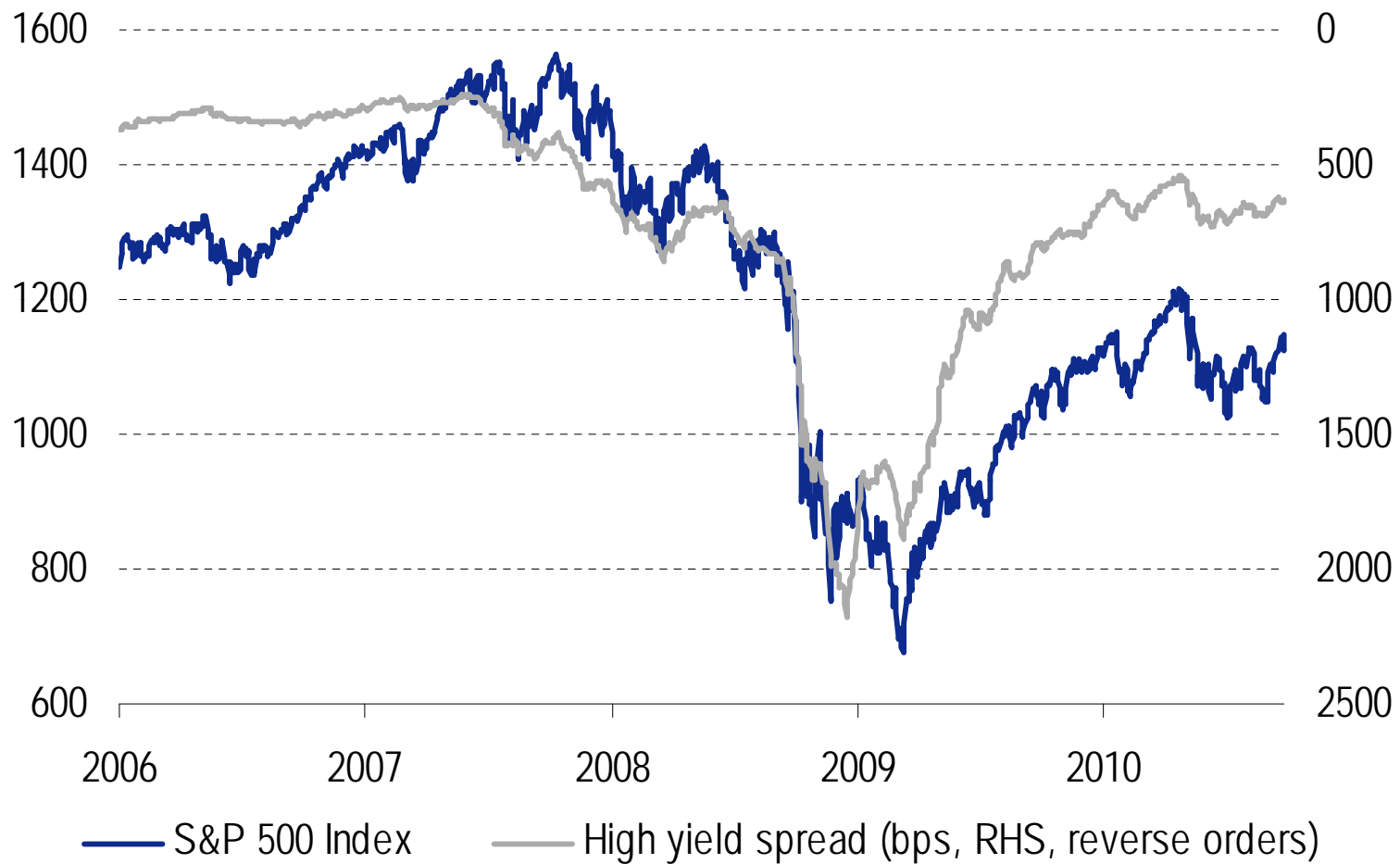
State-driven lending on the rise in Brazil



How are asset prices reflecting this?

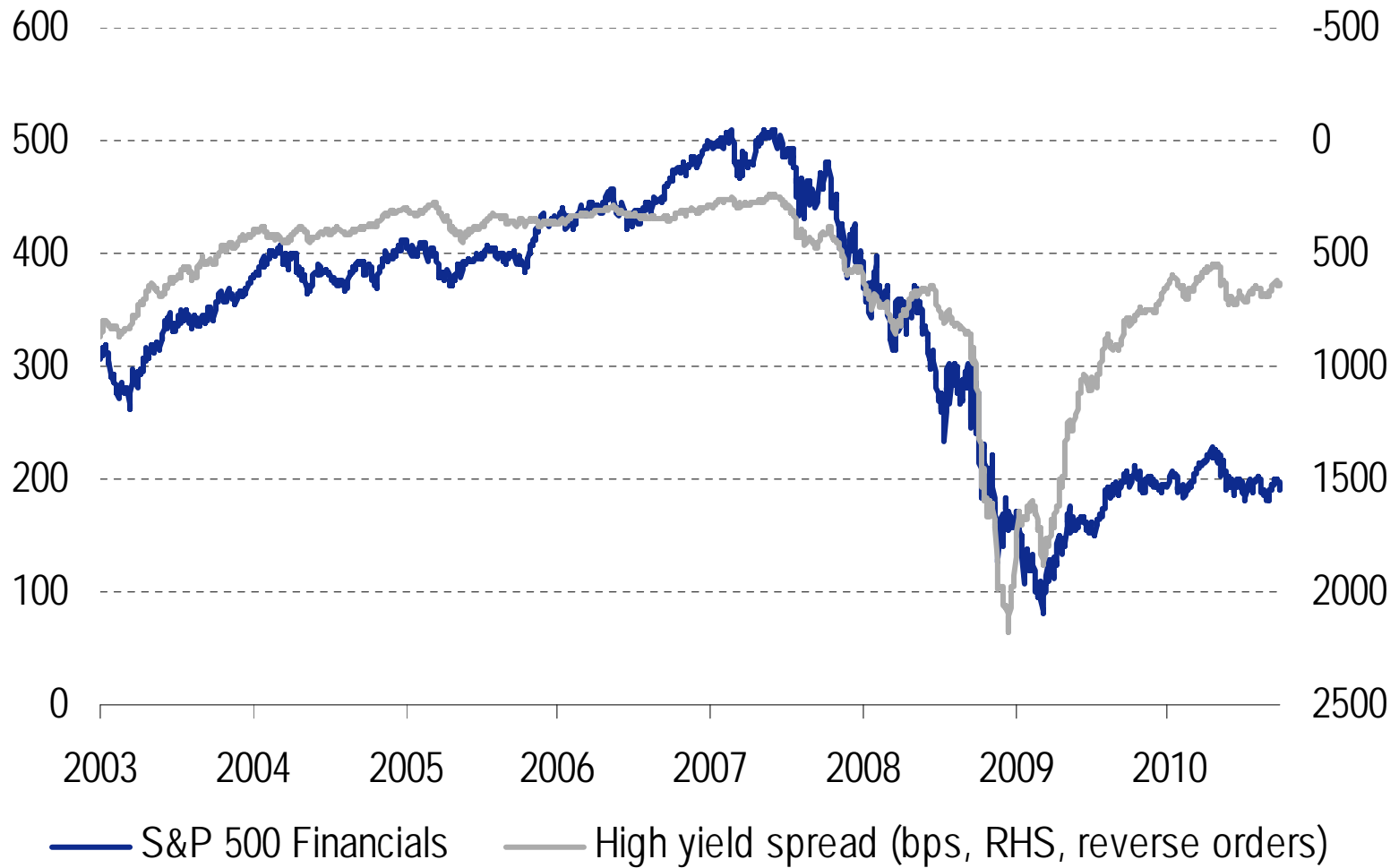


The credit cycle and equities – current spreads point to further upside in the S&P 500



