

Investment View

3^d Quarter 2010



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Summary 3d Quarter, 2010

Global economic growth is expected to slow down in H2 carrying over into 2011, but we do not anticipate a “double-dip” scenario. The IMF projects global economic growth of 4.6%, while the EU is forecasted to grow at 1%, this year. Emerging markets are forecasted to grow at 7.1%. The U.S. economy is forecasted to be the best performing economy of the advanced nations, growing at 3.3%.

The IMF also states that downside risks have increased due to the sovereign and financial sector risks.

A drop in confidence about fiscal sustainability, policy responses, and future growth prospects is casting a cloud over the outlook of financial markets. The stress test by EU regulators on 91 banks, to be published in July, may reassure investors, which would be very good news for stock and bond markets alike.

With confidence building and risk appetite improving, investors are expected to switch out of defensive into more rewarding asset classes such as equities.

Emerging market equities and Financials are expected to be the first beneficiaries.

The price of Gold is expected to soften. Slower economic growth will cause headwinds for commodity prices, such as oil, in the medium-term.

Long yields of Bunds or Dutch government bonds are expected to remain low in the absence of inflation and as long as the EU sovereign crisis remains unresolved. Credit spreads of investment grade Credits are expected to narrow. Euro and USD short term interest rates are expected to remain low for a longer period of time.

The outlook of the Euro is clouded in the absence of near term fiscal integration within the European Union. Diversification out of the Euro should increase demand for the USD. Although the USD may act as a safe haven for a while, the U.S. sovereign debt and deficit problems will not be solved for some time.

Recommended asset allocation for a balanced portfolio – 2010

| | Q1 | Q2 | Q3 |
|----------------------------|-------------|-------------|-------------|
| Cash & deposits | Underweight | Underweight | Underweight |
| Government bonds | Underweight | Neutral | Neutral |
| Inflation linked bonds | Underweight | Underweight | Underweight |
| Investment grade credits | Neutral | Reduce | Overweight |
| Emerging market debt | Buy | Buy | Buy |
| Convertible bonds | Neutral | Underweight | Underweight |
| High yield | Sell | Sell | Buy |
| Equities developed markets | Overweight | Overweight | Overweight |
| Equities emerging markets | Underweight | Underweight | Buy |
| Hard commodities | Sell | Sell | Underweight |
| Soft commodities | Buy | Neutral | Neutral |
| Property | Underweight | Underweight | Underweight |

1. Economy

In July, the IMF raised its forecast for global growth this year to 4.6% up from 4.2% in April, reflecting a stronger-than-expected first half, while warning that financial turmoil has increased the risks to the recovery. The Washington based fund said global growth for next year is projected to be 4.3%. The fund cut its 2011 growth forecast for every Group of Seven industrial nation except the U.S. The U.S. economy will expand 3.3% this year and 2.9% next year, the IMF said.

The pace of global economic growth is showing some signs of slowing in May, which extended into June. Manufacturing Purchasing Managers' indices ("PMI") in June dropped in 15 of the 22 countries reporting data so far. Interestingly, the recent weakness is greater in the U.S. than in Europe.

In the U.S., the economy is still expanding, but at a slower speed. The June U.S. PMI fell from 59.7 to 56.2. The drop was higher than expected (59), although the level is still well above its historic average of 52.7 (a number >50 means expansion). House prices are at a record low making housing affordability (price to wage ratio) the highest in the last forty years. This leads us to believe that U.S. house prices should be close to a bottom, one of the keys to build confidence.

For the Euro area, the IMF kept its growth forecast for 2010 unchanged at 1% and reduced its 2011 outlook by 0.2% point to 1.3%. However, in June, the Euro area PMI only dipped from 55.8 to 55.6 giving evidence that European manufactures are clearly benefitting from the recent sharp drop in the value of the Euro.

Germany showed exceptional second-quarter growth with exports rising by 9.2% and industrial production by 2.6% in May compared to April.

The growth forecast by the IMF for emerging markets for 2010 was raised to 6.8%, from 6.3% in April. The fastest growth rate will be China's 10.5%, followed by India's 9.4% and Brazil's 7.1%. In China, the scare of overheating and inflation seems to have been addressed in time confirmed by the recent fall in China's PMI of June falling from 53.9 to 52.1 and the decline of house prices in the major Chinese cities. China's expansion will moderate in H2, with the slowdown carrying over into 2011, the IMF said.

