ARVEST FUNDS AG

Monthly Report for September 2009

Fund manager's strategy report

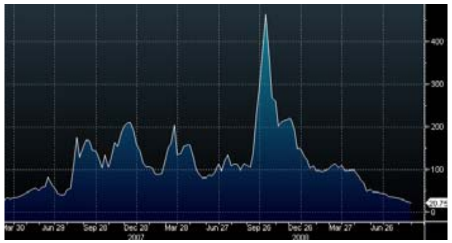
Financial markets on steroids

Stock prices have once again rebounded strongly since the beginning of March. Judging from the current sentiment among market participants, this phenomenon could continue for some time. The optimists are no longer fazed by pessimistic forecasts, such as those by economist Nouriel Roubini, now well-known as a result of the crisis. A headline in the German newspaper Frankfurter Allgemeine Zeitung (FAZ) from a few days ago read: "Roubini followers miss out on the rally". The big winners on the market include not only the raw materials and IT sectors, but above all the financial industry as well. This shows that risks still widely discussed at the beginning of the year have now faded even further into the background of investor awareness.

This renewed appetite for risk is not just evident in rising stock prices but in loan markets as well. Still, the news from loan markets has been less rosy than from stock markets – apparently, pessimists have maintained a greater presence in the former. Loan buyers are typically more risk-averse and are often willing to settle for lower returns, particularly when the creditworthiness of the borrower is of major concern. The memory of (in some cases) double-digit losses endured by these rather risk-averse investors has lingered only marginally.

TED spread

The TED spread earned special attention last year as a barometer for risk-taking tendency in the market. It indicates the required risk premium on short-term interbank loans versus risk-free alternatives. On October 10, 2008, at the height of the crisis, the risk premium had risen to 460 basis points, a new record that, barring a complete collapse of the system, is unlikely to be broken. As pessimistic as the markets were in October of last year, they now appear to have become rather confident. At just under 21 basis points, the risk premium is now lower than even before the outbreak of the crisis. Risk premiums demanded by market participants on the loan market have also fallen dramatically. In the words of ARVEST Privatbank CEO Stefan Kimmel: "Was it all just a dream?" Reasons for skepticism and corresponding caution in investment decisions remain.



Reasons for skepticism

The situation on the markets remains extraordinary. Despite impressive price rallies, it is still too early to speak of a return to normality. Returns on the loan market, even from companies with minimal credit ratings barely above junk status, have now fallen too sharply to compensate for their associated risks. Nevertheless, the demand for secure investment options appears to remain immense.

Massive government programs for the purchase of government and corporate loans in the US and elsewhere as well as the reduction of prime rates to near zero have resulted in an overall drop in returns. Given this scenario, it would certainly not be an understatement to say that the market is "on steroids." Market participants are being forced to take on significant risk due to a lack of alternatives, even with rock-bottom projected returns. This development harbors the seed for the next major market collapse.

Market participants are only content with such low returns when the probability of rising inflation is negligible. However, an economic upswing coupled with a deflation scenario is extremely unlikely.

The hope that impressive economic growth in China could pull the rest of the world economy out of recession should also be met with skepticism. For one, the growth of the US economy to 23% of world GDP versus China's 6.5% remains of major importance. Secondly, doubts regarding the validity of Chinese figures are not without merit, not least because, in contrast to GDP calculations in the West, loans granted by Chinese banks are included in GDP growth calculations even before an economic activity takes place. According to the Chinese calculation, even investors who obtain funds for speculative ventures through loans create economic growth!

Due to the continued instability of the real economy, it would be wise to avoid falling prey to the current market euphoria and taking on extraordinary risks. ARVEST stock funds will therefore continue to be defensively positioned.

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