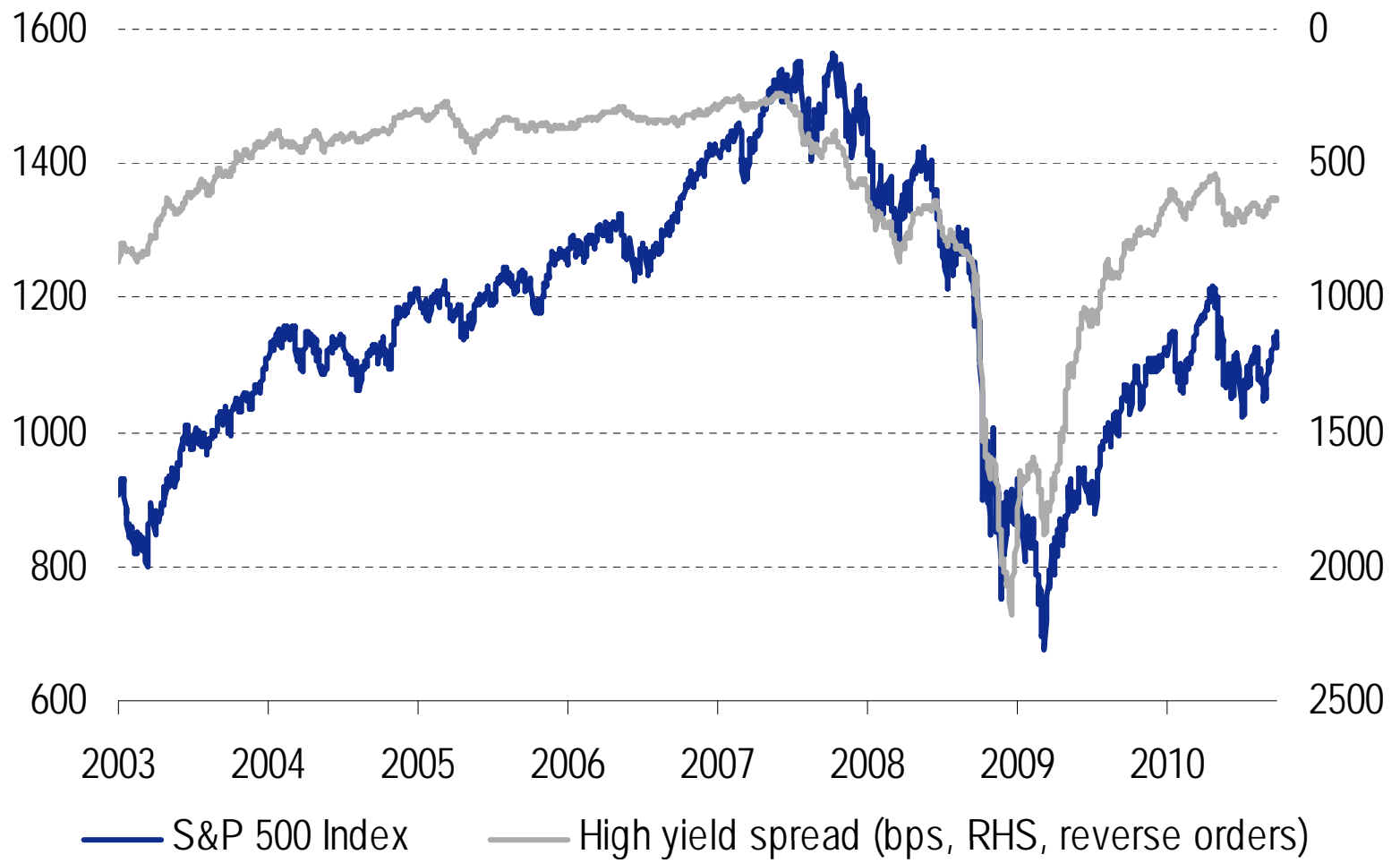
Source: Datastream, Julius Baer

In particular for financials



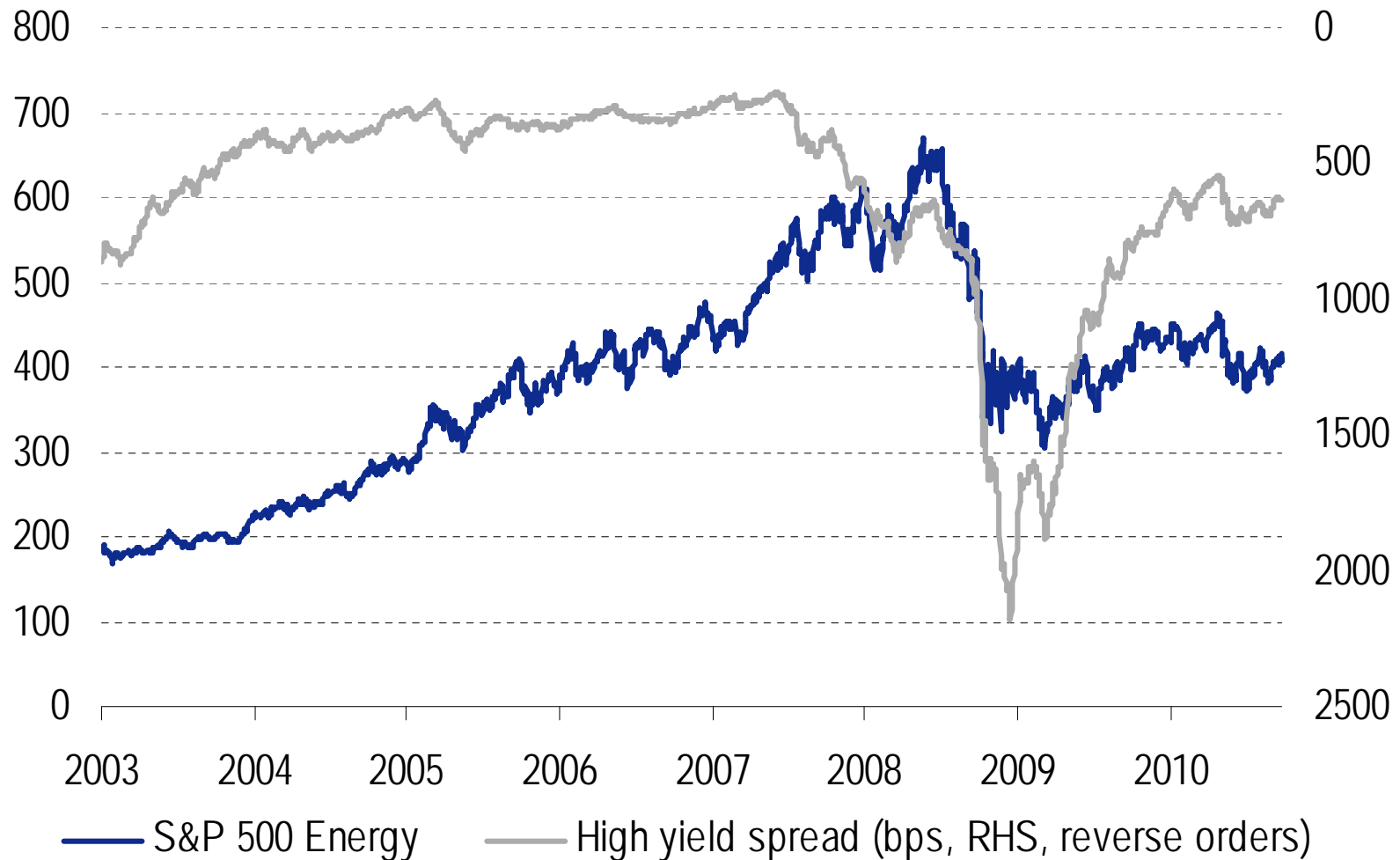
Source: Datastream, Julius Baer

...while the overall market seems less affected, looking at the credit cycle overall



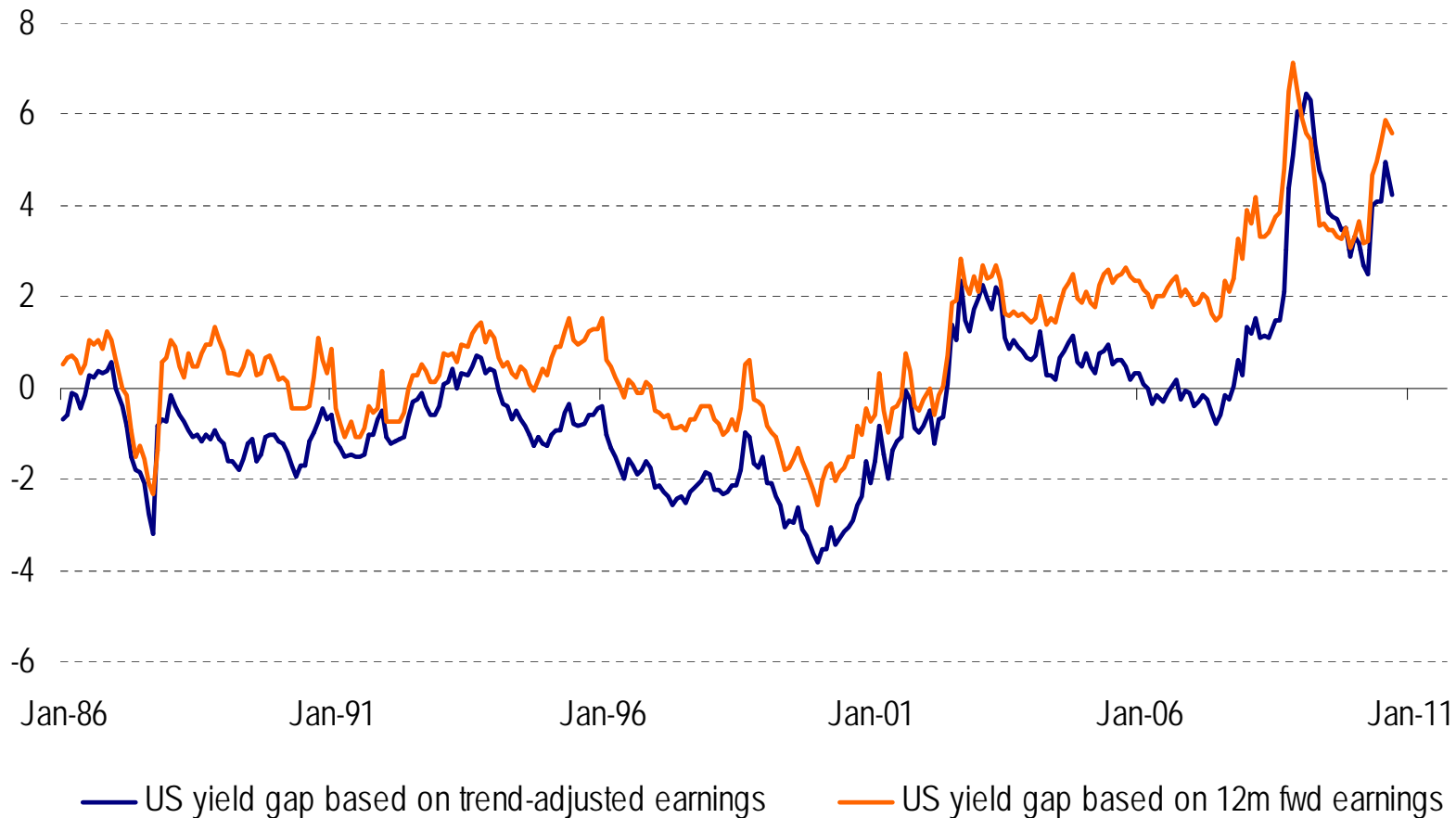
Source: Datastream, Julius Baer

...and energy stocks do not seem to be affected at all



Source: Datastream, Julius Baer

U.S. yield gap: Equities vs. corporates – risk premium on stocks still looks like an anomaly

