September 2012

Executive summary*

Deutsche Bank Research Highlights: "Asset Allocation: Staying Constructive" and "LT Asset Return Study: A Journey into the Unknown"

Our Global Markets Strategy Research team examines the sustainability of the current risk rally. They stay constructive on the expected up cycle in US data.

In the second piece, our Macro Research team discusses the latest in their series of long-term asset price studies. They argue that the best strategy for this decade remains an accumulation of core, higher quality, real assets on dips.

Investor Sentiment

Investors globally continue to search for credit strategies, with particular interest in structured credit. Many investors believe that while the easy money has already been made in this space, there are still pockets of inefficiency, and skilled managers should be able to exploit these opportunities to generate significant alpha.

Globally, we are seeing increased demand for managers in Asia. As such, we have received a number of requests in the past month for our upcoming Asia Managers Forum set to take place this October in Hong Kong. Further, we have noticed that of those interested in Asia, an increased number are interested in learning about Greater China onshore managers.

Performance

The median fund finished the month up 0.50% as markets rallied in response to positive signals from the Euro zone. Globally, CTAs had a challenging month with the median fund down 1.07%. All other strategies posted positive returns in August.

Year to date, the median hedge fund is up 3.15% with credit (7.54%) and distressed (7.76%) strategies extending their gains.

Leverage

Volatility declined sharply in August, ending the month at 14.34 – down almost 16% from the previous month. Gross exposure remained virtually unchanged at 2.35, while net exposure fell by 2.79%, ending August at 0.44.

Securities lending

We discuss the impact of the global economic slowdown on the steel and US coal industries. Additionally, we provide colour on why shorts are particularly interested in the renewable energy sector in Europe, and the electronics and transport space in Japan.

Regulatory

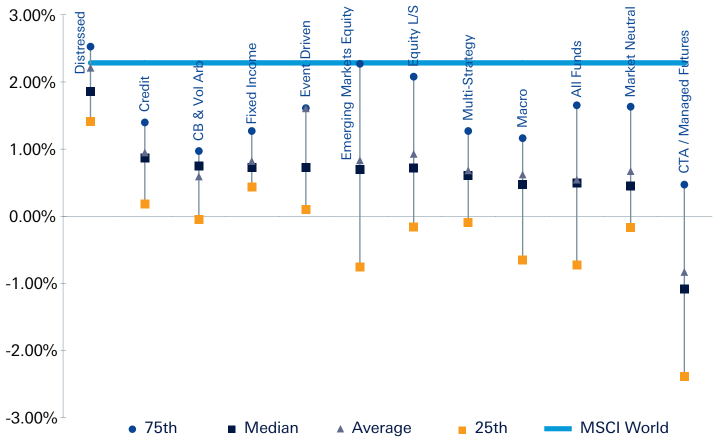
This month we discuss the latest developments across various pieces of legislation impacting European markets. These include the AIFMD, Regulation on Short Selling and Certain Aspects of CDS, European Market Infrastructure Regulation (EMIR), resolution of Financial Market Infrastructures, technological challenges to market surveillance, LIBOR/EURIBOR Rate Setting and Her Majesty's Treasury's discussion paper.

In the US, we examine the issue of the extraterritorial application of OTC derivatives regulation under the Dodd-Frank Act.

The main headline from Asia reports that China will open the door to foreign hedge funds looking to raise funds from onshore China. We also highlight other noteworthy developments, such as the South Korean short position reporting regime, the consultation on the regulation of electronic trading in Hong Kong, China's finalised new QFII rules and the proposal for short sale control enhancements in Taiwan.

Global performance

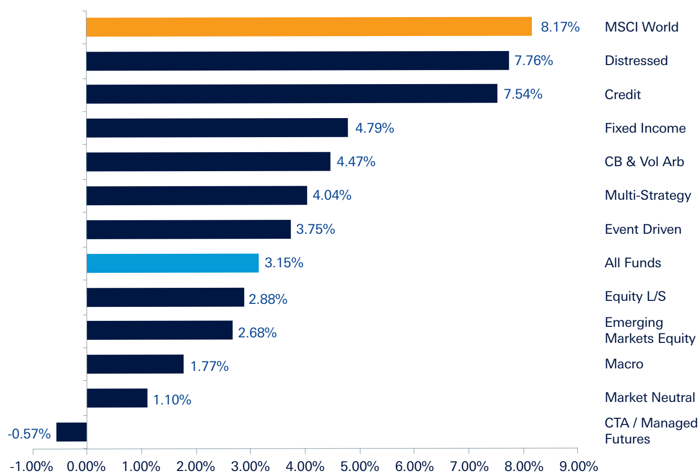
August 2012 Performance Dispersion



Median			
Distressed	1.86%	Equity L/S	0.70%
Credit	0.88%	Multi-Strategy	0.64%
CB & Vol Arb	0.75%	Macro	0.50%
Fixed Income	0.73%	All Funds	0.50%
Event Driven	0.73%	Market Neutral	0.48%
Emerging Markets Equity	0.70%	CTA / Managed Futures	-1.07%

Source: Hedge Fund Intelligence (HFI), September 2012

August 2012 Cumulative Median Performance by Strategy



Source: Hedge Fund Intelligence (HFI), September 2012

* This document contains extracts and opinions from various departments and business areas within Deutsche Bank, including extracts from Research Reports, as well as from external reports specifically referenced herein. It is not, however, a research piece and has been produced by a front office function. Also, please refer to the body of the document for a more detailed description of and proper references to the topics covered in the Executive Summary section.

For further information on any of the issues discussed in this newsletter, please contact the Markets Prime Finance team: email: GPF.Trends@db.com

