

# Investment Policy Committee Bank Leumi (Switzerland)

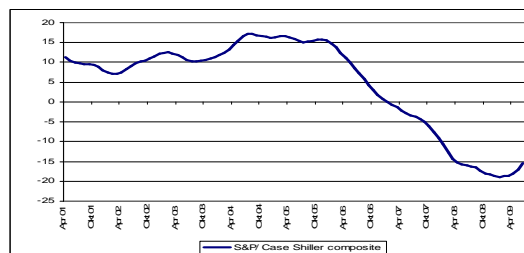
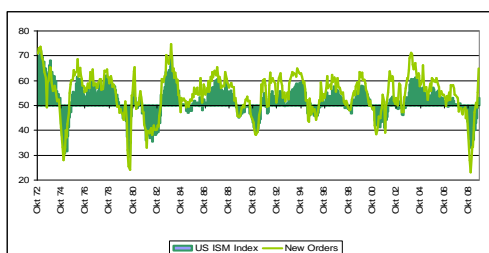
Fourth Quarter 2009

GDP growth	2008			2009E			2010E		
	2008	2009E	2010E	2008	2009E	2010E	Monetary Policy		
United States	0.4	-1.3	2.7	3.8	0.3	2.4	end of 2010		
Euro Zone	0.6	-4.5	0.7	3.3	0.3	1.6	3.25		
Switzerland	1.8	-2.1	1.8	2.4	-0.3	0.8	2.50		
UK	0.7	-3.9	1.3	3.6	1.7	1.5	3.00		
Japan	-0.7	-5.7	0.9	1.4	-1.0	-0.2	0.00		
China	9.0	8.2	8.7	5.9	-0.5	2.7	6.00		

## 1. Economic environment

### United States

2Q will most likely mark the last quarter of negative growth in this economic cycle. We expect a sustainable recovery. The expansion is anticipated to be driven by inventory rebuilding, residential housing improvement, exports and continued government consumption. The uncertainty in respect to personal expenditures is elevated. Economists have incorporated very low expectations in their models and certain indicators point to a less negative outcome. The two crucial factors to closely monitor are the savings rate and the employment outlook. The saving rate recently recovered strongly from zero to around 6 %, yet fell back to the current 4.2 %. The latter equals the average over the past 20 years. Analysis based on responses to past changes in wealth relative to income suggests that the personal saving rate could level out near its current value. This contrasts however with most current expectations, which assume a significantly higher rate. The propensity to save will be primarily determined by the further development in the labor market. While the unemployment rate rapidly approaches the 10 %-level, the more reliable enrollment data show a significant and constant improvement in the rate of job losses over several months. The most recent Beige Book revealed that some districts reported a slight pickup in the demand for temporary workers, which historically serves as a reliable guide to future employment trends. The rate of decline in headline retail sales remained quite stable since the beginning of this year, but the “cash-for-clunkers” program, due to its “use-it-or-lose-it” clause suggests that future sales have been brought forward. In sum, we assume that current estimates in respect to the development in the savings rates are too pessimistic and think that companies will be less inclined to let go qualified employees in an environment of a potential economic recovery. Wealth effects from housing and the stock markets have also surprised positively. The housing sector shows a clear upturn in existing home sales, which should continue based on pending home sales statistics. Some short-term uncertainty may arise due to the termination of the first-time homebuyer tax credit incentive. Additionally, inventory levels are still uncomfortably elevated. Yet price developments have probably caught everyone by surprise as the year-on-year rate in decline has been reversed and month-on-month comparisons even turned positive in the most relevant Case Shiller composite. Residential housing, which weighed considerably on economic growth during the crisis, is therefore anticipated to contribute to the expansion. The inventory rebuilding theme is widely accepted by market participants and was indeed one of the main triggers for renewed optimism. In fact, the improvement in leading indicators continued and the ISM has reached positive territory for the first time in 19 months. The sub-component of new orders even jumped to 64.9, which signals, simply and plainly, growth. Interestingly, also export orders advanced to expansion ground. Exports, which are currently supported by an attractive USD, may also contribute positively to GDP over coming months.

