Asset Management Partners

Investment Outlook for the fourth quarter of 2011

▪ Global macroeconomic outlook

Global **economic growth** has **slowed down** even **further** since the second quarter. The development of various indicators over the summer months has led to the downward revision of growth expectations for 2011/12 and triggered **mounting fears of recession**.

For the time being, **neither the global nor the US economy** is likely **to relapse into recession**, even though the **risk of such a scenario** has **risen**. Different initial macroeconomic positions (debt) are likely to increase regional disparities within Europe and the emerging markets.

With mounting fears of a domino effect and various open questions about the **stability of the banking sector**, the **European debt crisis** has reached a **new dimension**. This is likely to hamper growth rates in several (southern) European countries.

The **emerging markets** are heading for a **soft landing**. The potential risk of overheating has, in many cases, been significantly reduced and growth rates should return to much more sustainable levels. **Domestic demand** remains **resilient** and is **a key driver of growth**.

▪ Traditional investments

- Currencies Anticipated trading range for USD/CHF: 0.85 – 0.95 and for EUR/CHF: 1.20 – 1.30.

- Bonds We favor corporate bonds over government bonds with short maturities, complementing them with convertible and emerging market bonds denominated in local currencies. Yields in the developed economies remain at unattractive levels.

- Equities Macroeconomic and political factors such as the debt crisis in Europe and fixing the debt ceiling in the United States have been dominating the equity markets. Investors have been paying scant attention to positive corporate news (solid balance sheets; high free cash flow (FCF)) despite attractive valuations and positive earnings momentum. Having previously reduced equity exposure, current valuations suggest gradually increasing it again.

▪ Listed alternative investments

- Private equity Operational performance intact, although market ratios likely to temporarily affect valuations and deal volume. High beta characteristics call for prudence.

- Infrastructure Predictable, relatively stable development plus inflation-linked tariffs are positive.

- Commodities Contrasting trends: flight to safety (gold) versus fears of a relapse into recession with a massive impact on prices. We see only limited upside potential in the short term.

Market data

GDP Growth %	Country	2010	2011E	2012E
Industrialized Countries	USA	3.0	1.7	2.3
	JPN	4.0	-0.4	2.9
	EMU	1.7	1.7	1.0
	UK	1.4	1.2	1.8
	Switzerland	2.6	2.0	1.4
Emerging countries	China	10.3	9.0	8.7
	India	8.5	7.6	7.9
	Brazil	7.5	3.6	3.8

Exchange rates	30.09.11	% -1 M	% -3 M	% YTD
USD/CHF	0.9082	12.68	8.07	-2.89
EUR/CHF	1.21565	4.93	-0.26	-2.80
GBP/CHF	1.4151	8.06	4.89	-3.06
USD/JPN	1.1784	12.10	12.96	2.27

3 month Libor	30.09.11	-1 M Bp	-3 M Bp	YTD Bp
CHF	0.02	1.8	-15.2	-14.7
USD	0.37	4.7	12.9	7.2
EUR	1.50	1.1	0.4	55.6

Government (10y)	30.09.11	-1 M Bp	-3 M Bp	YTD Bp
CHF	0.92	-17.3	-77.9	-79.8
USD	1.92	-30.8	-124.5	-137.8
EUR	1.89	-33.2	-113.8	-107.6

Stock market	30.09.11	% -1 M	% -3 M	% YTD
SMI	5531.74	0.06	-10.59	-14.05
S&P 500	1131.42	-7.18	-14.33	-10.04
Nikkei	8700.29	-2.85	-11.37	-14.94
FTSE-100	5128.48	-4.93	-13.74	-13.08
DJ EURO-STOXX 50	2179.66	-5.32	-23.48	-21.95

Commodities	30.09.11	% -1 M	% -3 M	% YTD
Gold oz/USD	1623.97	-11.04	8.22	14.30
Oil (WTI)	79.2	-10.91	-17.00	-13.33
Copper (Spot)	6998	-24.41	-25.66	-27.48

Sources: Bloomberg M.St, GS, UBS, DB, Barclays, BofAML, JPM, 09/2011

Editorial

Having gone through the collapse of Lehman Brothers and the ensuing recession, the financial markets are again wrestling with a crisis of confidence. Misgivings about the policies and institutions as a result of the high debt burdens on both sides of the Atlantic as well as the European Union's lack of credibility have impacted economic development surprisingly quickly. It is now understood, however, that if the European crisis drags out further it could have drastic consequences.