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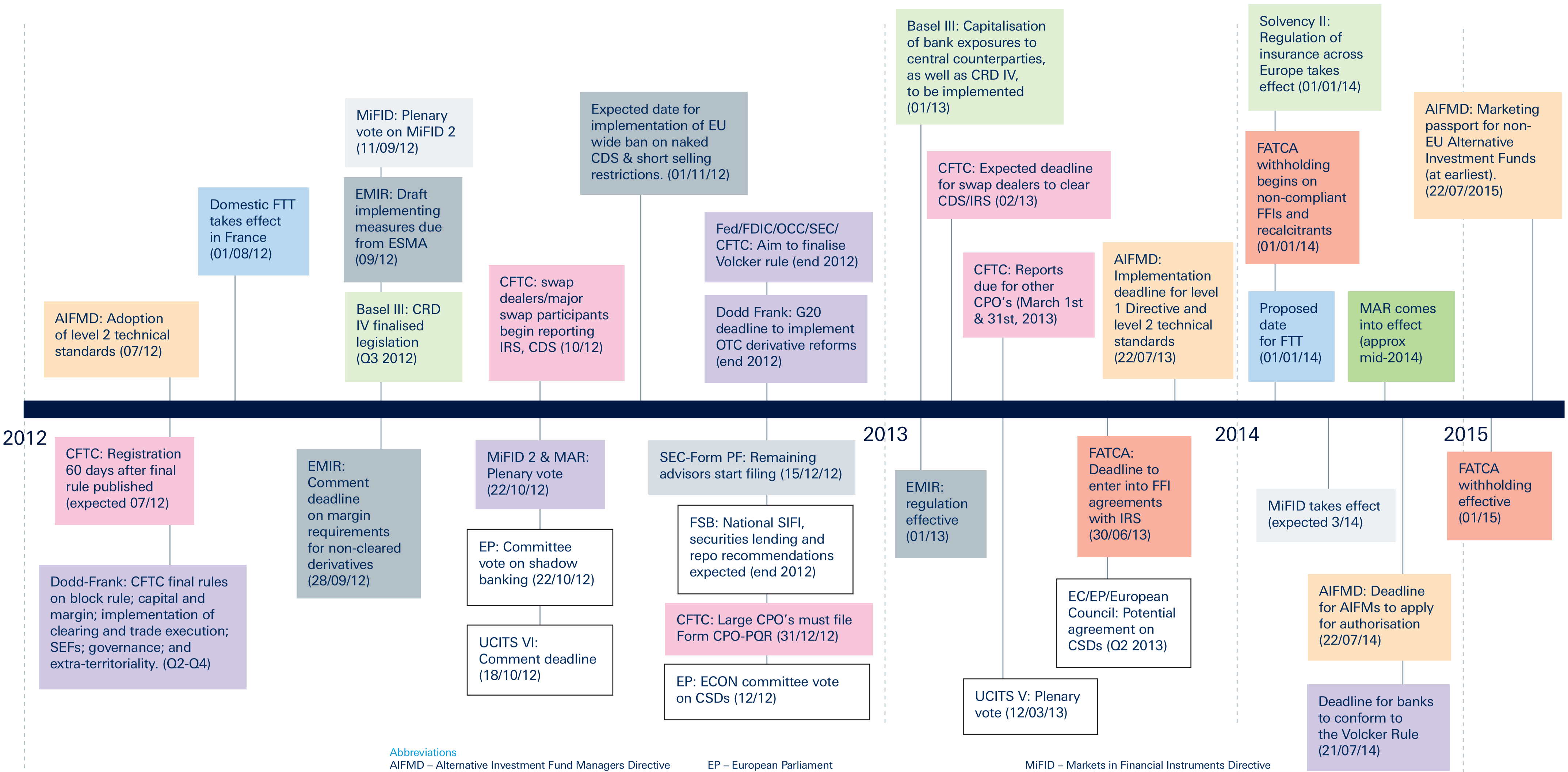


Abbreviations

AIFMD – Alternative Investment Fund Managers Directive
CBRC – China Banking Regulatory Commission
CDS – Credit Default Swap
CFTC – Commodity Futures Trading Commission
CRA – Credit Rating Agency
CRD – Capital Requirements Directive
CSD – Central Securities Depositories
EBA – European Banking Authority
EC – European Commission
ECON – Economic & Monetary Affairs Committee
EIOPA – European Insurance and Occupational Pensions Authority
EP – European Parliament
EMIR – European Market Infrastructure Regulation
ESMA – European Securities Market Authority
EU – European Union
FDIC – Federal Deposit Insurance Corporation
FFIs – Foreign Financial Institutions
FSB – Financial Stability Board
FTT – Financial Transaction Tax
HFT – High frequency trading
IRS – Interest Rate Swap
JFSA – Japanese Financial Services Agency
MAR – Market Abuse Regulation
MiFID – Markets in Financial Instruments Directive
OCC – Office of the Comptroller of the Currency
PRIPs – Packaged Retail Investment Products
SFC – Securities and Futures Commission
SEC – Securities and Exchange Commission
SEF – Swap execution facility
SEPA – Single Euro Payments Area
SIFI – Systematically Important Financial Institution
UCITS – Undertakings for Collective Investment in Transferable Securities

Source: Deutsche Bank Government & Regulatory Affairs and Hedge Fund Consulting

Hong Kong - SFC release consultation on the regulation of electronic trading

On 24th July, the SFC released a paper considering the controls that the regulator feels will provide a framework for Direct Market Access ("DMA"), internet trading, electronic trading and algorithms. Much of the paper considers who should be responsible for such orders, the appropriate level of testing, record keeping and monitoring, and the due diligence that brokers should perform on their clients.

The paper proposes that all securities listed on an exchange would be in scope including shares, futures, options, ETFs, warrants and exchange traded certificates. It would seem from the current drafting that this would include securities listed overseas as well as in Hong Kong. Additionally, the paper considers leveraged FX and will update the Internet Guidance Note released in 1999.

The points that have generated the most interest are two-fold. It suggests that brokers would be ultimately responsible for order sent through by clients, for the testing and roll out of the systems, and for security including the suggestion that brokers should be able to tell if the person logging on is authorised to do so. Additionally, brokers would need to perform due diligence on their clients to ensure competency and given the paper does not currently distinguish between professional and retail investors; there is currently no guidance as to how this should be assessed.

Comments will be received the by SFC until September 24th.

China - CSRC published the finalised new QFII rules

CSRC have published on their website the finalised version of "Provisions Concerning Issues Related to the Implementation of the Administrative Measures for Securities Investments in China by Qualified Foreign Institutional Investors".

- Each QFII should open sub-accounts for its prop trading activities and client trading activities. When QFII open accounts for its customer the name can be "name of QFII + name of customer". While the customers are long term investors such as mutual fund, insurance companies, pension funds, endowment fund, charitable foundation, and sovereign funds, the assets should be segregated from QFII and its custodian. In terms of how the "sub-account" can be opened and how to allocate the QFII quota to each sub-account, CSRC is expected to lead a conversation with CSDCC and SAFE shortly.
- Each QFII can appoint 3 brokers in each market, up from the current one broker requirement. However, the practical implementation depends on the account opening framework which is still being finalised by CSRC and SAFE.
- The lower requirements for applicants are:

Investor	Current	Drafted new
Securities	Years of business experience > 30 yrs AUM >= USD 10 billion Net Asset >= USD 1 billion	Years of business experience > 10 yrs AUM >= USD 5 billion Net Asset >= USD 500 million
Fund	Years of business experience > 5 yrs AUM >= USD 5 billion	Years of business experience > 2 yrs AUM >= USD 500 million
Insurance	Years of business experience > 5 yrs AUM >= USD 5 billion	Years of business experience > 2 yrs AUM >= USD 500 million
Commercial	AUM >= USD 10 billion Top 100 globally in terms of total assets	Years of business experience > 10 yrs AUM >= USD 5 billion Tier-1 asset >= 1 billion
Other institutions	Years of business experience > 5 yrs AUM >= USD 5 billion	Years of business experience > 2 yrs AUM >= USD 500 million

- Investment scope for QFII expanded to include exchange traded stocks/bonds/warrants and Interbank market's fixed income instruments.
- Limits for QFII relaxed, the holding limit for all QFIIs in each individual stock has been raised to 30% from 20%, can exceed this limit given special approval related to strategic holdings.
- Application process eased by adding online documentation features, for application process details please contact us and happy to direct to our custodian department for further information.