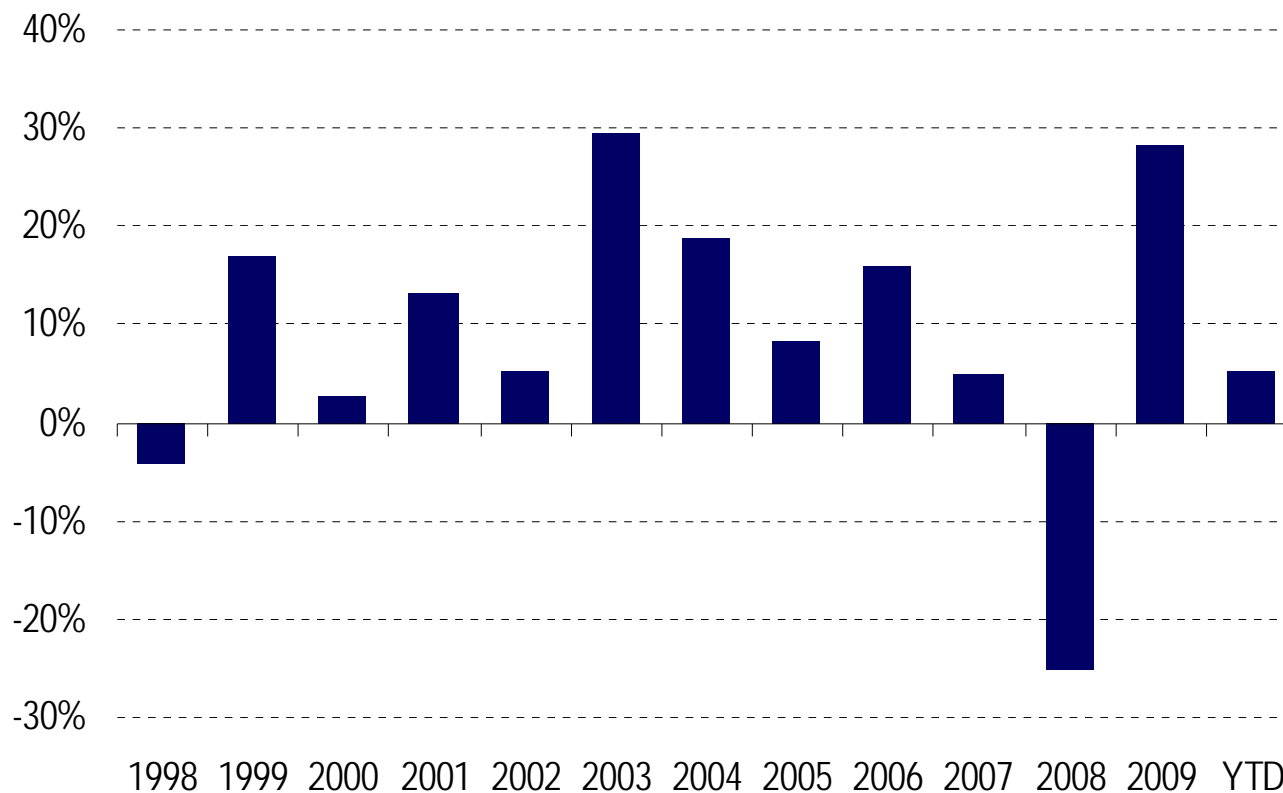


Source: Datastream, Julius Baer

Distressed Credit Situations

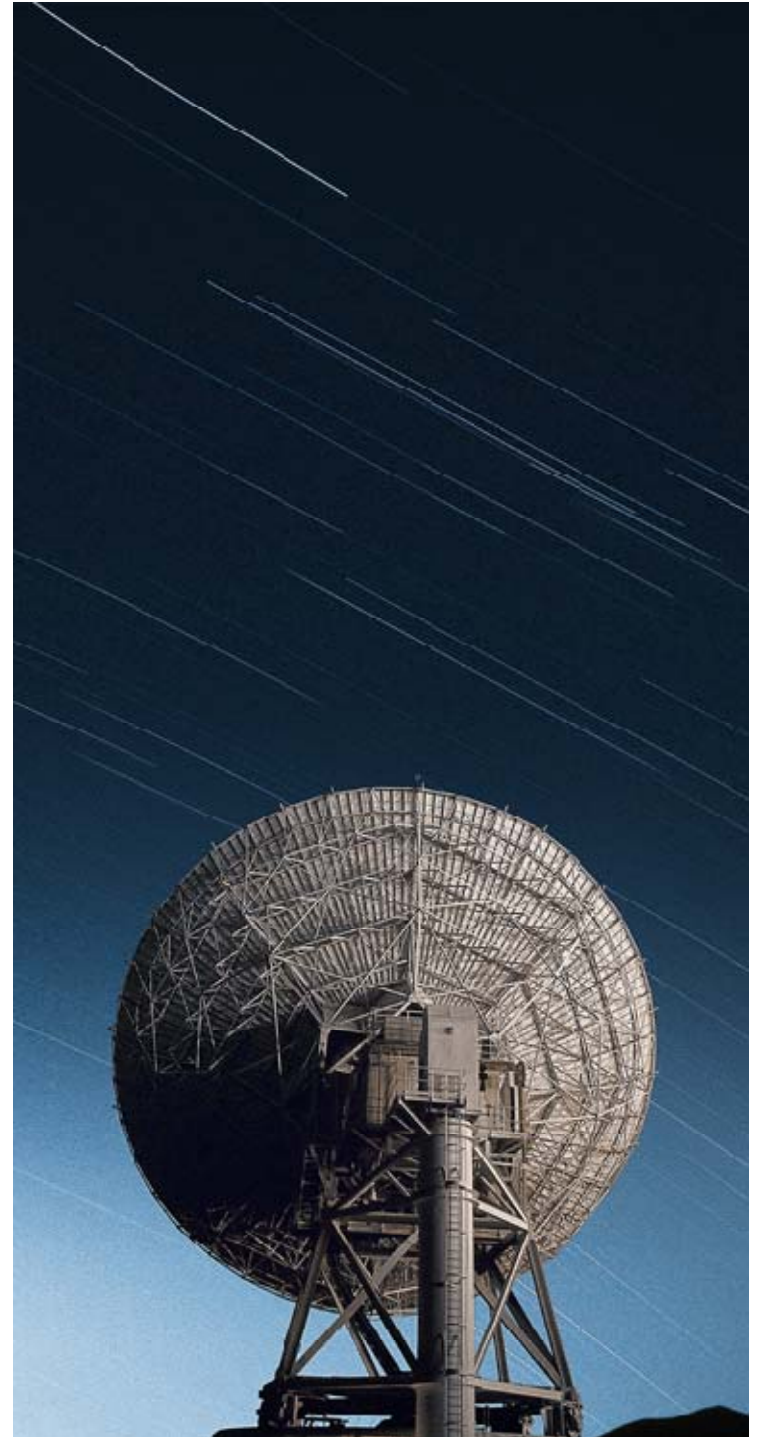
Attractive Historical Returns

Annual Return % HFRI Distressed / Restructuring Index

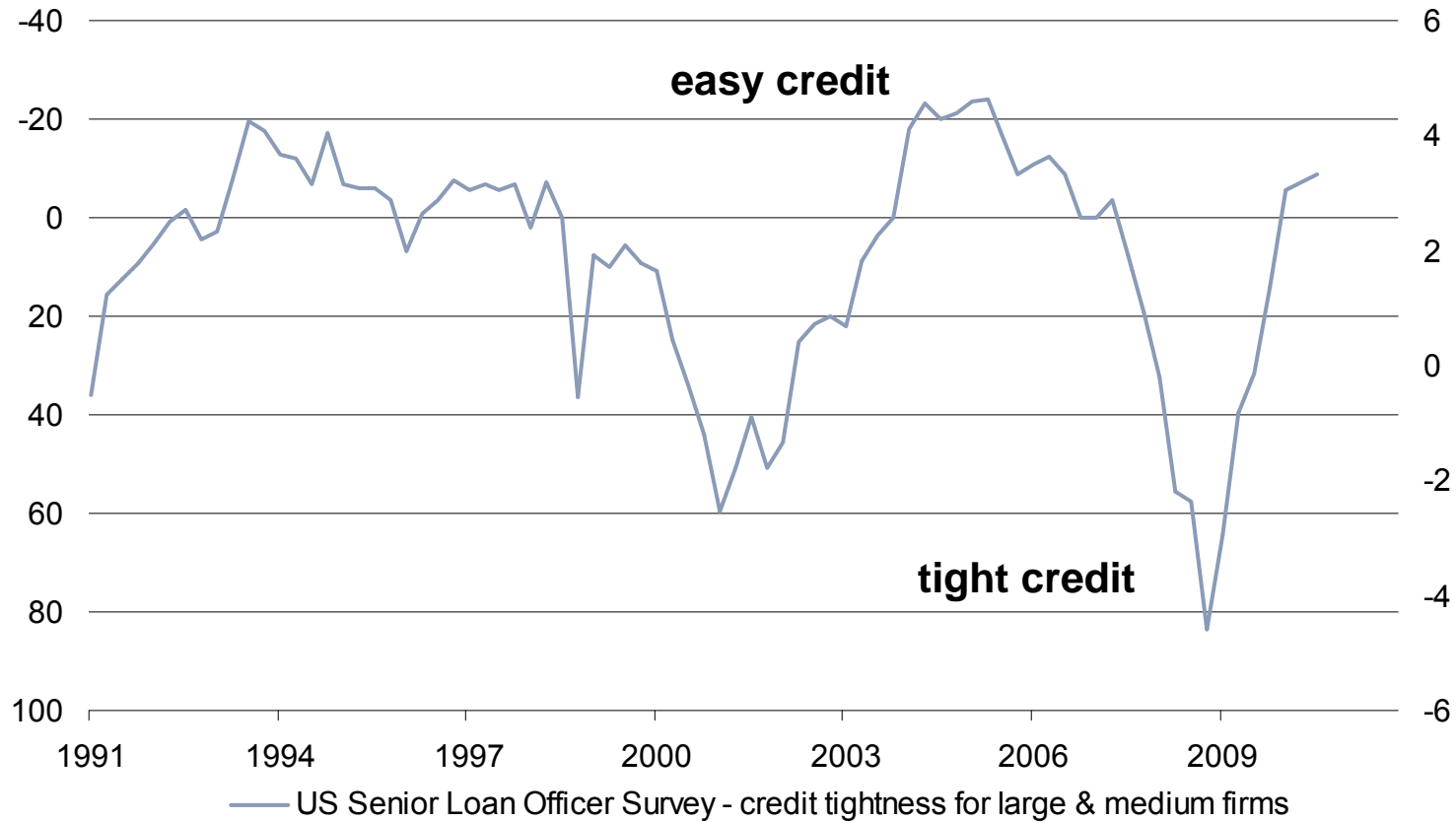


Source: HFRI, Bloomberg

The long and the short of it: The credit-easing portfolio vs. the credit-tightening portfolio

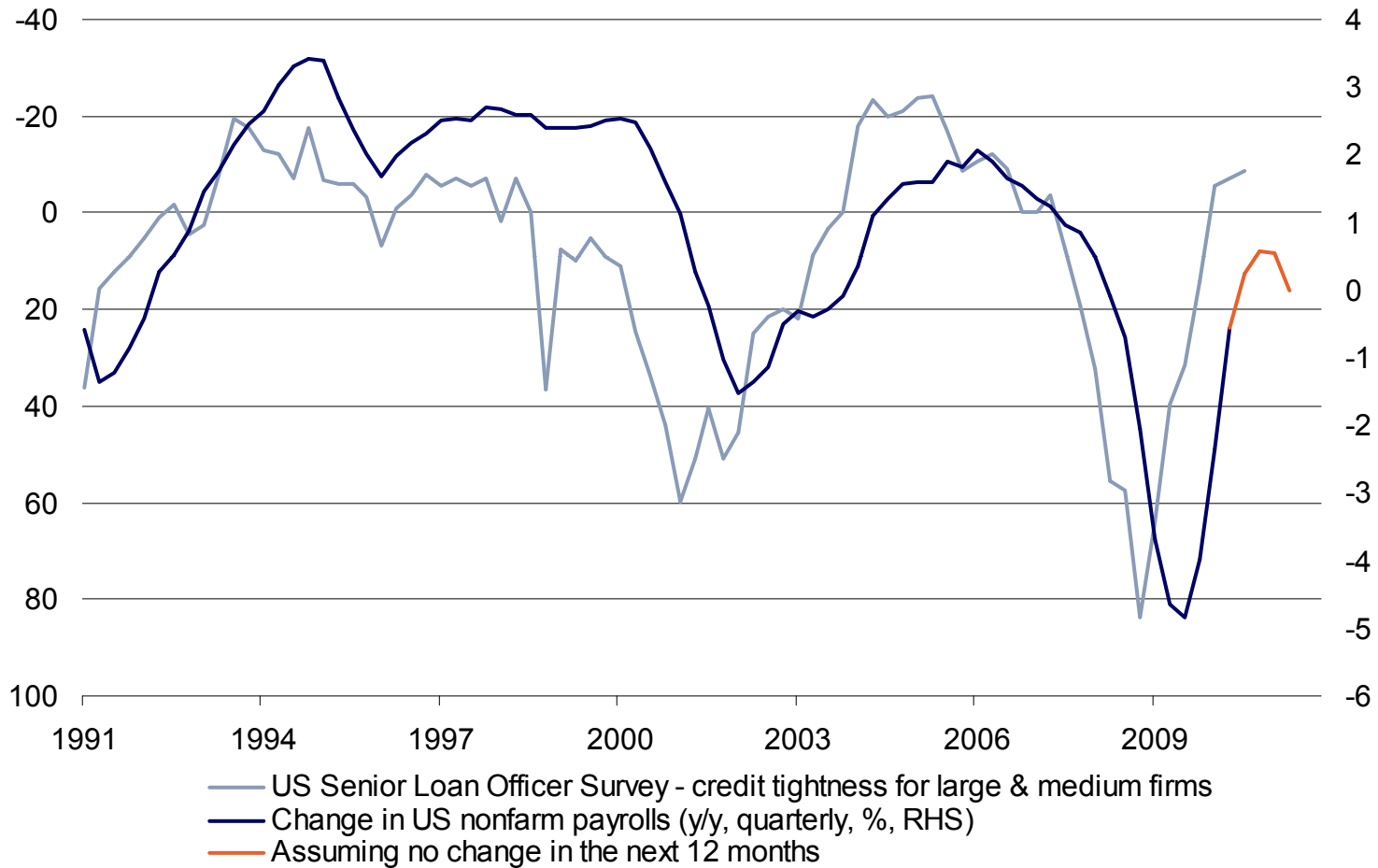


The credit crunch: Framework – the Fed’s Senior Loan Officer Opinion Survey (net percentage tightening standards), inverted



