

Investment View

2nd Quarter 2010

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Summary 2nd Quarter, 2010

1. V-shaped world economic recovery is under way, we expect consolidation from here.
2. Biggest risks to global economy are trade wars and premature tightening.
3. Leading economic indicators slowed down in February, but improved again in March.
4. Inflation more a threat in emerging than in developed markets.
5. Exit of Central Bank support programs, higher interest rates in emerging markets and sovereign risk concerns are likely to push real interest rates higher.
6. Bonds should still outperform Cash.
7. Longer dated EURO government bonds are still a buy.
8. Investment grade corporate bonds are no longer a buy.
9. Emerging market debt and its currencies are still attractive.
10. Equities should outperform Bonds and Cash.
11. Earnings of companies should continue to be strong, driven by higher top line growth, greater operational leverage and low credit costs.
12. Tactical market indicators give “overbought” signal in Equities.
13. We expect European equities will start to outperform the US and emerging markets.

2010 Road Map Asset allocation for a balanced portfolio

	Q1	Q2
Cash & deposits	Underweight	Underweight
Government bonds	Underweight	Neutral
Inflation linked bonds	Underweight	Underweight
Investment grade credits	Neutral	Reduce
Emerging market debt	Buy	Buy
Convertible bonds	Neutral	Underweight
High yield	Sell	Sell
Equities developed markets	Overweight	Overweight
Equities Emerging markets	Underweight	Underweight
Hard commodities	Sell	Sell
Soft commodities	Buy	Neutral
Property	Underweight	Underweight

1. The global economy

The latest data support the view that the global economic recovery is on track, looking more sustainable than three months ago. In February, the International Monetary Fund (IMF) revised its estimate for world growth from 3.1% to 3.9%. The IMF wrote:

“In most advanced economies, the recovery is expected to remain sluggish by past standards, whereas in many emerging and developing economies, activity is expected to be relatively vigorous, largely driven by buoyant internal demand.”

More recent economic data confirm the views expressed by the IMF:

1. Leading indicators in core European countries surged in March resulting in above-trend growth. Purchasing Managers Indices (PMI) improved again in March, suggesting that economic activity is gaining momentum at the end of Q1, 2010. There were upward revisions to German and French PMI's and sizeable gains in Italy. The jump in Spain (51.3) was even more impressive after 27 months in the red, with Ireland (49.6) following close behind. With the periphery joining a recovery, partly already in full swing at the core, this upswing looks more balanced and is therefore more likely to prove sustainable. We anticipate this could result in GDP growth above market forecasts.
2. Service sector activity in Europe (70% of EU GDP) expanded at its fastest pace for over two years. The new business orders increased for the 7th successive month, climbing to its highest level since October 2007 to 54.5 up from 51.9 in February 2010.
3. The recent March US employment report seems to signal the long awaited recovery with Payroll rising by 162,000. We believe this may be the start of a sustained rebound in employment, which should carry the economy forward as fiscal stimulus begins to fade next year.
4. The Central Bank of Australia raised interest rates for a fifth time by 25bps in six meetings, raising its cash target to 4.25% from a low last year of 3.00%. The concluding paragraph of their report was identical to last month: *“with growth likely to be close to trend and inflation close to target over the coming year, it is appropriate for interest rates to be closer to average”*.
5. Banc of America raised its Russia 2010 average GDP growth forecast to +7.0% YoY from 5.0%. They see higher household consumption and higher inventory restocking than expected.
6. The Chinese economy continued to grow strongly with 11.9% in Q1 YoY.

China

Chinese economic activity indicators, such as exports, industrial production and retail sales, indicate the continuing growth momentum of the Chinese economy. In our latest Quarterly Review, we became more neutral on the economy of China as we expected a slow down. But, China continued to grow strongly, despite the Chinese government's decision to increase the reserve requirements rates for banks twice in two months. We maintain the view that China's high growth rate appears unsustainable and that the Chinese's property sector must be slowed down (property presents 30% of fixed asset investments). We therefore expect further liquidity tightening. We also expect the Chinese government will decide to revalue the Yuan.