Hedge funds are not included in the language of the regulation meaning they are neither explicitly able to or prevented from applying for a license.

China to open doors for hedge funds

As reported by Financial Times, China has indicated they will give foreign hedge funds permission to raise funds from onshore China.[11] The program, called the Qualified Domestic Limited Partner program will provide a new channel for domestic capital to flow abroad, and also an opportunity for Chinese wealthy citizens and institutions to seek alternative returns such as arbitrage and short selling strategies.

Like other reforms in China, this hedge fund reform will start cautiously. Licenses to operate in China will be issued in Shanghai only to the world's largest hedge funds with AUM over US$10 billion, and there will a limit of US$5 billion of total quota which can be raised collectively by licensed funds.

It has also been reported that hedge funds are already queuing to apply, as the US$5 billion will not be split evenly between funds but divided competitively.

Taiwan - TWSE proposed new short sell control enhancement

One 17th July 2012, the TWSE announced proposals to change the short selling rules. A new requirement is that the Stock Borrow Loan can be transferred into the client's TDCC/custodian account on the same day. The lending parties shall ask for the client's consent that the execution brokers are allowed to check and verify the SBL information as to the short sale orders they received. The lending party will be responsible for the monitoring of multiple requests to check if the aggregated number of checked requests exceeds the numbers of the real positions borrowed by the client.

If the FINI borrower defaults trade settlement with the same securities firm, or fails to repay loans/financing from the same securities firms, or fails to complete settlement on futures contract, the securities firm shall notify the FINI to liquidate its outstanding SBL transactions on the following business day, and then close the FINI's SBL trading account accordingly. If the FINI borrower fails for repay loans/financing or defaults at another securities firm, securities finance enterprises or futures commission merchant (FCM), the FINI will be suspended from SBL trading with all securities firms or securities finance companies. However, the borrower is still able to rollover existing loans, return borrowed securities or swap SBL collaterals.

[11] http://www.ft.com/intl/cms/s/0/77acb744-ca91-11e1-89be-00144feabdc0.html#axzz26FXDeeiL

Despite the traditional summer recess period, August saw activity in a number of areas that have the potential to impact the European markets generally, rather than funds directly. When the summer break concludes, negotiations will also resume on other relevant dossiers including MiFID, MAD and MAR, FTT and CRD IV.

Alternative Investment Fund Managers Directive (AIFMD)

The European Commission is expected to publish the delegated acts (implementing measures) for the AIFMD in the early autumn, based on the advice it received from the European Securities and Markets Authority (ESMA) earlier this year. From the iterations of the measures that have been seen over the past months, it seems that the Commission will be taking a strict view on a depository's liability for assets under custody. It is expected that this may impact custody services in the EU significantly.

Regulation on Short Selling and Certain Aspects of CDS (SSR)
In mid September, ESMA is due to publish a consultation paper on possible guidelines for the Short Selling Regulation, looking in particular at the market making exemption. ESMA will likely publish its final guidelines in December. The Regulation itself will enter into force on 1st November.

European Market Infrastructure Regulation (EMIR)

ESMA is expected to submit final draft technical standards for the implementation of EMIR to the European Commission by 30th September.

In addition, the Joint Committee of the European Supervisory Authorities (ESAs) formally announced a request for the postponement of the deadline for the submission to the European Commission of the 'joint draft regulatory technical standards on risk mitigation techniques for OTC derivatives contracts not cleared by a CCP', to align the European approach with the on-going global development of international standards being developed by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO), which are currently under consultation until 28th September 2012.

The EBA expects the European Commission to confirm a new date after the 30th September 2012 deadline has passed.

Resolution of Financial Market Infrastructures (FMIs)

On 1st August a consultation paper on the recovery and resolution of financial market infrastructures (FMIs) was published by the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO).

The consultation describes proposed approaches for recovery plans and resolution regimes and covers all types of FMIs (i.e. payments systems, central securities depositories, securities settlement systems, central counterparties (CCPs) and trade repositories). It builds on the CPSS-IOSCO April report on 'Principles for financial market infrastructures', which requires FMIs to have effective procedures to enable them to recover from financial stresses, as well as the Financial Stability Board's 'Key Attributes of Effective Resolution Regimes for Financial Institutions' released in November 2011. The 'key attributes' cover all systemic market participants (including payment systems, central securities depositories, securities settlement systems, central counterparties, and trade repositories) and sets out standards for the establishment of national resolution regimes and obligations regarding cross-border cooperation and coordination.

The deadline for comments is 28th September.

Technological Challenges to Market Surveillance

On 22nd August, IOSCO published a consultation report on the 'Technological Challenges to Effective Market Surveillance: Issues and Regulatory Tools', which seeks public comments on a series of proposed high-level recommendations aimed at helping Market Authorities improve market surveillance, particularly on a cross-market and cross-asset basis; and making more useful to market authorities the data collected for surveillance purposes.

Comments on the consultation report are sought by 10th October 2012. After its analysis of the public responses to this consultation report, IOSCO will issue a final report.

LIBOR/EURIBOR Rate Setting

European Parliament Questionnaire

On 20th August, the European Parliament published a questionnaire relating to the public consultation on "Market manipulation: Lessons and reform post Libor/Euribor".

The questionnaire was published by the Economic and Monetary Affairs Committee (ECON) to inform a report that Arlene McCarthy MEP is due to deliver on EU Commission proposals for amendments to the Regulation on Insider Dealing and Market Manipulation (MAR) and the Directive on Criminal Sanctions for Insider Dealing and Market Manipulation (MAD). This follows additional proposals by the European Commission to further amend the scope of the proposed market abuse legislation to ensure that the manipulation of benchmarks is subject to criminal sanctions.

Her Majesty's (HM) Treasury Discussion Paper

On 10th August, HM Treasury published a discussion paper which initiates a review of the structure and governance of LIBOR and the corresponding criminal sanctions regime. The review will look at whether participation in the setting of LIBOR should be brought into the regulatory perimeter under the Financial Services and Markets Act 2000 as a regulated activity, and whether there are any potential alternative rate-setting processes.

Stakeholders have until 7th September to submit written responses to the review. The review will aim to publish its conclusions by the end of September. Any necessary legislative changes will be considered for inclusion in the Financial Services Bill currently before Parliament or the proposed Banking Reform Bill.

