Investment Policy Committee
Bank Leumi (Switzerland)

Second Quarter 2010

Esther Meier / March 23, 2010

Bank Leumi (Switzerland)

Bank Leumi Switzerland

Claridenstrasse 34
8002 Zürich Telefon 044/207 95 66 Telefax 044/207 95 75 e-Mail emeier@leumi.ch

GDP growth				Inflation			Monetary Policy
	2009	2010E	2011 E	2009	2010E	2011E	end of 2010
United States	-2.4	3.5	3.3	-0.4	2.4	2.4	2.00
Euro Zone	-4.1	1.0	1.4	0.3	1.2	1.4	1.25
Switzerland	-1.5	1.9	2.0	-0.5	0.8	1.0	1.50
UK	-5.0	1.6	2.0	2.2	2.9	2.3	1.50
Japan	-5.2	2.0	1.8	-1.4	-1.3	-0.5	0.00
China	8.7	9.6	8.9	-0.7	4.0	4.0	6.00

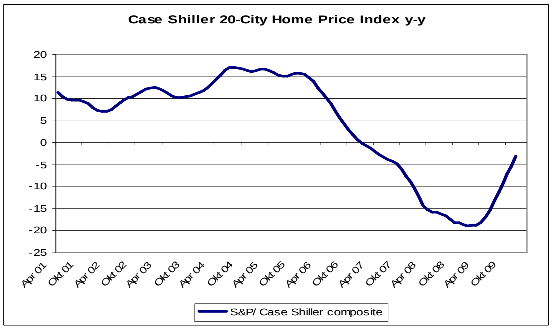
1. Economic environment

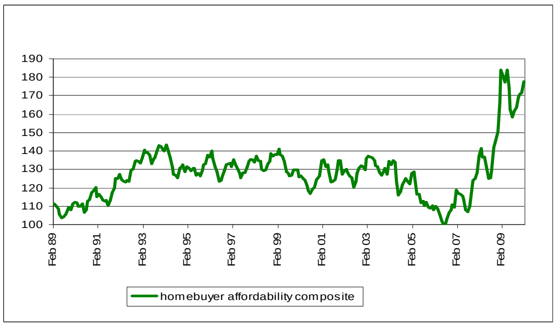
United States

We continue to expect the US to remain on a sustainable recovery path, but not at the powerful growth rate of 5.9 % registered in 4Q09 as inventories contributed approximately 4 percentage points to this expansion and some lower attribution in the upcoming quarter seems plausible. Business investment contributed positively to growth for the first time since spring 2008. Investment in equipment and software jumped 18.2% in the final quarter of last year. The thesis of accelerating business spending seems in tact with business equipment production rising for the third consecutive month in February on rising demand for computers, communication gear and semiconductors. Bookings for capital goods excluding aircraft and military equipment, representing a viable gauge for future business investments, have significantly risen. Rising corporate profits, increasingly supported by revenue gains, suggest that corporations have enough internal funds for capital expenditure. We consider business investments as a major engine propelling this recovery forward. Exports supported growth substantially for the second quarter in a row, contributing 2.3 percentage points to growth. Economic development outside the US seems quite robust, which is particularly true for emerging markets. This provides further support to US exports over coming months, which is also reflected in the elevated level of the ISM new export order sub-index. Non-manufacturing export orders, however, do not yet signal expansion.

Personal consumption added for a second consecutive quarter to growth. The development was less vivid than the previous quarter when the government's cash-for-clunkers program boosted auto sales. A string of consumer-related statistics has turned into positive territory or shown improving trends in recent months. Even consumer credit surprisingly rose by $ 5 billion in January. This seems particularly significant as it touches several of the most disputed and critical questions. It was widely believed that consumption has to decline sharply as indebted households face a job-less recovery - and thereby less income – forcing them to increase the savings rate. The savings rate jumped indeed from 0.8 % in spring 2008 to 6.4 % in May 2009. Since then, it steadily declined and currently stands at 3.3 %. Consumers probably reacted to rising disposable income, which bottomed exactly in May of last year. Additionally, rising stock prices led to a clear turnaround in net worth of households. Sceptics point to the fact that the recovery so far uniquely lies on stimulus measures and correction in the inventory situation. There are however strong signs that companies are inclined to increase capital spending again and some started even to upgrade their sales force as the very lean workforces seem insufficient for a revenue upturn. Employment losses have in any case already declined significantly and might have been tarnished by harsh winter storms most recently as indicated by important job losses in the construction industry. Importantly, the household survey showed the second consecutive increase in employment. This statistic has arguably indicated more accurately turning points in the labor market in the past. The most telling sign of an ameliorating employment situation comes from the temporary work force, which tends to lead the general labor market. After several months of growth, temporary payrolls are now above last year's level for the fist time in nearly three years. Only four months ago, they were still 20 % lower. Strong positive impulses are also expected from census hiring over the next few months. It now appears that the unemployment rate peaked last October. We expect consumer spending to continue to support economic growth. This spring, households will get some additional income through fiscal benefits, additionally supporting consumer spending.

