

Mid Year Thoughts on the Global Economy and Asset Markets



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This article offers some reflections on the behaviour of the global economy and asset markets at the end of the first half of 2010. The period started well for equities and other risk assets, with many of the 2009 recovery trends remaining in place (albeit at a slower pace than before). However, a marked reversal was experienced in May and June, and this left most risk assets substantially down for the half year.

There have been some worrying signs of slower growth in the global economy, with leading indicators and business survey readings falling noticeably from the peaks seen a few months earlier. This has been triggered by the inevitable waning of the stimulus from the inventory cycle and fiscal policy. Markets have become concerned because activity data in both China and the US have been weakening simultaneously after a period of exceptional strength.

However, on a more encouraging note, there have been indications that more sustainable sources of growth in the developed economies – consumption, capital spending and exports – are beginning to recover, if only slowly. Furthermore, domestic demand growth in many of the major emerging economies still seems fairly robust.

At mid year, the most sensitive economic indicators available to us continue to suggest that the global economy, although slowing, has still been growing somewhat above trend (4-5% in Q2). Our current view is that there will be some further slowdown to a global growth rate which is close to trend in the second half of 2010 (4%), though the US is likely to grow a little below trend (2-2.5%), and there are increased downside risks that a more severe slowdown could occur in that country.

In the most likely case of approximately trend global GDP growth, there would appear to be some scope for a recovery in equities and other risk assets. However, the downside economic risks are too important to ignore, and asset managers need to consider hedging strategies to protect portfolios against these risks.

Market Performance in 2010 H1

- Last year, as the global financial system returned from the brink of collapse, risk premia in asset markets declined sharply, and this determined the pattern of market performance in all asset classes. Equities and commodities substantially out-performed government bonds, and it seemed likely that this would continue into 2010.
- Risk assets performed well in the first quarter, maintaining the trends they had displayed since the markets hit bottom in March 2009. However, this did not last into the second quarter (Table 1 and Graph 1). Significant falls in equities and other risk assets occurred in May and June, leaving global equities down by 7.8% in the half year, commodities down by 11.2% and high yielding currencies down by 11.0%. Bonds have been the best performer – up by 4.0%. Corporate credit has generally performed almost exactly in line with government bonds, while emerging market credit has out-performed both by a small margin.
- Hedge funds returned -1.2% in the first half of the year according to the daily HFRX hedge fund indices. The top funds of funds are probably ahead of this by around one percent. Given the tough environment for the major asset classes and risk premia, this is not a particularly surprising result. Following the strong rebound in returns seen last year, all the major hedge fund styles have seen much lower gains than last year, and several of the most important strategies are now in negative territory for the year. For example, macro funds have on average produced negative returns of around 2.3% so far this year, while equity long/short funds are down by 3.4%. Credit, convertible and other fixed income funds have eked out positive returns of the order of 1-2% on average.
- The sharp market sell-off in May and June has raised fears of another financial market melt-down. The key question is whether this is a minor mid course correction in the markets, of the sort we saw frequently between 2003 and 2007? Or is it something more severe? In the extreme, could it even be as severe as we saw in 2008?

Activity in the Global Economy

- In our current view, this will most likely turn out to be a period of mid course correction, rather than the start of a major double dip in the global economy and financial markets. That collapse was in part caused by excess leverage in the financial sector. Fortunately, there appears to be much less leverage in the system than there was two years ago. The investment bank and hedge fund sector, in contrast with its behaviour in September 2008, seems this time to have reduced risk extremely quickly so that its exposure to falling markets was probably fairly minor by the beginning of June. It would be very surprising if the risk exposures of hedge funds and other financial institutions turned out to be anywhere near the levels which led to the great collapse of September 2008, so a return to the frightening market conditions seen after the Lehman collapse seems somewhat improbable.
- For the most part, the global economy remained reasonably healthy in the second quarter, though there was a clear slowing in momentum during the period. We