Dodd-Frank Act: Extraterritorial Application

A number of regulators have written to the CFTC expressing concern at some aspects of the extraterritorial application of OTC derivatives regulation under the Dodd-Frank Act (DFA). Regulators have raised concern at the lack of an equivalence based process for transaction level requirements for swap dealers based outside of the US, and the potential requirement for non US dealers to comply with US rules. In relation to the 'substituted compliance' process, regulators have asked for further clarity as to how this assessment will be conducted.

Regulators that have written to the CFTC include the UK FSA, European Commission, Bank of Japan & Japanese Financial Services Authority. A joint letter was submitted by the Australian Securities and Investments Commission, Reserve Bank of Australia, the Monetary Authority of Singapore, the Hong Kong Monetary Authority, and the Hong Kong Securities and Futures Commission.

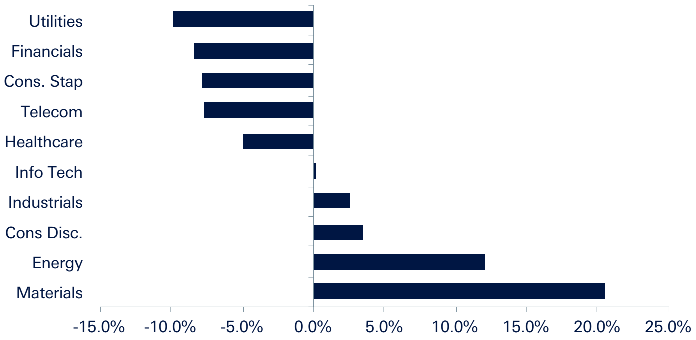
South Korea launches short position reporting regime

Beginning August 30th, investors who hold open short positions in South Korean equities in excess of 0.01% a company's outstanding shares must submit details of their short position to the Financial Supervisory Service (FSS) via their reporting portal and the Korea Exchange (KRX). Prime brokers in Asia were well prepared for this new rule as the South Korean regime largely mirrors the short reporting requirements implemented by Hong Kong in June earlier this year. The differences between the two regimes are fairly minor and include the threshold (0.01% of shares outstanding for South Korea vs 0.02% for Hong Kong) and the position monitoring methodology (reportable South Korean short positions must be continuously disclosed on a T+3 basis while reportable Hong Kong positions are reported weekly based on the investors position the final business day of the previous week). Neither regime requires the disclosure of short positions via derivative instruments. South Korea has not yet announced plans to make the data that it gathers public, while the SFC in Hong Kong plans to eventually publicize started posting aggregated short position data on its website on September 7th.

[10] Deutsche Bank Government & Regulatory Affairs Group
This is a summary of some of the themes underlying recent regulatory developments affecting hedge funds and their managers. It does not purport to be legal or regulatory advice and must not be relied on for that purpose. Deutsche Bank is not acting and does not purport to act in any way as your advisor. We therefore strongly suggest that you seek your own independent advice in relation to any legal, tax, accounting and regulatory issues relating to the merits or otherwise of the products and services discussed.

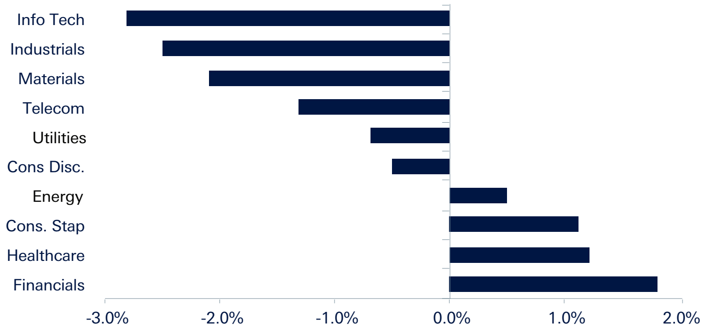
Global [5]

US % short interest sector change - August 2012



Source: Data Explorers & Deutsche Bank, September 2012

European % short interest sector change - August 2012



Source: Data Explorers & Deutsche Bank, September 2012

Global economic slowdown drives shorts in the steel industry

The global steel industry had a bumpy ride in August as represented by the price activity in the Market Vectors Steel Index Fund. While the ETF fell by just under 3% on the month, the stock closed the month of August down more than 9% from its monthly high on August 10th ($46.22). Due to the global economic slowdown, demand for steel in Europe, the US, and China has declined. In fact, the situation in China, the largest consumer of steel, is considered to be worse than the 2008-09 crises as the economy has slowed down significantly. Shares of US steel manufacturers continued to fall during the final week of August, suggesting a recent jump in domestic prices may prompt more customers to buy cheaper imported products. These price increases have not been matched internationally, creating the potential for increased imports later this year and preventing these price hikes from sticking. In Europe and China steel prices have already corrected, falling at least 10% in both markets since late April/early May 2012. Until we see industry shifts in either production curtailments or increases in demand, it will be difficult for US steel prices to continue their divergence from the rest of the market. Given the recent volatility in the overall sector, we have seen significant interest from directional funds looking to trade names like AK Steel, Arcelormittal and US Steel.

The securities lending team in Japan has been watching the steel sector closely, as poor demand conditions in China dragged iron ore prices to their 32-month lows and funds have been enquiring about the borrow situation. While the market saw close to $100 million in returns in Nippon Steel this month, we may see an increase in shorts going forward as lenders indicate interest is starting to rise again. Kobe Steel is another name to watch in the sector with the CDS widening and reported shorts starting to increase towards the end of the month.

US coal producers face pressure from shorts

Four of the largest U.S. coal producers (Alpha Natural Resources Inc., Peabody Energy Corp, Arch Coal Inc, and Walter Energy Inc.) made $20 billion of acquisitions last year to reduce their dependence on the domestic power industry. However, those deals have not worked out as planned. Prices for metallurgical coal have fallen 16% so far this year amid slowing steel output in China and Europe. That may mean the US coal industry, which has already seen the bankruptcy of Patriot Coal Corp. in July, will continue to burn through cash for another year.[6]

U.S. coal producers have been closing mines and firing workers this year as some power plants switched from coal to gas. Gas is trading close to a decade-low amid booming output from shale rock. Alpha's 70% drop in 2012 makes it the worst performer on the 29-member Stowe Global Coal Index, which lost 31% in the period. Arch Coal is down 57% and Peabody has declined 32% in the period.

Not surprisingly, three of the four names mentioned above top the list of short interest in this sector. As of the August 15th Bloomberg reported figures, Arch Coal Inc short interest was the highest with more than 46 million shares in short interest, Alpha Natural Resources was second with more than 35 million shares in short interest, and Peabody Energy Corp was in third with almost 18 million shares in short interest.

Muted activity in Europe

The French Financial Tax that came into effect on 1st August seemed to have little impact on volumes. However, continued economic unrest in the EU and uncertainty over an effective solution to the ongoing sovereign credit issues led to overall lower volumes in both execution and subsequently stock loan. In addition, short sale bans introduced in Spain and Italy towards the end of July further hampered flow.