Residential investments contributed for the second quarter in a row to growth, albeit very modestly. It previously fell for 14 consecutive quarters. The precipitous fall in existing home sales in the beginning of the year raised doubts regarding an eventual recovery in the residential real estate market. Data over coming months will offer a clearer picture to what extent stimulus measures, notably the first-time homebuyer tax credit and mortgage purchases, have supported promising trends in existing home indices that started to occur in the summer of 2008. In fact, home prices still hover around the lows last reached in 2002, but year-on-year price changes consistently moved up since April 2009. Inventory levels, which remained at an unconstructively high level, not the least due to record foreclosures, only recently experienced a significant reduction. In the new home sales area, inventories reached the lowest level since spring 1971. Housing starts and building permits undershot the 70's level by far and seemingly form a bottom more recently. The 3-months moving average in building permits already began to move higher. Importantly, the combination of low mortgage rates and attractive house prices pushed homebuyer affordability to an absolute record level, which should lead to effective house purchases, particularly in an environment where insecurity in respect to the employment situation has tempered. We therefore anticipate residential investment to continue contributing positively to GDP. Commercial construction activity, however, is still dragging. Government spending showed a slight negative contribution. The bulk of the impact from the fiscal stimulus will be felt however in 1H10. Given the improving financial conditions, the long-lasting impulse from the fiscal stimulus and probable growth contribution from exports, business investments and consumption we consider the actual economic recovery as sustainable and anticipate a GDP expansion of 3.5 % in 2010.





Inflation remained subdued in the beginning of the year. The headline CPI remains above 2 % due to base effects related to energy prices. Core inflation, at 1.3 % in February, has been weighed down by shelter prices: this category fell 0.4 % y-y, which is highly significant in light of its representation of 40 % in the index. Importantly, the core rate ex-shelter has actually risen in recent years from 1.5 % in 2007 to 2.5 % currently. As the shelter component follows house prices with a minimum lag of a year and year-over-year house prices started to increase in February 2009 (Case-Shiller 20 metropolitan areas) it seems highly probable that we are close to a bottom in this important sub-category. Import prices rose 11.2 % in February, which was slightly below the January rate. Importantly, the non-petroleum measure moved further into positive territory after having been negative throughout 2009. Stronger domestic demand and a weaker trade-weighted USD on a y-y basis should lead to further upside. Capacity utilization has recently moved up from a truly depressed level as inventories are normalized and demand proved more robust than initially anticipated. Given the structural changes occurring in the US economy, the utilization rate in different industries should be closely observed, rather than the general level. The Federal Reserve argues that the substantial resources slack continues to restrain cost pressures and longer-term inflation expectations were stable; therefore inflation will likely be subdued for some time. We would caution that inflation expectations had sharply increased from close to 0 to the elevated averages reached between 2004 and 2008, but recently slowed down in light of softer macroeconomic statistics. Expectations have the potential to change extremely fast, which the development over the last year just demonstrated. Doubts in respect to the timing and the success of the exit strategy could therefore easily lead to an uncomfortable high level. Our scenario calls for above consensus growth, which implies that some of the lost pricing power is anticipated to eventually be reinstalled. We fear that the central bank will be behind the curve, thereby creating some upside inflation risk.

In light of improved functioning of financial markets, the Fed has been closing the special liquidity facilities that it created to support markets during the crisis. The only remaining such program, the Term Asset-Backed Securities Loan Facility, is scheduled to close on June 30 for loans backed by new-issue commercial mortgage-backed securities and on March 31 for loans backed by all other types of collateral. It specifically plans to finish a $ 1.25 trillion of agency mortgage-backed securities and about $ 175 billion of agency debt purchase program by end of 1Q. By announcing an increase in the supplementary financing program (SFP) authorities ramped up their liquidity withdrawal program. Planned auctions in spring should drain approximately USD 200 billion directly from excess bank reserves, which currently stand at USD 1.2 trillion. Since the Fed is still in the process of purchasing USD 200 billion of assets, the SFP expansion will not shrink the balance sheet during this time frame. More serious liquidity drainage is expected in the subsequent months by using term deposits and reverse repos. The latter serves to indirectly raise interest rates. Additionally, we anticipate the Fed to continue the normalization of the discount rate in a swift manner, thereby forcing depository institutions to borrow in private markets rather than from the Fed.