The central banks' traditional and unconventional monetary recipes should revive the stuttering economy. But the easing of monetary policy has not achieved what it was supposed to achieve and there are doubts as to whether taking additional measures will kickstart the real economy. The central banks are currently buying up government bonds, but this rightly has its skeptics.

The recent IMF meeting and the calls to stabilize the financial system – also with regard to the capitalization of the banks – have so far had the desired effect.

As we assume that it should be possible to mitigate the risks mentioned above and we continue to assume that there will be no relapse into recession, the corporate sector, which is in solid shape, should soon regain the spotlight. Equity investments have become riskier, but if the situation eases they should hold some upside potential.

In our special topic, we look at what opportunities and risks the Swiss stock market holds against the background of the temporarily exceptionally strong Swiss franc.

Your Asset Management Partners Team

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Macroeconomic environment

(Situation in Switzerland, see also special topic on page 4)

For time being, relapse into recession unlikely

Declining growth rates, high public debt and fiscal restrictions as well as systemically relevant member states possibly getting caught up in the European debt crisis give little cause for optimism. However, it is important to note here that we do not support the very gloomy scenarios which, temporarily at least, have become dominant and led to the gold price overshooting and to record highs for the Swiss franc against the euro and the US dollar.

We continue to assume moderate economic growth rates and do consequently not expect a backdrop into recession. Going forward global economic development should in our view with a high probability exhibit the following characteristics:

- ***below average growth rates***
- ***no signs of an abrupt halt to the cycle***
- ***protracted period of public debt reduction***

The “new normal", which was originally expected for the United States, is generally likely to become the future scenario for the developed world. The "new normal state" means lower growth, lower consumption, higher unemployment and higher private savings rates. Underlying this is the assumption that the economy in the wake of the crisis of 2008/09 does not return to its previous growth path, but instead has persistently lower trend growth.

Slowdown in growth for 2011/12 – instead of economic acceleration

Looking back at the path the economy has taken this year, it is clear that the expected «acceleration in economic growth» has not happened. Quite the opposite: the risks of the economy deteriorating further down the road are very real, though, as stated earlier, we do not expect a relapse into recession. In mid-September, the International Monetary Fund (IMF) revised its growth forecast for the world economy for 2011 and 2012 down to 4.0% (from 4.3% and 4.5% respectively), while it cut its forecast for US growth for 2011 from 2.5% to 1.5%.

Lower growth expectations for 2011/12

% YoY	2011		2012	
	Currently	June 11	Currently	June 11
World	**4.0**	4.3	**4.0**	4.5
Industrial countries	**1.6**	2.2	**1.9**	2.6
USA	**1.5**	2.5	**1.8**	2.7
Japan	**-0.5**	-0.7	**2.3**	2.9
Euro area	**1.6**	2.0	**1.1**	1.7
Great Britain	**1.1**	1.5	**1.6**	2.3
Emerging countries	**6.4**	6.6	**6.1**	6.4
China	**9.5**	9.6	**9.0**	9.5
Brazil	**3.8**	4.1	**3.6**	3.6
Russia	**4.3**	4.8	**4.1**	4.5
India	**7.8**	8.2	**7.5**	7.8

Source: IMF, September 2011

Macroeconomic focus in post-crisis environment*: United States: Temporary or permanent slowdown in growth?* Special effects following the earthquake in Japan and the sharp rise in oil prices at the beginning of the year have accounted for a significant part of the reduction in growth rates in 2011. The prospect of normalization in Libya has already led to a decline in the premium in the oil price, while the logistic bottlenecks for Japanese manufactures have been overcome. However, the political debate about lifting the US debt ceiling and the sluggish labor market have weakened confidence.