The two biggest risks to the global economy are a trade war between the US and China and a premature tightening of global monetary and fiscal policies.

As is well known, competitive tariffs helped worsen the Great Depression of the 1930s. Today, the equivalent would be for Asian central banks to stop buying US debt and for the US to impose border tariffs across Asian products. The current mix of trade and capital flows between the two regions is extremely unbalanced: the US has a massive trade deficit with China and it is financed with an equally massive accumulation of mainly dollar reserves by China. This "vendor financing"—lending to your customer to buy your goods—is not sustainable and needs to be addressed. But, the rebalancing should be done in a gradual and cooperative manner; a sudden shift would damage both economies. With US unemployment near 10% and an important election (US Senate) coming in November 2010, the political rhetoric could get quite hot this year and some additional small protectionist measures, though unwelcome, may happen.

For countries that are quickly closing their output gaps, the optimal policy is not to slow domestic demand, but to allow the demand to shift out of the country. Thus, rather than resist the natural revaluation of the Yuan, China should be using currency appreciation as its primary tool to tighten financial conditions.

For the global economy, the best policy path going forward is for China to start revaluing the Yuan and for the US to stay the course with easy monetary and fiscal policy and to forgo protectionism.

Is the Euro zone at risk?

The Greek troubles and the public debate over the role of the IMF have not been helpful for the global reputation of Europe. Moreover, the lack of leadership and the fact that the Maastricht treaty did not provide for enforcement or penalties or even exiting a country, have only increased the crisis. The media coverage of strikes in Greece has not helped a favourable world opinion. Ultimately, the stronger EU countries, such as Germany and France, may have to bail out the weaker Southern European countries (Portugal, Italy, Greece and Spain) for the EURO pact to remain in place. Otherwise, the pact is not sustainable in its present form. The introduction of two EURO standards would become reality (this was suggested by the Dutch during the Maastricht treaty discussions). The problem of the Greek crisis is also one of Western banks. French and German banks hold large chunks of Greek debt.

In the end, the overall fiscal problems of Greece must be manageable with long-term reforms put in place. Ireland has shown this political will and the Irish sovereign debt market has improved considerable. It is important for the EU that the Greek contagion crisis is contained. Otherwise, the end of the EURO will be a true possibility. But this contagion issue is far from over and we may well see the financial markets attacking the Portuguese sovereign debt market soon. So far, the safety net offered by the EU and the IMF has been taken seriously: spreads on Spanish sovereign debt have remained stable.

For the Euro zone, the Greek crisis may even be a blessing in disguise:

1. Bond markets and peer pressure are now forcing the EURO-periphery countries to deliver long needed fiscal and structural reforms.
2. Europe's fiscal surveillance tools are evolving in a way that will make a repeat crisis more unlikely.
3. The EURO zone is now getting a head start on the fiscal adjustment that other parts of the Western world will likely have to tackle in the years ahead as well.

The additional fiscal tightening in the EURO-zone periphery countries should not account for more than an estimated minus 0.3% of overall EURO-zone GDP and its impact on overall EURO-zone growth may even be smaller than that. Over time, it could be fully offset by a less overvalued EURO exchange rate.

2. Economic indicators

To track the global economic recovery, we follow, among others, six indicators:

Indicator	Trend
- Copper price	Trades on new cyclical highs, looks topy
- AUD/USD	Trades at 2009 highs, loses momentum
- Kospi (Korea) share price Index	Trades at 2009 highs, no break-out yet
- EM & G3 leading indicators	After Feb dip, March was strong again
- Shanghai real estate	Negative
- US housing	Stabilising and starting to be positive

Our indicators paint a picture of consolidating economic growth. Copper prices jumped to the highest price since August 2008 after imports by China, its world's largest consumer, surged on rising demand. The three-month contract on the London Metal Exchange rose on April 2010 to \$8,043.75 a metric ton, which is the first time above the \$8,000 mark since the collapse of Lehman Brothers in September 2008. However, we have become more cautious on the copper price as Chinese stockpiles are the highest since at least 2003.