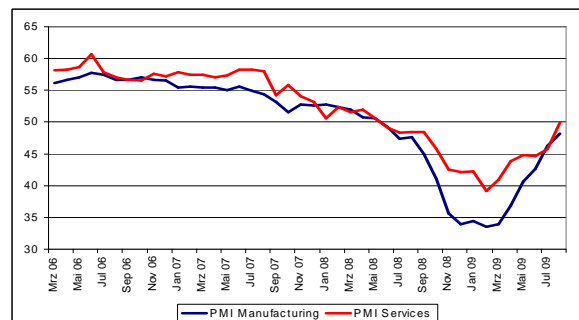
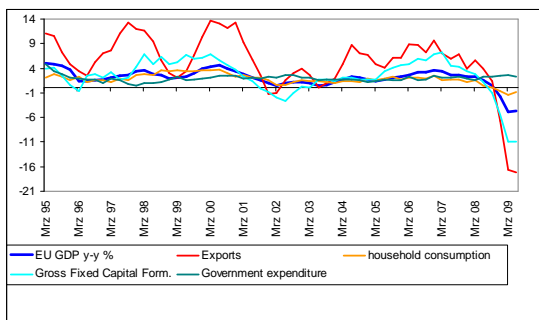


Fed chairman Bernanke strongly believes in the output gap concept and he therefore perceives the danger of an inflation breakout as very limited. Indeed, most price indicators have dropped sharply and in some instances even fell into negative territory. But inflation indicators often follow with a lag. More market driven data, such as Treasury breakevens, consumer inflation expectations, commodity prices and the steepness of the yield curve might reflect some uneasiness about future inflation pressure. With the economic activity continuing to stabilize, investors wonder indeed if the Federal Reserve will be successful in finding a timely exit strategy. Should monetary authorities wait too long in shrinking the Fed's balance sheet, which experienced a breathtaking expansion over recent months, inflation expectations could kindle very fast. But since historic events, comparable to the current crisis, have shown that central banks tend to tighten monetary policy too early, thereby putting economic growth at risk, the FOMC seems currently very hesitant to take out excess liquidity. A low level of interest rates is beneficial to finance the enormous government debt and it is crucial to mortgage lending and corporate refinancing. We reckon that reducing the balance sheet will be more difficult to orchestrate than the Fed currently admits as the expansion in recent months occurred in longer-term assets. The TALF program has a minimum term of three years and agency mortgage-backed securities, which represented a main focus, have a duration of at least four to five years. Furthermore, some possible exit strategies would be efficient for several hundred billions, but not the trillions involved. We therefore consider raising Fed fund rates a viable option but fear that this instrument will only be used with a delay. Consequently, we expect yields to rise and the yield curve to remain steep.

**Eurozone**

Recent data point to a stabilization in the Eurozone. The draw-down in inventories is perceived as largely behind us after the exceptionally large negative 0.7 percentage point contribution to GDP in 1Q and 2Q of this year. Leading indicators in the manufacturing sector imply a significant rebuild in stocks, which should represent a main factor to growth in 2H09. The observed revival in world trade is also expected to support economic growth, notably in Germany. The combination of re-stocking and increasing exports should eventually lift capacity utilization. Business investments are therefore supposed to start increasing from very low levels sometime in 2010. Government expenditures are anticipated to add to growth in 2009. Consumer spending may, however, witness future sluggishness after a modest sequential increase of 0.2 % in 2Q, which was supported by car purchases incentive schemes. Retail sales, which are excluding auto sales, remained in negative territory for five quarters in a row. The weak start to 3Q09 suggests no change in this trend. Rising unemployment and slowing employee compensation are main factors for expected weakness in consumption. A rise in inflation, as energy price base effects reverse, additionally impact purchasing power. The deficit situation represents another reason for sub-par growth: The European Commission estimates the Eurozone deficit to reach 7.4 % in 2010 and the government debt to soar to 82 % of GDP, which is substantially above the Stability and Growth Pact limits. This will undoubtedly limit future government spending capabilities and might lead to an even higher tax burden later in 2010.