"The overarching policy challenge is to restore financial market confidence without choking the recovery," the IMF report said.



The recent PMI numbers, showing a slowdown in economic growth in the advanced economies, have made markets anxious about the prospects of the economy sliding back into a double-dip. Although this cannot be excluded, we believe a second-dip scenario is a remote probability. In our opinion, the set back in growth is only temporary in the aftermath

of the European crisis. Double-dips are very rare (happening just once—1981—in the past 90 years) and current leading indicators are a long way from signalling a recession.

The Global Purchasing Manager Index for new orders tends to lead economic growth by six months and the index numbers are still consistent with an estimated 4-5% global GDP growth in 2010. In addition, corporate free cash-flow and cash on balance sheets are at all-time highs.

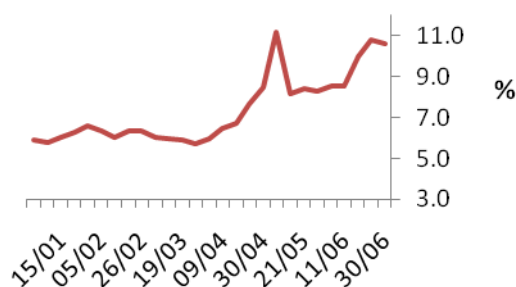
The results of the stress tests on 91 banks carried out by European Union regulators, to examine whether they can withstand a shrinking economy (drop of 3% of GDP) and a drop in government bond values will be published on 23 July. Regulators are counting on the tests to reassure investors that most banks have enough capital to withstand a debt default by a European country.

2. Sovereign debt crisis

The European sovereign debt crisis which followed the credit and banking crisis is of grave concern. To see Greece as a member of the European Union risking to default, with risks of contagion to Spain and other EU countries, is frightening. To see “South American” conditions in Europe was unthinkable some years ago. The Maastricht treaty set the maximum sovereign debt at 60% of GDP for European Union members. But in most countries, this ceiling had already been reached before the crisis. Sovereign debt levels now have increased from an

average of 61% to 80% of European Union GDP in 2010.

5.9% Greek Government 10/22/22 Yield



The Federal debt of the U.S. before the credit and banking crisis was lower compared to the EU, but in the meantime, it has proportionally grown faster than the debt of the European Union, from 40% to 89% of GDP.

There is general agreement that government debt and deficit levels must come down. However, this could derail the recovery from the post-Lehman recession and austerity may even be self-defeating, as it may hit demand and tax revenues.

Research by Bank of America Merrill Lynch has found that “intelligent” austerity can support growth as scaling back government spending can raise business profitability and makes the economy more competitive; households see this as a signal that fewer tax hikes are necessary in the future and credible austerity programs pave the way for lower interest rates and risk premiums.

The German and the UK policy makers follow this course of thinking. The French government has yet to enact meaningful austerity measures.

Like Ireland, Greece has taken very aggressive actions and seems ahead of planned budget cuts.

U.S. policy makers argue that tightening should be delayed to let the stimulus take its full effect on the economy. Austerity would be introduced gradually after a longer period of positive economic growth. There are historic examples that too early tightening had adverse results. After the Crash of October 1929, President Herbert Hoover increased taxes to maintain a balanced budget, thereby cutting liquidity. He also approved the Smoot-Hawley act increasing customs duties on some 20,000 products. This resulted into a trade war on a world wide scale further worsening the Depression.

3. Interest Rates

With the current high unemployment rates and low capacity utilization rates in the U.S. and Europe, disinflationary pressures remain high. As a result, core inflation should drop further in the next two years.

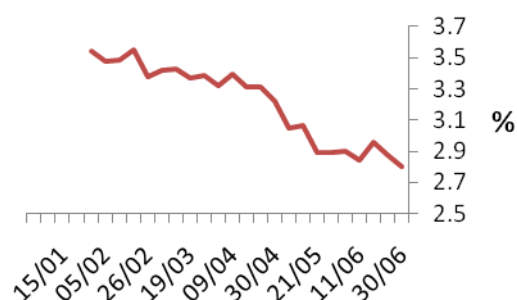
Investors worry more about long-term growth raising the implied risk of deflation. This has increased the demand for bonds in general. The extreme fall in nominal bond yields of Treasuries, Bunds and Dutch government paper this year is largely the result of flight to quality, following the Greek sovereign crisis.