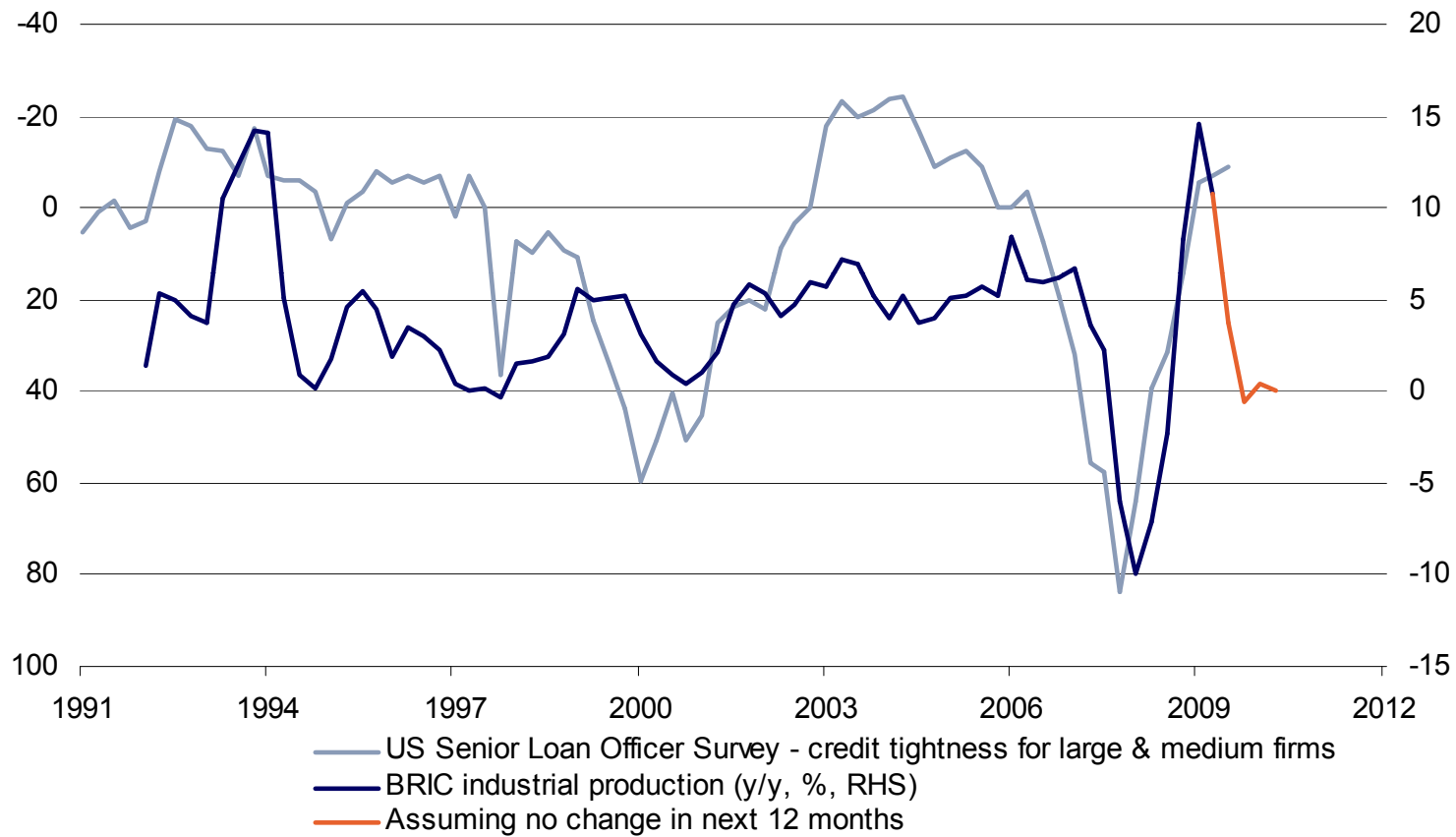
Source: Datastream, Julius Baer

Leading U.S. non-farm payrolls



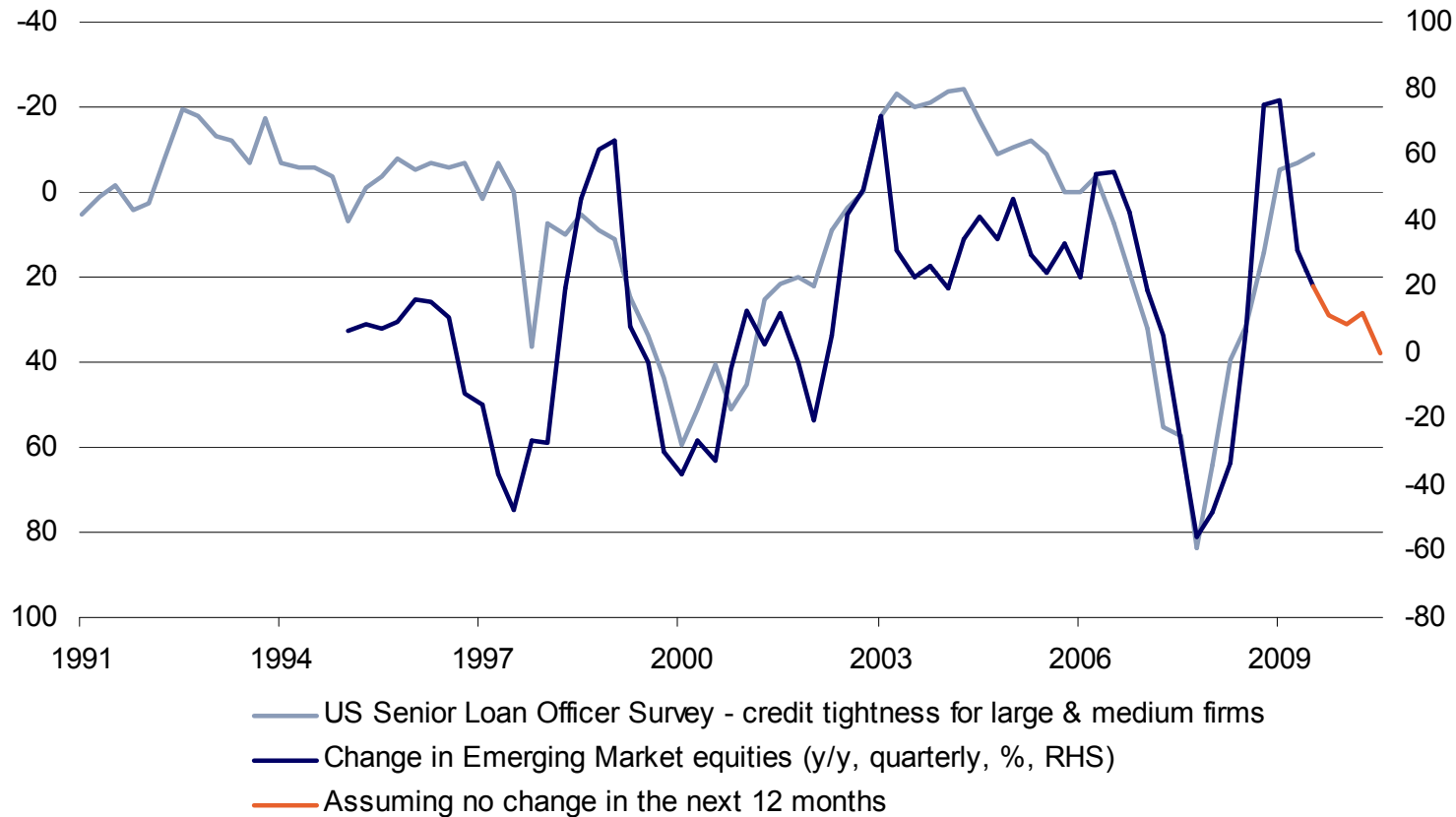
Source: Datastream, Julius Baer

BRIC industrial production



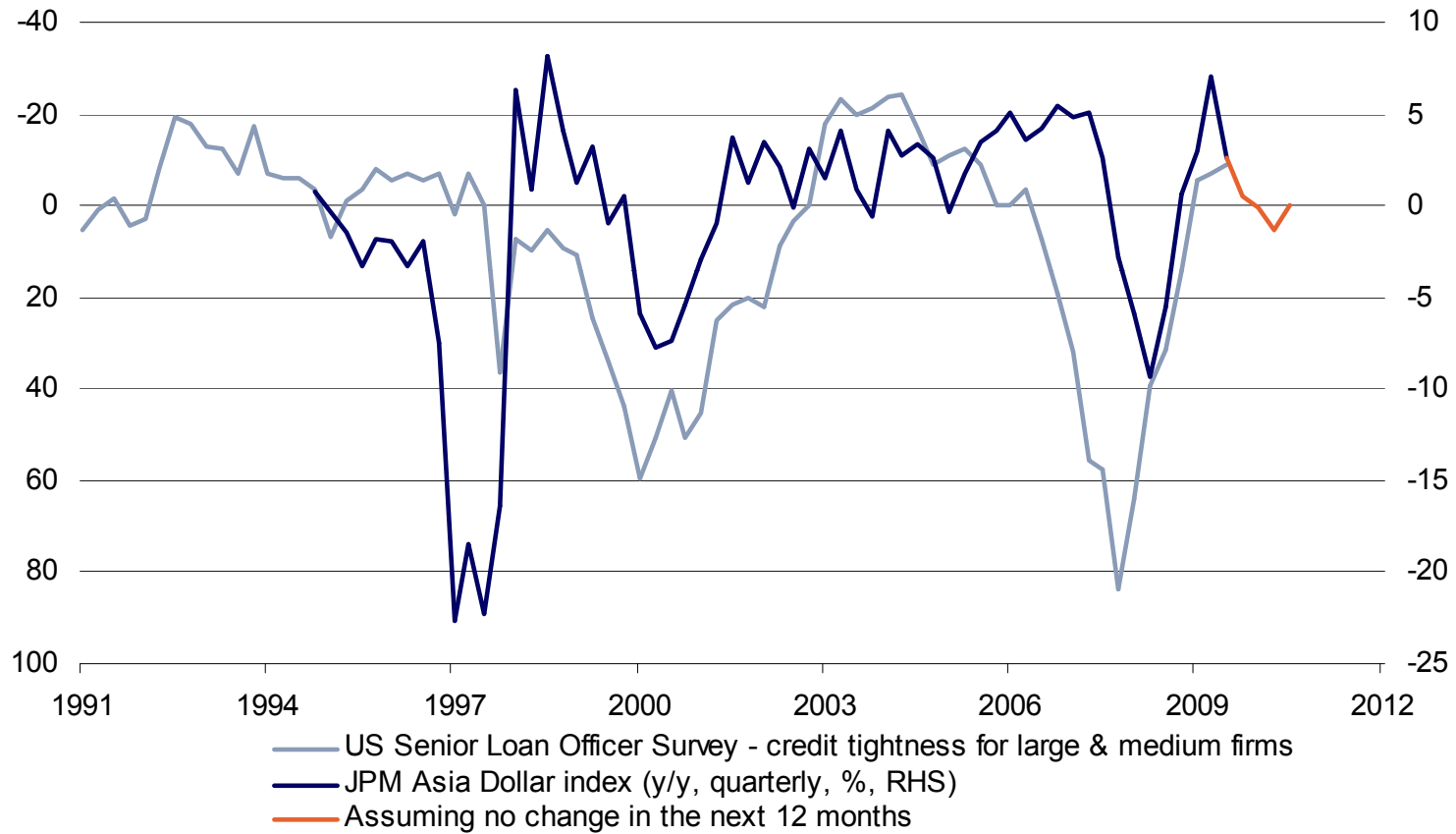
Source: Datastream, Julius Baer

The end of the credit crunch? Equities → emerging markets



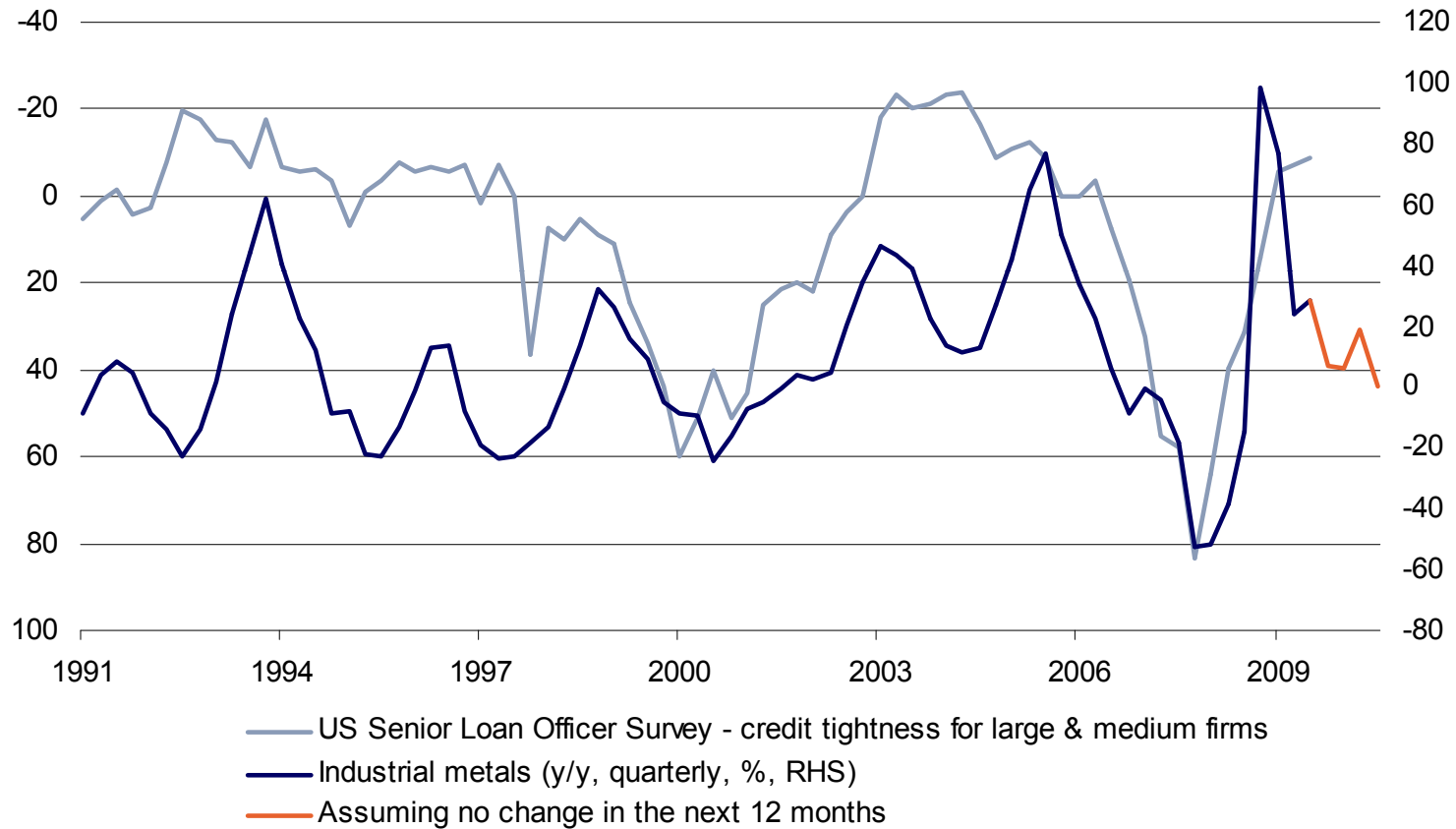
Source: Datastream, Julius Baer

Asian currencies



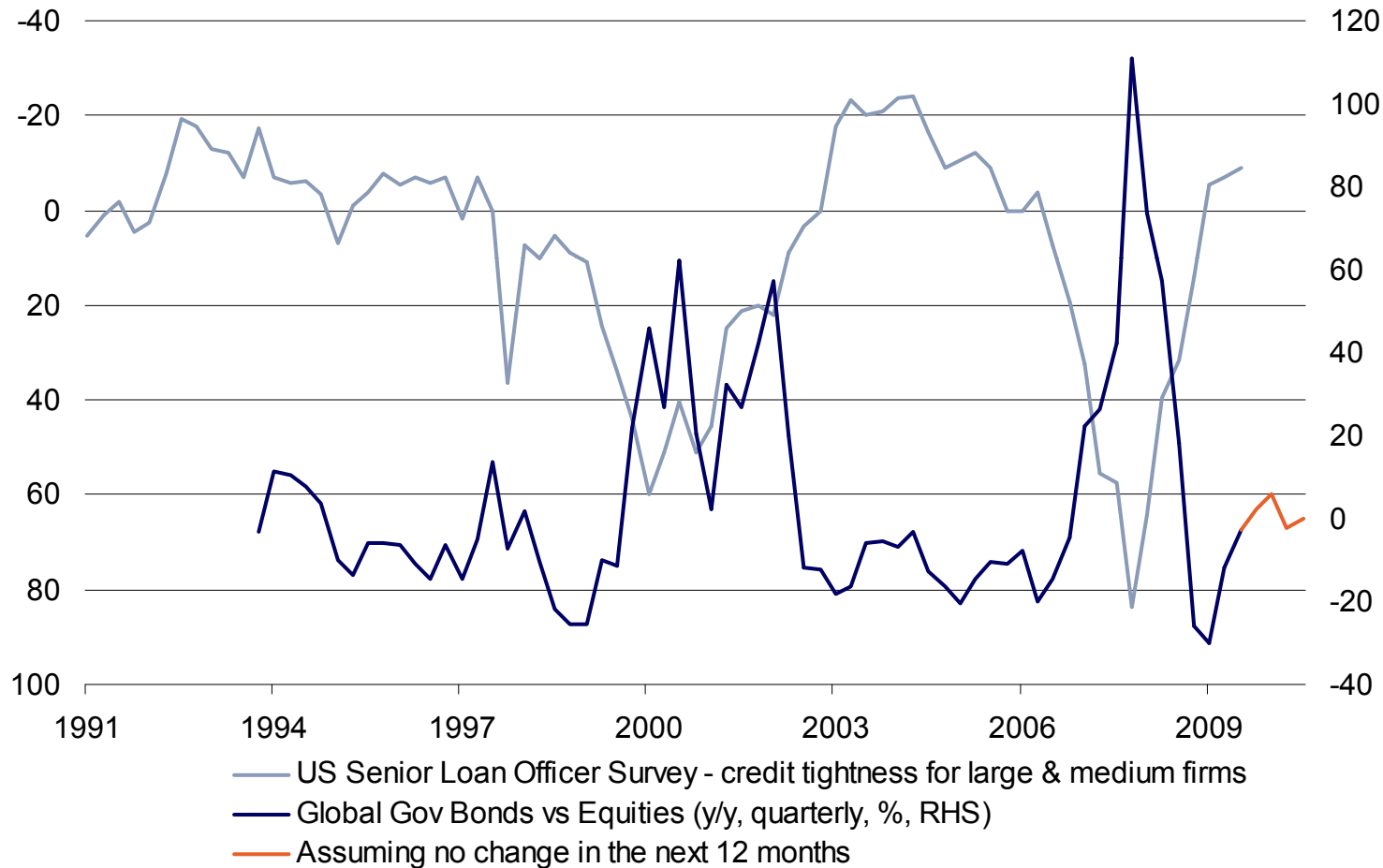
Source: Datastream, Bloomberg, Julius Baer