MARKET MONITOR

As of: 30-Jun-10

ASSET TYPE	Benchmark	Currency	2005	2006	2007	2008	2009	YTD-10	Rolling 5y pa	2009				2010	
										Q1-09	Q2-09	Q3-09	Q4-09	Q1-10	Q2-10
GLOBAL EQUITIES															
World (Developed and Emerging)	MSCI AC World	Local	14.8%	14.4%	5.2%	-40.9%	26.2%	-7.8%	-0.4%	-9.3%	16.3%	14.5%	4.5%	3.8%	-11.1%
World (Developed and Emerging)	MSCI AC World	\$	8.8%	18.8%	9.6%	-43.5%	31.5%	-10.4%	-0.1%	-11.3%	21.2%	17.3%	4.3%	2.7%	-12.7%
World (Developed and Emerging)	FTSE All World	£	22.2%	4.9%	8.4%	-21.7%	17.8%	-3.3%	5.0%	-10.9%	5.9%	21.0%	3.2%	9.3%	-11.5%
DEVELOPED EQUITY MARKETS															
MSCI World		Local	13.7%	13.5%	2.8%	-40.1%	22.8%	-8.1%	-1.4%	-10.6%	15.5%	14.3%	4.1%	4.2%	-11.8%
USA - Large Cap.	S&P 500	Local	3.0%	13.6%	3.5%	-38.5%	23.5%	-7.6%	-1.8%	-11.7%	15.2%	15.0%	5.5%	4.9%	-11.9%
USA - Large Cap.	Dow Jones Industrial Average	Local	-0.6%	16.3%	6.4%	-33.8%	18.8%	-6.3%	-0.6%	-13.3%	11.0%	15.0%	7.4%	4.1%	-10.0%
USA - Technology	NASDAQ	Local	1.4%	9.5%	9.8%	-40.5%	43.9%	-7.0%	1.8%	-3.1%	20.0%	15.7%	6.9%	5.7%	-12.0%
USA - Large Cap. Growth	Russell 1000 Growth	Local	4.1%	7.8%	10.5%	-39.3%	34.8%	-8.4%	0.0%	-4.6%	15.8%	13.5%	7.5%	4.2%	-12.1%
USA - Large Cap. Value	Russell 1000 Value	Local	4.4%	19.2%	-2.7%	-38.8%	16.3%	-6.2%	-2.9%	-17.6%	15.8%	17.5%	3.6%	6.2%	-11.6%
USA - Mid Cap.	S&P Midcap 400	Local	11.3%	9.0%	6.7%	-37.3%	35.0%	-2.1%	2.6%	-9.2%	18.2%	19.5%	5.2%	8.7%	-9.9%
USA - Small Cap.	Russell 2000	Local	3.3%	17.0%	-2.7%	-34.8%	25.2%	-2.5%	1.4%	-15.4%	20.2%	18.9%	3.5%	8.5%	-10.2%
Eurozone	MSCI Euro	Local	21.6%	17.8%	7.0%	-45.9%	22.5%	-11.3%	-2.7%	-14.4%	16.1%	19.9%	2.9%	-0.3%	-11.0%
Japan	Topix	Local	43.5%	1.9%	-12.2%	-41.8%	5.0%	-7.3%	-5.1%	-10.0%	20.2%	-2.1%	-0.2%	7.8%	-14.0%
UK	FTSE 100	Local	16.7%	10.7%	3.8%	-31.3%	22.1%	-9.2%	0.9%	-11.5%	8.2%	20.8%	5.4%	4.9%	-13.4%
EMERGING EQUITY MARKETS															
MSCI Emerging Markets Free		Local	31.5%	25.6%	30.4%	-47.2%	58.6%	-5.4%	10.9%	3.7%	23.4%	16.0%	6.9%	1.1%	-6.4%
Asia	MSCI EM Asia	Local	24.5%	24.4%	35.9%	-48.6%	64.3%	-4.1%	10.6%	5.2%	27.6%	15.8%	5.6%	-0.6%	-3.4%
Latin America	MSCI EM Latin America	Local	32.9%	33.6%	32.2%	-39.6%	58.3%	-9.4%	16.5%	3.8%	20.0%	16.8%	8.9%	2.0%	-11.1%
Eastern Europe	MSCI EM Eastern Europe	Local	55.8%	37.1%	17.9%	-66.6%	66.2%	-7.7%	4.7%	-1.7%	25.5%	22.3%	10.2%	4.8%	-12.0%
Europe, Middle East & Africa	MSCI EMEA	Local	46.2%	22.9%	19.1%	-50.0%	46.2%	-4.8%	7.8%	0.0%	16.5%	15.8%	8.4%	5.0%	-9.4%
BRIC (Brazil Russia India China)	MSCI BRIC	Local	n/a	47.7%	45.3%	-55.0%	68.0%	-8.2%	n/a	4.7%	29.8%	13.7%	8.8%	0.8%	-8.9%
GLOBAL BONDS															
Global Aggregate - Hedged in USD	BarCap GlobalAgg TR	\$	4.3%	3.6%	5.3%	5.6%	5.1%	4.0%	4.8%	0.0%	1.5%	3.2%	0.3%	1.7%	2.3%
Global Aggregate - Hedged in GBP	BarCap GlobalAgg TR	£	5.8%	3.3%	5.8%	7.6%	5.3%	4.1%	5.4%	0.1%	1.5%	3.3%	0.3%	1.8%	2.3%
Emerging Markets Debt	JPMorgan EMBI Global TR	\$	10.7%	9.9%	6.3%	-10.9%	28.2%	5.4%	8.1%	3.4%	10.8%	10.2%	1.5%	4.2%	1.2%
COMMODITIES															
S&P GSCI Spot		\$	39.1%	0.4%	40.7%	-42.8%	50.3%	-5.6%	6.6%	2.7%	25.6%	2.8%	13.4%	1.1%	-6.6%
Global Commodities	S&P GSCI TR	\$	25.6%	-15.1%	32.7%	-46.5%	13.5%	-11.2%	-7.2%	-10.6%	19.2%	-1.8%	8.4%	-0.9%	-10.4%
Global Commodities	Reuters Jefferies CRB TR	\$	23.0%	-2.9%	22.2%	-35.0%	23.6%	-8.7%	-0.1%	-3.9%	13.5%	3.8%	9.3%	-3.5%	-5.4%
Energy	S&P GSCI Energy TR	\$	31.2%	-26.8%	41.9%	-52.4%	11.2%	-11.4%	-11.0%	-14.7%	26.7%	-4.1%	7.3%	1.4%	-12.6%
Industrial Metals	S&P GSCI Ind Met TR	\$	36.3%	60.9%	-5.6%	-49.0%	82.4%	-14.3%	11.9%	6.0%	22.6%	20.7%	16.3%	4.5%	-18.0%
Precious Metals	S&P GSCI Prec Met TR	\$	18.6%	24.1%	27.9%	0.5%	25.1%	13.0%	22.1%	5.2%	0.5%	9.9%	7.6%	1.7%	11.1%
Agricultural	S&P GSCI Agric TR	\$	2.4%	13.3%	28.3%	-28.9%	3.8%	-18.2%	-3.5%	-6.0%	1.1%	-1.9%	11.3%	-17.9%	-0.3%
Oil Price	WTI Cushing Crude Oil Spot	\$	40.5%	0.0%	57.2%	-53.5%	77.9%	-4.7%	7.3%	11.3%	40.7%	1.0%	12.4%	5.5%	-9.7%
Gold Price	Gold Spot \$/Oz	\$	17.9%	23.2%	31.0%	5.8%	24.4%	13.2%	23.9%	4.2%	0.8%	8.8%	8.9%	1.5%	11.6%
HEDGE FUNDS															
Global hedge funds universe	HFRX Global Hedge Fund Index	\$	2.7%	9.3%	4.2%	-23.3%	13.4%	-1.2%	0.8%	0.7%	4.8%	5.1%	2.2%	1.6%	-2.8%
Convertible Arbitrage	HFR Index Convertible Arbitrage	\$	-5.7%	9.6%	-0.9%	-58.4%	42.5%	1.9%	-7.6%	9.4%	10.1%	14.0%	3.8%	2.2%	-0.2%
Distressed Securities	HFR Index Distressed Securities	\$	1.2%	9.6%	4.0%	-30.7%	-5.6%	0.4%	-4.3%	-5.2%	-3.7%	-0.2%	3.5%	5.3%	-4.7%
Equity Hedge	HFR Index Equity Hedge	\$	4.2%	9.2%	3.2%	-25.5%	13.1%	-3.4%	0.0%	0.8%	5.2%	5.3%	1.4%	0.3%	-3.7%
Equity Market Neutral	HFR Index Equity Market Neutral	\$	0.2%	4.8%	3.1%	-1.2%	-5.6%	1.9%	0.6%	-2.5%	-1.0%	-2.9%	0.8%	1.0%	0.9%
Event Driven	HFR Index Event Driven	\$	2.8%	10.3%	4.9%	-22.1%	16.6%	-0.7%	1.9%	2.3%	6.6%	4.9%	1.9%	2.3%	-2.9%
Macro	HFR Index Macro	\$	6.7%	5.6%	3.2%	5.6%	-8.8%	-2.3%	2.7%	-0.6%	-5.4%	-1.4%	-1.6%	0.6%	-2.9%
Merger Arbitrage	HFR Index Merger Arbitrage	\$	3.7%	10.7%	4.9%	3.7%	8.1%	0.1%	5.9%	1.7%	2.1%	2.0%	2.1%	1.7%	-1.6%
Relative Value Arbitrage	HFR Index Relative Value Arb.	\$	-1.0%	10.6%	5.8%	-37.6%	38.5%	1.3%	0.6%	1.5%	14.6%	12.3%	6.1%	2.6%	-1.3%
CURRENCIES															
\$ effective rate	Average vs 6 major currencies	n/a	12.8%	-8.2%	-8.3%	6.0%	-4.2%	10.5%	-0.3%	5.1%	-6.2%	-4.3%	1.6%	4.1%	6.1%
€ vs \$	Spot Exchange Rate	n/a	-12.6%	11.4%	10.5%	-4.2%	2.5%	-14.5%	0.0%	-5.2%	5.9%	4.3%	-2.2%	-5.7%	-9.4%
€ vs \$	Spot Exchange Rate	n/a	-10.2%	13.7%	1.3%	-26.5%	10.8%	-7.6%	-4.4%	-1.9%	14.9%	-2.9%	1.2%	-6.1%	-1.6%
¥ vs \$	Spot Exchange Rate	n/a	-12.8%	-1.1%	6.5%	23.2%	-2.4%	5.2%	3.5%	-8.3%	2.7%	7.4%	-3.6%	-0.5%	5.7%
€ vs £	Spot Exchange Rate	n/a	-2.7%	-2.0%	9.1%	29.9%	-7.1%	-7.7%	4.6%	-3.1%	-7.9%	7.4%	-3.2%	0.3%	-8.0%
CHF vs \$ (Swiss Franc)	Spot Exchange Rate	n/a	-13.2%	7.6%	7.6%	5.7%	3.7%	-4.1%	1.6%	-5.9%	4.9%	4.8%	0.2%	-1.9%	-2.2%
CAD vs \$ (Canadian Dollar)	Spot Exchange Rate	n/a	3.4%	-0.3%	16.8%	-18.1%	15.9%	-1.1%	3.7%	-3.3%	8.4%	8.7%	1.7%	3.6%	-4.6%
AUD vs \$ (Australian Dollar)	Spot Exchange Rate	n/a	-6.1%	7.6%	11.0%	-19.7%	27.8%	-6.3%	2.3%	-1.6%	16.6%	9.5%	1.7%	2.2%	-8.3%
BRL vs \$ (Brazilian Real)	Spot Exchange Rate	n/a	13.5%	9.3%	20.5%	-23.9%	33.8%	-3.5%	5.7%	0.4%	19.0%	10.5%	1.4%	-2.8%	-0.6%
RUB vs \$ (Russian Ruble)	Spot Exchange Rate	n/a	-3.6%	9.3%	6.9%	-19.3%	1.6%	-3.9%	-1.8%	-10.1%	9.0%	3.8%	-0.1%	2.0%	-5.8%
INR vs \$ (Indian Rupee)	Spot Exchange Rate	n/a	-3.5%	1.0%	13.2%	-19.0%	4.6%	0.2%	-1.2%	-3.7%	5.5%	-0.4%	3.4%	3.8%	-3.5%
CNY vs \$ (Chinese Renminbi)	Spot Exchange Rate	n/a	2.5%	3.1%	7.2%	6.9%	0.1%	0.7%	3.9%	0.0%	0.0%	0.1%	0.0%	0.0%	0.7%