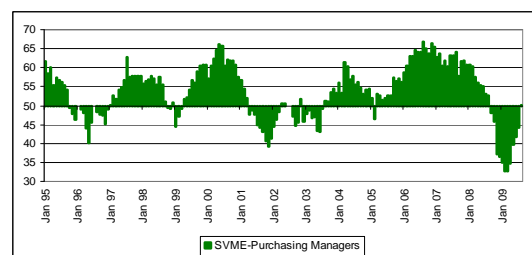
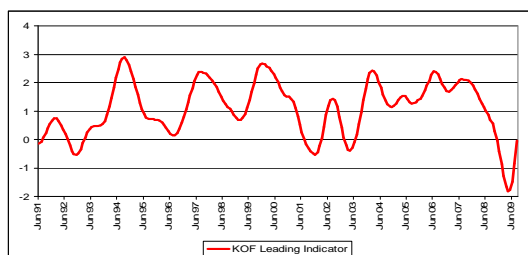
The ECB supports the notion that the recession has ended. But it remains cautious in respect to future growth, which corresponds to our view. The European Central bank considers the weakened banking system, the need to restructure balance sheets and volatile commodity prices as the main issues for worry. Given this still prudent scenario, the central bank sees no reason to fully exit its expansionary policy stance for the foreseeable future. At the same time, it emphasized that a degree of phasing out has already been built into the design of the measures and the operational framework was well equipped to facilitate an eventual unwinding. Contrary to other central banks, the ECB showed reluctance in respect to outright purchases of securities. It has focused on the vast market for covered bonds and created therefore rather a catalyst than true demand. Should non-standard measures however trigger risk to price stability, the ECB is determined to act immediately. We expect the ECB to remain on hold well into 2010.



## Switzerland

2Q GDP contracted much slower than expected, falling by 0.3 % from the previous quarter and 2 % from a year earlier. Negative growth impulses emanated in particular from the balance of trade in services. The decline in exports of services continued at almost the same pace as in the previous quarter (- 4.6 %). Imports of services rose 1.5 %. The trade in goods contributed however positively to growth, as imports fell more sharply than exports. The latter decreased by 2 %, which represents an improvement in comparison to the drops of 8.9 % and 6.1 % in 4Q08 and 1Q09, respectively. The stabilization in world trade is encouraging news for this export-sensitive country and hints to a further amelioration for the rest of this and next year. Final consumption continued to develop positively, rising 0.7 % on growth in housing, energy, furniture, health and telecommunications. Surprisingly, household consumption rose 0.6 % after increasing 0.3 % in 1Q despite rising job losses. The still moderate unemployment rate of 3.9 % may explain this phenomenon. The labor market is expected to continue to worsen as many short-work programs are set to expire. The unemployment rate could reach close to 5 % in 2010. Government expenditures increased by 1.2 %. Fixed investments grew, but only due to construction, which rose an impressive 3.5 %. Equipment and software investments, however, declined by 0.8 %, but fell less than in the previous quarter. The purchasing manager index reached positive territory for the first time in a year, which is surprising in light of the strong exchange rate. Machinery orders still fell sharply year-on-year, but the rate of decline has improved markedly in 2Q. The KOF Swiss leading indicator rebounded strongly, signaling that the process of GDP contraction is likely to end at the beginning of 2010. Since the start of the year, the Core GDP module, which excludes construction and banking, has posted a sustained strong recovery. Importantly, the construction and banking modules now also show signs of tentative upwards movement. We expect the economy to bottom out over coming months and to improve noticeably in 2010.

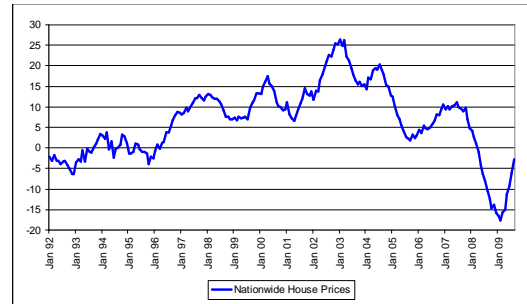
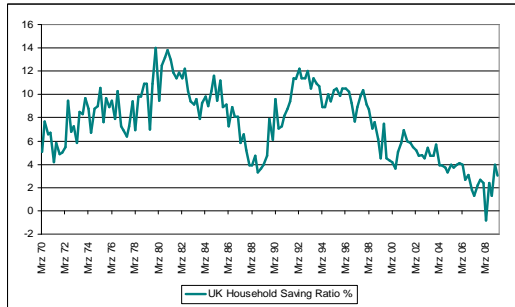
Headline inflation has begun to rise again after having reached a 50-year low of - 1.2 % in July. Energy prices represent the main factor for fluctuation: they pulled down inflation over the past year, but the price collapse in last autumn now drops out of the year-on-year comparison. The so-called base effect leads to higher headline inflation also if energy prices should not continue to increase. Additionally, food inflation seems to have reached bottom. Core inflation remained in positive territory, but may still pursue its downward trend. A member of the SNB stated that the time for higher rates has not yet come. We observe that during the crisis, the Swiss central bank showed a high degree of pro-activeness, which should also be demonstrated in the recovery phase.



