



## Investment Outlook - First quarter of 2012

### Global macroeconomic outlook

Global economic growth slowed down further in the second half of 2011 amid increased economic uncertainty. However, the global economy is unlikely to relapse into recession in 2012.

**United States:** Key leading macroeconomic indicators have been remarkably robust in recent weeks and indicate continued, but sluggish economic growth (the "new normal").

**Europe:** Various Peripheral European countries are likely to relapse into prolonged recession, with the risk of contagion to core European countries rising.

**Switzerland:** The strong Swiss franc and the strong dependence of key sectors on exports – especially to Europe – hold risks, should there be an unexpectedly sudden downturn in growth in the wake of turbulence in Europe.

**Emerging markets:** Central banks in the emerging markets beginning to loosen their restrictive monetary policy. In China, for instance, the central bank cut the minimum reserve requirement for commercial banks. Domestic demand should hold up and contribute significantly to the expected growth.

### Traditional investments

- **Currencies** Anticipated trading range for USD/CHF: 0.90 – 1.00 and for EUR/CHF: 1.20 – 1.30.
- **Bonds** We continue to favor corporate bonds over government bonds and are sticking to short maturities. Yields are low and have likely reached a turning-point.
- **Equities** High dividend yields and historically attractive valuations suggest investing in equities despite high stock market volatility. The return of investor confidence should see fundamental factors move onto the investors' radar.

### Listed alternative investments

- **Private equity** Share prices have already discounted a sharp contraction in net asset value (NAV), which seems somewhat overdone. Balance sheets are more solid and as such the situation is very different to that in 2008/09.
- **Infrastructure** Should hold up well again this year on account of defensive characteristics – high predictability, stable earnings trend and inflation-linked tariffs.
- **Commodities** Balance sheet contraction in the banking sector and fears of recession have weighed on commodities and offer little price potential. The focus for the time being is likely to be on less cyclical commodities.

## Market data

GDP Growth %	Country	2011E	2012E	2013E
Industrialized Countries	USA	1.8	2.0	2.4
	JPN	-0.3	1.9	1.5
	EMU	1.5	-0.6	0.9
	UK	0.9	0.6	2.0
	Switzerland	1.9	0.4	1.3
Emerging countries	China	9.1	8.3	8.6
	India	7.1	7.2	7.8
	Brazil	3.1	3.4	4.1
Exchange rates	31.12.11	% -1 M	% -6 M	% YTD
USD/CHF	0.9381	2.65	10.41	0.31
EUR/CHF	1.21679	-0.91	-0.16	-2.71
GBP/CHF	1.4589	1.71	7.53	-0.05
JPN/CHF	1.221	3.64	14.56	5.97
3 month Libor	31.12.11	-1 M Bp	-6 M Bp	YTD Bp
CHF	0.05	0.0	-12.3	-11.8
USD	0.58	5.2	33.5	27.8
EUR	1.29	-11.5	-19.9	35.3
Government (10y)	31.12.11	-1 M Bp	-6 M Bp	YTD Bp
CHF Eidgenossen	0.74	-22.6	-106.6	-104.1
USD Treasury	1.88	-19.2	-128.4	-141.7
EUR Bund	1.82	-45.1	-119.6	-113.4
Stock market	31.12.11	% -1 M	% -6 M	% YTD
SMI	5936.23	3.80	-4.83	-7.77
S&P 500	1257.6	1.07	-6.13	0.00
Nikkei	8455.35	-2.18	-14.32	-17.34
FTSE-100	5572.28	0.36	-6.97	-5.55
DJ EURO-STOXX 50	2316.55	-1.11	-19.44	-17.05
Commodities	31.12.11	% -1 M	% -6 M	% YTD
Gold oz/USD	1563.7	-10.46	4.22	10.06
Oil (WTI)	98.83	-1.52	3.57	8.15
Copper (Spot)	7590	-3.43	-19.38	-21.35
Nickel (Spot)	18724	7.04	-19.97	-24.22

Sources: Bloomberg M.St, GS, UBS, DB, Barclays, BofAML, JPM, 12/2011

## Editorial

The debt crisis on both sides of the Atlantic has shaken the confidence of investors in politics and institutions. Individual countries have had urgent debt reduction basically forced upon them by capital markets. Valuations for various asset classes already reflect an, in part, extreme scenario for the eurozone.

Europe and the USA face a long period of debt reduction. Drastic austerity measures and structural reforms are likely to affect economic growth and also dominate the forthcoming presidential elections in the United States.

Meanwhile in Europe, fiscal union is becoming an increasingly realistic possibility. This, however, is likely to take time. In addition, stricter capital adequacy requirements for banks will increase the risk of a credit crunch, which will again affect the economy. In our special topic, we look at possible scenarios for the future development of the eurozone as well as at the new characteristics of the financial markets.

