

Weekly Report

Outlook 2010

Our 2009 forecast started with the Warren Buffet citation "be greedy when everyone is fearful and fearful when others are greedy". While our optimism looked foolish at the beginning of the year it turned out astonishingly accurate for this exceptionally volatile year. The anticipation of correct trends in interest rates and central bank policies will most likely determine the success in forecasting in 2010. Interestingly, opinions on these subjects diverge substantially. The improving economic environment, including an amelioration of the labor market and noticeably better financial market conditions will force the Federal Reserve to execute a more convincing exit strategy of the ultra-accommodative monetary policy than generally anticipated. We expect higher rates in the US with the short-term increasingly reflecting rate hikes and the long-end inflation fears. Economic growth in the Eurozone will be driven by external demand. Consumption, however, is anticipated to remain sluggish, which should together with a relatively strong currency, sovereign risks and some balance sheet restructurings by non-financial corporations lead to a slow recovery. As the euro area is anticipated to lag the global upturn, the ECB will be more hesitant in raising benchmark rates than other central banks. It therefore will be difficult for the EUR to continue showing strength. Growth in China will further accelerate, but overcapacity in certain areas, rising fear of asset bubbles, triggered by an unprecedented credit expansion and building inflation pressures will force the central bank to tighten policy. Exit strategies and rising rates will challenge equity performance.

Foreign Exchange

While the USD seems over-bought on a short-term basis, it seems attractive longer term. Should economic figures confirm the upturn even of lagging indicators such as employment, which corresponds to our scenario, the Fed will take stronger action as currently foreseen by investors to absorb liquidity from the markets. As the USD has been the favored funding currency in carry trade operations, anticipated rising interest rates would force investors to unwind their positions. It should particularly trend favorably against the EUR as the ECB is anticipated to lag benchmark rate increases versus other central banks. We are bearish on the JPY. While it could become again the favored funding currency for carry trade operations, fundamentals are outright negative. Given the expected economic slowdown and associated measures by the government and the BoJ, we anticipate interest rates to develop more dynamically outside of Japan. We consider market estimates in respect to the UK economy as overly bearish. Inflation expectations have improved. The BoE is proactive. The GBP has potential.

	Short-term trend	Last
EURUSD	→	1.4417
USDCHF	→	1.0386
USDJPY	→	92.43
GBPUSD	→	1.6143

Fixed Income

Bond markets will face a much harsher environment in 2010 as several crucial factors will change. First and foremost, the extraordinary easy monetary policy of the central banks will be abandoned. We expect all central banks, with exception of the BoJ, to turn to interest rate hikes. Those, which have used bonds buying as a measure of quantitative easing, will reverse it. The exception here seems also to be Japan. The current abundant liquidity will probably decline during the course of the year. We therefore underweight bonds in our asset allocation. Government bonds are considered outright unattractive. Instruments, which allow us to short Treasuries, such as the TBF or TBT are therefore favored. Corporate bonds seem most appealing at the high yield level. Since we expect interest rates to rise, we position ourselves at the very short-end of the curve. We keep our investments in inflation linked instruments and still favor floaters. European bonds are preferred, but only on a relative basis - the current unattractive level of yields keep us very prudent in establishing new positions.

	Forecast end 10	Last
US 10y T %	4.80	3.83
Fed funds	2.25	0-0.25
Bund 10y %	4.00	3.39
ECB rates	1.50	1.00

Stocks

We continue to overweight stocks, but no longer at the maximum rate. The favorable outlook in respect to the economic environment and subsequent earnings growth favor stock investments. Operating profits are anticipated to rise in double-digits as revenue expansion should finally kick in. Cost cutting will play a more subdued role. Profit margins are generally expected to slightly increase. As central banks will unwind their extremely loose policy, liquidity will be less abundant, thereby moderating a major force of the current upturn. As inflation will increase, market multiples will no longer expand. Importantly, the consensus towards stock investments has altered dramatically. Positive surprises will get scarcer. But stocks should benefit from lacking alternatives as bonds became unattractive as an asset class. Sector wise, a potential consolidation phase could favor some more defensive names and higher quality stocks. But cyclical stocks should still be overweighted given the anticipated sustainability of the economic upturn. Most recently, we switched Starbucks (SBUX) in Exxon Mobil (XOM) and ASML (ASML NA) in Smiths Group (SMIN LN).

	Forecast end 10	Last
S&P 500	1230	1132
NASDAQ	2450	2310
DJ STOXX 600	270	257
SMI	7000	6604