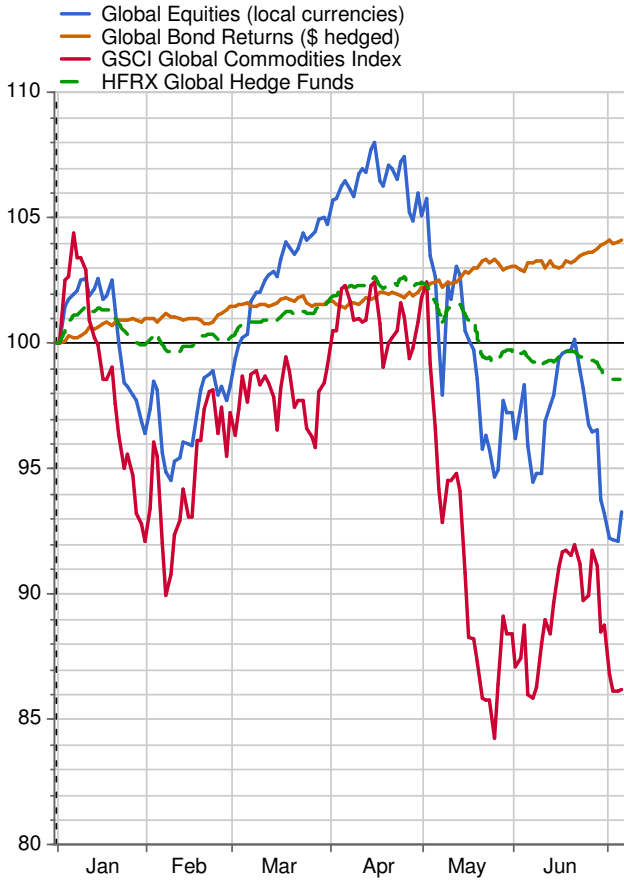
Source: Bloomberg

Notes: "TR" stands for "Total Return"

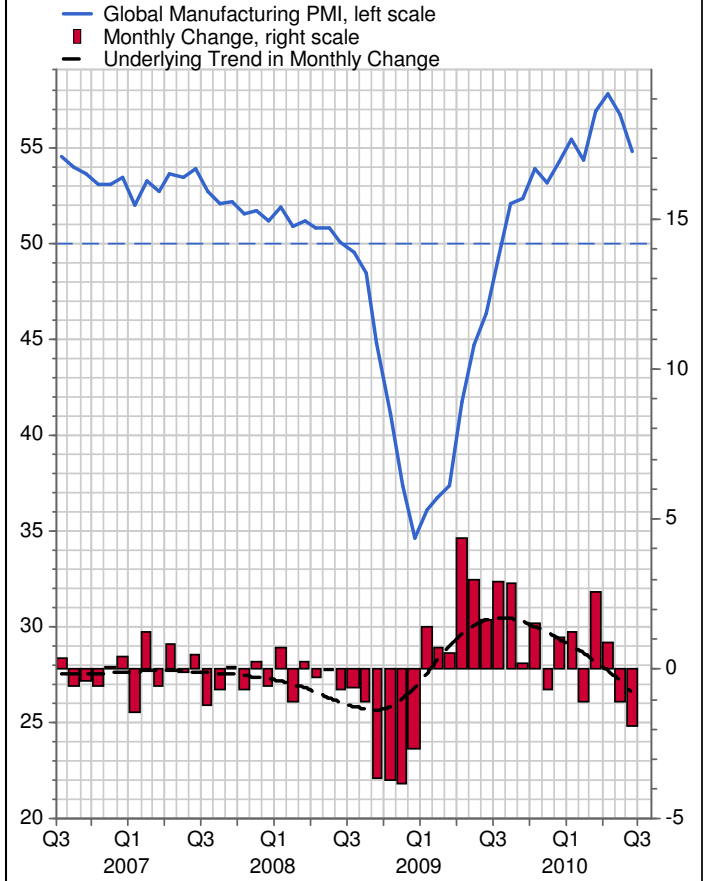
believe that two things are probably happening simultaneously. The global economy is slowing from the abnormally rapid growth rate which is common in the first phase of a recovery; and it is also switching from temporary to more permanent sources of growth. It was always possible that markets would become nervous while this change of gear was taking place, since in its early stages it is difficult to distinguish between a healthy slowdown, based on more sustainable sources of growth, and a more sinister lurch towards a double dip recession.

- The latest official GDP data have been very robust, but they of course lag well behind the markets' perception of global growth. US GDP recorded 4.2% annualised growth in the latest two published quarters (2009 Q4 and 2010 Q1); Japan recorded 4.5%; Asia ex Japan around 10%; Latin America 5%; and Emerging Europe 3%. EMU countries underperformed other regions, managing only around 0.6% growth in Q4/Q1. UK growth has been reported to be 1.5% on the official figures, but these are almost certainly understated. Overall, global GDP growth (measured at PPP exchange rates) exceeded 5% during this period.
- GDP data for the second quarter are still unavailable, but if we translate the business survey indicators published in Q2 into likely GDP growth rates, using long established statistical relationships, we find that the implied growth rate of the global economy was around 4-5% per annum, which is slightly down on the preceding period, but is still about 0-1% above trend. Since the emerging economies are clearly growing more rapidly than the developed world, this suggests that the OECD has probably been growing at 2-3%, with Europe growing at around 2% in Q2. Europe usually lags the world cycle, but perhaps has done so more than usual this time, because the euro has been very overvalued until recently. The recent decline in the euro may trigger an improvement in Eurozone growth, relative to the global average, over the next few quarters.
- The strong rise in cyclical indicators in the US and Asia since the upswing started in 2009 Q1 has been normal for the upswing phase of the cycle. These have now started to decline from their earlier peaks, which is also fairly normal. But the question is – how much further will they decline? The global manufacturing PMI was 54.8 in June, compared with a peak of 57.8 in April (Graph2). The global services PMI was about 55.8 in June, down from 56.8 in April. These PMIs are still signalling above trend growth, and would need to drop by another 3-4 percentage points from here before they would signal that global GDP growth had fallen meaningfully below trend.
- Looking ahead to the second half of 2010, the growth rate of global leading indicators (eg the OECD indicators) has also slowed a bit in recent months, but remains strongly positive (Graph 3). The 6-month annualised growth rate in the OECD leading indicators peaked at 16% in October 2009, and although this has now fallen to around 9% in April 2010, the current rate remains higher than anything seen in the boom period of 2004-07.
- Our proprietary US recession probability models still give essentially zero risk over the next 12 months. However, our proprietary weekly US growth models have dipped recently. We use these models to ensure that we do not miss major inflection points in US/global activity. They were effective in 2008 in giving timely warning