The end of the credit crunch? Commodities → industrial metals most sensitive to the credit cycle



Source: Datastream, Julius Baer

The end of the credit crunch? Equities vs. government bonds – a hedge against the cycle



Source: Datastream, Julius Baer

The credit cycle portfolios

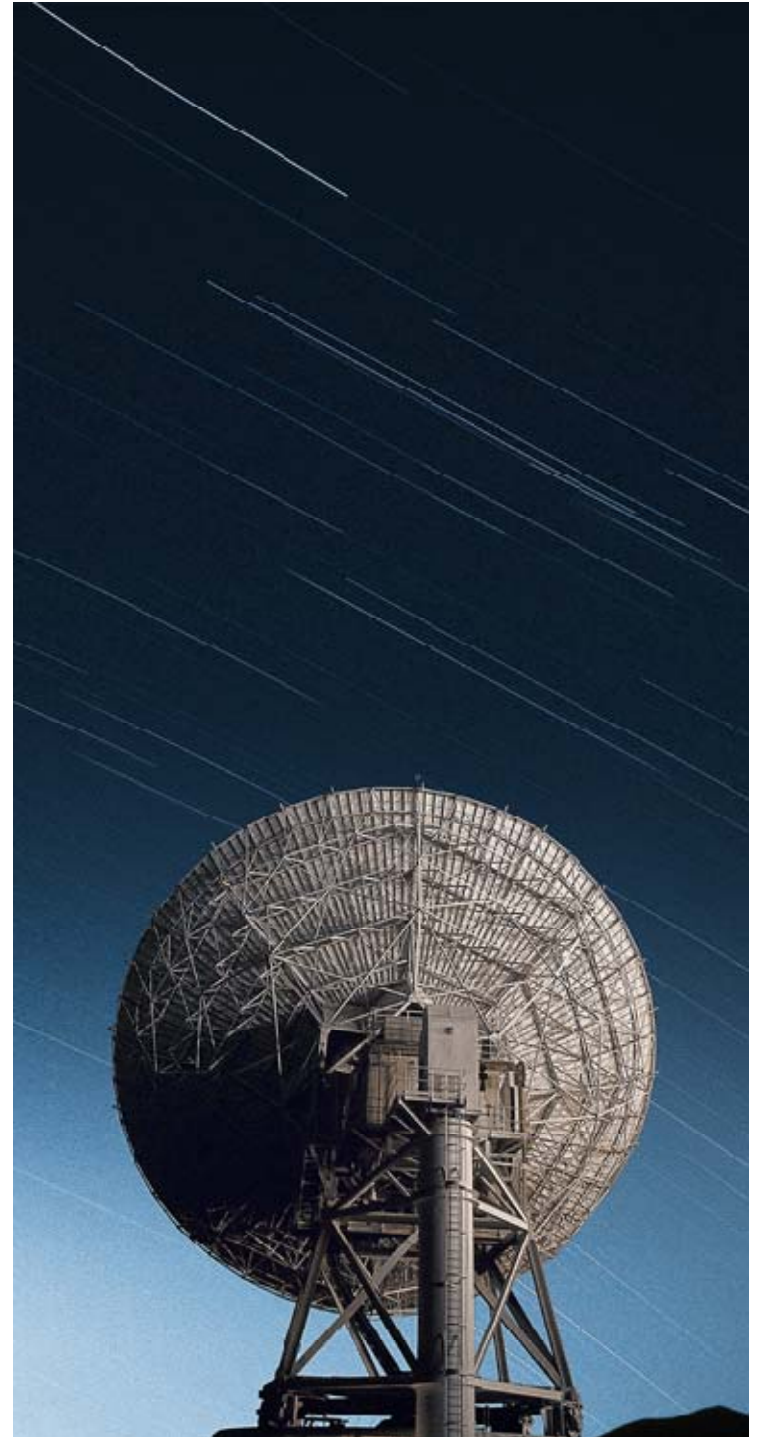
The easing cycle portfolio

- LONG: Equities, Financials, Consumer Discretionary, Industrial metals
- SHORT: AAA bonds, Defensives, Energy
- PAIR TRADES (Long/short):
 - Equities / Gov. bonds
 - Equities / AAA bonds
 - Cons. Discr. / Consumer staples
 - Financials / Healthcare