Renewable energy in Europe continues to see demand from shorts
The renewable energy sector remained one of the most concentrated shorts in Europe with levels in Vestas Wind above 12%, short interest remains in excess of 15% of the free float with funds staying short through the recovery from the low of 25DKK at the end of July through DKK 40. The stock is still down over 35% from the peak of 2012.

Funding concerns around Japanese electronics firms

Within the consumer/office electronics space, Sharp Corp continues to be the main focus due to concerns over the financing of Y360 billion in commercial paper (due this year) and Y200 billion in outstanding convertible bonds expiring in 2013.[7] This month lenders saw significant selling from underlying funds and recalled nearly 20 million shares ($55 million) from the market. We continue to see strong demand from funds with rates now in the 15% range. Sharp also announced it may need to sell stock holdings after Foxconn said they were looking to renegotiate their investment plans in the company due to loss in market value.[8] This sparked interest in Pioneer as Sharp is their 3rd biggest shareholder. Borrow in Pioneer has been illiquid since June this year, but supply got tighter with funds showing demand in the 5% range. In light of the Japan electronics theme we also watched Panasonic closely this month. We saw about $150 million returned to lenders over the past 3 weeks, signifying there is little appetite to short at this stage.

Sustained short interest in the Japanese transport sector

The transport sector remains a focus area with demand for All Nippon Airways increasing as we approach the Japan Airlines listing on Sept. 19th.[9] Rates are holding firm in the 25% range and we do expect there is around 12 million shares worth of callable exposure in the market, which will funds will need to cover ahead of the Sept. 20th record date.

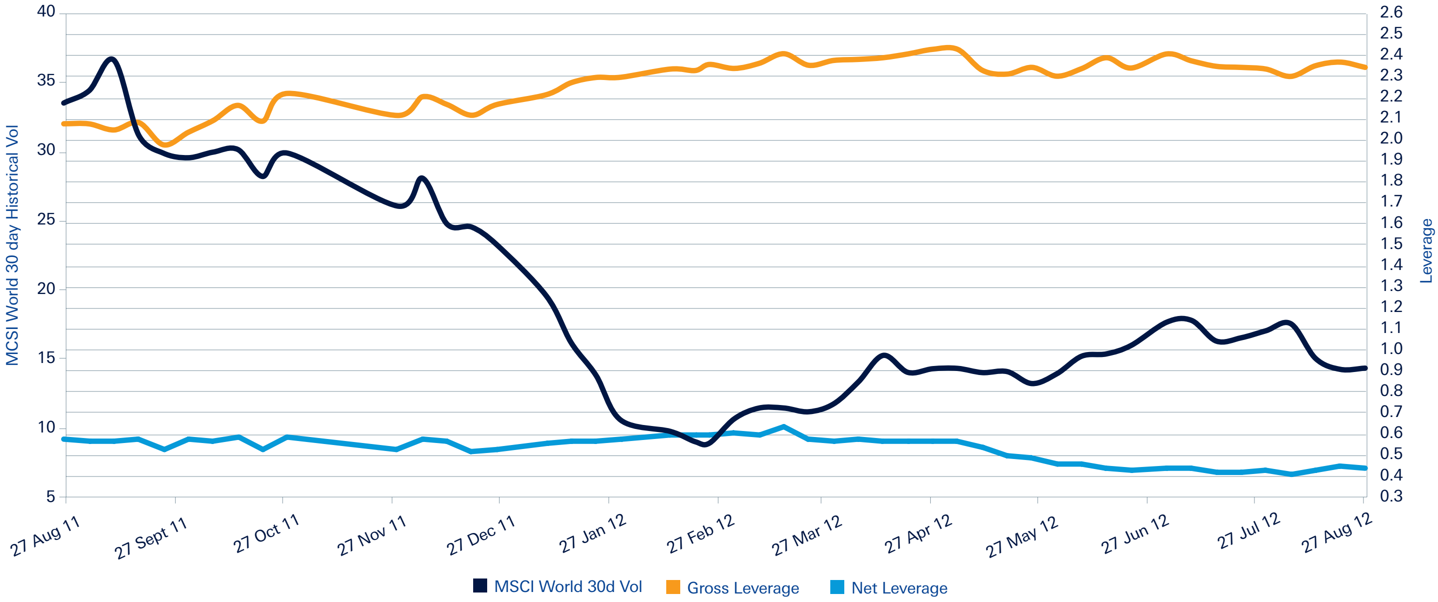
[5] This material has been produced by the Deutsche Bank Securities Lending Group and must not be regarded as research or investment advice.
[6] http://in.reuters.com/article/2012/07/09/us-patriot-bankruptcy-idINBRE86816620120709
[7] http://online.wsj.com/article/BT-CO-20120816-703704.html
[8] http://www.bloomberg.com/news/2012-08-27/foxconn-sharp-need-to-tackle-high-tax-labor-gou-says.html
[9] http://news.yahoo.com/japan-airlines-list-again-tokyo-exchange-042715218--finance.html

Marketing material - For institutional investors only

Global

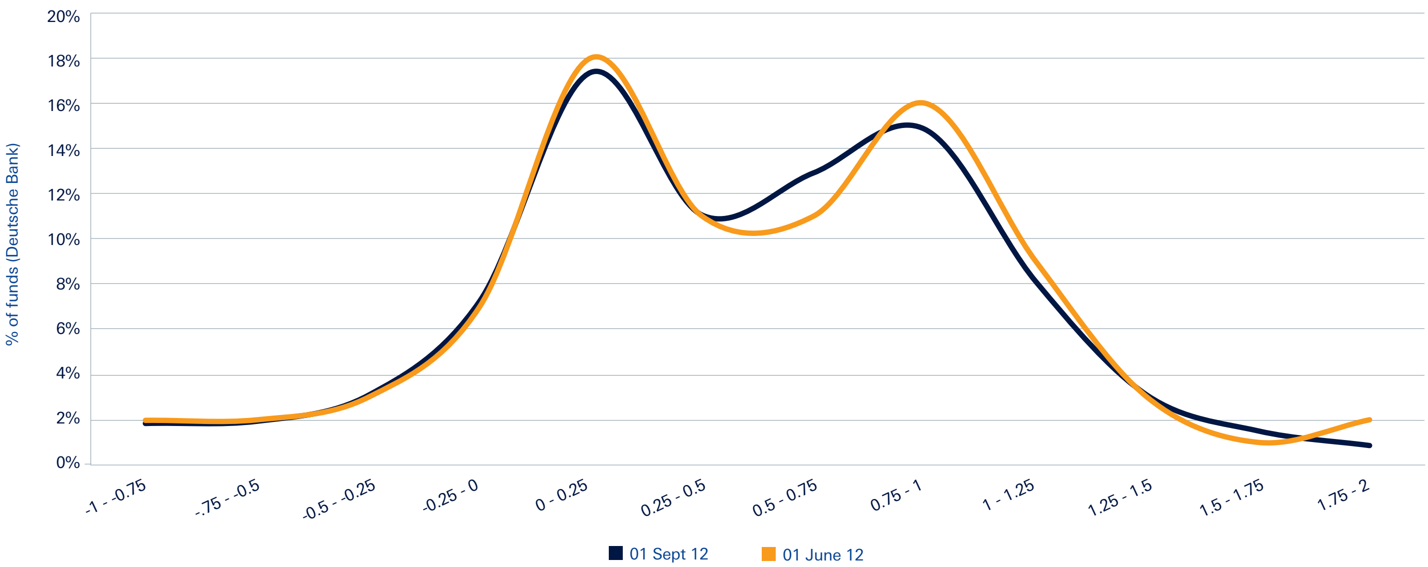
- Volatility declined sharply in August, ending the month at 14.34 – down almost 16% from the previous month. Gross exposure remained virtually unchanged at 2.35, while net exposure fell by 2.79%, ending August at 0.44.
- The percentage of funds in the 0.25 – 0.75 net equity leverage band have increased quite significantly since the beginning of June. However, the percentage of funds in the higher net equity leverage range (0.75 – 1.25) have dropped.