Controversial situation and signals: In the United States, the breadth of the stimulus package presented by the Obama administration, targeting increased spending on infrastructure and the growth of the labor market, surprised the markets. The very same America, having had its credit rating downgraded, then passed a fiscal program that sets a debt ceiling equivalent to 1.5% of gross domestic product (GDP). The measures above, if implemented, would, on the other hand, generate a stimulus equivalent to 0.5% of GDP (source: GS estimate).

Stabilization? Key indicators such as the ISM (still >50) and the capacity utilization suggest the economy is stabilizing [ISM data for manufacturing (non-manufacturing) - June: 55.3 (53.3); July: 50.9 (52.7); August: 50.6 (53.3). Capacity utilization – July: 77.6% (June: 76.7%)]. The revised growth expectations allow room for positive surprises in the coming months.

Debt crisis in the euro zone: Relief or continued tension? The European countries' different debt burdens will impact growth momentum significantly in the future, widening disparities within the euro zone. A prolonged, recessionary phase will be difficult to prevent in certain southern European countries. The risk of contagion across Europe has increased, but so far the politicians have failed to come up with a solution that inspires confidence and engenders a turnaround. The financial interdependence of countries and banks suggests that there will be no break-up of the euro zone. A deepening of the crisis since the summer is likely to lead to more political involvement.

Emerging markets: End of the interest rate cycle and more moderate inflation rates in sight? Inflation seems to have peaked, while the interest rate cycle in a majority of regions is expected to slowdown. Brazil, for example, surprised by cutting rates by 0.5% to 12.0%. At roughly the same time, India raised its rates by 0.25% to 7.25%. This demonstrates how different the countries' positions are. We expect China, which is crucial for the world's economy, to have a soft landing. Thus, for the time being, the risk of overheating seems to have abated.

Conclusions

Under our investment scenario for the fourth quarter, we do not expect any sudden economic setbacks. The focus is currently on public debt and the stability of the banking sector. In the euro zone, there is movement on the political front, but progress is taking time. Increased clarity should bring positive effects for consumer sentiment and business investment (CAPEX cycle).

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Traditional investments

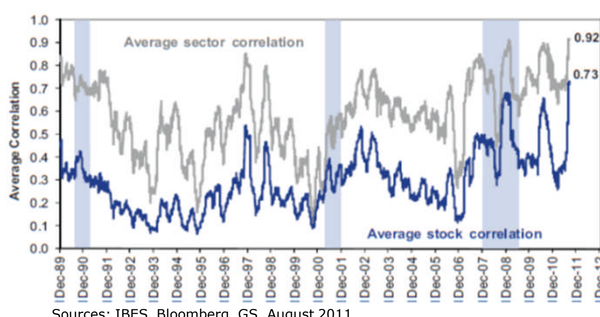
Bonds: Continuing low rate environment

In Switzerland, in connection with the appreciation of the Swiss franc, the Swiss National Bank (SNB) has fixed a target range for the 3-month Libor rate of 0.00%-0.25% and is targeting a Libor rate close to 0%. The US Federal Reserve confirmed that it would be maintaining its low interest rate policy (key federal funds rate: 0.25%) through to mid-2013. In Europe, the European Central Bank (ECB) brought its low interest rate policy, which it had pursued since May 2009, to an end, raising rates twice by 0.25%. It is unlikely to move on interest rates further given the current developments. At 2.6-2.8%, the inflation rate continues to persist above the target level of 2.0%, though the economic development in southern Europe and the slowdown in growth suggest that the low interest rate environment will last for some time. The European debt crisis has caused government bond yields to slide to historical lows. The yield on German bunds currently stands at 1.89% (52-week low: 1.68%; 52-week high: 3.49%), on 10-year Swiss government bonds at 0.92% (0.85%; 2.13%) and on 10-year US Treasuries at 1.92% (1.77%; 3.74%). Disappointing economic indicators, coupled with the flight to safety, have seen yields on government bonds (D, CH, USA) fall sharply.

Equities: Volatile markets and marked differences in performance

Political wrangling in the United States about raising the debt ceiling, the European debt crisis and rising fears of contagion spreading to the European banking sector, together with mounting fears of recession, resulted in significantly higher market volatility. Various indices plunged to new year lows. The high sector and stock correlation gives some indication of the panic-like, very unspecific selling.