The FOMC statement still carries the notion that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations were likely to warrant exceptionally low levels of the federal fund rate for an extended period. But other voices raise concern that leaving the interest rates at extremely low levels for much longer could lead to the build up of financial imbalances and increase risks to longer-run macroeconomic and financial stability. The reluctance to change the wording may be explained by uncertainty in respect to mortgage rates due to the end of MBS buying programs. The Fed therefore would like to keep maximum flexibility. Should mortgage rates react in a controlled way, as private investors may be attracted by yields of mortgage-backed securities in the context of improving trends in that sector and a strengthening labor market, the language might be changed promptly. We would also expect the inclusion of reserve draining measures in future statements. Interestingly, the Fed Board recently issued advisory urging banks to strengthen their management of interest-rate risk. We would argue that even if inflation remains on target, the absorption of liquidity will lead to higher interest rates. Given the above mentioned normalization process and anticipated payroll increases, we consider benchmark interest rate hikes as a logical subsequent step, which will probably occur at the beginning of 3Q.

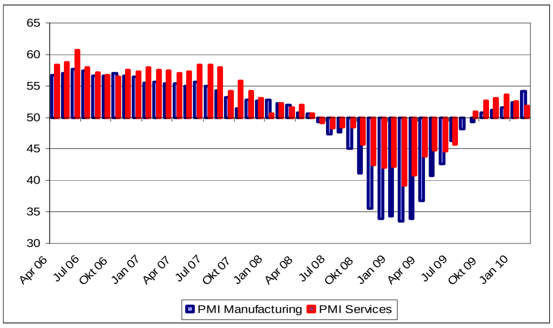
Eurozone

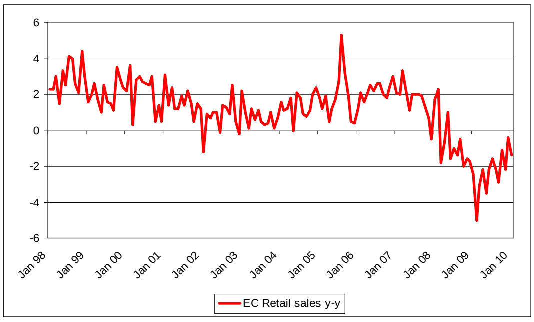
The way European countries deal with the Greece crisis is symptomatic: Lots of politics, discussions and proposals but in the end an outside party might have to solve the problem. The root of the trouble is of course that many seemingly too different countries decided to form a union 20 years ago and failed to overcome stark imbalances within the region. The globalization trend in recent years has yet deteriorated the position of many countries, which seem now even less able to compete on a global basis. Instead of undergoing tough reforms to improve their competitiveness and productivity, these countries count on the solidarity of other European member states. Germany, in particular, which went through a painful adjustment of labor costs several years ago and now successfully exports its goods on the world market, is pressured by Euro area members to import more goods from them. Stubbornly weak consumption in Germany, as a result from years of wage moderation, elevated taxes that increasingly lead to a dangerous brain drain and upcoming elections incentivized the German government this year to cut the annual tax burden by EUR 5 billion. This amount could substantially increase if it does not endanger the plan to reining in public deficit by 2012. But it seems illusionary to think that stronger consumption in Northern Europe would solve the problems of fiscally challenged Euro members. An involvement of the IMF seems currently the most probable outcome, particularly as Germany appears to have given up its opposition to such a step. Strong resistance emanates still from the ECB, which dislikes the idea that an outside party – the largest shareholder of the IMF is the US – could influence fiscal and monetary matters of a Euro-sharing country. But realistically, the IMF might prove to be a better support for Greece than any European solution as the organization can work out a pragmatic rescue plan without having constantly to fight changing political currents. In any case, the adjustments imposed on Greece might be difficult to achieve in light of the recession and rising debt costs, particularly without the possibility of influencing the exchange rate. The seriousness of the Greek situation and other fiscally challenged countries are anticipated to represent a long-lasting drag on economic growth in the Eurozone.

Bank Leumi (Switzerland)

Bank Leumi Switzerland
Claridenstrasse 34
8002 Zürich Telefon 044/207 95 66 Telefax 044/207 95 75 e-Mail emeier@leumi.ch