1. Major Asset Classes - Total Returns in 2010

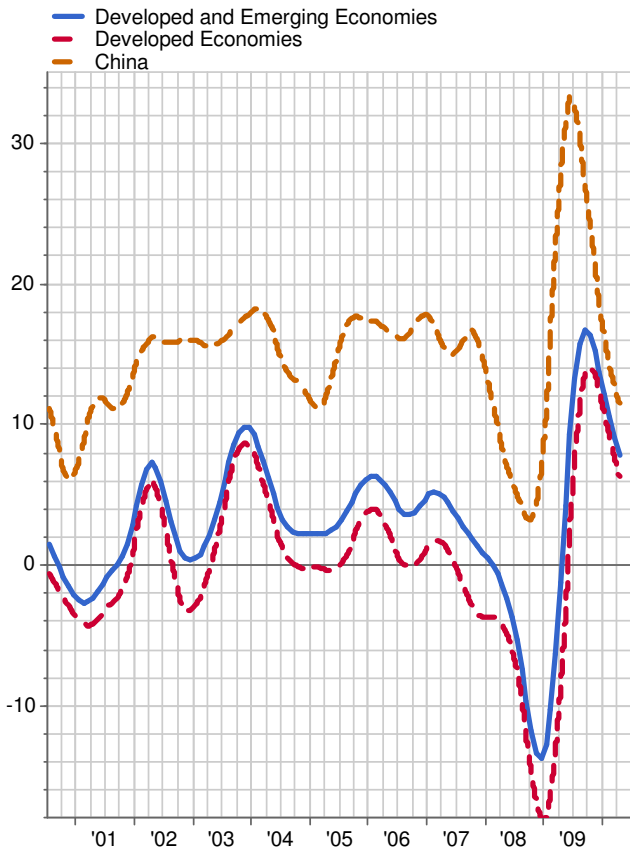


2. Global Manufacturing Sector - Monthly Surveys

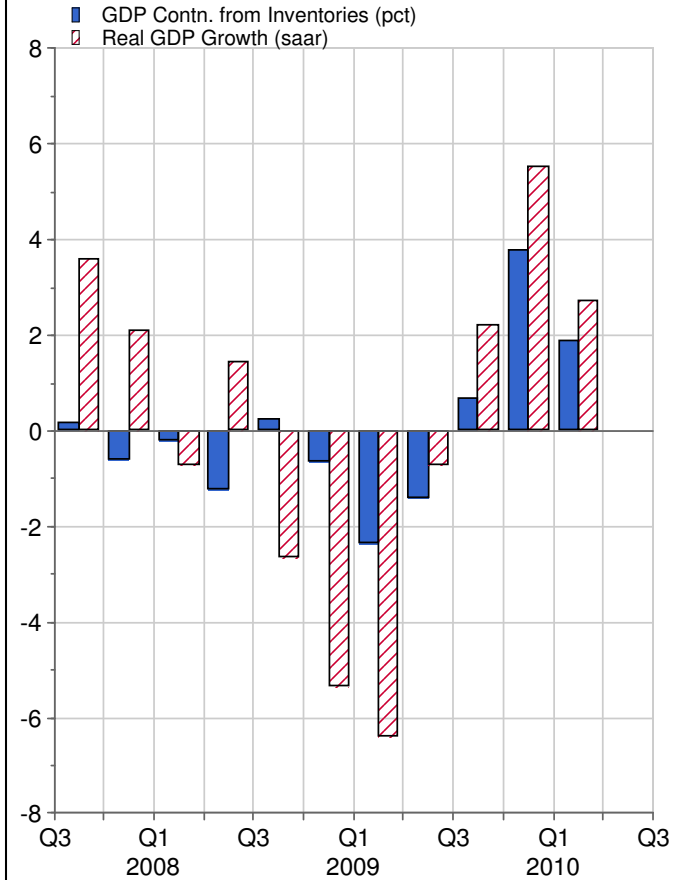


3. Leading Economic Indicators for the Global Economy

(OECD series, 6 mth annualised % change)



4. A US Cycle Largely Dominated by Inventory Swings



of deep recession. They are now reporting estimated US growth over the latest 13 weeks of around 2.1%; and are also around 1.9% for forecast growth over the next 13 weeks. This compares with numbers of around 5% a few months ago. So far, we view this as (just about) consistent with trend GDP growth on a global basis in the second half of the year, but we would become a lot more worried if these US figures dropped much further.

Sustainable Growth?

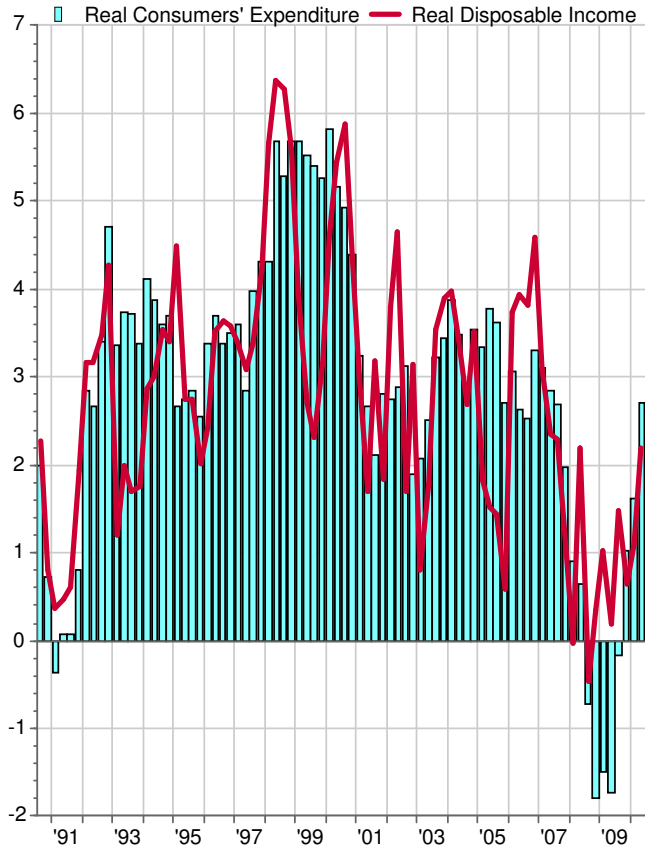
- While GDP growth rates remained fairly healthy in the first half of 2010, they were dominated by four temporary forces: the inventory cycle; catch-up spend in consumer durables, especially autos; the tail end of emergency fiscal expansion; and the lagged effects of China's policy easing in late 2008/09. In the US, most or all of the recent expansion in GDP has been triggered by these forces (Graph 4) and the key question is whether solid growth can be maintained as and when these temporary forces run out of steam, as they are now doing.
- The good news is that longer term forces for growth are beginning to pick up somewhat. First, US real consumer spending is now growing at around 2-3% (Graph 5), and underlying growth in private sector payrolls has recently returned to positive territory, growing at about 100,000 per month so far this year (Graph 6), with labour income growing at about a 7% rate (mainly stemming from more hours worked rather than hiring new workers). Second, capital investment is beginning to respond to strength of corporate balance sheets and remarkable growth in corporate income (at a 30% rate). Capital goods orders in the G7 are growing at about a 30% rate, and fixed investment could grow by 10% in the US, though by less in Europe (Graph 7). Third, exports from the US/EU/Japan are rising at double digit rates as emerging market demand remains very strong (Graph 8). Taken together, there is a reasonable chance that these forces will be strong enough to maintain global GDP growth at about trend in the rest of 2010, though this may become harder as fiscal policy is tightened in 2011.