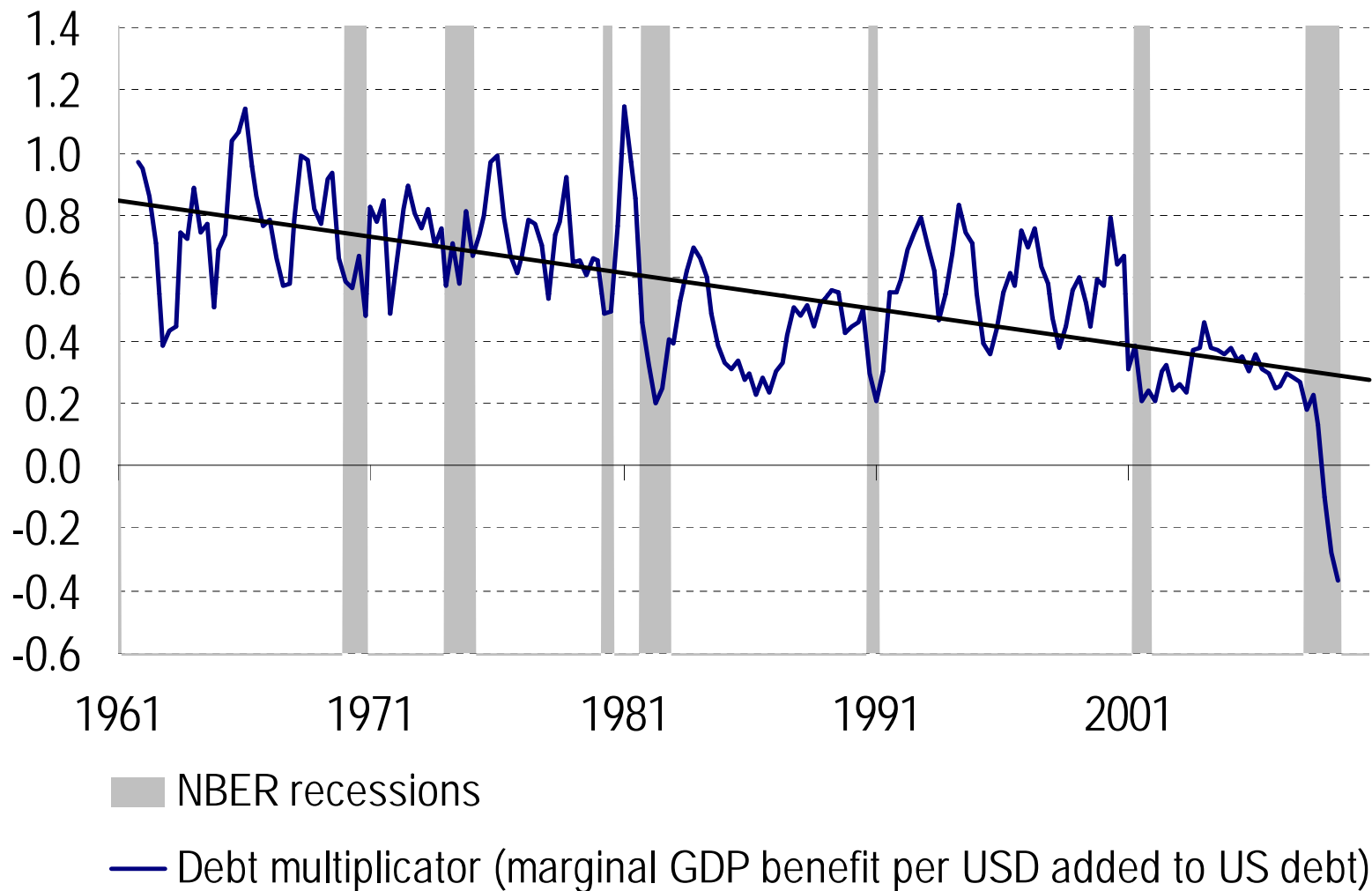
The tightening cycle portfolio

- LONG: Energy, Agricultural Commodities, AAA Bonds, Defensives
- SHORT: Global Equities, Europe, Cons. Discretionaries, Financials
- PAIR TRADES (Long/short):
 - Gov. Bonds / Equities
 - AAA bonds / Equities
 - Commodities / Equities
 - Precious Metals / Industrial M.
 - Healthcare / Financials

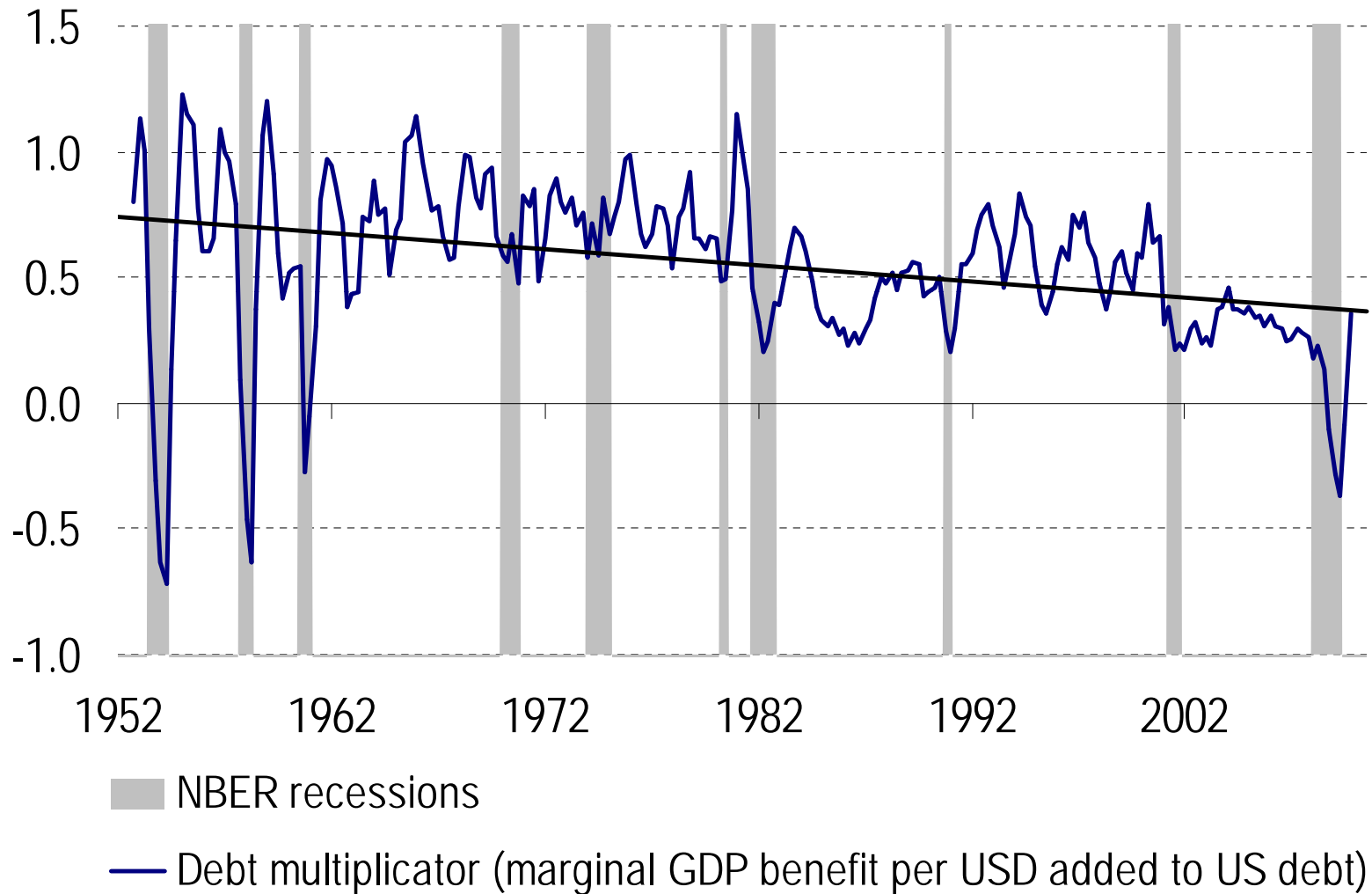
Is this time different?



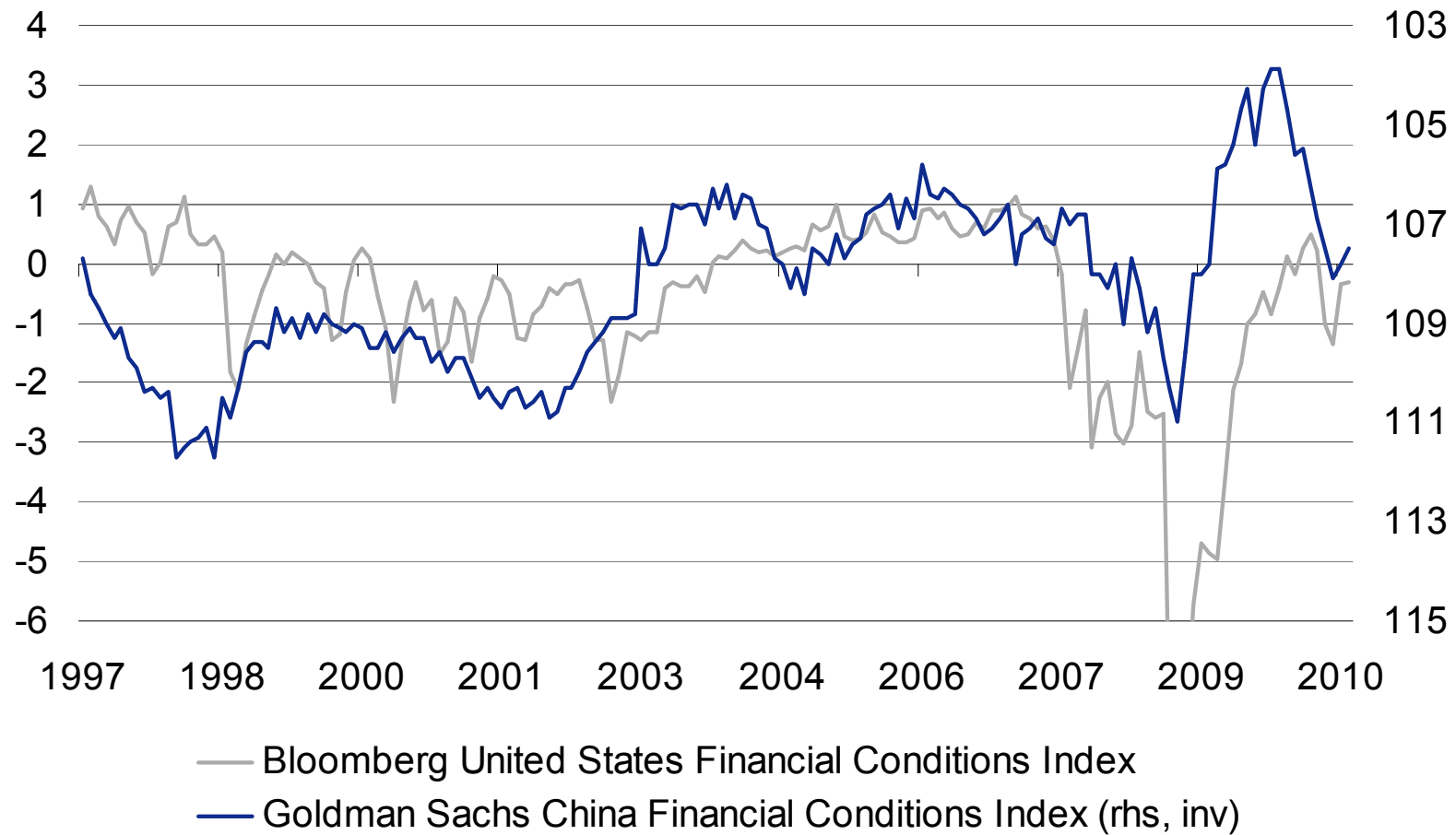
Debt saturation? Marginal productivity of debt in the U.S. economy shrinking