Last year saw the risk-return profile change in all asset classes and the credibility of the concept of the so-called "riskfree rate of interest" increasingly challenged. Despite the ongoing risks, equities still remain interesting. Companies' solid balance sheets and strong earnings momentum remain key investment criteria. For the time being, politicians are likely to be the biggest threat to the markets.

*Your Asset Management Partners Team*



## Macroeconomic environment

### Gloomy outlook for 2012

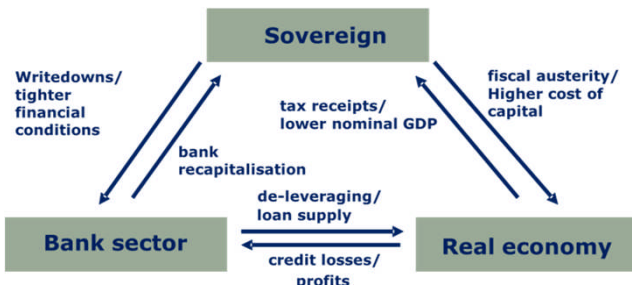
At the current time, it is very difficult to gauge how the global economy will develop over the course of 2012. High national debt levels together with the reluctance of institutions and policymakers to embrace necessary austerity measures are likely to continue dominating the financial markets. Certain eurozone government bonds as well as bonds issued by some banks have lost the trust of many investors. The concept of the risk-free rate of interest for government bonds has lost some of its credibility. Drastic fiscal austerity measures in Europe and the United States have become unavoidable and could weaken economic growth.

- **Political uncertainty is dominating the markets**
- **Increased risk of recession in Europe's core**
- **Protracted period of public debt reduction**

### Need to break the negative feedback loop

The schematic below of the European debt crisis illustrates the substantial "negative" feedback loop between the key players. It is now a question of combining efforts at the European level to break this negative spiral. There is no alternative. It is necessary, moreover, to avoid global contagion at all cost, as the economic fall-out would be fatal.

Schematic of Europe's debt spiral



Sources: Partners Group, JP Morgan, GS, December 2011

### Possible scenarios

We have identified three possible scenarios to address debt concerns: 1) the break-up of the eurozone, 2) drastic austerity measures or 3) stagnation followed by reflation, which would see the European Central Bank (ECB) increase the money supply to facilitate the purchase of additional government bonds. For details on this, see our special topic on page 4.

- **Europe's monetary union is likely to survive**
- **Real asset price inflation in the long run**

### Global economic slowdown

The global economy is unlikely to relapse into recession in 2012. It is forecast to grow at 3.2% (2011E: 3.7%). The emerging markets, which are forecast to grow by 5.5% in 2012 (2011: 6.3%), should again contribute significantly to world GDP in 2012. The developed world is expected to grow by 1.2% (2011: 1.4%); growth should accelerate from mid-year.

**Eurozone remains problem-zone** Continuing uncertainty in Europe will cause economic growth to slow down for the time being. Many EU countries have only just started to implement austerity cuts and reforms. The ECB when it reduced rates in December by a further 0.25% to 1.0% and purchased government bonds (from Italy, Spain) possibly averted an escalation and created some breathing space. The risk of recession in core Europe is rising, while the peripheral countries of Southern Europe are presumably already in a recession.

### Switzerland: In the wake of Europe's turbulence:

The Swiss economy lost some of its momentum on the back of the continued strength of the Swiss franc in the third quarter, with exports (-1.2%) declining for the first time in three years. The big Swiss banks are forecasting growth of 1.7-1.9% (0.4-0.5%) for 2011(12). Despite an expansionary monetary policy, inflationary pressure remains low, which should lead to an inflation rate of around 0.4% in 2012.

**US economy proves to be surprisingly robust:** The US economy is continuing to expand moderately. Key leading indicators such as the ISM manufacturing index still lie above the critical value of 50 (2011 low: August 50.6; current: November 52.7) and capacity utilization remains stable at 77.8% (June: 76.7%; long-run average: 81%). The trend so far and expectations for 2012 are for a continuous, but slow improvement. This confirms the "new normal" scenario, as characterized by lower growth rates and consumer spending, continued high unemployment and a higher savings rate. No decisive fiscal measures should be expected now in the run-up to the presidential elections in November. Automatic expenditure cuts can therefore be expected from 2013.

### Emerging markets as vital driver of growth:

Domestic demand in the emerging markets is likely to remain robust and will be a vital economic driver. Favorable conditions (low public debt, more room for interest rate cuts, favorable demographics) are cause for further optimism. Fears of a hard landing in China are overdone in our opinion. Combating the risk of overheating has yielded to first steps in easing monetary policy in many emerging markets.

### Conclusions: Politicians in focus

Under our investment scenario for the first quarter of 2012, we expect the debt situation in Europe to ease thanks to a series of measures adopted at the political level.