Global Net & Gross Equity Leverage vs. Volatility



Source: Deutsche Bank Markets Prime Finance Risk, September 2012

Global – August 2012 Quarterly change in net equity leverage distribution across funds



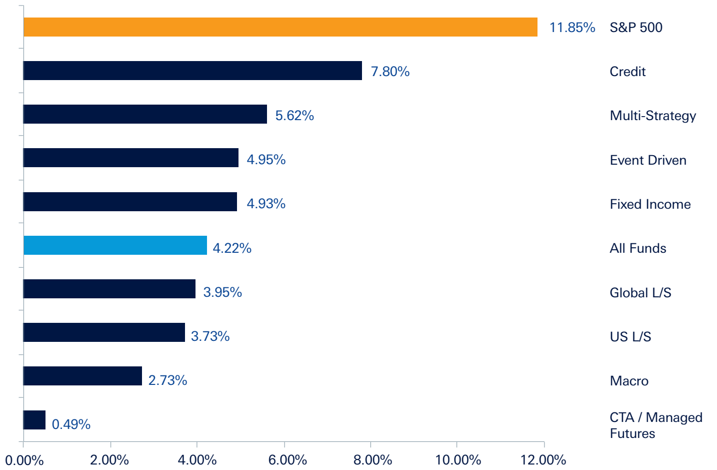
Source: Deutsche Bank Markets Prime Finance Risk, September 2012

[4] Deutsche Bank Markets Prime Finance Risk, Septmber 2012

Marketing material - For institutional investors only

Americas

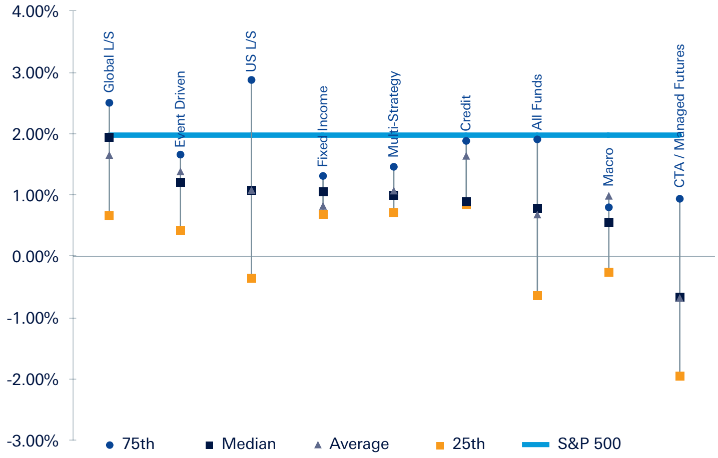
2012 Year to date median performance



Source: Hedge Fund Intelligence (HFI), September 2012

Americas

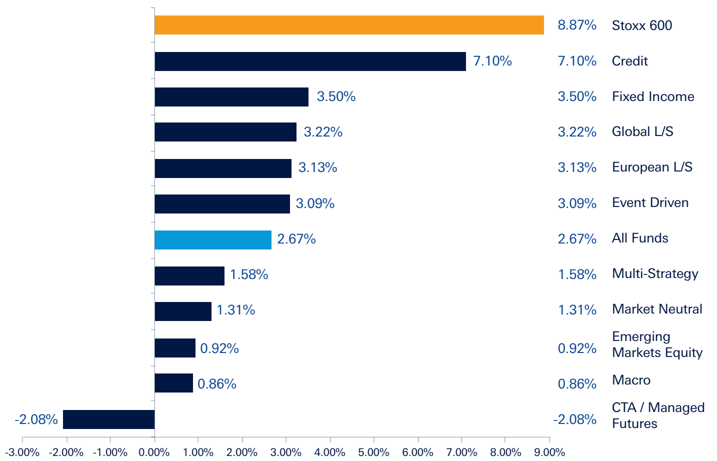
August 2012 Performance Dispersion of returns



Source: Hedge Fund Intelligence (HFI), September 2012

Europe

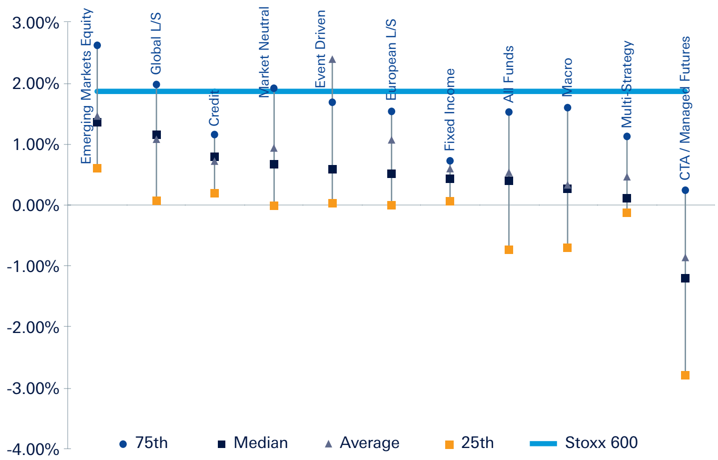
2012 year to date median performance



Source: Hedge Fund Intelligence (HFI), September 2012

Europe

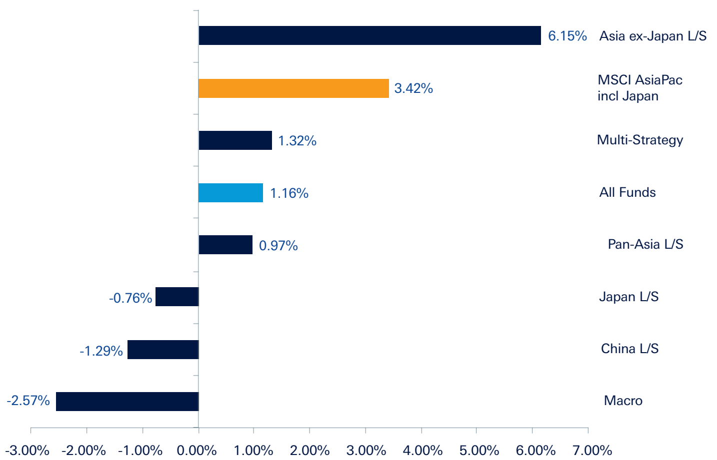
August 2012 performance dispersion of returns