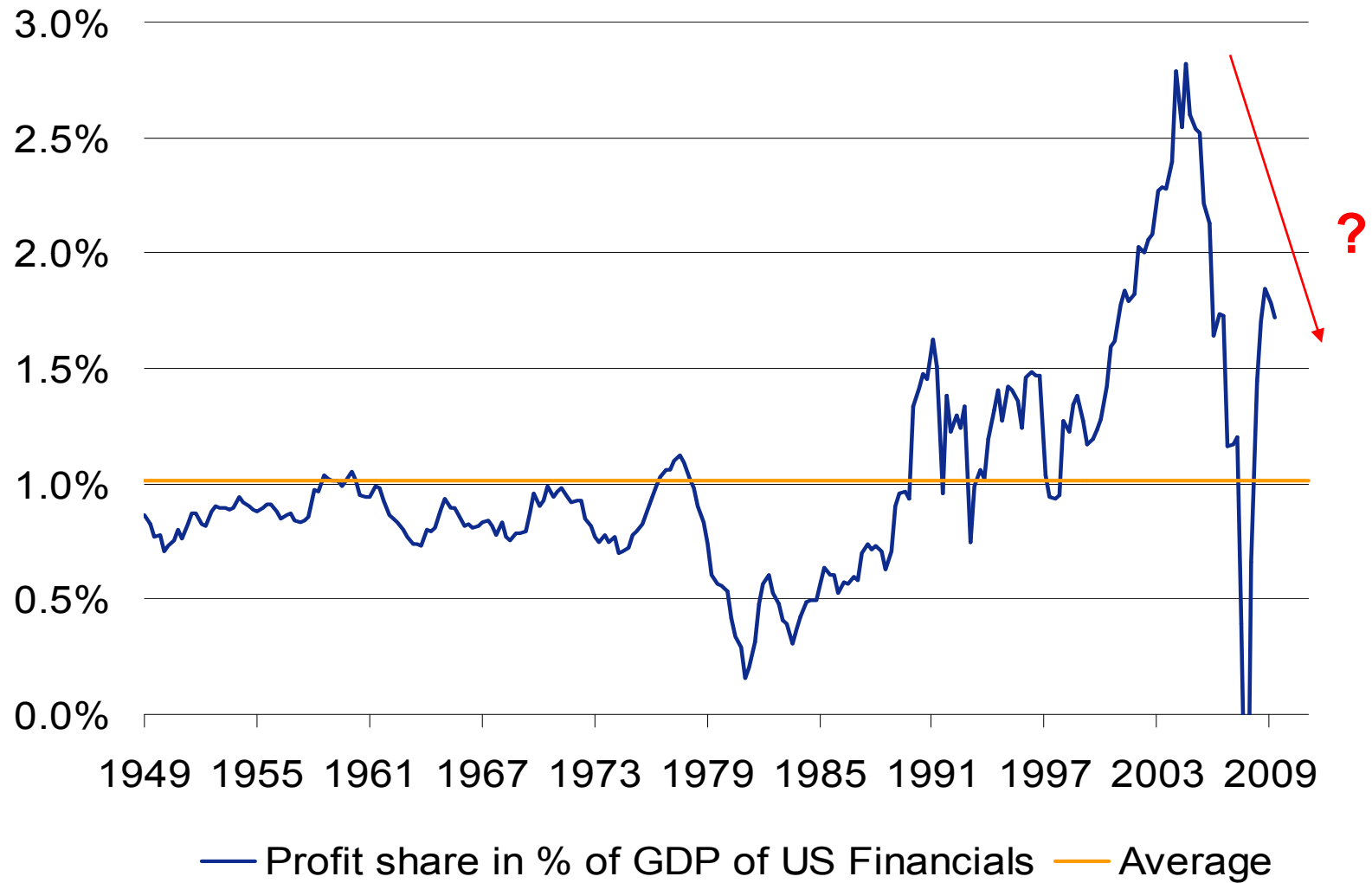
Debt saturation? The full picture



The China factor – how soft a soft landing?



Financial regulation – eating into profits?



Summary

- A new credit cycle seems underway with massive deleveraging taking place, in particular in the financial sector (less of an issue in non-financials) in mature markets
- Most emerging markets have decoupled in the sense that governments are mitigating the cyclical swings through credit expansion (in particular China and Brazil) – in contrast to debt-saturated mature markets
- The improvements in balance sheets is partially reflected in credit spreads; equities still lag the credit markets and do not fully reflect the surge in corporate bonds
- We took the Fed's Senior Loan Officer Opinion Survey as a proxy for the credit cycle and found the following sensitivities:
 - Financials are most sensitive to the credit cycle, as expected; non-financials tend to lag and have held up marginally better this time than in previous cycles
 - Emerging market equities are less correlated with the credit cycle, but were punished heavily before rebounding this time, in a historical comparison
 - The USD tends to fall against major currencies as soon as easing of credit standards kicks in
 - Commodities: The least correlated asset class; industrial metals the most sensitive
- What could be different this time? DIMENSIONS of the situation → debt saturation, the China factor, financial regulation, amplitude of the swings, leverage in Financials / consumers' balance sheets: A more muted cycle ahead?



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very much for
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then it is of benefit for both sides."**

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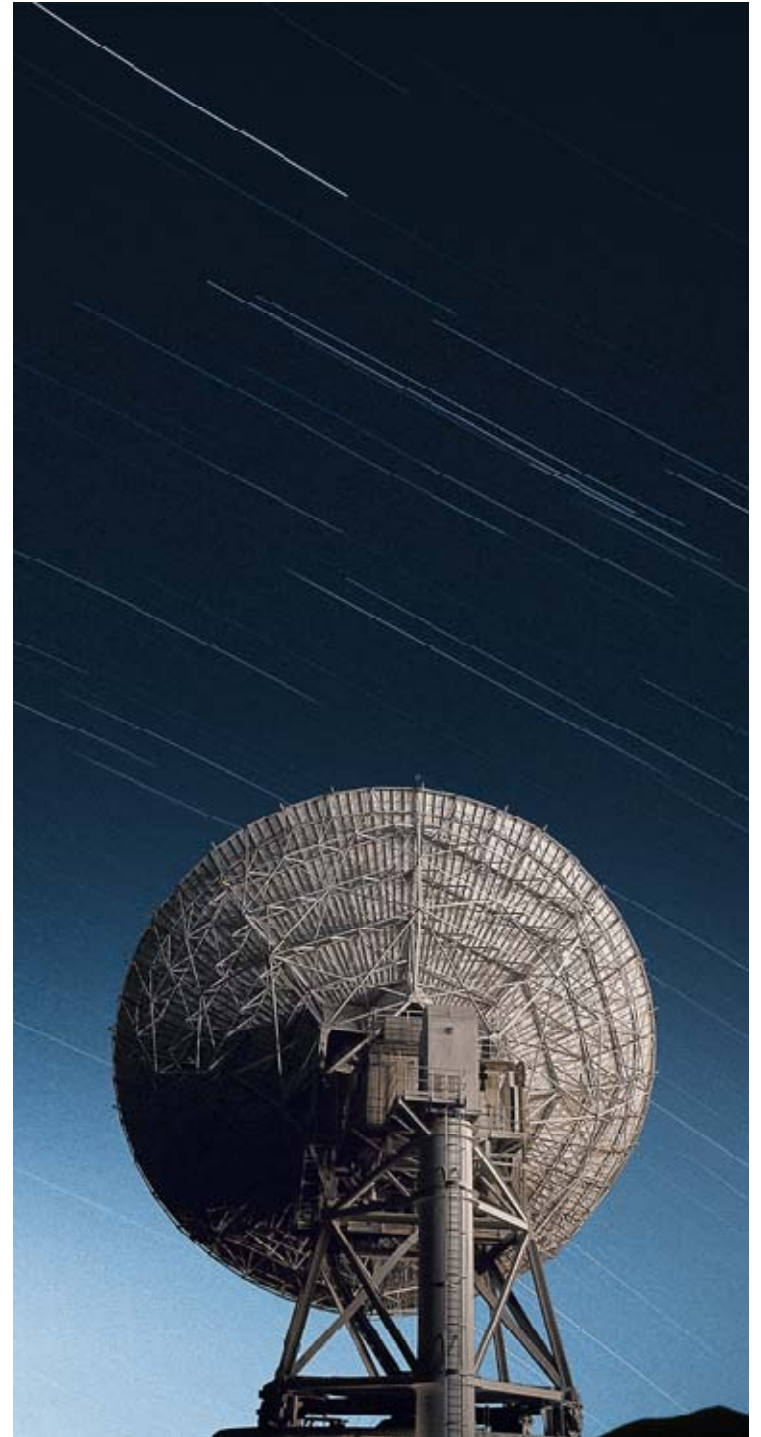
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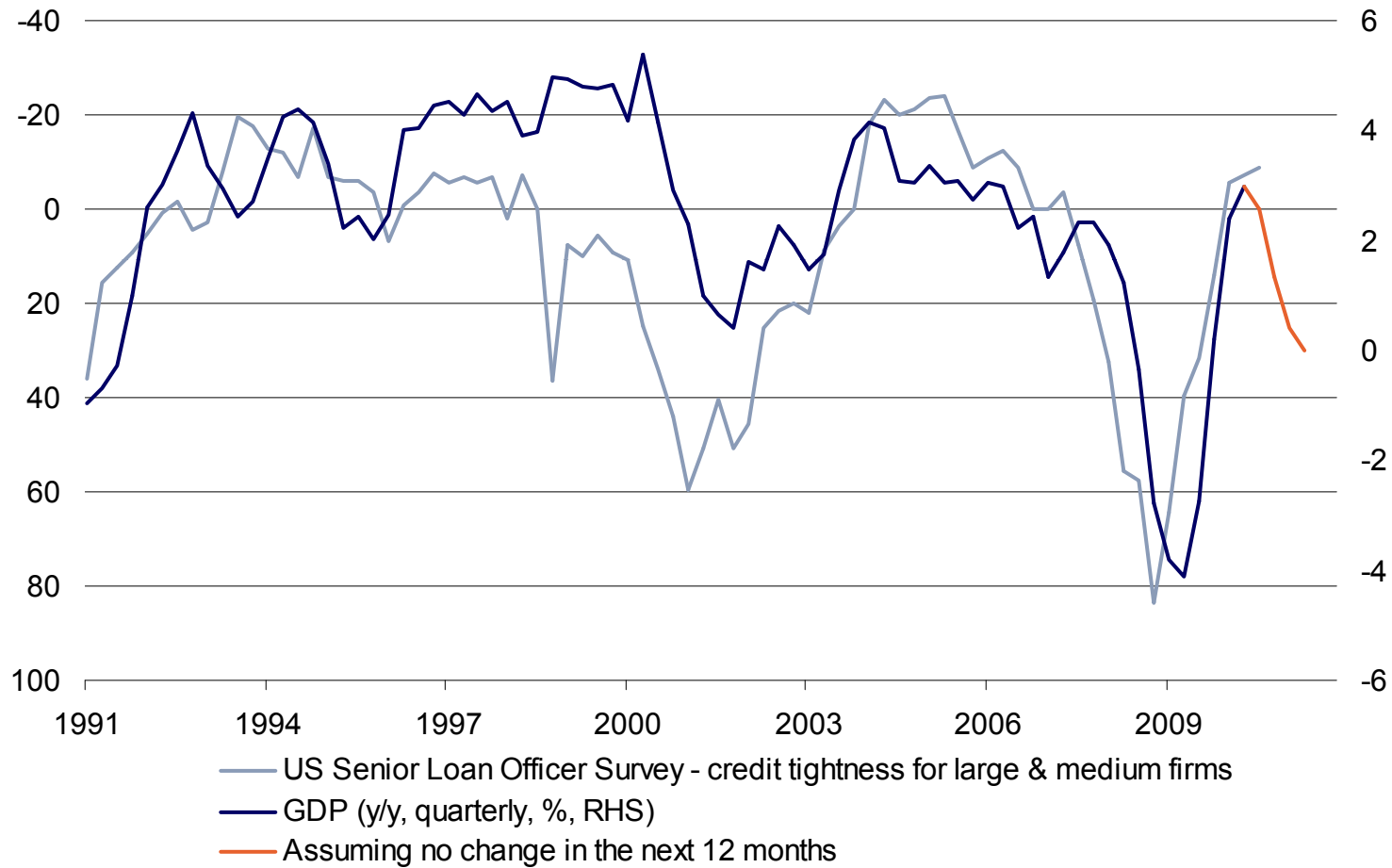
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Appendix