The AUD is losing momentum as the tighter monetary conditions in Australia and China are being felt. The AUD is vulnerable for a correction should world economic growth disappoint or risk aversion emerge.

The Korean Stock Exchange (Kospi) reached a new high in April 2010, but exporting companies have been hurt by a recently stronger Won. With South Korea's Central bank raising its economic growth forecast, we think interest rate and currency worries may dampen equity sentiment in the short-term.

Leading economic indicators in emerging markets and the developed world rose again in March after a short dip in February. The US Institute of Supply Management Non-Manufacturing index showed that new orders were at 62 in March versus 35 in December 2008. The current number is now at 2005 levels and after an almost 80% rise from its lows, we expect some consolidation. Global Manufacturing and Semiconductor data are still strong and are even back to 2004-2005 levels. We think the chances are high that there will be some consolidation instead of moving much higher in the coming months.

Despite surging property prices in Chinese cities (12% YoY in Q1) and rising development volumes, the Shanghai property index is in a negative trend since June 2009. The index shows that the market expects additional restrictive liquidity measures which could further hurt property prices and equities.

The US housing markets seems to stabilize with the “house-price-to wage” ratio at a 40-year low and with a significantly reduced housing inventory. We have been surprised by the strength of some of the housing markets globally, such as Australia (where house prices are 9% above the previous peak), Canada and the UK (where they are close to the previous peak), despite the house-price to wage ratios in each of these countries being well above their historic norms. This makes us think that it is quite plausible that housing stabilises in the US, where the house-price-to-wage ratio is still at its 40-year low.

3. Inflation

It is difficult to measure inflation and to distinguish between broad-based inflation and short-term pricing power shifts such as from commodity price movements. This is the reason why economists look at core and headline inflation. Core inflation (core CPI) excludes energy and food. The latter usually have strong price movements. Headline inflation (CPI) measures price movements of a basket of energy, food, cost of labour (ULC) and rent. If CPI is rising, but unit labour costs are not, then that indicates a pricing power shift from consumers (labour) to producers (profits). This is not considered structural inflation.

Bond markets are generally very sensitive to core inflation and usually anticipate its return by about six months (yields go up). Inflation linked bonds are one of the indicators we look at to measure the market expectation for inflation. As soon as bond investors see inflation coming back, the risk premium increases, resulting in higher bond yields and lower bond prices. In such cases, longer dated bonds usually suffer more price declines.

Real long-term government bond rates really surge when governments fail to address their excessive deficits or have great trouble refinancing their debt. This is currently the case with Greece (see further under “bonds”).

Inflation in the US

History is repeating itself: core measures of inflation always drop early in economic recoveries, and this is happening again today. March data showed that core CPI increased only 0.1% MoM and 1.1% YoY.

Sceptics of low inflation point to the fact that the entire drop in the core CPI is due to weakness in home rents, and that core inflation will quickly turn should housing pick up. We think that record vacancy rates will keep rents low for a longer period and that any inflationary impact from rising house rents will not occur for any time soon.

On the pricing side, the core US Producer Price Index (core PPI) is particularly weak, slowing from 3.8% to 0.9% in the last 12 months. On the labour cost side, which underpins business pricing, all measures of compensation are slowing and unit labour costs are falling at the fastest pace in the 60-year history of the series. With a 72.7% capacity utilization rate and a 9.7% unemployment rate, there is plenty of spare capacity in the US. We do not see resumption in core PPI as a serious short-term risk.

In the US and Europe, inflation expectations were drifting higher earlier this year until they were depressed by the sovereign crisis in Greece and disappointing US data in February. But, while Greece is in for a long tough period of austerity, fears of contagion appear to be ebbing. The US data has improved and seems consolidating further. Only when the labour market recovery gains momentum, inflation expectations are likely to rise, and this will force the Fed to defend their credibility.