While many countries in the eurozone are showing signs of entering a recessionary phase, we expect the US economy to expand at a modest pace. Growth rates in the emerging markets are likely to level off at more sustainable levels as momentum slows.

A vital pre-condition for economic recovery in the second half of 2012 would be achieved if fears of the insolvency of a systemically relevant country were to recede over the coming months.



## Traditional investments

### Bonds: Low interest rate environment reaffirmed

In Switzerland, the Swiss National Bank (SNB) set a **target range** for the **3-month LIBOR** rate of **0.00%-0.25%** several months ago due to the strength of the Swiss franc. The **United States** has also maintained the status quo on its key interest rates. The US Federal Reserve has repeatedly confirmed that it will maintain its low interest rate policy (key federal funds rate: 0.25%) through mid-2013. In Europe, the **ECB** returned to its **low interest rate policy**, which it has pursued since May 2009, when it cut interest rates twice by 0.25%. This came even though inflation was running at 3.0% in November (inflation target: 2.0%).

The debt crisis in Europe has led to **continued low yields** on government securities for Switzerland, Germany and the United States. The yield on German bunds currently stands at 1.824% (52-week low: 1.76%; 52-week high: 3.49%), on 10-year Swiss government bonds at 0.735% (0.73%; 2.13%) and on 10-year US Treasuries at 1.877% (1.71%; 3.74%). If economic growth picks up in the second half of 2012 (as we anticipate it will), then **yields** can be expected **to rise**.

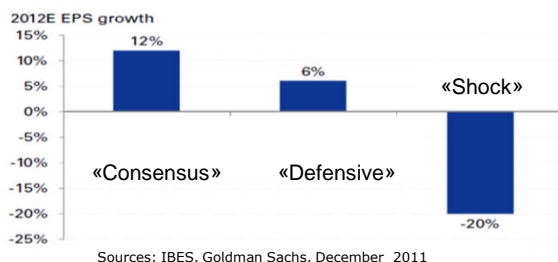
### Equities: Low valuations and robust earnings

Equities are trading at historically low valuations and are being made even more attractive by high dividend yields (diagram 1). For the EURO STOXX 50 the dividend yield is around 4.69% and for the S&P 500 around 2.04%. This roughly corresponds to the yield on 10-year Treasuries and underlines the relative attractiveness of equities compared to other asset classes. In 2012, high margins are again likely to largely contribute to solid earnings development, though consensus expectations are at variance (diagram 2).

Diagram 1: S&P 500 & STOXX EUROPE 600: PE 88-11



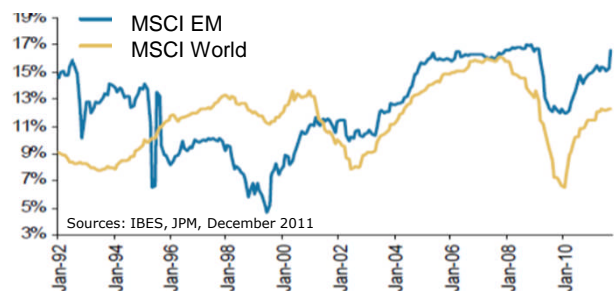
Diagram 2 Wide range of earnings expectations for 2012



The factors above underlie our largely **constructive expectations** for equities. For the time being, stock market development is likely to continue to be dominated by politics and to exhibit high volatility.

Fundamental factors are likely to come to the fore later. The portfolio should be continuously monitored with an eye to sudden changes in relevant financial ratios (as in the diagram below). On the basis of individual stocks, high earnings momentum and solid balance sheets remain promising.

### Return on equity: World versus emerging markets



## Listed alternative investments

**Listed private equity:** If the crisis were to deteriorate sharply (which we currently assume will not be the case), this would affect net asset value (NAV) because of the possible knock-on effect on operational businesses. This scenario is already reflected in **low valuations** relative to **NAV** and has led to a widening of discounts to around 40%. **Over commitment** and **leverage levels** of the asset class are **lower** than what they were in 2008/09 and therefore the two situations are comparable to only a limited extent. Company-specific factors play the biggest role. Listed private equity should rebound when market confidence returns.

**Listed private infrastructure:** Economic uncertainty and rising inflation rates in certain regions, as well as readily predictable earnings, favored this asset class in 2011. Thanks to **inflation-linked tariffs** and **low interest rates**, some sectors – particularly utilities (e.g. water, gas and transmission) – are likely to continue to benefit from these conditions.