## United Kingdom

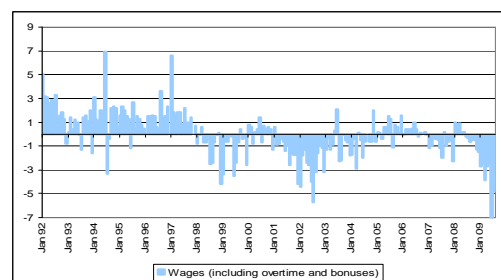
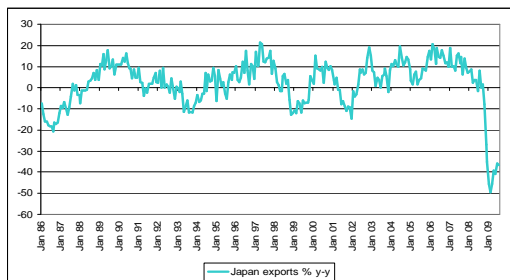
The contraction in 2Q GDP of 0.7 % q-q contrasts with slight growth in other large European economies. Several indicators point, however, to growth in 3Q09. The PMI Services index reached positive territory already four months ago. Combined with the PMI Manufacturing, which most recently is hovering around the 50-level, the composite index stays at 53.3, which is consistent with low q-q GDP growth. Net trade already started to contribute positively and taking into account the stabilization in trade volume as well as the GBP weakness, further improvement from this sector is anticipated. Inventory rebuilding and strong government consumption are probably the strongest drivers in the near term. Household expenditures showed accelerating year-on-year declines in 2Q09. A significantly deteriorating labor environment, a large drop in household wealth and a rise in the saving rate have mostly caused that drop. Encouragingly, though, consumer confidence improved significantly in recent months and the saving rate recovered to 4 %, which might point to relatively stable retail sales going forward. Importantly, house price indicators continued their upwards trend, which is supposed to improve the wealth effect. The low level of capacity utilization does not speak for an imminent improvement in capital spending, which has dropped considerably in previous quarters.

The decision by the Monetary Policy Committee to extend its quantitative easing purchases at a time when other key central banks started to discuss exit strategies and emphasized the phasing out of current stimulus measures, left an impression of uncertainty and heightened cautiousness. Nevertheless, the large amount of policy stimulus together with encouraging trends mentioned previously, we expect the UK to emerge from recession in 2H09. The rate of success in reversing the massive economic support will determine future inflation potential. Political pressure to improve the state of public finances could eventually lead to a VAT increase sometime in 2010. While this could dampen the rate of recovery, we consider the current consensus view as too pessimistic.



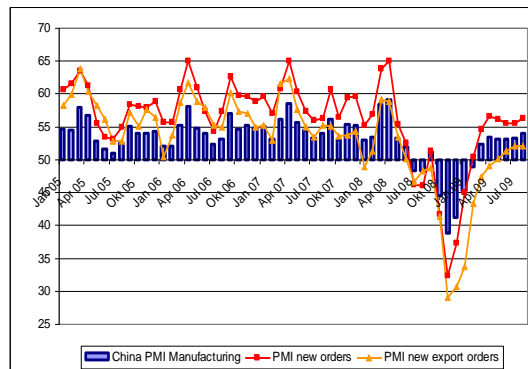
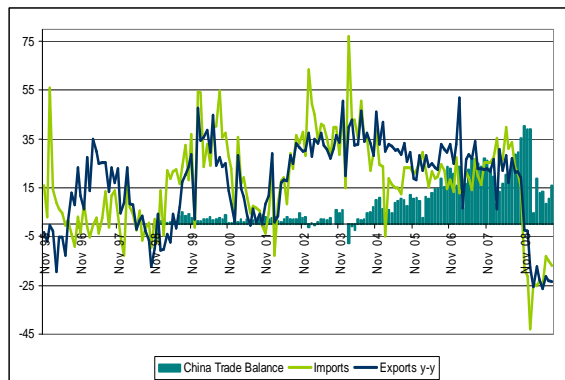
## Japan