The current US bond market does not expect a surge in inflation with 10yr Treasury yield at 3.8% and the 10yr Treasury Inflation Protected Security (TIPS) yield at 1.5%. Historically, 10yr Treasury yields have shown a strong relationship with unit labour costs, that is core CPI, but no relationship with commodity prices (headline inflation).

Inflation in Europe

Core European inflation has now been trending down for more than a year. March core inflation eased to 0.9% vs. 1.0% YoY in January. We believe inflation will stay low for longer than generally expected, due to the very low rates of capacity utilisation and the risk of higher structural unemployment. Economists forecast inflation of around 0.9% by the end of 2010 and around 1.4% by December 2011. This is in sharp contrast to the CPI Swap market, where inflation expectations are 2.0% for Europe, compared with 2.1% in the US over the next five years.

The outlook for UK inflation is more uncertain as the reason for the persistently high level of prices is unclear. Core CPI inflation has been trending up for over a year and currently stands at 3.1%. If, as the Bank of England suggests, the weakness of Sterling and changes to VAT are responsible, then inflation may weaken sharply in the coming months. However, there may be more structural reasons for high price pressures and this presents risks which we believe should be priced into the inflation premium.

Although the Bank of England is no longer buying Gilts, its stock of £200bn represents an inflationary risk that is not present in Europe. We also note that the market has consistently underestimated UK inflation over the past two years. This suggests a higher probability of upside inflationary shocks in the UK.

Inflation in emerging markets

Chinese inflation data remain reassuring. Chinese YoY consumer price inflation slowed from 2.7% February to 2.4% in March. The index declined by 0.7% MoM. The uptick in February reflected the Chinese New Year holiday base year effects and a seasonal tick-up in food prices. The March data showed that February was mostly temporary, but the rise of 12% in property prices is a concern.

In the rest of Asia and other emerging countries there is a trend for higher inflation, especially food inflation. Policy makers in the emerging markets have the chance this year to do something historic: pre-emptively tighten to prevent inflation and a return to the old pattern of “boom-bust”.

4. Interest rates

The continued economic recovery in emerging markets has induced a more hawkish stand by their central banks. So far this year, China, India and Brazil have tightened their reserve requirements. Malaysia and India also hiked key interest rates, while Brazil (inflation now at 5.22%) and Thailand clearly signalled rate increases in their last monetary policy meetings. Were this to happen, overnight rates in Brazil may go to 9.25% up from 8.75%. China’s Premier sounded hawkish on inflation and with better than expected exports and industrial output, we think a third hike in the bank reserve ratio is imminent in April. For the moment, China’s interest rates are still low (government paper stands at 2% for one year), which is very accommodative.

While the emerging countries increase rates, the developed world is starting to withdraw some of the stimulus programs introduced during the Financial crisis. Although liquidity withdrawal by central banks is not the same as policy tightening, it is a similar step along the road to tightening. Below, we highlight some of the key steps taken by policy makers in the developed world so far:

1. The Fed raised the discount-rate on February 18, which may have been of symbolic importance only, but re-introduction of the Supplementary Financing Program (SFP) is reducing excess reserves of banks, and forced term repo and term deposits of banks with the US Treasury are tools to reduce reserves further.
2. The Bank of England has suspended its buying of Gilts for quantitative easing.
3. The ECB has altered the way it will provide liquidity to the market — the effect of which will be to shorten the period for which fixed-rate funding will be available.

While none of these measures amount to a tightening of interest rates per se, they do imply higher financing costs and make a rise in policy rates more do-able. Although a first rate move may change the cost of financing, it is not necessarily bad news for the financial markets. But more important is the signal it sends that policy rates are on their way back up through a series of future hikes. The signalling effect is what is crucial.