Yields in advanced economies are currently low, giving the Fed and ECB enough time to implement a slow and gradual removal of its monetary accommodation. For the time being, we

do not expect any rate rise by the Fed or the ECB.

As long as the European sovereign debt crisis remains unresolved, it is expected that yields of government paper issued by strong debt countries will remain low.

**3,5% Dutch Government
07/15/2020 Yield**



How this sovereign crisis will end is not yet clear. The current EU members show with their plans that they have the political will, but successful implementations of announced measures still need to be tested. The ultimate solution is that the EU becomes a fiscal union next to a monetary union. The EU integration has made a lot of progress were it not for the financial markets.

It is expected that Germany, currently the strongest EU member, probably has to foot the bill and accepts paying a good part of the deficits of the weaker EU countries. This is highly controversial and it may even lead to the fall of Frau Merkel's coalition.

The herd behaviour effect of the flight to quality may lead to a price bubble of high quality government bonds. Due to this effect, Bund yields have probably fallen a bit too far and we see little value in holding on to these assets, unless the

economy would enter a double-dip. There is also the possible risk that the upcoming bank stress test results will show weakness in some German Landesbanken. It is interesting that recent Spanish bond auctions were received well, which helped stabilize peripheral spreads. However, we are far from retracing the move in rates/spreads/curve since early May this year.

The ECB has emerged as the only buyer of peripheral debt, and that raises questions about how much debt the ECB might end up having to own. Also, as the record deposit levels with the ECB suggests, interbank lending continues to be muted, which is adverse to building up economic activity. There are concerns about how the activation or funding of the €440 billion Rescue Fund would play out if needed to be tapped by any one country. The results of the bank stress tests in late July could lead to some event risk as well. Further, according to our estimates, July marks one of the highest bond redemption months (at €75bn) for the Euro zone.

However, we don't believe that this is a liquidity-driven crisis, since clearly the ECB is committed to provide ample amounts of liquidity. This crisis is more about sovereign solvency which needs to be addressed with "intelligent" austerity.

Given that the effects of policy measures will take time, we expect sovereign risks around Europe to continue. This should keep German and Dutch government bond yields low for the time being.

4. Deflation

Although the risks for deflation in the Western economies have gained momentum, this is not our core view. Deflation requires falling wages (which account for 70% of inflation) – yet, wage growth is still positive in almost all major developed regions. On the other hand, in European countries with sovereign debt problems, pressures on wages, social security and pensions have become bigger leading to stronger deflationary pressures.

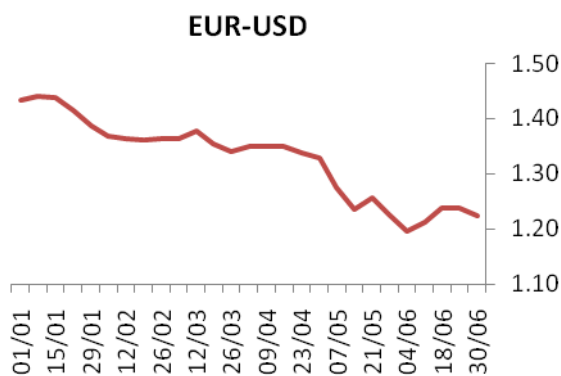
Emerging markets which represent 47% of Global GDP show signs of inflationary pressures and some countries like China, Brazil and Korea have initiated monetary policy measures to counter risks of inflation. China probably provided too much liquidity to counter the banking and credit crisis. It also recently decided to raise salaries. China potentially has a big inflation problem endangering the country's export position.

5. Currencies

The current sovereign debt and deficit crisis in Europe has affected the landscape of the Euro in two ways. First, it has put in doubt the Euro's attractiveness as a reserve currency. Secondly, it has reduced the Euro's "investability" following the reduced attractiveness of non-AAA sovereigns. If the Euro area sovereign bond market is assessed on a narrow AAA basis, estimates are that its size falls from \$5.6trn. to \$3.1trn. It falls to about \$2.7trn. if reserve managers focus only on French and German government debt. This compares to global FX reserves of \$8.4trn.