The rate of recovery in 2Q was less pronounced than expected. GDP increased by 0.6 % q-q (2.3 % annualized). Even worse, the degree of economic contraction in 1Q was widened to a staggering 3.3 % (-12.4 % annualized). The inventory draw-down was particularly severe and obscured by overseas backlogs of Japanese subsidiaries. On the positive side, stock re-building should contribute positively to GDP in 3Q. Exports underpinned growth in 2Q. Given the favorable outlook for the US and China, which are the two largest destinations for Japan, exports are anticipated to contribute positively this year and in 2010. The outlook for private consumption is somewhat more complicated. Consumer expenditure showed growth in 2Q, which can be attributed to government stimulus on eco-friendly cars and appliances. Fundamentally, though, consumption is not supported: The unemployment rate rose to 5.7 % and employee income continued to deteriorate. Once the stimulus effect has vanished, consumption is set to weaken. The newly-elect DJP party program vows for a shift in focus to domestic demand and promises generous child allowances and welfare payments, yet this support will probably only become effective in FY2011. The changed political landscape may also affect public expenditures. The DJP initiatives will cost an estimated JPY 16.8 trillion, or \$ 177 billion respectively. To finance these plans, government spending has to be cut, given the budget constraints. DPJ representative Hatoyama already vowed not to exceed new bond sales for the next fiscal year from this year's record JPY 44.1 trillion. More insights can only be obtained once the FY2009 second supplementary budget will be submitted, probably some time in October. Proposed household support measures and revisions to the previously planned expenditures will offer a clearer picture on how expansionary DPJ policy will truly be. Capital spending was a drag in 2Q. Towards year end, increasing exports and higher capacity utilization should incentivize investments. Signs of a recovery in machinery orders point in this direction. Japan seems still rather be plagued by deflation than by inflation. No change in BoJ policy is therefore anticipated in the foreseeable future.



## China

The impressive reacceleration in economic growth has mainly been triggered by strong government-led investment focusing on massive infrastructure expenditures and an unprecedented credit expansion. While the sharp increase in bank credit provided the necessary funding for investment growth – a segment, which has been central to the Chinese success story for many years- it also substantially increased the risk of asset price inflation and future bad loans. Given these threats, it seems only logical that the extremely expansive monetary policy is now in the process of being reversed. To put the credit growth in perspective: In the time frame from January to June, new loans exceeded by 50 % the amount of the whole year 2008. The People's Bank of China reportedly changed its monetary policy objective to “ensuring domestic demand and promoting economic growth”. It ordered state-controlled banks to rein in excessive lending and resumed the auctioning of one-year central bank bills to soak up excess reserves in the banking system. This led to a sharp drop in new lending volume in July, scaring off investors. August, however, saw an unexpected increase in new lending activity again. The key question going forward is to what extent the liquidity-driven expansion will be slowed down and what instruments will be used. For the rest of the year, we expect the central bank to continue fine-tuning monetary policy, but to refrain from rising benchmark interest rates as the government still targets and 8 % economic growth for 2009. The recovery in the Chinese economy seems firmly in place with domestic demand still acting as the primary engine.



## 2. Market Outlook

### a) Fixed Income USA

The Treasury yield curve has steepened significantly, signaling the end of the recession. The Federal Reserve seems, however, very hesitant in removing extraordinary measures, despite various indicators hinting to economic growth from 3Q09 on. Quantitative easing may be cautiously unwound starting towards end of 2009, but increases in fed fund rates seem no option to the US central bank this year, despite their extreme low levels. The delayed removal of massive liquidity at times of economic recovery will most likely rekindle inflation fears, lifting the yields on the longer end and keeping the yield curve unduly steep.