The Minutes of the March FOMC meeting show that the Federal Reserve remains focused on the economic fundamentals of America. The Minutes did not discuss the exit strategy, there was no mention of a possible re-start of the Mortgage Backed Securities purchase program, and it did not say that a discount rate hike was imminent. Overall, nothing in the Minutes suggest a looming change in the trajectory of monetary policy: we therefore continue to expect the Fed to keep rates on hold until the end of this year.

The ECB traditionally has a more inflation “hawk” attitude and inflation in Europe is higher than in the US, at the moment. It is possible that the ECB will raise rates before the US and we may see an interest rate hike by the ECB of 25 bp in 4Q 2010. We would like to stress that we believe it will be a good sign that interest rate will be gradually increased, as this reinforces the view of a durable economic recovery.

Generally, we expect that improved employment numbers should trigger the first interest rate hikes in the Western economies.

Deficits and interest rates

To contradict our previous stated view for expected low interest rates in the developed world, there is a risk of a surge in real long-term interest rates as governments continue to struggle with excessive deficits.

An IMF economic report, published in November last year, points out that higher fiscal deficits and higher outstanding debt lead to higher real interest rates and ultimately higher inflation. Both are trends adverse to bond market prices. The US and UK are especially vulnerable to be punished by the bond market. The U.S. currently has a deficit of 10% of GDP and a growing stock of outstanding debt. The UK’s deficit has increased to 12.9% of GDP.

Bill Gross of PIMCO warns investors in his April letter:

“An investor must be concerned with future unfunded entitlement commitments which portfolio managers almost always neglect, viewing them as so far off in the future that they don’t matter. Yet should it concern an investor in 30-year Treasuries that the Congressional Budget Office estimates that the present value of unfunded future social insurance expenditures (Social Security and Medicare primarily) was \$46 trillion as of 2009, a sum four times its current outstanding debt? Of course it should, and that may be a primary reason why 30-year bonds yield 4.6% whereas 2-year debt with the same guarantee yields less than 1%”.

At the moment, sovereign risk seems the bigger threat to higher real interest rates in the developed world.

5. Currencies

We continue to hold the view that we expect the USD to remain strong against G10 currencies and weak against emerging market (EM) currencies. Much of the USD strength is reflective of growing problems outside the US, particularly in Europe. The debt crisis in Greece has emphasized fundamental issues in the EURO, such as a lack of unified fiscal policy, while having essentially the same monetary policy for 16 very different economies. Meanwhile, the Yen has been weakening amid modest Bank of Japan action against entrenched deflation.

In contrast, the US economy has been outperforming Europe since March 2009, with the Fed taking small incremental steps toward policy tightening in order to prepare nervous markets. Moreover, US growth numbers have been modestly above expectations and generally well above G4 competitors. Economic fundamentals should remain the key factor behind the strength/weakness of currencies. The relatively strong economic outlook for EM countries implies in the long-term a strengthening of their currencies against the USD and the EURO. Commodity currencies like the CAD and NOK are also likely to show relative outperformance. We have become more cautious on the AUD after an increase of 28% against the USD. This currency is most vulnerable should the Chinese government continue its restrictive liquidity measures, lowering growth expectations for the Australian economy.

The outlook for European currencies, other than the EURO, varies. The case for gradual CHF appreciation remains solid. The Swiss Frank is a haven of stability unhampered by the recent banking crisis. Market sentiment toward the GBP turned extremely negative in March and, in our view, is now overdone; upside is building, which will improve even more if the Tories get back into power.

The market expects an RMB (Yuan) revaluation of between 2%-4% this year. China has already taken incremental steps toward tightening to fight the inflationary impact caused by their “soft” currency policy. The outlook for a RMB revaluation is key for a global currency view because overall emerging market currency reserve demand for EURO’s has been a crucial factor in USD weakness throughout much of the last couple of years. A revaluation of the RMB will be another sign that demand for alternative currencies than the USD, resulting from massive EM FX reserve accumulation, should diminish.