GDP growth decelerated in 4Q in comparison to the previous quarter, expanding by a miniscule 0.1 %. Exports continued to rise strongly and contributed 0.3 percentage points to growth. Germany remained a main beneficiary from increasing global demand. This trend should continue according to PMI data and order improvements reported by the German VDMA. Reflecting the significant recovery in global trade, the Eurozone export market is assumed to increase close to 7 % in 2010. Domestic demand, however, stayed weak with household consumption being flat versus 3Q and gross fixed capital declining 0.8 %. The weakness in private expenditures seems broad-based across sectors. Retail sales, which exclude automobile sales, fell for the seventh successive quarter in 4Q, despite relative strength in December. The situation has not improved at the beginning of this year and the PMI Retail indicator even points to a deterioration. Consumption is obviously dampened by weak labor market prospects. Euro area employment suffered the sixth quarterly decline at the end of the year. Some recent data suggest that the pace of deterioration was slowing rapidly. Some credible job creation has been reported by Germany for both December and January as export activity was vivid. Hiring intentions stated in surveys support the improving environment there. The hard hit Spanish employment market also shows some stabilization since last October, but probably due to artificial support from government initiatives. The unemployment rate still stands at a sorrowful 18.8 %. We would therefore treat this data with caution and expect the labor market to remain unsupportive over coming months. Contrary to the US, many European companies tried to retain labor, at least on a reduced basis, despite plunging output. Disposable income may develop positively in Germany given the stabilization of the employment market and some fiscal stimulus, but this should be more than offset by aggressive fiscal tightening in Ireland and Southern Europe. Precautionary savings should remain high in this environment. In light of the uninspiring perspectives we continue to anticipate subdued private consumption for 2010.



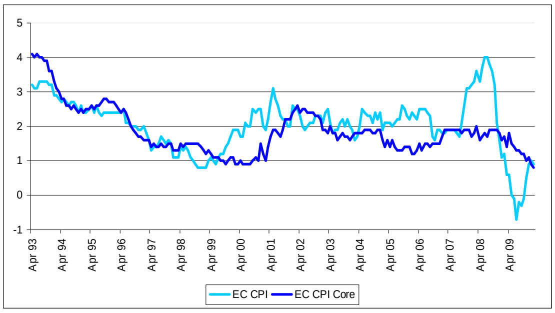


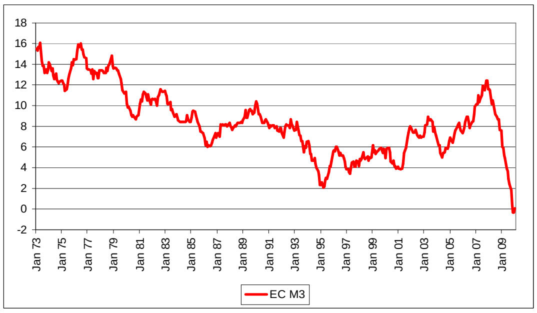
Hardly any impetus is anticipated from the investment side. Capital expenditures plunged at an unprecedented rate at the peak of the crisis. The deterioration in investments continued for the seventh quarter in a row in 4Q. Gross fixed capital declined 0.8 % after having dropped 0.9 % in 3Q. Given record low capacity utilization and weak domestic demand, non construction investments should remain sluggish. Construction expenditures fell sharply once again, plunging by 1.1 %. It demonstrates that the correction is still far from over for some countries hit by the real estate markets. Anticipated weak demand and price uncertainty hence continue to weigh on construction investments. Contrary to 3Q, inventories failed to contribute positively to the expansion and government expenditures slightly declined by 0.1 %. We expect GDP growth of 1 % in 2010. Temporary factors that supported the economy will fade away over time, the process of repairing balance sheets should continue over coming months, private investment is projected to be dampened by high levels of unused capacity as well as low demand prospects and fiscally challenged countries will not only impose stringent measures, but also pressure the banking system in Northern Europe.

Annual HICP inflation turned positive in 4Q09 after having reached a low of – 0.4 % in 3Q09. This pattern was mostly due to strong base effects from past falls in commodity prices. Inflation is expected to remain close to the January level of 1 % over the coming months. Later in the year, the rate of inflation is anticipated to increase only modestly, reflecting the gradual improvements in activity. Importantly, the continued weakness in the labor market should keep compensation per employee relatively low, which is supposed to lead to a higher level of productivity, particularly following the elevated unit labor costs growth in 2009. Also core inflation may remain subdued taking into account the weakness of aggregate demand, particularly for non-essential goods, and the anticipated trend in labor costs. Downward pressure on supply chain prices have however moderated and import prices may rise.

Bank Leumi Switzerland
Claridenstrasse 34
8002 Zürich Telefon 044/207 95 66 Telefax 044/207 95 75 e-Mail emeier@leumi.ch

Inflation expectations remain firmly anchored, in line with the ECB's target of keeping inflation rates below, but close to 2 % over the medium term. The plunge in the annual growth rate of M3 continued and reached even negative territory at the end of last year. This is truly striking in light of the over 12 % growth, which was registered at the peak of the cycle. Trends in M3, together with the negative annual rate of growth in loans to the private sector, support the assessment that the underlying pace of monetary expansion is moderate. Additionally, the steep yield curve favors the move into longer-term investments. The development in these aggregates is anticipated to remain restrained. There are however interesting trends occurring: annual growth in loans to households has turned positive. This is more than offset by declining growth in loans to non-financial corporations. The latter represents however a classic laggard. Importantly, the very attractive market conditions encouraged enterprises to substitute bank financing by market-based options.