Since we expect interest rates to increase over a longer time period, we underweight bonds, particularly Treasuries and favor the very short end of the curve as well as Floaters, TIPS, and Short-Treasuries-instruments.

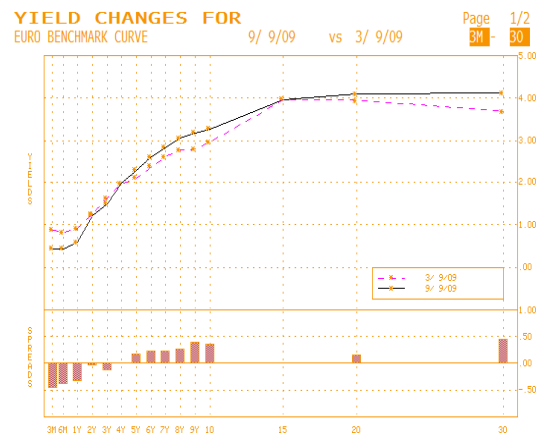
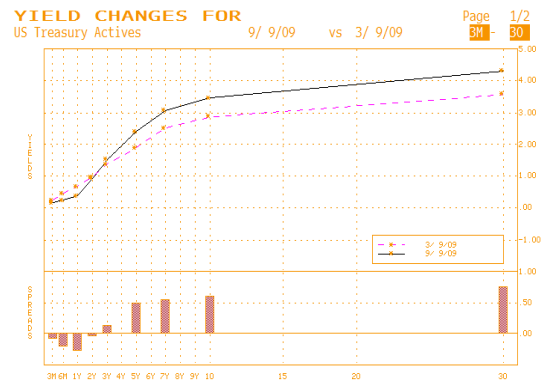
### b) Fixed Income Europe

There are sings of nascent recovery in Europe. While the ECB believes that the recession has ended, it considers some factors in the recovery as temporary in nature, notably the rebuilding of inventories and certain parts of the fiscal stimulus program. Additionally, ongoing balance sheet corrections could potentially derail the economic expansion. We are particularly prudent in respect to consumer expenditures, which will most likely experience negative growth rates in future months, after the phasing out of the auto incentive program in Germany. The ECB articulated probably the clearest "exit strategies" among central banks and emphasized that several of the extraordinary measures will unwind naturally.

We expect the ECB to stay on hold until at least mid 2010. The yield curve should remain steep.

### c) Fixed Income Switzerland

Risks in respect to deflation have clearly diminished. For 2010 and 2011, the SNB now expects slightly positive readings. During this crisis, the SNB showed a high degree of pro-activeness, which should also be demonstrated when the central bank senses that the worst of the crisis is behind us.



#### d) US Stock Market

Positive economic and earnings revisions led to an impressive market rally since the lows of March. While company revenues remained subdued, reflecting the deep recession, earnings surprised positively. Aggressive cost cutting and more favorable input prices explained most of the excess return. According to our economic scenario, top-line growth is anticipated to resume, notably towards the end of the year. Given the enhanced operating leverage, margins should improve considerably as a consequence. 2010 earnings are expected to rise 25 % versus 2009 offering strong support to stock valuation. We suspect that many investors missed out on the current rally and are under pressure to find an accurate entry point, which explains, why no meaningful correction has occurred so far. We still consider equities the most attractive asset class. Nevertheless, due to the uniqueness of the extraordinary measures which have been taken by the central banks and governments, history is no guide to the current situation. Will unwinding be interpreted as tightening measures or as steps to normalization? While both mean that enormous sums of liquidity will be taken off the market, the interpretation of the situation could mean a totally different outcome: A mere unwinding might be interpreted positively as it reflects a more solid economic environment and more visibility. Tightening, however, is always first greeted with a correction in stock prices. Eventually though, investors will again concentrate on the improved profit picture and a second wave of an equity market upturn occurs. Sector wise, a potential consolidation phase could favor again some more defensive names. But cyclical stocks should still be overweight, particularly in anticipation of a second leg in the upturn. At a P/E of 13.7x estimated 2010 earnings the market seems still attractively

valued. The risk premium has declined, but is still, historically speaking, at an alluring level.