Deflation Pressures, But Only in the Developed Economies

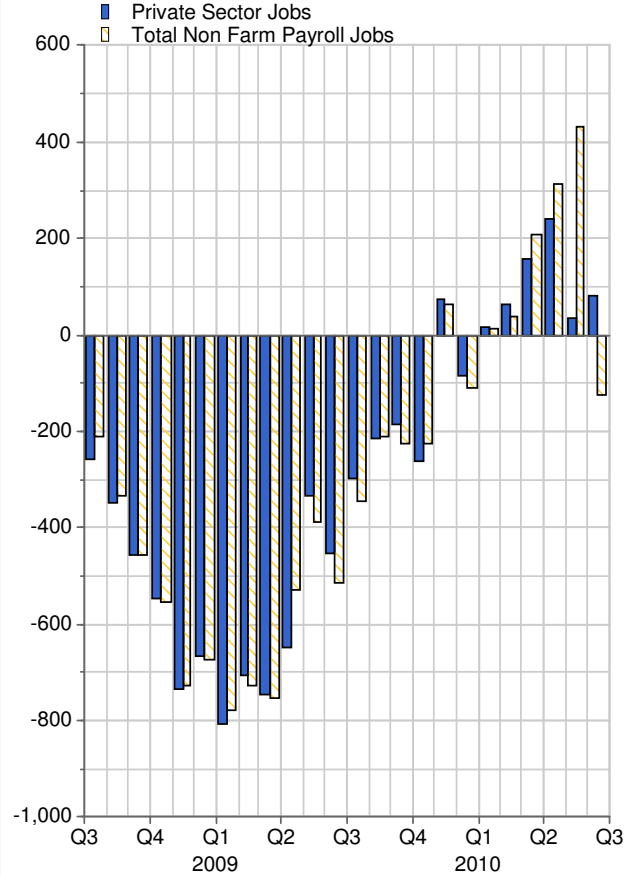
- Even if the global economy manages to sustain above-trend growth, spare capacity will remain very high for a prolonged period. The global output gap is probably still in excess of 4% (Graph 9). The main difference compared with earlier cycles is the abnormally high level of unemployment in the US, which has reached levels previously seen only in Europe. The margin of global excess capacity is therefore greater than in previous cycles, and in the labour market is more tilted towards the United States than previously.
- Excess capacity will continue to dominate the outlook for inflation in the developed economies. Inflation on a core basis has been dropping for the past 18 months, and it is now under 1% in the US and the EU. Headline inflation will also be dropping soon, assuming that oil prices do not rise sharply. Attempts by central banks to boost monetary growth have not been very successful, and in any case would not be likely to increase inflation rates for several years. A further drift towards deflation is a more imminent threat in the G7 than inflation (Graph 10).

5. Real Disposable Income and Real Consumers Expend.

(% change on a year earlier)

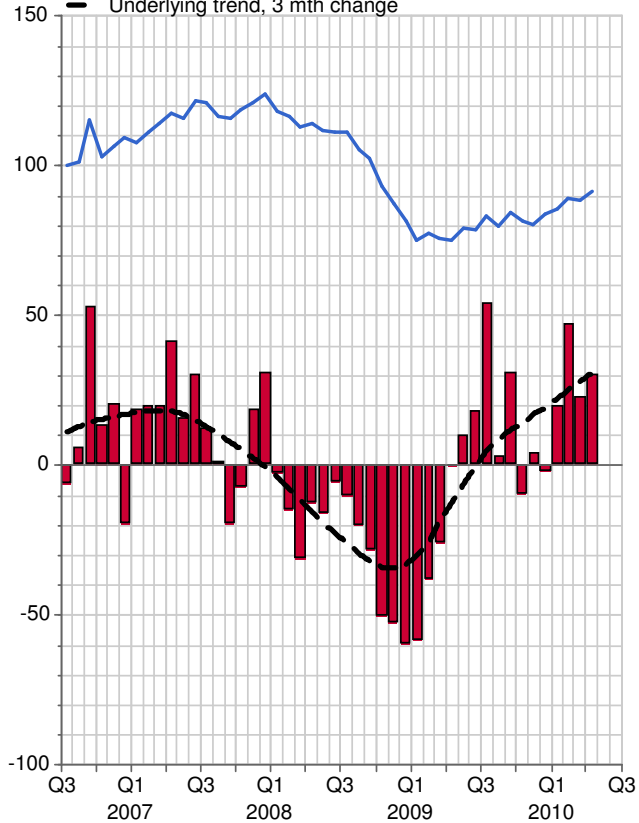


6. US Employment Figures : Monthly Changes (000)



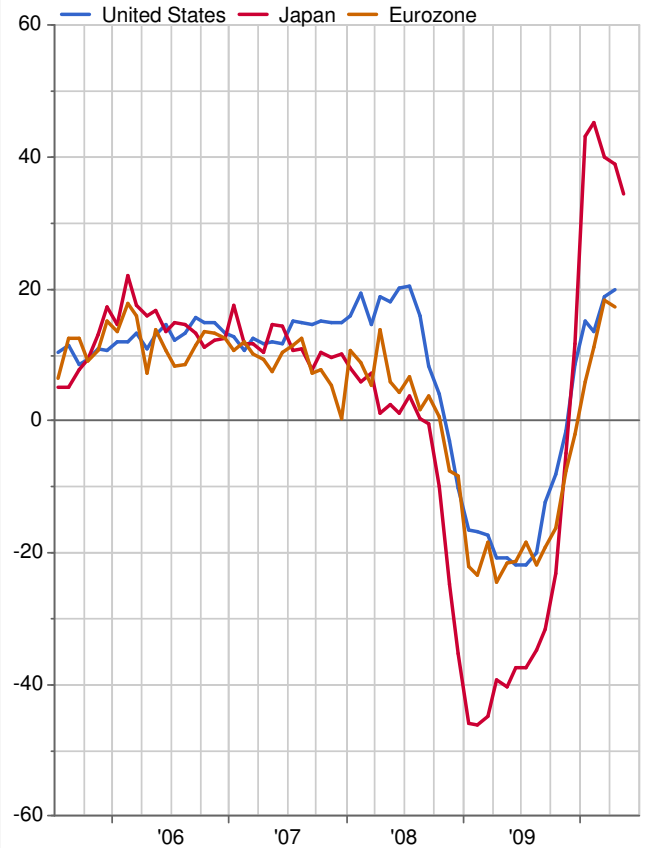
7. New Capital Goods Orders (G7 Economies)

Level of New Orders (blue line)
3 month % change (red bars)
Underlying trend, 3 mth change (black dashed line)



8. Export Growth in the Major Developed Economies

(% change on a year earlier)

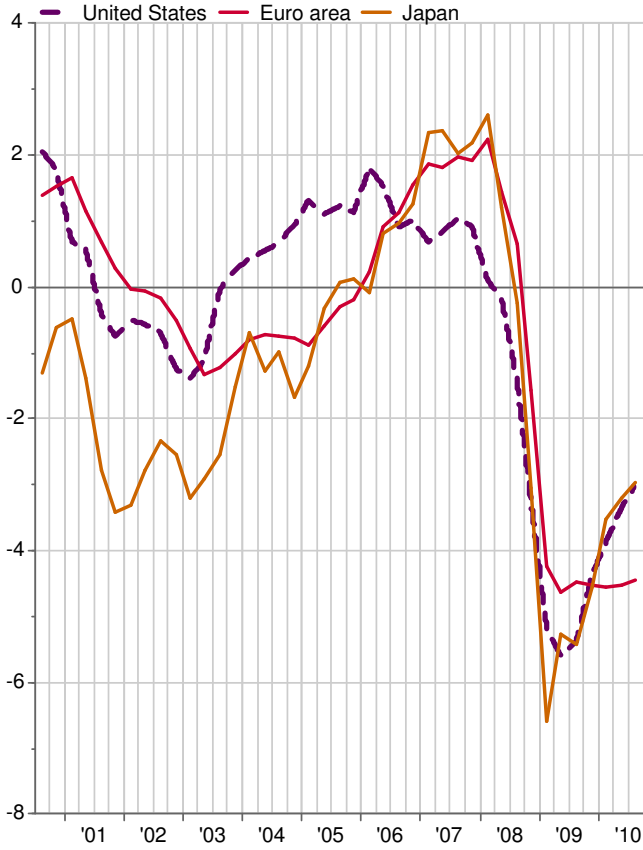


- This is not, however, true in the majority of emerging economies. In those countries, there is no overhang of excess private sector debt, no need for fiscal tightening, and no large output gaps. Inflation is generally rising in these economies, leading to more urgent pressures to tighten monetary policy, even while the opposite is happening in the developed world. This is an unusual development, which could lead to dislocations in currency and other financial markets, creating interesting opportunities for asset managers.
- In past economic cycles in the developed world, risk assets have generally performed well in periods when output gaps are high but falling, inflation is low, and central banks are not tightening policy. In fact, this is perhaps the most compelling pattern in financial market performance in the past several decades. Low but positive inflation, with extremely accommodating central banks, should therefore be a positive for equities and other risk assets. But if this should tip into outright deflation, it could quickly become a big negative. This is why there is so much concern in markets about a double dip recession.

