A Meeting of the Minds

Our colleagues at QFR Capital Management LLC organized their first annual forum on November 29th , 2012. They manage an emerging markets macro hedge fund, the QFR Victoria Fund, which has a good risk/return profile.

The forum was a "Big Ideas" event, covering Portfolio Strategy, Economics and Geopolitics, and featured some key thought leaders in each of these fields- Nobel Prize winner Myron Scholes, economist Robert Shiller and former US Secretary of Defense Robert Gates, to name a few. The QFR team used this as an opportunity to shape their own views on the world in 2013, and invited their key clients to participate.

Participating in forums such as this - rich with intellectual capital - is extremely beneficial for BigSur. Our global view is shaped by consulting "best in class" research sources across different asset types and markets. We synthesize data and information from these sources, and integrate our own understanding of the dynamics and correlations across these markets to come to our own holistic view. In this piece, we share the key takeaways of the forum - which we used as high quality inputs to enrich our own views - and the conclusions we drew which can be translated into investment ideas and positioning of client portfolios. Most of the key takeaways are around credit and FX markets. In sum, what we learned at the forum reinforced our views on the market, and strengthened the conviction in the calls that we had.

Key Takeaways (to be expanded upon):

- Reflationary Policies will still dominate the global markets in 2013
- A World with a Shortage of Safety Assets
- A World with many Asset Bubbles, mainly in G-3 Government Bond Markets
- Spread Products will continue to perform: The issue of *Net* Issuance
- Credit stories going in different directions between Developed (DM) and Emerging (EM) Economies
- Geopolitics: Every coin has two sides

The Thinking Man's Approach

December 2012 | Series #3
Ignacio Pakciarz | CEO

QFR Capital Management LLC organized their first annual forum, a "Big Ideas" event covering Portfolio Strategy, Economics and Geopolitics. Several key thought leaders were featured in the forum, and they shared their views on the current state of the world and outlook going forward. In this piece, we share the key takeaways of the forum and the conclusions we drew. In general, we left the conference feeling more

BigSur Conclusions

After September's FED meeting, BigSur's take on the market was that we were poised to see a continuation of the rally in the market. We continuously challenge and revisit our thinking process, and it is forums like this that give us the critical intellectual fuel to undergo this process. We have thus, come to the following conclusions:

- We have a higher conviction level in terms of our previous portfolio positioning. Our positioning for 2013 remains largely unchanged:
    - Underweight Treasuries
    - Overweight Spread Products
    - Overweight Emerging Markets versus Developed Markets
    - Overweight "Real" Assets

- One of the ideas that we will pursue with a greater prominence will be that of "carry trade", with an emphasis on Asian and selected Latin American currencies. Given the environment of poor credit creation in developed markets, we think that the prefect ground is set up for currencies like CNH (offshore traded Renminbi), KRW (Korean Won), MXN (Mexican Peso), BRL (Brazilian Real), TRY (Turkish Lira), AUD (Australian Dollar, NOK (Norwegian Kroner) to mention some.

- We highlight once again the importance of timing in entering and exiting positions, given that we foresee sharp corrections in an upward trending market for risky assets.

- Corrections will mainly be driven by political or geopolitical events.

- An "active management approach" will be important in 2013, just as it was in 2012 to add alpha. This stage of the market provides the opportunity to take advantage of inflection points. One needs to continuously research and stay on top of positions in this type of market. To constantly be on top of technicals, and of flow analysis is a necessity in today's environment. This will be a vital thing to do in 2013.