➤ **S&P 500 target 1120**

#### e) European Stock Market

Economic and earnings recession should end in 3Q09. While the market has already discounted part of the new growth cycle, the anticipated strong profit upturn of approximately 20 % still justifies a positive view on stocks. Liquidity drain and inflation fear could lead to a consolidation phase, however, probably some time at the beginning of 2010. Cyclical stocks should still be overweighted as a reflection of an economic upturn. At a P/E of 12.4x estimated 2010 earnings, the European equity markets are considered attractively valued.

➤ **DJ STOXX 600 target 250**

#### f) Swiss Stock Market

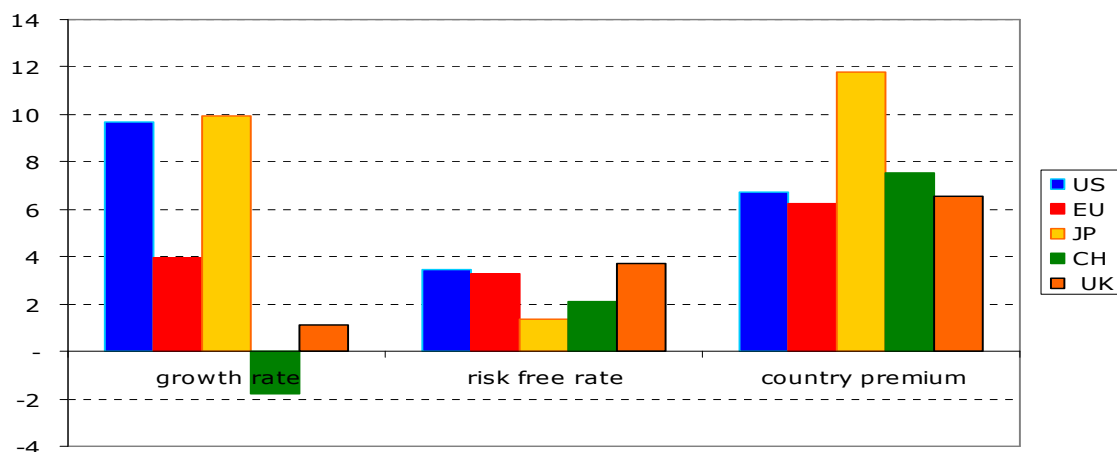
The slightly more defensive posture of the Swiss market will likely lead to a relative underperformance, notably in the beginning of the economic upturn. Nevertheless, the estimated P/E of 12.3x estimated 2010 earnings seems alluring. Due to the heavy weighting of some strongly international-oriented companies (Novartis, Nestle, Roche, UBS, Credit Suisse) the index is less sensitive to developments in Switzerland.

➤ **SMI target 6500**

#### Conclusion:

**We keep our overweight equity exposure**

**Country Risk Premiums & Growth Rate est.**  
(consensus 5 year avg. est.)



**g) Foreign Exchange OUTLOOK**

**Investors will switch focus from the deficit situation to interest rate policy over coming months.**

**EURUSD:** The trend reversal in the USD will only occur when investors start to anticipate fed fund interest rate hikes. As we expect the FOMC to react late, a substantial re-rating of the USD will probably not occur this year. Next year, however, we suspect the US to raise rates more drastically and earlier than the ECB. The USD should then strengthen considerably.

**EURCHF:** Similar to the JPY the CHF has played a role of safe haven. Less risk aversion leaves the CHF vulnerable. The actual and verbal intervention by the SNB should additionally lead to less CHF strength.



➤ **EURUSD seen at 1.40 at year end**

➤ **EURCHF seen at 1.54**

**USDJPY:** This currency pair is expected to react to the risk assessment of investors. Most recently, extremely low interest rates worldwide led to repatriation of capital to Japan, however. We expect interest rates to develop more dynamically outside of Japan, particularly in 2010 and expect a weakening of the JPY then.

**GBPUSD:** Market estimates in respect to the UK economy are overly bearish, in our opinion. The BoE is very proactive and aggressively tries to stabilize the economy. Risk to a further appreciation of the GBP is mostly of political nature.



➤ **USDJPY seen at 98 at year end**

➤ **GBPUSD seen at 1.70 level**



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