One likely lasting by-product of the debt crisis in Greece is that the USD has significantly increased its position as the dominant international reserve currency. Investors now have much more uncertainty in the EURO’s ability to become the alternative reserve currency. The Greek debt crisis in particular highlighted the importance of having a unified bond market as a key feature of an international reserve currency. The US government bond market is still the ultimate store of value for financial markets. With the USD’s status as the international reserve currency relatively more secure amid the EURO’s downturn, diversification bids away from the dollar will likely diminish. Of course, such currency status cannot be taken for granted over the long run; FX concerns around recent US debt auctions that were not greeted warmly by bond markets have for instance increased.

6. Commodities

Hard commodity prices are consolidating near 2008 highs, but we have mixed feelings if the current prices are sustainable.

The demand recovery for commodities seems to be intact (recent global manufacturing PMI data showing supportive expansion in the sector). We also saw that Chinese metals trade data in March remain very constructive for industrial demand, with imports of copper and iron ore near record highs. On the other hand, this is the time of the year of peak demand for hard commodities and with inventories climbing we believe there is only limited room for prices to increase further. Chinese stockpiles of copper are the highest since at least 2003.

The latest oil demand data from China continue to show robust growth, though it may be set to fade. High crude oil prices and government imposed restraints on retail prices, may erode China's seemingly unstoppable appetite. Moreover, more of the imported crude is being refined and exported, as China is now a net exporter of both distillates and gasoline.

What's the catalyst for a sustainable move in the price of crude oil above \$80/bbl? The recent move above \$80/bbl is largely due to issues on the refining front that are likely to disappear in the short-term as refiners exit its maintenance cycle. As a result of reduced production by refiners, distillate inventories in the US are currently trading just above year ago levels. In Europe, however, stocks have remained elevated. The release of floating storage (tankers) may be partially blamed for this.

We expect crude oil to be breaking sustainably above \$80/bbl, ultimately trading to \$95/bbl by year-end, but we view this as a second-half year event, should inventory draw-down and economic growth continue to be strong. This improves the outlook for the energy sector in general.

Precious metals have maintained their upward trend (which started in October 2008 after the Lehman crisis), with Gold climbing to new highs in USD until November 2009 (\$1200), which was an all time high in all other major currencies. For the first time, Gold prices moved up while the USD was strong. In the past, Gold was only considered a hedge against a weak dollar. How can this be explained?

The main reason must be the perceived risk of a potential break-down of the financial system and asset values following the biggest financial crisis since World War II. Gold purchases could also be cheaply financed with prevailing low US interest rates. Returns on money deposits and credits have been so low that lack of earnings on Gold deposits became acceptable to investors. With deleveraging and the low investment cycle in capital goods, property or Oil, Gold turned out to be a good alternative.

It is interesting to note that the Gold price did not rise at the outset of the Greek sovereign and Dubai crisis. It did not act as a hedge at the time, while in our opinion this was/is supposedly one of the main reasons for holding Gold.

Since its peak in November 2009, the price of Gold has moved sideways, which may say that investors believe the worst is behind us. Risk appetite is increasing and cash may be moving out of Gold into riskier assets such as equities.

At this stage of the economic cycle, we do not anticipate Gold prices to continue moving up. Firstly, we are at the end of the long cycle of low interest rates in the US, making borrowing for Gold purchases more expensive. Secondly, US money market rates will gradually move up starting to compete with non-productive assets such as Gold. Other asset classes such as Oil will also become more attractive once the economic cycle has turned more positive.

Agricultural prices continue to move sideways, except for life stock, as fundamentals are not strong with especially high inventories and rising production.

7. Fixed Income

During the credit crisis (2008-2009), panic stricken equity investors sought massive refuge in cash. Western Central Banks' almost zero interest rate policies ultimately penalized such risk aversion. In 2009, investors went looking for higher-yielding alternatives primarily in high quality fixed income instruments, such as government bonds and investment grade corporates. They were rewarded as Credits turned out to be one of the best returning asset classes. For 2010, the outlook appears different. Unlike in 2009, investors cannot presumably lower portfolio risks by increasing allocation to debt, because the risk of interests moving up has increased. We forecast that debt in general may lead to lower returns relative to equity. Cash is still no alternative.