Source: Hedge Fund Intelligence (HFI), September 2012

Asia

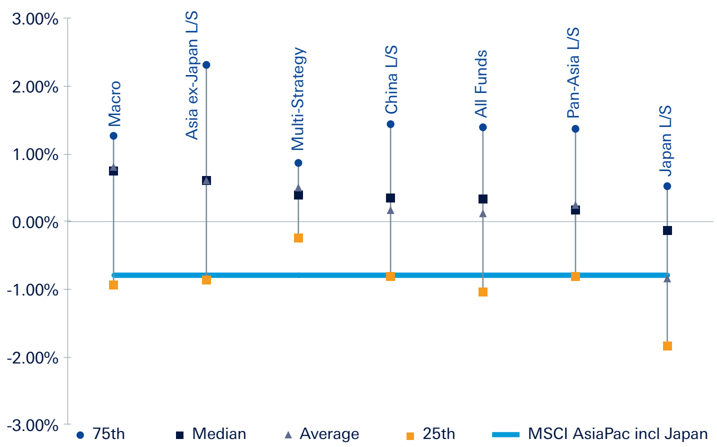
2012 year to date median performance



Source: Hedge Fund Intelligence (HFI), September 2012

Asia

August 2012 performance dispersion of returns



Source: Hedge Fund Intelligence (HFI), September 2012

Investor sentiment by region

Europe

European investors continue to be more liquidity-focused than their peers across the pond. Particularly for a number of EU family offices and fund of funds liquidity remains important and as such, a number continue to show preference for UCITS structures.

Strategy focus continues to be non-correlated managers, particularly commodity trading advisors, despite the strategy's relative underperformance this year. We have also seen expressed interested in opportunities within the structured credit universe.

Amid continued market volatility and macro uncertainty in Europe, a number of family offices and funds of funds have shifted their focus to Asia in search of new talent and strong returns, particularly in the Asian equity l/s space. As such, we have received a number of requests in the past month for our upcoming Asia Managers Forum set to take place this October in Hong Kong.

In the UK pension space, a few have taken the summer months to undergo a strategic asset allocation review with the view to implement new structures in 2013. These investors are therefore currently focused on managing their existing portfolios and assessing any gaps in their exposure. The majority are relying on external consultants to assist them in the process.

Finland

The Hedge Fund Capital Group has had several conversations with Finnish investors this month. In terms of strategies, we are seeing some investors with dry powder to put to work in the UCITS space. We are also seeing increased interest in equity l/s, despite its relative underperformance this year. Indeed, there are some managers that have had excellent performance, and as a result are standing out amongst their peers as interesting potential investments. In terms of discretionary macro, there are some concerns about performance for these funds in this highly politicised market, but Finnish investors have mentioned that they are still keen to hear about interesting managers in this space.

The Finnish pension funds still tend to favour blue-chip managers. This is partly because of the large headline risk that they face from the local press when they invest in hedge funds. That said, they are willing look at high-quality managers in the start-up space if they have a previous relationship with them. Track records are preferred, but they can be from a previous institution.

Asia

Asian based investors continue to show more interest in credit strategies, particularly on the more structured end of the spectrum as they anticipate dislocation/potential opportunities in the Asian credit markets on the back of bank's deleveraging and the lack of alternative sources of funding in the region. However, by and large, investors are open to meeting managers of any strategy as long as they are performing well.

Feedback from the private banks in the region is that asset-raising from their Asia client base into hedge fund managers continues to be slow. Asian high net worth (HNW) clients have a very low appetite for risk at the moment and are seeking yield-enhancement products, with a low risk profile that are able to give them returns slightly over bank deposit rates. Even private equity, which has traditionally been a popular investment for HNWs, is not seeing much inflow, if any. Most private banks in the region continue to be opportunistic in terms of adding managers to their approved list and working with relationship managers to educate/promote hedge funds as an asset class, but none expect to see a significant pickup in demand for the rest of 2012.

Regarding investor appetite for Asian product, we are seeing a marked increase in interest in learning about Greater China onshore managers in the past few months. As the China Securities Regulatory Commission has been active in approving new qualified foreign institutional investor (QFII) quotas for long term/end investors, a number of the investors we speak to have approached us for help in finding onshore A share/ sunshine fund managers who can help them manage their own QFII quota allocations.

US

Midwest

This month, the capital introduction team did several one-on-one meetings with allocators in Chicago and Minneapolis. Despite the usual August slow-down, allocators are still engaged and actively sourcing new managers. A few trends and common themes emerged during our discussions. First, many allocators were looking at the structured credit space. Many of these allocators commented that while the easy money has already been made in credit, there are still pockets of inefficiency, and skilled managers should be able to exploit these opportunities to generate significant alpha. Second, the funds of funds and other limited partners are making tactical reductions to their equity l/s portfolios and redeploying the monies in multi-strategy, credit l/s, and event driven. Other allocators commented that equity l/s is still a core component of their portfolio, but they are adding more market neutral managers or ones with a particular sector or geographic focus.

Our meetings with mid-sized and large funds of funds also focused on what their business development strategies were in the short and intermediate term. As they continue to see net capital outflows from their commingled vehicles, they are taking several steps to restructure their businesses. First, many are entering the consulting space and competing for the non-discretionary mandates. Despite the lower fees and higher level of client service demanded relative to their traditional mandates, funds of funds see these consulting mandates as a way to stabilize their top line. In addition, several funds of funds said that they are pressuring managers to reduce fees, so that they become "fee neutral". However, it remains to be seen if they are able to able to actually negotiate such arrangements. Funds of funds are also willing to establish funds of ones and/or separately managed accounts for key clients as a way to keep clients that no longer want to pay the higher fees of commingled vehicles.

[3] From Deutsche Bank's Hedge Fund Capital Group

Asset Allocation: Staying Constructive [1]

Investors are increasingly concerned about the sustainability of the risk rally

We became constructive in late June as our US data surprise index (MAPI) bottomed and on a reading that a new line of agreement across the Troika (IMF, ECB and EC) on dealing with the euro crisis reduced tail risk (Getting More Constructive, June 26). The S&P 500 rallied 11% since the bottom as US data surprises turned up and Draghi's "whatever it takes" promise reduced euro stress. Investors are increasingly concerned about the sustainability of the rally. Many have argued that equities have gotten ahead of the data and are ignoring significant risks.