One implication is that the Euro's share of newly accumulated reserves is likely to be smaller and the USD's share larger as we go forward. A second implication is that diversification demand for the GBP, CAD and AUD is likely to rise. Recent GBP price action and data on foreign buying of gilts suggests this is already happening. However, the recent weakness in risk appetite has masked this effect to some extent for the AUD en CAD. We expect emerging market currency accumulation to rise faster in H2.

We see for the moment little long-term potential for the Euro to appreciate in the absence of fiscal integration within the European Union. We also need to see commitments by EU regulators implementing credible plans to lower deficits over the medium term.



Although the USD has been acting as a safe haven, it is not obvious that this status can be maintained on the longer term. Much will depend on the U.S. economy and if it can grow out of its deficit problems.

We are positive on the outlook of the commodity currencies in general. The Canadian dollar, the Australian dollar and the Norwegian Kroner are backed by

natural resources such as oil or other commodities. UK Gilts have been able to maintain their AAA status, which has enhanced the attractiveness of the Pound Sterling as an alternative to the Euro.

After a long period of anticipation, the People's Bank of China (China's central bank) announced "enhanced" currency flexibility with a "continued emphasis" on a basket of currencies. On the surface, China's announcement of a new currency regime seems like a big deal; under the surface it looks like a tiny step. China is not delivering the large U.S. dollar revaluation desired by U.S. policy makers. Moreover, with their increased focus on a basket of currencies and given that the Remnibi has strengthened significantly against the Euro this year, China's policy makers are unlikely to allow their currency to move much against the U.S. dollar. A small appreciation will likely have little impact on growth and inflation for the U.S. and a small impact on the economies of China's other trading partners. What China has done is buy some extra time. However, unless the bilateral exchange rate moves much quicker than we expect, political pressure will quickly escalate into the U.S. elections in November this year.

6. Commodities

In June, soft commodities took the top spot of price gainers, led by coffee and sugar. Corn rallied 9% on the last day of the month as the U.S. Department of Agricultural released lower than expected acreage numbers. Metal and oil prices made strong gains through 2009 on the

back of global fiscal and monetary stimulus packages. But moving into 2010, uncertainty over the strength of the global economic expansion has caused headwinds for industrial metals and oil. The price of oil declined by 7.1% to USD 75.6 per barrel in H1. Oil peaked at USD 86.8 per barrel on April 4. We expect the price of oil to stay soft this year. Metals demand should pick up as soon as early indicators of economic growth turn bullish.

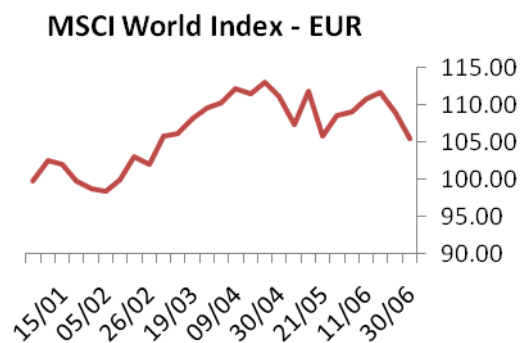
The price of Gold denominated in Euro has reached new highs in Q2, which gives an indication that general risk appetite has decreased. We remain cautious on Gold as most of the upward move has been supported by speculative money inflows. Once general risk appetite returns, cash will be moving out of safe heavens such as Gold into riskier assets such as equities. We may see the first signs of such moves in H2.

7. Equities

At this point in the economic cycle, when growth has picked up from the trough, but momentum is starting to show signs of peaking, equities usually endure a soft period. The perception of risks has markedly increased which already lead to strong stock market corrections in February and May this year.

At the end of June, stock markets of advanced economies discounted a mild global recession and it seems that markets are overly pessimistic in their outlook for economic growth and company earnings. Economic growth will probably slow down in H2 evidenced by a

flatter yield curve and lower world trade. But the global economy is still expanding and that is the key.