Sector and stock correlation



Sources: IBES, Bloomberg, GS, August 2011

Looking ahead: Opportunities and risks

We expect market volatility to remain high and politics to continue to significantly dominate the markets. Mounting fears of recession (probability of relapse into recession <50%) contrast with strong indications of resilient fundamental data. Comparing the positive and negative factors, we get the following result:

Positive: 1) largely solid corporate balance sheets; 2) household deleveraging in the USA; 3) lower price pressure on major input factors; 4) high margins coupled to; 5) moderate company valuations and attractive dividends; and, finally and importantly, 6) firms have so far seen no sudden slump in sales, despite slowing growth momentum.

Negative: 1) the unsolved debt problem in Europe; 2) rising risk of a recession (>50%); 3) break in trend GDP growth rates in the developed world with negative consequences for corporate earnings momentum; 4) the banks' high recapitalization needs; as well as 5) rising risk of a growing tax burden (e.g. Robin Hood tax) and regulations. Furthermore, central banks are likely to come under increasing political pressure, which will affect their independence.

Conclusions: As soon as the politicians in Europe come up with a solution to the debt problem, then sentiment for equities is likely to improve on the back of resilient fundamental data as well as a lack of investment alternatives.

Listed alternative investments

Listed private equity: Operational performance seems to be still intact. Exit volumes have increased further; market conditions permitting, further exits can be expected to follow. Exits (IPOs, M&As) have typically been achieved above net asset value (NAV), which gives an indication of how conservative the valuations are. However, equity markets are now trading much lower, impacting private equity investments at least in the short term and temporarily offsetting operational gains.

Listed private infrastructure: Dividend yields looking increasingly attractive (sector: 6.0%): The prevailing economic uncertainties, together with rising inflation, favor this investment class due to a more stable income profile, on the one hand, and the fact that various sectors enjoy inflation-linked tariffs, on the other. If interest rates remain low, this should have a positive effect on individual sectors. Cyclical themes (e.g. ports, airports and toll roads), however, should be avoided for the moment.

Commodities: Flight to safety fuels gold price

Precious metals: The prevailing market uncertainty has sent the price of gold soaring, reinforcing its role as a flight currency. Once the financial markets start to calm down and confidence returns, the price should fall back; strengthening of the US dollar would also drive the gold price lower. ***Industrial metals:*** Fears of recession have sent industrial metal prices sharply lower still. The downward price trend is likely to continue as long as GDP figures keep being revised downwards. China's economic development and its significant demand for industrial metals will shape the price going forward. ***Energy:*** Energy prices were overshooting at the beginning of the year, but as the situation in Libya has gradually calmed down the premium has declined. Robust demand for the major energy sources should cause only moderate price pressure in the coming months. Continuing contrasting price trends for ***agricultural commodities*** is likely to lead to price consolidation.

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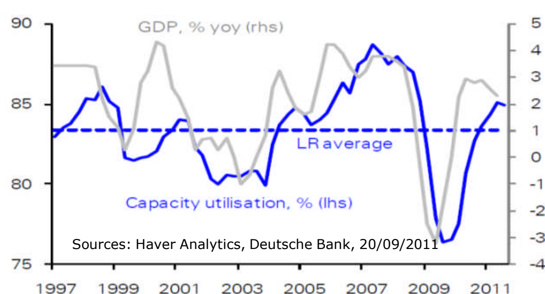
Special topic: Outlook for Swiss equities following recent currency dislocation

SMI with upside potential after currency turmoil

Macroeconomic uncertainty

The global economy is forecast to grow by 4.0% in 2011/12, but, as mentioned earlier, the chance of this figure being revised downwards is rising. The Swiss economy is expected to grow by around 2.1-2.3% on average (KOF: 2.8%; 1.5%) in 2011/12, albeit with declining momentum. Thus, the outlook for growth in Switzerland is weaker than for the United States (2.3%). A recession has probably been averted after the SNB's intervention, which so far has proved successful. High capacity utilization confirms the continued firmness of the economy.