The ECB continues to gradually phase out non-standard operational measures. It will keep full allotment in the main refinancing operations (MROs) and special-term refinancing operations until mid-October at the minimum, which is a longer commitment than was generally expected. The Governing Council also decided to return to variable rate tender procedures in the regular 3-months longer-term refinancing operations (LTROs) starting in April, targeting smooth conditions in money markets. Jean-Claude Trichet indeed noted that money markets were functioning very similarly to 3Q07. Also term-lending had resumed on a satisfactory scale. As such, the current pace of phasing out was appropriate. At the same time, the ECB claims to continue to provide liquidity support to the banking system, thereby facilitating the provision of credit. As we expect the Eurozone to lag the global upturn due to the above-mentioned factors, we only expect a modest benchmark interest rate increase in 4Q at the earliest.

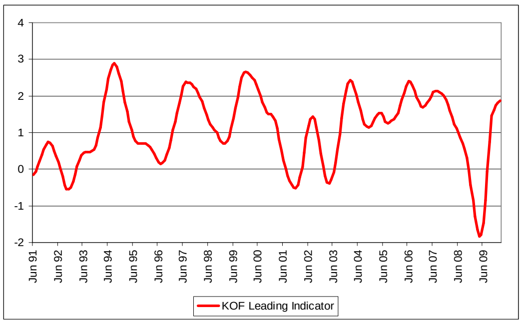
Switzerland

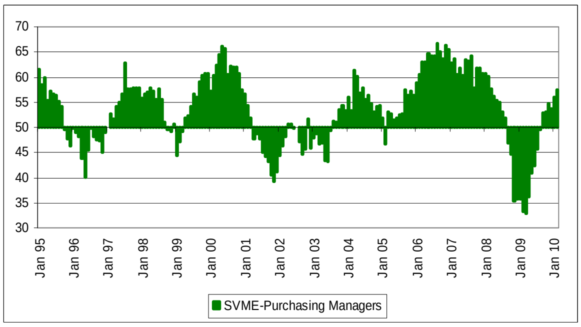
The Swiss economic recovery accelerated in 4Q by growing 0.7 %. The expansion was driven by both domestic demand and exports. Contrary to many European countries, private consumption continues to expand robustly. Significant growth is stemming from health care as well as food and beverages. But also economically sensitive areas, such as shoes and clothing developed positively - in fact for the first time in five quarters. Some weakness resided only in the "other" category, mainly covering financial services and insurance. Consumption may continue to hold up well. Retail sales rose energetically at the beginning of this year and the consumption index points to further strength. Additionally, in the SECO consumer confidence release the majority of respondents sees the present time as a "good time to buy". Yet concerns over the employment situation still weigh on sentiment and may slow down the momentum. Interestingly, forecast of unemployment peaking at 4.9 % in 2010/11 have sharply been revised downwards. It might be that we are currently in the process of peaking. Another element differentiates the Swiss economy from other European countries. The recovery has not yet benefited from inventory contribution, quite on the contrary: Inventories subtracted 0.7 percentage points from 4Q GDP. It is explainable by the lagging of the inventory cycle in comparison to other countries, which is of course beneficial for future growth. Inventories should therefore contribute positively to the GDP expansion in coming quarters.

leumi
Bank Leumi (Switzerland)

Bank Leumi Switzerland
Claridenstrasse 34
8002 Zürich Telefon 044/207 95 66 Telefax 044/207 95 75 e-Mail emeier@leumi.ch

Very important to the Swiss economy are exports. Particularly the exports of goods (excluding valuables) grew strongly, rising by 3.2 %. It was the second consecutive quarter of growth. Chemicals, precision instruments as well as watches and jewellery mainly contributed to the expansion. Some areas, such as metals, machinery, equipment and electronics still stagnated, though. Exports of services slightly declined by 0.2 %. In light of the elevated level of the Swiss Franc exchange rate the recovery in exports is even more impressive. Overall, net trade added 0.7 percentage points to GDP. Assuming further improvement in global trade, exports should remain buoyant. Positive impulses from exports are also confirmed by the KOF Swiss leading index. Government consumption rose by a significant 1.7 % in 4Q and is anticipated to expand in 2010, albeit at a slower rate. Gross Fixed Capital Formation rose by 1.4 %, which is quite remarkable given the 3.4 % increase in the previous quarter. It was mainly driven by investments in equipment and software, which grew by 3.9 %. Construction investments declined however by 1.5 %. Construction should lose momentum as positive effects from low interest rates and government stimulus will eventually fade. On the production side, the support was broad based with only the industry sector stagnating. Of particular interest is the financial services sector with an increase of 1.1 % in value added after a sustained period of weakness. While uncertainty is clouding the banking sector, it is interesting to observe that regional banks have picked up business from the two dominant banks during the crisis and assets are still flowing to private banks, contrary to expectations. We expect GDP to grow close to 2 % in 2010, which is somewhat above the SNB forecast, but in line with leading indicators.