Also, for large cap companies, the picture looks quite bright in general. Company margins are still quite good, although margin improvements may only come from revenue growth as cost cutting have been largely implemented. With global economic growth of around 4.3% forecasted by the IMF in 2011, revenue growth into the coming year can be expected.

But other factors are positive as well: free cash-flow of companies stands at all time highs and M&A activities are clearly picking up. Companies are also prepared to invest again in capacity expansion. Inventories have been restocked, but they remain at surprisingly low levels.

Stock markets in the U.S. and Europe currently demand a high equity risk premium ("ERP") of 6.2%, which is high compared to historic numbers (4.5-4.9%). The ERP should come down when the sovereign and financial crisis stabilizes.

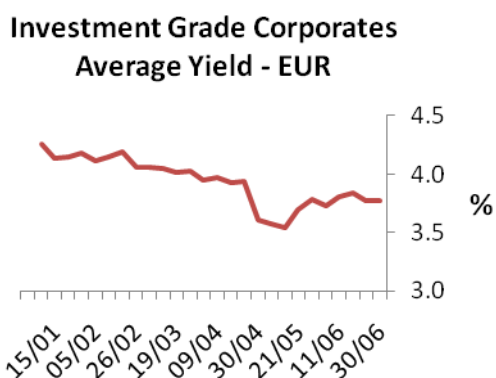
The MSCI world index, covering equities worldwide, was up by +4.4% in Euro in H1, despite negative returns of the Western

stock markets in local currencies. This shows the large impact of the USD appreciation this year.

It is our conclusion that equities are an attractive asset class, despite near term risks and volatility. Most equity markets are down for the year but we expect a return to positive territory by the end of the year. We stick with the same key investment themes: global growth is likely to be stronger than domestic growth, and we continue to prefer companies levered on to the World trade cycle and emerging markets in particular.

8. Credits

Investment grade Credits rallied at the start of the year. They remain attractive as long as AAA government yields stay stable. At the end of June, investment grade Euro Credits (min. BBB) yielded on average 3.77%. This is 135bp over Bunds.



In April and May, credit spreads over Bunds increased due to the sovereign crisis in Europe. Were sovereign risks in the EU to diminish, we expect credit spreads to narrow again.

High Yield bonds look more attractive again as U.S. high yield spreads have increased from around 350bp in January to around 650bp at the end of June.

9. Conclusion

The outlook of world economic growth seems to be overshadowed by pessimism about Europe. In comments published by the Financial Times, Jean-Claude Trichet said that the world should not write off the eurozone, as a surge in German exports highlighted Europe's economic resilience. The gloom over Europe's prospects was overdone. Economic data "are not confirming this pessimism", he said. A double-dip into recession "is not at all what we are observing", he added.

His comments underline that emergency measures to stabilise Europe's monetary union are taking effect. The ECB further believes that the European Union plans to publish bank "stress tests" this month will further strengthen investor confidence. After the publication of revised growth numbers by the IMF, the stock markets gained confidence and financial stocks, early indicators, rose sharply.

This confidence building is necessary for risk appetite to return and it is possible that we are at its early stage. Were this the case, the second half of this year should be an interesting period for equity investors.

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Table 1: Ranked Performance of Various Indices, 1st Half 2010

| | |
|--|--------|
| Gold \$ per Ounce | +10.8% |
| MSCI World in € | +4.4% |
| JP Morgan Global Gvt. Bonds in € | +4.1% |
| Credits in € | +3.3% |
| High Yield in \$ | +2.5% |
| Barclays CTA Index | +0.6% |
| JP Morgan Cash Index 1M in € | +0.2% |
| HFRX Global Hedge Fund Index \$ | -1.7% |
| CV Bonds in € | -1.8% |
| MSCI Europe | -5.8% |
| Barrel of Oil in \$ | -7.2% |
| MSCI China Free in \$ | -7.3% |
| MSCI Emerging Markets in \$ | -8.6% |
| MSCI USA in \$ | -9.1% |
| MSCI Japan in JPY | -9.2% |
| Rogers International Commodity Index in \$ | -11.9% |
| Copper in \$ per Lb. | -14.1% |
| MSCI Latin America in \$ | -14.3% |



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