Below we discuss in more detail the key takeaways from the conference:

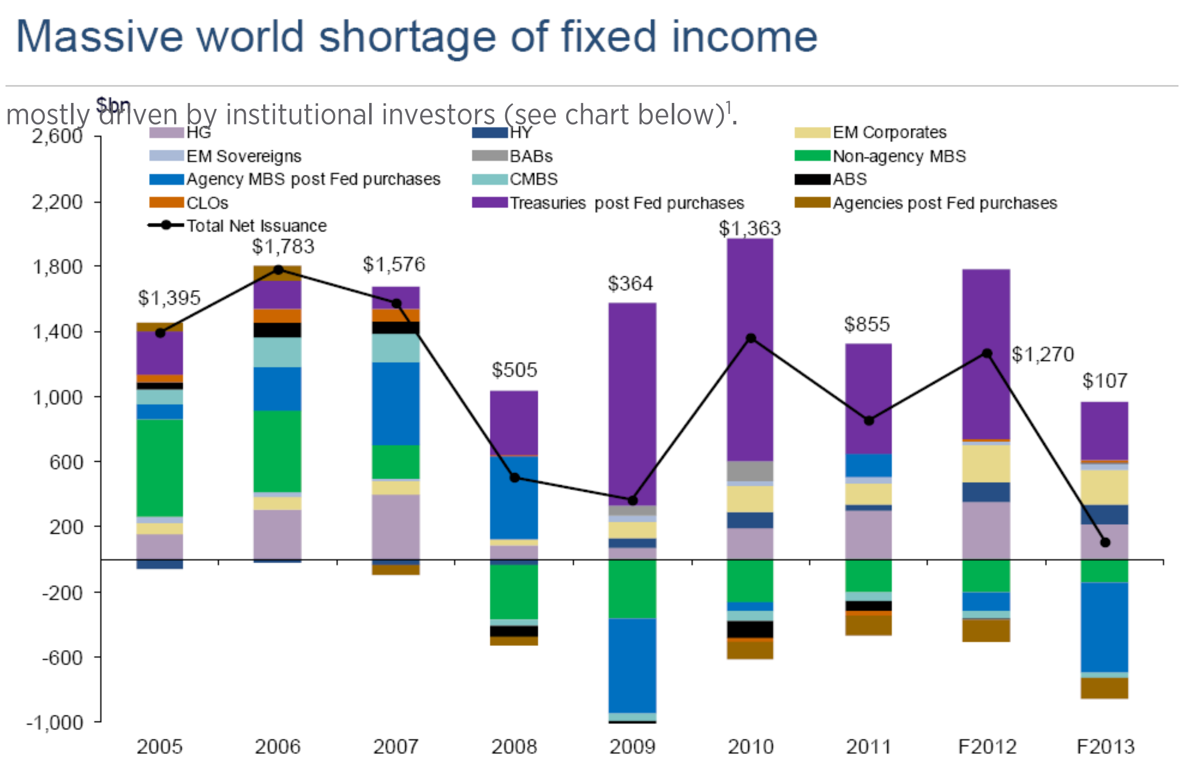
Reflationary Policies will still dominate the global markets in 2013

- There was a clear and unanimous conviction amongst the participants that in no way will G-3 interest rates increase during 2013. The Fed, ECB and the BOJ will continue with a very aggressive monetary policy.

- There was an undivided certainty amongst participants that inflation would not be an issue for 2013 nor 2014. However, Martin Feldstein, a Professor of Economics from Harvard, does believe that in a 5 year period, inflation could creep up to 5%. At that time, depending upon the Fed's ability to execute an early exit of aggressive monetary policies, capital markets could be under pressure. But we are far away from that point, as the global industrial production recovery cycle has a long way to go for the world to start feeling inflationary pressures.

- The supply-demand dynamics facing Fixed Income are very strong. While net fixed income supply is down from the post crisis peak, fixed income demand from both US and foreign investors will remain robust. The below chart illustrates the evolution of fixed income supply over the last several years:

mostly driven by institutional investors (see chart below)[1].



A World with a Shortage of Safety Assets

- The lack of yield available from safe assets is probably the biggest challenge most of our clients face. Safe real rates have collapsed and are in many cases negative for maturities below 15 years.