The influence of several events; recovery of economic growth, concerns over government deficits, weak Treasury auctions and uncertainty over the ending of general Central Banks stimulus programs, is expected to dampen the outlook for stable interest rates

Government bonds

We see global government bond yields continuing to move slightly higher from here. US and European bond yields tend to correlate closely with the US Institute of Supply Management (ISM) or the German Institut für Wirtschaftsforschung (IFO) data and we suspect that both ISM and IFO will head a little higher over the coming months. Another important reason may be that markets second-guess the degree of tightening required to stabilise government debt to GDP in the developed world (US, UK and Japan). Finally, investors are clearly overweight in bonds relative to equities, especially on the retail side and we expect selling pressure to increase during the course of this year.

Investors of government debt should be careful not only to avoid a debt trap, but also to minimize reflationary risks and currency devaluation when selecting bonds. Government bonds will enter a difficult period when global reflation proves to be successful.

PIMCO, the largest global bond manager, advises to buy bond positions on the short-end of selected sovereign yield curves subject to successful reflation (U.S., Canada and Brazil) and longer ends of selected sovereign yield curves that can withstand potential debt deflation (Germany, Netherlands and Sweden).

We also favour investing in longer durations in general and specifically in long-dated Bunds and Dutch government paper. We think the risk of interest rates moving up is in the short-end and not so much in the long-end of the yield curve. For USD investors, we favour short-dated Canadian government bonds. We believe it is interesting to invest in currencies of emerging market countries, such as Brazil, to profit from potential currency appreciations Vs the EURO.

Although we mentioned possible risks for short-dated government bonds, we do not expect a fierce sell-off. Most of the rise in leading indicators has already occurred (it is in the price) and there is still plenty of demand for bonds from banks and retail investors. The US consumer is deleveraging and has turned to saving. The US consumer cash reserve pool has increased tremendously which is a source of funding. Despite the historic high saving rate, European consumers save even more, at the moment.

Corporates

We think the time has come to start selling positions in EURO investment grade corporate credits (Corporates), for a number of reasons:

1. Yield to maturities have been falling to levels between 2 and 3% and the uptick compared to interest on cash is not attractive any more.
2. The ECB may raise rates in 4Q, 2010 and interest rates of shorter dated Credits may rise in anticipation about six months in advance.
3. The spread between Corporates and Government bonds has narrowed to historic lows and further narrowing is not expected.
4. A potential rise in government bond yields should also increase yields in Credits, unless the spread continues to narrow even more, which we do not believe.
5. The corporate bond market is now dominated by bank issues. New issues by companies have practically dried up.

Bank balance sheets have improved in general helped by low interest rates, economic recovery, restructuring and raising capital. As a result, bank debt has become more interesting. Yields are still relatively high.

8. Equities

The MSCI World Equity index (in local currency) has risen 14% from its February lows. For the 1st Quarter, this index was up by +8.9% in EURO and +2.7% in USD.

While tactical indicators appear stretched, which may lead to short-term stock market corrections, we believe the stock markets may surprise on the upside in 2010.

We have become more confident on a sustainable recovery in the US. A double dip scenario has become less likely by the day. The current scenario is ideal for stock investments: low inflation, low interest rates, low economic growth, mostly healthy balance sheets and good earning reports of most companies.

While global money markets saw tremendous outflows (325Mrd USD) during Q1, 2010, over 90% of it went in to credits/corporate bond products and only a small proportion to stocks. According to a Bloomberg survey, 72% of US investors have missed the rebound in stock prices since March 2009. It can be expected that at some stage, stock investors will return to the market in higher proportions which should sustain the current money-flow into stock investments.