Headline inflation continued its upswing after having reached a 50-year low of – 1.2 % in July of last year and stands currently at 0.9 %, mainly due to crude oil price effects. Core inflation fluctuates around 0.5 % for the last 3 months. The SNB expects against the background of relative moderate recovery of the economy and the employment market that price increases should remain low despite the highly expansive monetary policy. In fact, the SNB has been efficient in unwinding unconventional measures. Purchases of Swiss corporate debt were formally ended and non-standard tenders discontinued. Additionally, the outstanding volume of swap balances has fallen almost to zero. With no sign of a credit crunch, the actual monetary policy seems overly accommodative. The SNB continues to emphasize it would decisively act to prevent any excessive appreciation of the CHF against the EUR. We consider the central bank as highly pro-active and expect an interest rate increase as soon as the currency environment allows it.

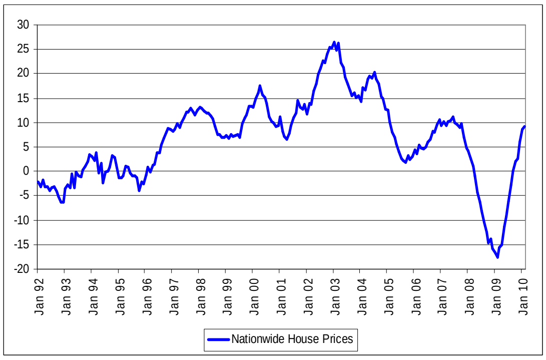
United Kingdom

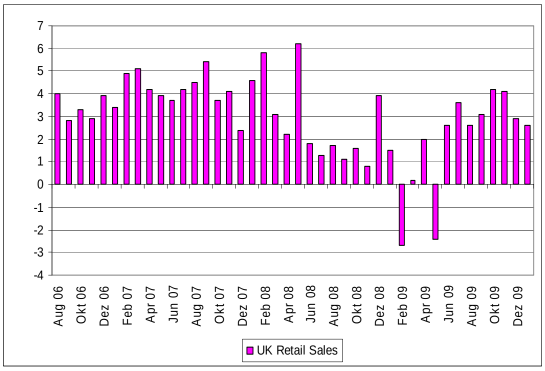
Economic activity in the UK has been lagging other regions of the world. The 4Q GDP growth of 0.3 % represented therefore a great relief as it not only signaled the end of the recession, but also showed better activity than in the Eurozone, albeit only vaguely. On the positive side, household consumption rose 0.4 %, accelerating somewhat from the 0.1 % growth in the previous quarter. Retail sales held up surprisingly well, increasing on average by 3.2 % since June 2009. This is even more noteworthy as the savings rate has risen sharply from minus 0.7 % in March to 8.6 % in September of last year. More accurate data are unfortunately not available, but trends in the US, which shows a similar pattern, let us assume that the saving rate might have trended down during subsequent months. Income growth has been significantly reduced, but was still positive, currently expanding at around 1.5 %. Consumers found probably some comfort in the extraordinary recovery in house prices and a general notion that the worst in the financial crises was over.

Consumer-related statistics were mixed at the beginning of this year, but the VAT hike in January and unduly harsh winter weather represented additional obstacles. BRC retail data point however to a recovery to the long-term average. Contrary to expectations, consumer credit data demonstrated buoyant growth at the beginning of the year, which indicates a certain easing of credit conditions. After an uneven start, we expect household consumption to contribute positively to economic growth in 2010, even more so as the unemployment rate seems to top out at current levels. Changes in inventories added 0.5 percentage points to the expansion and we foresee further economic support throughout the year. Exports rose vigorously in 4Q, but this was also the case for imports, resulting in net trade representing a drag to GDP. When exports tumbled at the start of the year, skeptics were fast in emphasizing that the already weak currency failed to stimulate exports. But reported logjams at ports have probably caused sizeable interruptions. Strong imports of semi-finished goods, which presumably are used for the production process, are indicating that the disappointing output in manufacturing at the start of the year was an aberration. In fact, the level of the purchasing manager index is consistent with healthy expansion in manufacturing and also BoE agent survey hint to continued underlying enhancement. The improvement in global trade combined with the weakness in the currency should lead exports to offer solid support to GDP growth. Business investments have strongly disappointed. Political uncertainty may have played a role, as managements may be hesitant to allocate money without having a better grip on fiscal consequences. The relatively late improvement in economic growth and generally very negative sentiment towards the UK could have been additional factors. We strongly disagree with the notion that the UK might easily fall back into negative growth territory. Admittedly, the UK economy struggles in many areas, but the overall conditions seem far less pessimistic than market participants seem to anticipate. We expect 2010 GDP growth of 1.6 %.