[1] Citi Prime Finance Analytics, "Institutional Investment in Hedge Funds: Evolving Investor Portfolio Construction Drives Product Convergence," 2011

- The supply/demand mismatch has been generated by the financial crisis. On the supply side, private sector securitization issuance almost completely dried up in the U.S. and Europe. Moreover, more than 50% of the U.S. private-label residential mortgage-backed securities issued in the 2005-2007 period with an AAA-rating were eventually downgraded to junk status. And while sovereign bond issuance has exploded, rampant rating downgrades meant that the proportion of advanced economies with a triple-A rating fell from almost 70% in 2007 to slightly over 50% by early 2012. In total, $15 trillion in sovereign debt has lost the top rating since 2007.

- On the demand side, heightened uncertainty and regulatory reforms have sharply inflated the need for high-quality fixed-income assets. The requirements of the new Basel III Liquidity Coverage Ratio alone could boost banks' demand for safe assets by trillions of dollars in the coming years. At the same time, the financial crisis has intensified the desire to save in many parts of the world. Household saving rates have increased, the corporate sector has built up a cash war-chest, and governments are under pressure to rein in their budget gaps (i.e. reduce dis-saving).

- We conclude that the world is likely to remain awash in yield-hungry savings for several years at least.

A World with many ASST bubbles, mainly in G-3 Government Bon Markets

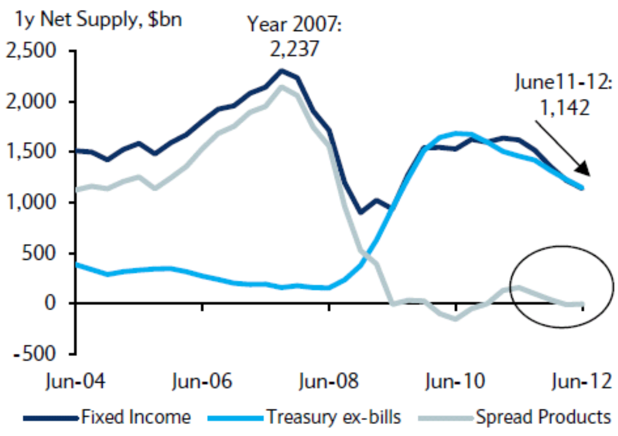
- Yields are at historic lows. The price investors are prepared to pay for income is very high these days. Another way of putting it is that there's a safety bubble. The largest eight stock markets in the world trade with higher dividend yields than their respective domestic government bond markets. This is the first time we've seen this in 50 years! In 2012 there has been over $400 billion outflows out of equity funds, while more than $1 trillion inflows into bonds funds.

- Macroeconomic and regulatory uncertainty makes it impossible to estimate precisely the pending supply/demand mismatch for high-quality bonds. Nonetheless, estimates presented below suggest that, even considering the prospect of plentiful government bond issuance in the five years, the ex-ante demand for safe assets could exceed the ex-ante supply by $1.5 trillion in a worst-case downgrade scenario. The mismatch would result in a growing scarcity premium, at least for those instruments that investors and regulators believe are "safe". As the above quote highlights, the IMF is most concerned with the potential for financial market instability caused by distortions in the price of "safety". Investors could be forced to take more risk than they normally would as high-quality fixed-income instruments become dearer. It could also lead to asset bubbles and pricing discontinuities when assets no longer satisfy regulator criteria. Much of the current overvaluation in U.S. Treasury securities can be traced to flight to safety flows in the absence of a viable investment alternative.