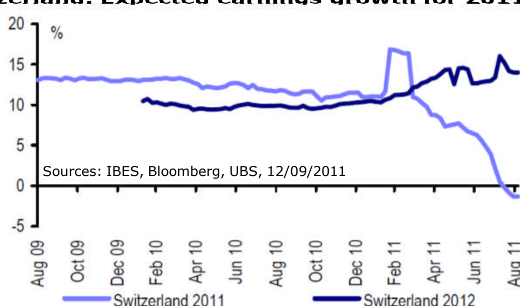
Capacity utilization lies above long-run average



Currency-related break in 2011 earnings momentum

At the beginning of this year, earnings expectations for Swiss equities for 2011 were around the 12-15% mark. After having been revised downwards several times in the meantime, earnings expectations are now for -1.0%. In Europe, forecasted earnings growth has moderated to 8.0%, down from 16.0% originally. Switzerland's different earnings trend for 11/12 compared to the rest of Europe is basically down due to recent exchange rate developments.

Switzerland: Expected earnings growth for 2011/12



Forecasted earnings growth for 2011, shown above, have been revised downwards a number of times since the publication of the half-yearly results and due to foreign exchange rate developments. Forecasted sales and earnings are currently based largely on spot prices close to the Swiss franc's record high. The SNB's intervention in September, if it proves sustainable, is likely to ease the situation. Average exchange rates give some idea of the degree of dislocation: H1-10: CHF-USD (EUR): 1.07 (1.44); H2-10: 1.00 (1.33); H2-11: 0.87 (1.27) versus August: 0.78 (1.12).

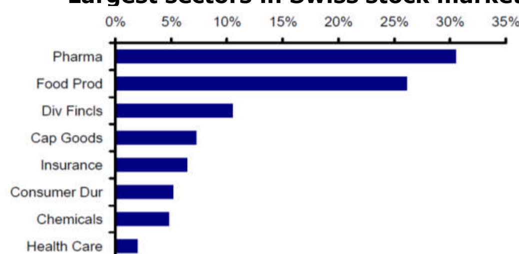
Reasons for the Swiss franc's strength

The Swiss franc's status as a «safe haven» in uncertain times alongside gold is not an abstract concept. A balanced budget since 2006 – which, according to the OECD, can also be expected for 2011/12 – and a trade surplus of around 15% have been the prerequisites for this status along with low unemployment. Furthermore, Switzerland is the only country out of the G7 nations whose GDP is higher than during the financial crisis, thanks to growth in exports of 8.0% between the third quarter of 2009 and the first half of 2011.

SMI characterized by defensive properties

The SNB's move of setting a floor for the EUR-CHF exchange rate at 1.20, together with the defensive properties of the Swiss stock market characteristics, should increasingly become supportive, with the SMI outperforming more cyclical indices like e.g. the Dax.

Largest sectors in Swiss stock market



Sources: Thomson Datastream, UBS, 12 09/2011

Valuations seem moderate

Based on current earnings expectations for 2011, the SMI is trading at a price/earnings (P/E) ratio of 10x. Thus, it is trading at the lower end of its long-term P/E range of 10-16x and its average of 13x. Companies with high sensitivity to GDP as well as sectors with increased regulatory risk, such as banking, are primarily at risk of further earnings downgrades. Should the recent weakening of the Swiss franc prove sustainable, the earnings trajectory for export-oriented companies is likely to get a further fillip and the premium at which the sector is currently trading will be quickly reduced.

Overshooting of SMI opens up opportunities

Analysis shows that the index has outperformed the forecasted changes in expected earnings almost twice over. The performance of the index this year reaffirms this pattern and shows the upward potential that the SMI has. As regards investment decisions, we are currently paying particular attention to cyclical and currency sensitivity as well as the geographical breakdown of sales. Thus, companies with a high proportion of sales in the euro area (e.g. medical technology, suppliers to the automobile industry) currently have a higher risk. The globally-oriented SMI blue-chips hold more upside potential, thanks in some cases to high dividend yields.

Baar-Zug, September 2011

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