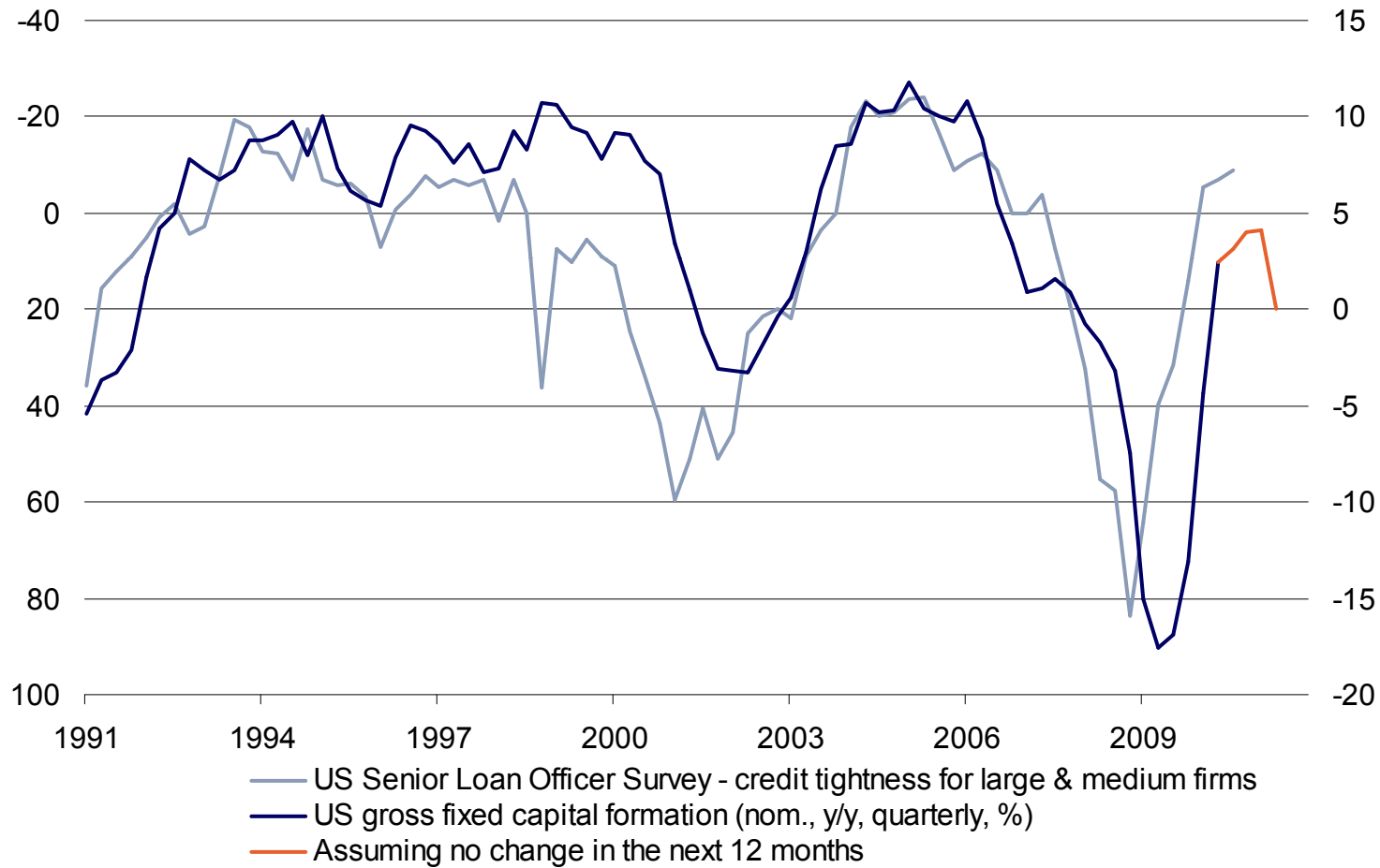


Leading U.S. GDP



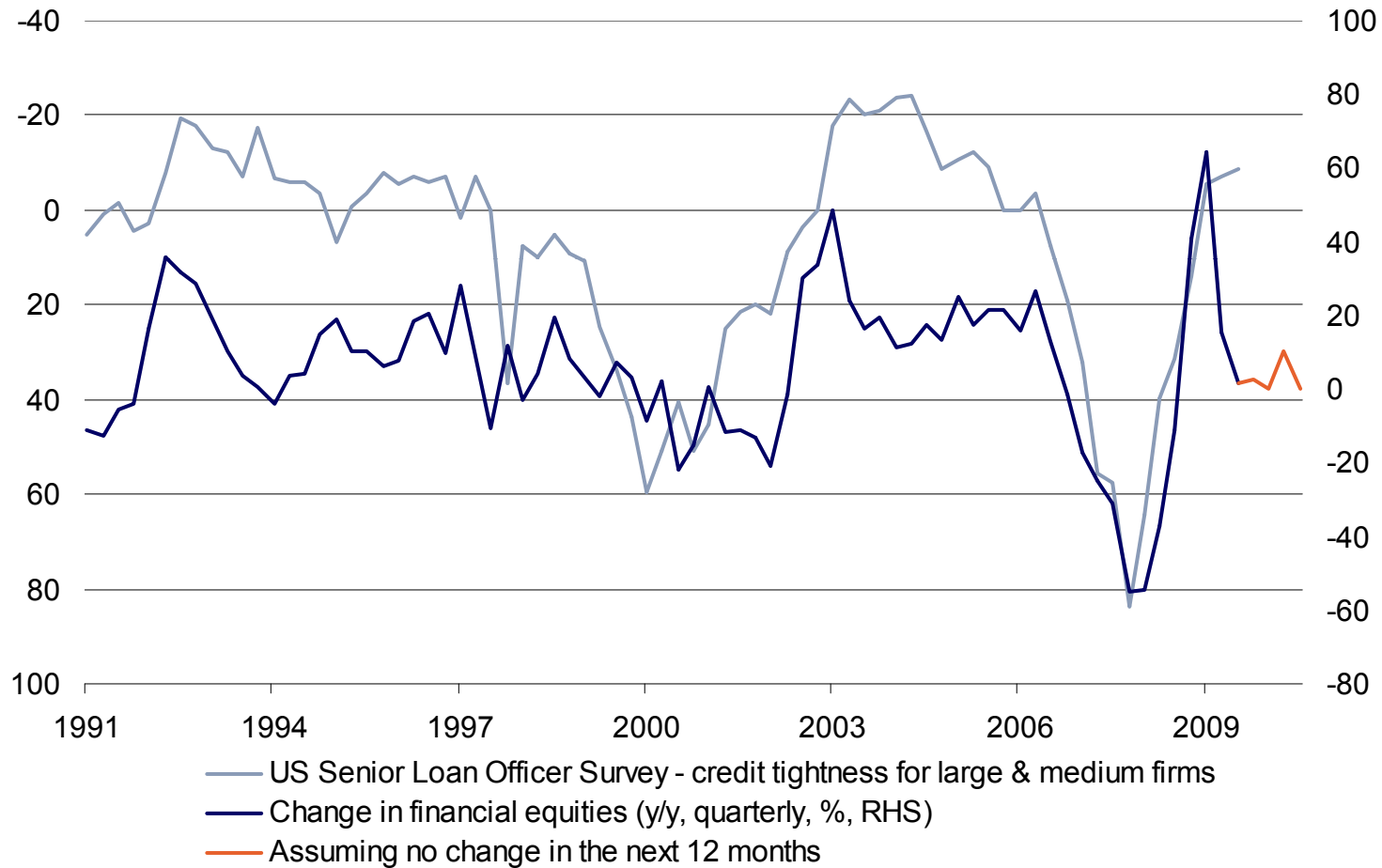
Source: Datastream, Julius Baer

Leading U.S. Capex



Source: Datastream, Julius Baer

High correlation with world financials, spike in returns at the beginning of the credit cycle



Source: Datastream, Julius Baer

Correlations of 12-month equity returns (regions and sectors vs the Loan Officer Survey)

	Rank		Correlation		Rank		Correlation
EQUITY REGIONS	1	Europe	-0.779	WORLD SECTORS	1	Financials	-0.746
	2	Europe ex EM	-0.778		2	Consumer Discretionary	-0.739
	3	European Union	-0.773		3	Non-Financials	-0.712
	4	Eurozone	-0.747		4	Industrials	-0.678
	5	Americas	-0.679		5	Oil & Gas	-0.630
	6	North America	-0.666		6	Utilities	-0.608
	7	Emerging Markets	-0.601		7	Telecom	-0.572
	8	Latin America	-0.532		8	Consumer Staples	-0.567
	9	Asia ex Japan	-0.517		9	Materials	-0.555
					10	Health Care	-0.527
					11	Technology	-0.483
					Global Equities	-0.751	
NORTH AMERICA	1	Telecom	-0.585	EUROZONE	1	Consumer Discretionary	-0.731
	2	Industrials	-0.579		2	Oil & Gas	-0.697
	3	Financials	-0.566		3	Industrials	-0.674
	4	Oil & Gas	-0.553		4	Financials	-0.668
	5	Consumer Discretionary	-0.547		5	Utilities	-0.611
	6	Materials	-0.511		6	Materials	-0.611
	7	Technology	-0.502		7	Consumer Staples	-0.552
	8	Utilities	-0.375		8	Health Care	-0.549
	9	Health Care	-0.315		9	Telecom	-0.530
	10	Consumer Staples	-0.298		10	Technology	-0.442
					North America	-0.653	
					Eurozone	-0.747	

Source: Julius Baer

Correlations of 12-month returns (regions and sectors vs the Loan Officer Survey)

COMMODITIES	1	Industrial Metals	-0.5032	MISCELLANEOUS*	1	Global Equities vs AAA Bonds	-0.815
	2	Non-Energy	-0.2835		2	EM Bonds vs AAA Bonds	-0.669
	3	Livestock	-0.1655		3	Cyclical vs Defensive Equities	-0.439
	4	Energy	-0.0875		4	EM Bonds	-0.316
	5	Precious Metals	-0.0835		5	Global Gov Bonds	-0.038
	6	Agriculturals	-0.0619		6	Commodities vs. Equities	0.412
		All commodities	-0.157		7	Precious vs Industrial Metals	0.543
			8		Gov Bonds vs. Equities	0.717	

Source: Julius Baer

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