Spread Products will continue to perform: The issue of net issuance

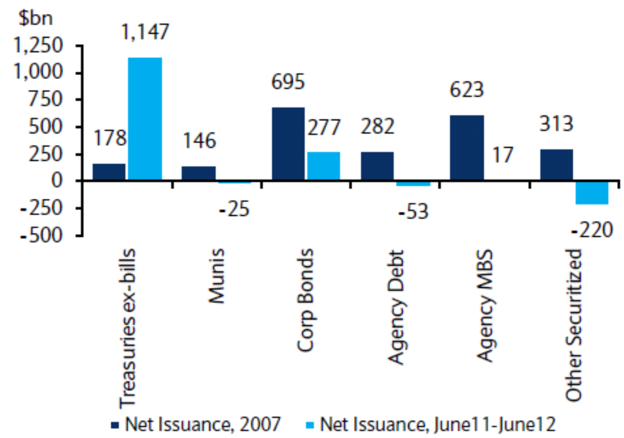
Although there is record breaking new issuance, there is a shortage of supply. This relationship is driven in part by corporate responses to recent developments. Companies do not want to get themselves in the position they were in 2008, when they could not roll over their debt. So today, they are retiring shorter-term paper and lengthening maturities, or using spare cash to fully retire debt. In many cases, companies are coming out ahead by buying back debt more cheaply than when it was issued. There is little credit creation outside the Treasury universe. This dynamic is positive for spread products. Pre crisis, net FI issuance was north of $2 trillion, of which almost all was spread product. In 2013 one can expect net treasury issuance of $850 billion and spread product issuance to remain anemic as the GSEs continue to shrink their portfolios and households continue to deleverage. The charts below illustrate this phenomenon:

Total net FI issuance remains well below pre-crisis levels, even as Treasury issuance is much higher…



Note: Fixed income and Treasury issuance exclude T-bills.
Source: Federal Reserve Flow of Funds

… because the issuance of spread product remains anemic

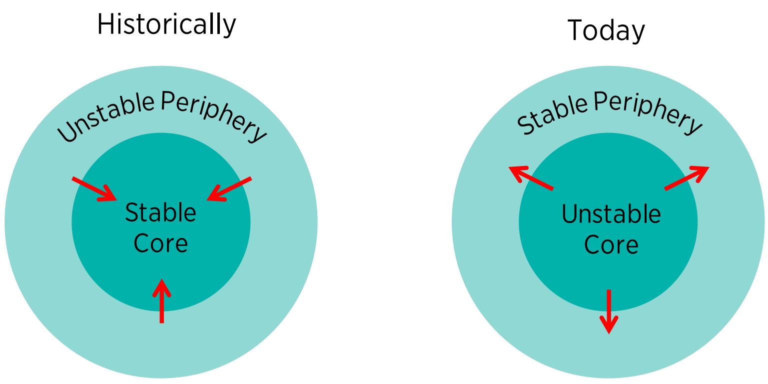


Note: Treasury issuance excludes T-bills. Corporate bonds issued by domestic non-financials, domestic financials and foreign issuers. Source: Federal Reserve Flow of Funds

Credit stories going in opposing directions between Developed (DM) and Emerging (EM) Economies

The IMF forecasts for growth in EM have been decreasing and are now at 5% for 2013. The IMF recognizes that there are structural transformations that need to take place as EM mature from a rapid, export-oriented, investment-biased economic model that dominated during the last decade to one that is more balanced (and consumer focused). Longer term, we continue to see potential for EM regional trends in population growth, urbanization, and industrialization to positively influence global demand dynamics. This would reduce the economic sensitivity of EM to DM consumption. The graphic on the next page illustrate the "risk" migration from the EM to DM.

"Risk" Migration from Periphery (EM) to Core (DM)



Geopolitics: Every coin has two sides

- The geopolitical segment of the forum featured former US Secretary of Defense and Director of the CIA, Robert M. Gates and international affairs expert Fareed Zakaria (Editor at Large of TIME magazines, host of CNN's international affairs program)- both of whom painted different pictures of the current world geopolitical situation.
- Mr. Zakaria views are that the global political backdrop has been more stable and peaceful than it has been for decades, and we are in a period of "extraordinary stability."
- Secretary Gates describes the world more as a "ticking bomb" as there are several situations that are currently "under control" but with a slight incident (or provocation) could easily and rapidly escalate. He described the world has being a place where countries are more than sufficiently equipped to take excessive force and could do so at a moment's notice.
- Our take is that investment strategy decisions should not be highly influenced by geopolitical events.

At BigSur, we are continuously challenging and revisiting our views, and attending an event such as this, where we were given access to some of the most notable minds in their given fields, just further enriches our critical thinking process and consequently our BigSur Global Holistic View. We believe this adds value to our clients, as we apply this view to our investment ideas and portfolio positioning.

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