Politics have come to the forefront as the deficit is anticipated to amount to 12.6 % of GDP, according to government estimates. While some observers are quick to compare this ratio with the 12.7 % of Greece, we would like to emphasize that the government debt only amounts to 55.8% of the economy, in sharp contrast to the 113 % estimated for Greece. While market participant fear a hung parliament and therewith inaction in respect to any serious deficit reduction, we would argue that whichever political party will gain power will spot the necessity of action in this respect.

The inflation picture in the UK is very distinct from other regions with major inflation indicators all rising substantially. The headline CPI jumped from 1.1 % in September 2009 to 3 % at the beginning of 2010, which is well above the 2 % target. Core inflation stands at a similarly elevated level. The retail price index experienced even a wider swing, catapulting form minus 1.6 % in June 2009 to currently 3.7 %. Inflation expectations for a 12 months horizon only rose marginally despite these sharp increases and the respondents' assessment of current inflation at 3.4 %. Respondents apparently agree with the BoE's view that the actual elevated inflation level is of temporary nature, representing one-off adjustments. The persistent margin of spare capacity is expected to exert downward pressure on inflation. We would argue that inflation expectations could swiftly change, should the macroeconomic environment turn out to be less tame than anticipated, as we expect and monetary policy remains extremely loose. In such a scenario, interest rates at the short- and long-end of the yield curve have to rise sensibly. We expect a relatively early monetary tightening.





Bank Leumi (Switzerland)

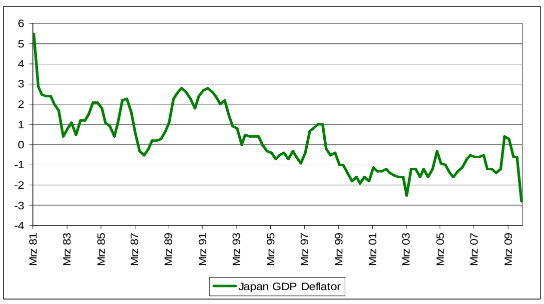
Bank Leumi Switzerland
Claridenstrasse 34
8002 Zürich Telefon 044/207 95 66 Telefax 044/207 95 75 e-Mail emeier@leumi.ch

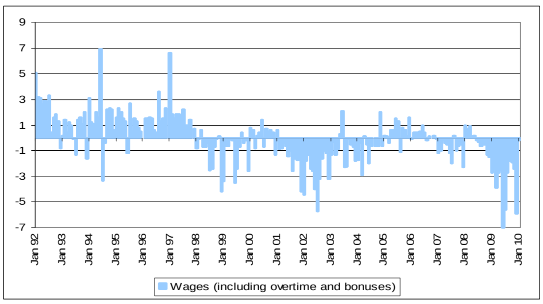
Japan

The Japanese economy expanded by 0.9 % in the period of October to December. The recovery was primarily driven by exports, which rose 5 % from the previous quarter and contributed 0.7 % to GDP growth. Vibrant development in Asian countries still offers considerable upside potential to exports. There are first signs that the revival in exports is filtering through to households. Consumer spending climbed by 0.7%, contributing 0.4 percentage points to GDP growth. The unemployment rate dropped to a 10-month low of 4.9% from a historic high of 5.6 % in July 2009 and the job-to-applicant ratio rose for the first time in nine months. Importantly, wages including overtime and bonuses are only slightly in negative territory after having fallen steeply in previous months. A further improving trend in these statistics raises hope that consumption may remain stable even after the JPY 70.2 trillion stimulus package unveiled by Prime Minister Yuko Hatoyama last December phases out. New auto sales fell 7.5 % m-m in February, suggesting government incentives to purchase eco-friendly cars and appliances may have already started to run their course. Yet an additional support stemming from childcare allowances will begin to be distributed and should add a total of JPY 2.3 trillion to the economy (0.5 % of GDP).