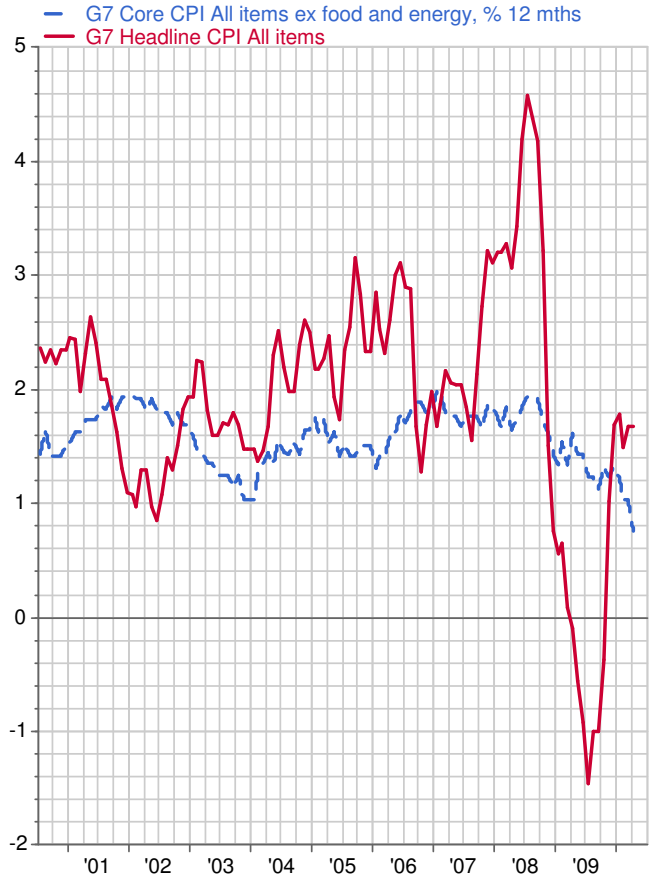
Risks to the Central Scenario

- In the developed economies, current cyclical forces seem to favour risk assets, provided that the recovery in global activity can be sustained and deflation is avoided. However, it is right to be concerned that these traditionally favourable cyclical forces could be derailed by exogenous forces this time. In many respects, things really are different this time, and risks to the central view abound in lots of areas:
- First, **stress in the financial markets**. The public debt crisis in Europe has triggered concerns that the financial markets could face a repeat of the stresses experienced during the sub-prime crisis in 2007/08. Stress measures in the financial system have generally not yet increased very markedly on a global basis, though European financials have been an exception. However, the sub prime crisis developed slowly at first and the European public debt crisis is certainly not over yet. Questions persist about the German willingness to permit sufficient emergency action to be taken, either in the EU budgetary package or in the extent and financing of ECB bond purchases. How big is the potential problem? For EU banks, there would have to be a 25% write-off of EU public debt to produce a hit equivalent to the subprime crisis, according to Goldman Sachs economists. While this seems fairly improbable, it is not out completely of the question. Our central assumption is that the European crisis will probably continue to rumble along, having periodic flare-ups which will further weaken the euro, but which do not quite lead to a break-up of the euro itself.
- Second, **premature monetary tightening**. Developed economies are experiencing worryingly low inflation rates, and are faced with imminent fiscal tightening as well. With these two forces firmly in place, they certainly cannot sustain any meaningful amount of monetary tightening for many quarters to come. In fact, central banks may well need to do more quantitative easing. Despite dissents on the policy committees, the leadership of the Fed (and even more the BoE) seem very unlikely to reverse their present aggressively easy stance before the end of 2011, and they might even need to increase their balance sheets further. The ECB has now