We stay constructive on the expected up cycle in US data surprises and data

The bulk of the rally so far has been driven by a decline in euro stress. But a turn in the MAPI preceded the decline in euro stress (Euro financials CDS) and the two have been closely correlated since. Our view remains that a turn in US data surprises was necessary for a bottom in risk assets and euro policy actions by themselves would have had less of an impact (Still Early, June 10).

We stay constructive here as:

- US data surprises and data are becoming more important in driving the S&P 500 as indicated by rising correlations. The correlation with euro stress on the other hand is near a 3yr peak and likely to come down;
- Both US data surprises and data should turn up. MAPI has rebounded from the bottom of its band since late June to the middle, near zero. A typical cycle would see MAPI rise to the top of its band. This positive phase of the data surprise cycle has over the last few years also been associated with a turn up in our composite index of the actual data;
- Macro data are a key driver of inflows into risk assets. Flows have been moving down the risk spectrum and should come to equities as the macro data turns up. Equity flows typically follow consumer confidence which should rise with improving data. The hurdle rate for equity inflows is low, with flows 96% of the time when VIX<24;
- The strength of the rally so far bodes well for the next leg. From a duration standpoint we are at a point where equities typically pull back (65d without a 5% drawdown). But stronger rallies, which surpass previous highs, tend to keep going: 10% incremental upside on average before the next 5% pullback.

Can risk assets rally in the face of so many risks?

Our view has been that better US data was a necessary condition for equities to rally, but the risks also need to remain in check for the rally to be sustained.

In our view:

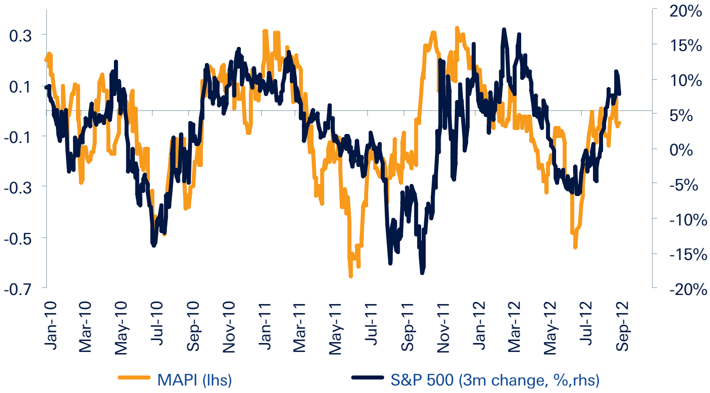
- Euro tail risk has receded. The outline of a framework for integration is falling into place and slow progress should continue;
- Lower EM inflation allows policy easing and limits the potential for a hard landing. EM growth is still soft but data is surprising positively; medium-term, EM is in for a protracted period of below trend growth;
- US elections are typically positive for equities. S&P 500 rallies 2.3% on average after elections and more so after close ones (5%) such as the present one; with the House staying in Republican control, 75% probability of an increased Republican mandate, either through the Senate or the Presidency, should be positive for equities (2012 US Elections, Sep 4);
- Fiscal drag not cliff. We see an agreement eventually being reached on areas with common support that reduces the extent of the fiscal drag relative to the CBO's scoring (1.5% versus 3.2% of GDP);
- Global earnings set to resume growth. We see trend-like growth of 6% as top-line continues to track nominal GDP and margins remain flat in the US and bottom in Europe/EM (Global Earnings Pause or Stall, Aug 3);
- Positioning in risk assets is still supportive. Macro hedge funds are still short, while LS equity funds are underweight and MFs and hybrid funds neutral.

[1] Deutsche Bank – Markets Research: Strategy; "Asset Allocation: Staying Constructive" 5th September 2012. http://pull.db-gmresearch.com/cgi-bin/pull/DocPull/3271-DECA/79041654/Asset_Allocation.pdf

[2] Deutsche Bank – Global Markets Research: Fixed Income; "LT Asset Return Study: A Journey into the Unknown" 3rd September 2012. http://pull.db-gmresearch.com/cgi-bin/pull/DocPull/760-57F9/76174012/GDPBD00000221625.pdf

Equities explained by the macro data, surprises and euro stress

The S&P 500 rallied as our macro data surprise index (MAPI) bottomed in late June and rebounded sharply back to neutral



Source: Bloomberg Finance LP, Deutsche Bank

LT Asset Return Study: A Journey into the Unknown [2]

This is the latest in our series of long-term asset price studies extending at DB back to 2005 and follows up 2010's "From the Golden to the Grey Age" and 2011's "A Roadmap for the Grey Age".

The title and picture refer to the fact that while economic history has been great in so far helping us understand the recent state of the world, many variables are now outside of any previous historical observations, even if we extend the analysis back hundreds of years. For example Dutch yields (our longest bond series but a similar story to many others) have been at all time lows in 2012 with our data stretching back 495-years, and UK base rates (our longest series at the front end) are currently a full 1.5% below the lowest they've been in the BoE's 318 year history. Incidentally the BoE's balance sheet relative to GDP has in 2012 rocketed past the previous record size with data stretching back to 1830.

It's also easy to forget that persistent Govt. deficits are a modern day phenomena and that balanced budgets were usually the norm outside of wars and crises. Since the final global currency link to gold collapsed in August 1971, we have generally seen 40 years of structural deficits across most the DW. Indeed the US has only had 4 surpluses (1998-2001) in 44 years. This would have been impossible under a Gold standard. Indeed did the global financial crisis (GFC) have its origins in 1971?

Elsewhere in the report we show:

- That Germany has been the strongest currency of its international DM peers over the last 80 years after the scars of the Weimar Republic.
- The evidence so far in our shorter cycle theory first introduced in these pages 2 years ago.
- How 5 years on from the start of the GFC we have seen no real growth or deleveraging in the DW.
- How European equities are cheap but only if Europe stays together.
- How US returns will likely be subdued for many years to come, especially in real terms.
- A big debate about Gold and the Gold Standard. Gold is now close to 600 year real adjusted highs, having been close to 800 year real lows before the global currency link to Gold collapsed in 1971. Has there been a paradigm shift in a world of fiat currencies or will the price or inflation eventually help it mean revert?
- To return to the Gold Standard today would be disastrous but over the next few years there will likely be increasing debate over its future potential comeback after the excesses of the last 4 decades.

In conclusion with so many important variables outside of their historical parameters with data stretching back hundreds of years, can we really say with any confidence how this current economic environment will end? The confidence levels in predicting the future must surely be at fairly low levels. As a minimum it perhaps shows how much stress there still is across the globe. We should perhaps give credit to the authorities in so far avoiding a catastrophic economic outcome. However our fate remains in their hands and their job is as challenging now as it was 5 years ago.