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Weekly Report

Who will dictate rates - the Fed or the market?

Ben Bernanke is currently not in an enviable position: in his reelection hearing he is confronted with a senator threatening to do everything to stop the Fed chairman's nomination. But the true fight surrounds the powers of the Federal Reserve: The central bank faces significant losses in influence on bank supervision, consumer protection and emergency lending ability, among other issues. In this highly politicized environment, it will be crucial that the Federal Reserve succeeds in keeping its independent role. It goes without saying that addressing non-popular exit strategies now is timing-wise somewhat suboptimal – particularly if those should include rising rates eventually. Yet what may please politicians may soon be considered unacceptable by market participants. The current strategy of the FOMC to keep interest rates at an exceptionally low level for an extended period of time in light of improving economic fundamentals may prove to be dangerous. How quickly market sentiment can change was evident after the data on US employment: Interest rate expectations underwent a dramatic shift. It is debatable if the unemployment rate has definitely reached its peak, but leading indicators definitely point to a continued improvement in the labor market, notably initial claims, number of weekly hours worked and temporary hiring. While tops in the jobless rate did not lead to immediate changes in the monetary policy in the past, the fed fund rate never ever has been at virtually zero. Given the probable topping out in the unemployment rate and steady increases in the breakeven rates, the Fed will have to act sooner or later - or the market will do so.

Foreign Exchange

The strengthening of the USD as a reaction of much better than expected employment data was remarkable and might even mark a turning point of the battered currency. All depends really on the assessment of future measures by the Federal Reserve. Should the unemployment rate be close to a top, which corresponds to our scenario, the FOMC will take stronger action than currently foreseen by investors to absorb liquidity from the markets. As the Fed has already signaled it will stop expanding its balance sheet from March onwards, which would reduce domestic liquidity creation and the market additionally starts to foresee benchmark interest rate hikes, the USD should indeed strengthen, particularly against the EUR. As the USD has been the favored funding currency in carry trade operations, anticipated rising interest rates would force investors to unwind their positions. Additionally, a trend reversal could lead investors to neutralize their extreme shortening of the USD.

	Short-term trend	Last
EURUSD	↓	1.4824
USDCHF	↑	1.0199
USDJPY	↑	89.54
GBPUSD	→	1.6415

Fixed Income

The ECB announced next stages to its exit strategy, which appears braver than what investors expected. While the benchmark interest rate remained at 1 % and Jean-Claude Trichet seemed not to object market anticipations that the rate will remain at this level until late next year, liquidity boosting operations will clearly be curtailed: Offers of unlimited one-year loans at 1 % will be awarded in December for the last time and offers for six months liquidity would end after an operation envisaged in March 2010. Additionally, the frequency of three-month offers would be reduced. Importantly, though, the ECB will continue to match in full, bank demands for liquidity in the regular weekly operations until at least mid April. The central bank also emphasized that these measures were not signaling a tightening of monetary policy and liquidity would remain extremely abundant for many months. Interestingly, Mr. Trichet stated policymakers should exactly balance the risk of acting too late with those of acting too soon, which seems to demonstrate that the perception among central bankers is slowly changing. We position ourselves for rising rates.

	Forecast end 09	Last
US 10y T %	4.00	3.46
Fed funds	0.25	0-0.25
Bund 10y %	3.70	3.20
ECB rates	1.00	1.00

Stocks

We consider DaVita (DVA) an attractive investment. The company provides dialysis services for patients diagnosed with chronic kidney failure. DVA has over 1500 outpatient dialysis facilities and acute units in over 700 hospitals. The company is located in 43 states, serving approximately 117'000 patients. Dialysis is a stable and recurring business. In 3Q, DVA reported adjusted internal growth of 4.8 %. Next to healthy volume growth, the quarter was characterized by stable private pricing, strong cost controls and very strong cash flows. Dialysis revenue per treatment increased \$ 2.79 from 2Q (+ 2 %) driven by an increase in physician prescribed pharmaceuticals, an increase in EPO's average selling price and improved commercial rates, whereas mix shift had a slight negative impact. Operating income grew by 10.5 %. Management raised the operating income guidance for 2009 to the \$ 930-950 range, reflecting the performance through 3Q. In addition, management expects prior operating cash flow guidance of \$ 550-600 million to be modestly exceeded. For 2010, operating income are guided to \$ 950 million to \$ 1.02 billion.

	Forecast end 09	Last
S&P 500	1120	1106
NASDAQ	2200	2193
DJ STOXX 600	250	248
SMI	6500	6476