9. Global Output Gaps -- OECD Estimates (% of GDP)

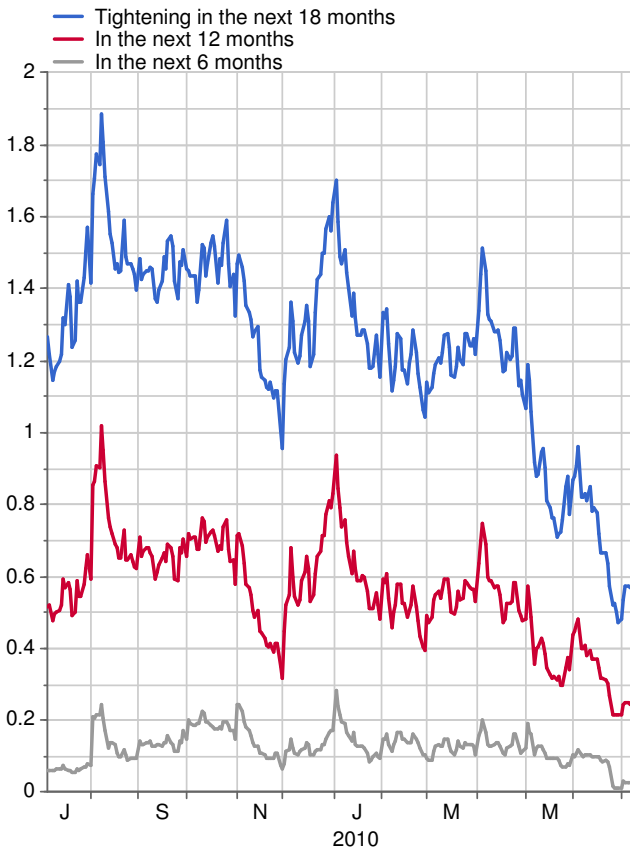


10. Consumer Price Inflation in the G7 Economies

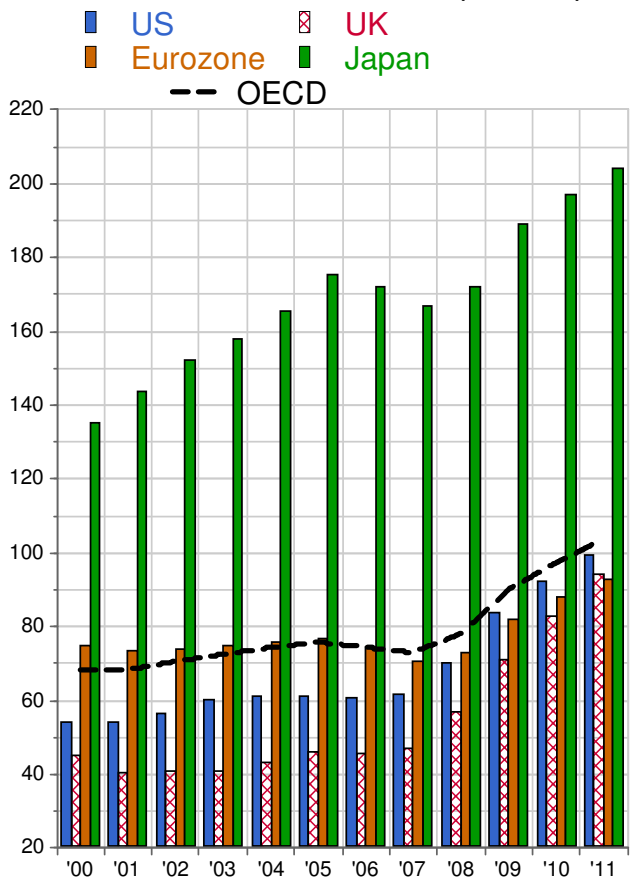


11. Amount of Monetary Tightening Expected in the US

Rate Changes Implied by the Fed Funds Futures Contracts



12. Gross Government Debt (% of GDP)



done the unthinkable in purchasing public debt in the secondary market, but has so far done this only in limited quantities, and has sterilised these operations to ensure that they do not lead to a net easing in monetary conditions. It may take further severe market disruption to induce the ECB to move further than this. Meanwhile, the BoJ seems to be doing very little. (Why change the habit of a lifetime?) Clearly, a great deal depends on the Fed. Its relaxed stance on the timing of the exit from abnormal monetary easing is the single most important factor in keeping risk assets underpinned, and the markets are anticipating (rightly in our view) almost no tightening in monetary policy for 12-18 months (Graph 11). If this changes, everything else would change.

- **Third, premature fiscal tightening.** In the developed world, overall fiscal policy was eased by over 2% of GDP in 2009, and policy this year will be roughly flat. It has always been planned that the fiscal stance will begin to tighten from 2011 onwards. At present, the planned tightening in G7 budgetary policy is only medium sized, at around 1.3% of GDP in 2011. Outside of the US, however, there seems to be a rising possibility that the previously planned degree of fiscal tightening will be increased and brought forward, especially in the major European economies (including the UK). Although current fiscal plans do not currently look sufficient to cause a double dip in the world economy, a more severe risk would develop if governments try to bring down public debt ratios on an accelerated timescale (Graph 12).
- **Fourth, a public sector debt crisis.** The markets have already tasted this in the Mediterranean bloc. However, the key differentiating factor in these economies is that they cannot use their central banks to purchase government bonds (assuming that the ECB is unwilling to do this). Elsewhere, there have been large declines in government bond yields, despite very large budget deficits and mounting public debt. As in Japan in the 1990s, deflation risk and very accommodating central bank policy have been more powerful forces than the state of the public finances. Should this change, trouble looms.
- **Fifth, China.** This requires a treatise of its own, but we assume that the current slowdown is the result of a moderate tightening in monetary policy which will be eased when inflation pressures begin to subside. Some western analysts predict a much more dramatic bursting of the over-investment bubble in China, probably focused initially on real estate. If they are right, a global double dip would of course be inevitable.

Market Valuation

- In general, it is usually correct to assume that the cycle in global economic activity has a more significant effect on asset market returns over periods of a year or two ahead than asset market valuations. However, the latter can certainly be important over longer periods of time, especially when they are at extremes. Currently, the valuation of the major asset classes is not providing dramatic signals, at least compared to the startling events of the past two years, but there are nevertheless some interesting points to note.

13. US 10 Year Government Bond Yields

Nominal and Inflation Adjusted (TIPS)

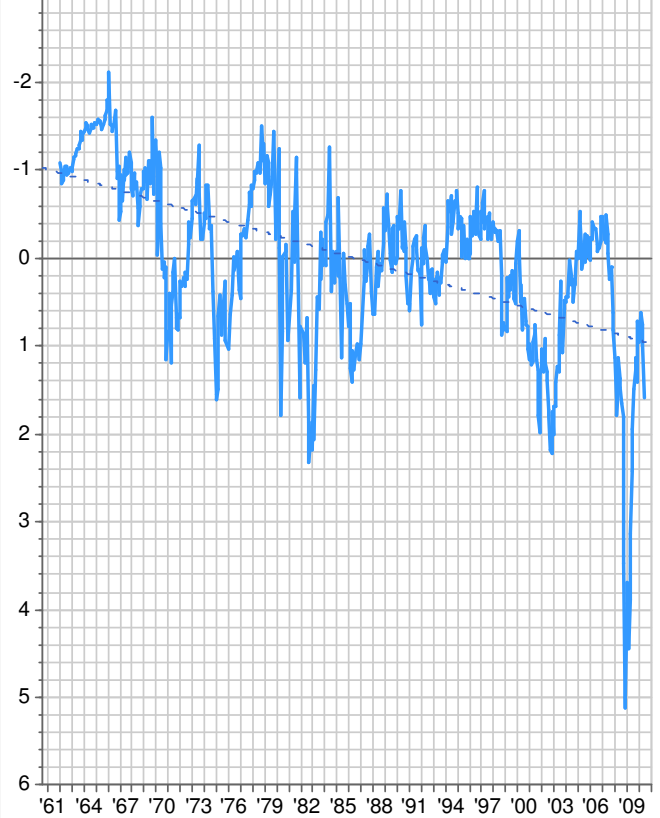
- Treasury Yield
- TIPS Real Yield
- - - 10 yr average
- - - 10 yr average



14. US Corporate Credit Valuation vs Government Bonds

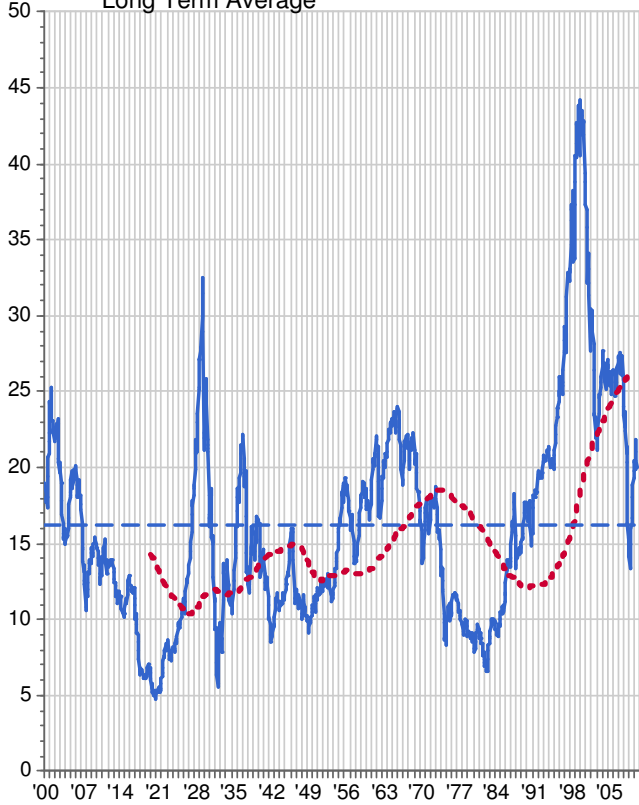
(Downward movements = cheaper credit vs government bonds)