**Commodities:** The asset class is being affected by the current turbulence in the financial markets and the gloomy economic outlook. The situation allows for little optimism for the first half of 2012. Banks' increased capital adequacy requirements play as important a role as declining growth momentum in China. The price of **gold** rose for much of the past year on the back of the "flight to safety", but then various reasons (profit-taking, falling demand, liquidity requirements, US dollar) eventually led to a price correction. **Economic uncertainty** and a possible acceleration in the rate of inflation are likely to reaffirm the role of **gold as a safe-haven currency**. We also see lower cyclical risk in energy. The high price sensitivity of supply and demand as well as intact long-term demand coupled with geopolitical risks (in the case of oil), make for increased **attractiveness** in the long term – especially for black gold. The planned reduction in nuclear-generated energy is likely to permanently **change the price structure** for **fossil fuels**.



## Three scenarios for Europe and relevant market characteristics

### Three macro scenarios

In the "Macroeconomic environment" section, we touched on three possible scenarios on how Europe could go in the future. Below we briefly outline these scenarios. We then go on, in a second part, to present the main characteristics of the current situation and show how the financial markets are being influenced.

#### Scenario 1: Exits from the eurozone (Italy, Spain)

**Positive:** Increased competitiveness of the countries that exit the eurozone; own monetary policy

**Negative:** Explosion of debt in EUR; immediate flight of capital; risk of gradual break-up of the eurozone

**Probability : 10%**

#### Scenario 2: Depression; drastic fiscal restrictions

**Positive:** Eurozone remains intact; integration process continues

**Negative:** Prolonged depression in peripheral countries, stagnation/recession in the eurozone

**Probability : 10%**

#### Scenario 3: Stagnation followed by reflation

**Positive:** Expansion of ECB intervention; eurozone remains intact; gradual fiscal integration

**Negative:** Recession in peripheral countries; stagnation coupled with higher inflation in long run

**Probability: 80%**

Sources: Scenarios, Partners Group AG, GS, JPM, December 2011

### Assessment of possible solutions

We basically consider a break-up of the eurozone (**scenario 1**) as rather unrealistic. The costs to all parties involved – and especially countries that would leave the eurozone – are immense. As long as the countries most affected profit from the support of the eurozone, there is no incentive to go down this path. Radical austerity measures (**scenario 2**) are likely to flounder from lack of support from the people. In Europe, political tradition calls for solutions that are supported by the majority. Furthermore, positive growth rates should help resolve the debt problem faster. A sober appraisal of the situation based on the economic rationale leads us automatically to **scenario 3**.

### Relevant characteristics of the current situation

**New era of saving:** Europe and the United States are looking at a protracted phase of debt reduction – and in particular at public sector debt reduction.

**Credit restrictions:** In Europe, higher capital requirements for banks will pose certain risks for small and medium-sized enterprises (SMEs) and therefore also for the economic situation there. By favorable contrast, many blue-chips have solid balance sheets and are flush with record levels of cash.

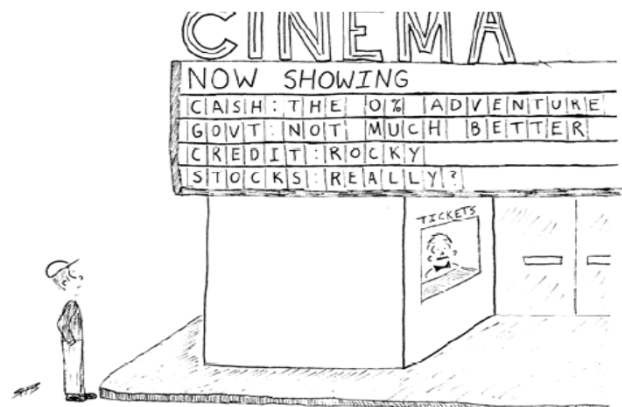
**Growing regional disparities:** The emerging economies are growing at a fast rate, while the economies of Europe and the United States are stagnating. Structural differences within the economic areas will accentuate their divergent development.

**Risk of higher inflation in the long run:** Despite certain deflationary tendencies, we anticipate that in the long run there will be asset price inflation. Initially, assuming that inflationary dynamics remain moderate, this would be positive for various asset classes.

**Sales and earnings momentum:** The earnings momentum of some companies is being significantly influenced by the regional composition of the sales and the related currency risk. Increased volatility in the foreign exchange markets and diverging economic outlooks are likely to increase this risk. For Europe, for example, currently the high export ratio, supported also by a weak euro, is positive. European blue-chips are on average generating 44-50% of their sales outside Western Europe.

### The impact on the financial markets

We are convinced that 2012 will bring compelling investment opportunities, due also to the high market volatility. However, the "politically driven markets" will remain challenging and vulnerable whenever there is any substantial change in the facts. As a result, the return possibilities of the different asset classes can also suddenly change. The cartoon below sums up the problems in the financial markets. Thus in 2012, too, the risk-return profile of all asset classes is likely to be subject to strong dynamics.



Source: Morgan Stanley, December 2011

Baar-Zug, January 2012

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