With the US 10-year Treasury yield having gone from around 3.65% to just below 4% in the past three weeks, concerns have risen that this would kill the equity market rally. With the short-end of the US Treasury yield curve still low by the loose monetary stance, the US Treasury yield curve has re-steepened, with the gap between 10-year yields and 3months now at around 380bp up from 350bp, historically a high number.

Historically, a steeper yield curve is seen as a bullish signal for equities and it is also associated with outperformance by cyclical sectors as long as long-term rates move up because of higher growth prospects and not higher inflation expectations.

We find the following supportive arguments for stocks:

1. Positive “growth-Inflation” trade-off. Inflation in developed markets continues to move lower, allowing central banks to remain growth friendly for a longer period. Manufacturing momentum is still robust. Evidence of a turn in capex is mounting and corporates hold record levels of cash on their balance sheets.
2. Earnings continue to be revised upwards. Margins are bottoming out at a high level, creating significant operational leverage to any top-line pickup. Lead indicators are bullish for Q1 results. Consensus forecasts are for 25% EPS growth in 2010 in Europe and 30% for the US.
3. Mounting evidence of a peak in delinquencies, while credit spreads continue consolidating and house prices are stabilising
4. We expect sovereign debt concerns to be contained. We do not anticipate peripheral Europe entering a solvency crisis. Interbank market risk is not increasing.
5. Valuations are undemanding. European forward 2010 P/E trades at 12.0x and the US forward 2010 P/E trades at 15.5x. The yield gap (bond yield vs earnings yield of equities) is supportive.

Another interesting measure remains the equity risk premium (ERP=the additional expected return equities give relative to bond yields).

Currently, on unadjusted IBES consensus numbers, the US and European equity risk premium is between 5% and 6% respectively. Credit Suisse believes that based on the two most important factors of ERP (credit spreads and the cycle), the ERP should be around 4.1% Vs the historical average of 3.6%.

European equities have underperformed US equities in Q1 of this year by 8% on a constant currency basis (EURO). Much of the underperformance appears to have come as a fallout from concerns over sovereign debt issues in Greece. Regionally, surveys show that investors are most bearish on the EURO zone, but while the growth differential between the US and Europe will remain, this has historically not led to EURO zone equity underperformance. In addition, a weakening EURO is becoming a tailwind for European stocks. We look for stock opportunities in Europe which have a large part of their revenues from outside Europe (prefer emerging markets) and trade at a discount to their global peers. We were right to have preferred US over European equities in the last 12 months. We now think European equities may take the lead.

Our Q1 2010 view, that developed equity markets would perform better in the first part of the year, has proven to be correct. Developed market equity valuations continue to look more attractive than emerging markets. As said in January, we recognize that economic and earning growth of emerging markets is superior to the developed world, but as real yields will rise in these countries, this high growth will also face a higher discount rate. Moreover, we still expect some slowdown from China, which could scare BRIC investors in the short-term. Strong stock price declines would obviously be an attractive moment to go back into emerging markets. We keep our focus on investments into sustainable growth companies that benefit from operational leverage, with high dividends and BRIC exposure.

Table 1: Performance of various indices in Q1 2010

Copper in \$ per Lb.	+5.6%
MSCI Latin America in \$	+1.3%
Barrel of Oil in \$	+3.3%
MSCI Emerging Markets in \$	+2.4%
MSCI China Free in \$	-1.6%
High Yield in \$	+3.0%
Rogers Int'l Commodity Index in \$	-2.3%
MSCI Europe	+3.0%
Gold \$ per Ounce	+1.5%
CV Bonds in €	+3.4%
MSCI USA in \$	+5.4%
MSCI World in €	+8.9%
Credits in €	+2.5%
HFRX Global Hedge Fund Index \$	+1.6%
MSCI Japan in JPY	+8.5%
JP Morgan Gvt. Bonds in €	+2.3%
JPMorgan Cash index 1M in €	+0.1%
Barclays CTA Index	+2.9%