- Credit/government bonds valuation
- - - Trendline: Linear



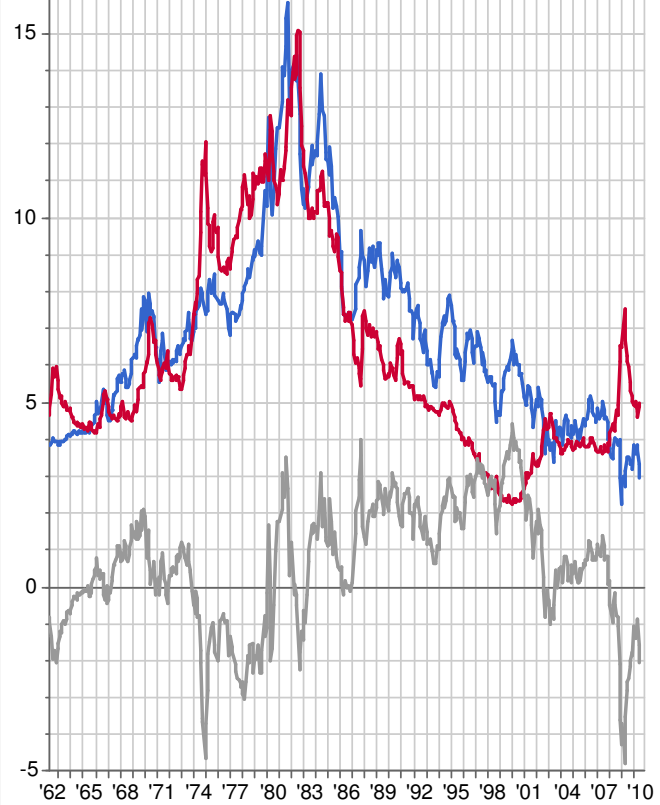
15. US Equities - Very Long Term "Shiller" P/E Ratio

- Long term P/E Ratio (Shiller)
- - - 20 Year Moving Average
- - - Long Term Average



16. US Equity Valuation Relative to Bonds

- 10 Year Treasury Yield
- S+P Earnings Yield (Shiller Method)
- Equity/bond Valuation (negative=cheap equities)



- Bond yields have fallen markedly this year, and have now reached levels which appear fairly valued on fundamental models which take account of public debt, monetary policy and the economic cycle (Graph 13). Many analysts have talked about a “bubble” in government bond markets, but it is quite difficult to envisage a sharp rise in bond yields while the Fed and other central banks are anchoring short rates at around 0.5%. The yield curve is already abnormally steep and will have a hard time steepening further, unless inflation unexpectedly starts to rise. Bond returns are therefore likely to stay positive, albeit at a slower rate than recently.
- Credit was massively undervalued relative to government bonds and equities at the height of the crisis last year. This is no longer the case. If credit is still undervalued, it is not by a large amount (Graph 14).
- Equity valuation is complex. Based on very long term valuation models, and comparing equities to their own history, one could argue that equities are in expensive territory, as they have been ever since the mid 1990s (Graph 15). However, relative to government bonds, equities are in the bottom part of the trading range which has been observed over the past 20 years, and the relativity between the forward P/E and the bond yield seems to favour equities over bonds (Graph 16). The forward P/E however assumes some quite demanding growth in corporate earnings in 2011. The required earnings growth would only be forthcoming if global GDP growth manages to remain above trend next year, which is a bit of a stretch. Currently, we favour average levels of equity risk in balanced portfolios, with some downside protection. European markets may out-perform, provided that the euro continues to decline, without actually breaking up.
- Emerging equity markets are no longer valued attractively relative to developed markets, so much of their relatively strong GDP performance may already be priced in. Inflation pressures are rising in these economies, and there are strong fundamental reasons for believing that their currencies will finally be forced to rise against the main developed currencies. If so, emerging equity markets may disappoint those who adopt a perennially bullish stance on these markets, but there should be some very interesting opportunities in emerging currencies, commodities, and in developed market equities which are particularly exposed to growth in the BRIC economies.

Conclusion

- Global GDP growth has remained above trend into the second quarter, and is expected to remain at trend over the rest of 2010. Inflation is low, and monetary policy remains aggressively easy – all of which would normally point to positive returns from risk assets. That probably remains the central case, but recent global activity data have been dropping, and downside risks have clearly been rising.
- Any responsible asset manager would have to concede that the current stance of public policy indicators in the developed economies is troubling. Financial conditions have tightened somewhat as a result of the increased market stress, especially in the European banking sector. In addition, massive public sector deficits are leading to pressures to tighten fiscal policy further in 2011, and this could leave the central banks with an unsustainable amount of quantitative easing to

do. Or quantitative easing might be tried, and might fail to work. These unprecedented policy problems clearly increase the downside risks facing the global economy and risk assets. The resulting left tail risks for markets cannot be lightly dismissed and need to be hedged by asset managers, even though such hedging is fairly expensive. Sometimes, the cost of insurance is not worth the price. At present, it probably is.

6 July 2010

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Market Indices

The HFRI Fund of Funds Composite Index (“HFRI FoF Composite Index”) invests with multiple managers through funds or managed accounts. The strategy designs a diversified portfolio of managers with the objective of significantly lowering the risk (volatility) of investing with an individual manager. The Fund of Funds manager has discretion in choosing which strategies to invest in for the portfolio. A manager may allocate funds to numerous managers within a single strategy, or with numerous managers in multiple strategies. The minimum investment in a Fund of Funds may be lower than an investment in an individual hedge fund or managed account. The investor has the advantage of diversification among managers and styles with significantly less capital than investing with separate managers. The HFRI Fund of Funds Index is not included in the HFRI Fund Weighted Composite Index.

The Merrill Lynch 3-Month Treasury Bill Index (“Cash”) tracks the performance of the 3-month U.S. treasury market. The index is unmanaged and is comprised of a single issue purchased at the beginning of the month and held for a full month. At the end of the month, that issue is sold and rolled into a newly selected issue. The issue selected at each month-end re-balancing is the outstanding Treasury Bill that matures closest to, but not beyond 3 months from the re-balancing date.

The MSCI World TR USD Index (“MSCI World TR”) is a free float-adjusted market capitalization index that is designed to measure global developed market equity performance. As of May 2007, the index consisted of the following 23 developed market country indices in North America, Europe and the Asia/Pacific Region: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States. Each component country index is a sampling of equity securities across industry groups in such country’s equity markets. Performance is shown in U.S. dollar terms assuming the reinvestment of gross dividends.

The Barclays Capital Aggregate Bond Index (“Barclays Aggregate”) is a market capitalization-weighted index. The U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM pass-through), ABS, and CMBS sectors. U.S. Agency Hybrid Adjustable Rate Mortgage (ARM) securities were added to the U.S. Aggregate Index on April 1, 2007, but are not eligible for the Global Aggregate Index. The U.S. Aggregate Index is a component of the U.S. Universal Index in its entirety. The index was created in 1986, with index history backfilled to January 1, 1976.

The S&P Small Cap 600 TR (“S&P 600 TR”) covers approximately 3% of the domestic equities market. Measuring the small cap segment of the market that is typically renowned for poor trading liquidity and financial instability, the index is designed to be an efficient portfolio of companies that meet specific inclusion criteria to ensure that they are investable and financially viable.

The S&P 500 TR (“S&P 500 TR”) has been widely regarded as the best single gauge of the large cap U.S. equities market since the index was first published in 1957. The index has over US\$ 3.5 trillion benchmarked, with index assets comprising approximately US\$ 915 billion of this total. The index includes 500 leading companies in leading industries of the U.S. economy, capturing 75% coverage of U.S. equities.

The ML High-Yield Master II Bond Index (“ML HY Bond Index”) is an unmanaged index that tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market. This unmanaged index does not reflect fees and expenses and is not available for direct investment.

The Merrill Lynch Corporate Master Index (“ML Corporate Master Index”) is a statistical composite tracking the performance of the entire US corporate bond market over time. The index includes dollar-denominated investment grade corporate public debt issued in the US bond market. Performance is measured in terms of total return (interest income plus price gains) for different time periods as well as option-adjusted spreads, which show the amount of yield difference or “spread” between the index and a benchmark US Treasury security that is attributable to all bond features—maturity, coupon, credit rating, liquidity, etc.—except for call features or other embedded options.

The statistical data regarding these indices has been obtained from sources believed to be reliable. The investments of the Fund (and its portfolio funds) are not limited to the investments included in these indices. In addition, these indices are not subject to any of the fees or expenses to which Prisma’s portfolio would be subject, and it is not possible to invest in these indices. These indices are being presented for comparison purposes only to show how the Fund’s performance compares to that of broad global markets.