The influence of the stimulus package can also be detected in industrial production. Historically, an upturn has always been led by producer goods, but this time it was initially driven by consumer durables. Most recently, though, production started to broaden out, which points to an increasingly sustainable economic recovery. There is still a fair amount of uncertainty to what degree private inventory drawdowns have been terminated. In the most recent quarter, they shaved 0.1 percentage points from growth, as automakers responded to higher demand by paring their stockpiles. Inventory management is of course also most relevant to predict capital spending activity, which has risen 0.9 % the last quarter, contributing 0.1 percentage point to GDP. Expenditures increased for the first time in seven quarters and seem to have started a bottoming process due to sharp upturn in industrial production, despite low capacity utilization rates and a strong JPY. Machinery orders, which signal business investment in three to six months, rose 2.2%, when excluding mobile phones. The probability of a double-dip recession has receded significantly, which is also supported by various leading indicators. We anticipate 2010 GDP growth of approximately 2 % after the sharp decline of over 5 % the previous year.

Japan continues to be plagued by serious deflation as witnessed by inflation indicators, particularly the GDP deflator, which dropped by a record 2.8 %. Finance Minister Naoto Kan renewed calls for the BoJ to help arrest deflation, which potentially damages growth prospects and makes it very difficult to stabilize public finances. Interestingly, Naoto Kan referred to GDP deflator as a measure of inflation rather than CPI. As Japan is having a more aggressive inflation target, pressures to extend quantitative easing further persist.





Bank Leumi (Switzerland)

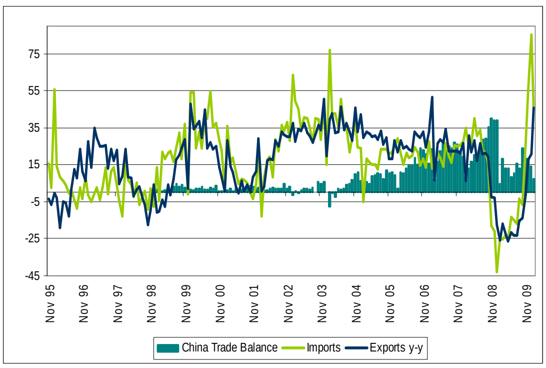
Bank Leumi Switzerland
Claridenstrasse 34
8002 Zürich Telefon 044/207 95 66 Telefax 044/207 95 75 e-Mail emeier@leumi.ch

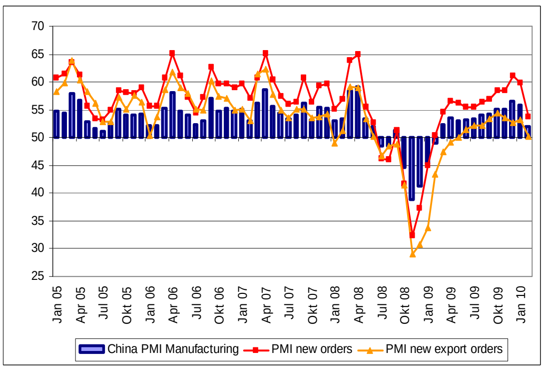
China

Economic growth accelerated in 4Q09 to the fastest pace since 2007. GDP growth soared by 10.7 %. The impressive expansion has been triggered by 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 overinvestment, excess capacity, asset price inflation and future bad loans. Recent economic data confirm the unimpeded growth in investments with urban fixed assets investments soaring by 26.6 %, which represents only a marginal slowdown from the over 30 % rise reached in previous months. To reign in rapidly expanding credit, the central bank raised the bank reserve requirement ratio twice this year and issued explicit credit restrictions since January 2010. Additionally, it increased the required down payment on land purchase. Some Beijing banks have augmented their preferential interest rates on first-home loans to 85 % versus 70 % and some have raised rates on mortgages for second homes. Despite all these measures urban property prices in the 70 largest cities are growing at the fastest pace in two year. Per capita spending on real estate has grown at 27 % a year during the past decade.

Asset investments have replaced exports as the main economic driver. Yet exports have staged a strong recovery more recently. Policy makers are reportedly seeking more evidence of a sustained export rebound before letting the Yuan appreciate. The clearest statement in that respect has come from PBoC's Governor Zhou Xiaochuan mentioning that anti-crisis policies, including the Yuan's peg to the USD, must end sooner or later. An eventual Yuan appreciation is anticipated to be gradual, at an annual rate of approximately 5 %. Official statements emphasizing that the Yuan was not undervalued makes a one-step revaluation unlikely. One of the biggest challenges for the government is certainly the implementation of a new growth model, in which consumption represents the primary engine. Retail sales indeed accelerated to over 20 % more recently, but the growth rate is still far below the expansion of fixed asset investments. To promote private consumption, enhanced income transfer to low-income households and consumption-supportive incentive programs were introduced.

CPI has accelerated to 2.7 % in February. Contrary to the inflation wave of 2007, the current situation is much more threatening: Now first signs of wage inflation can be detected in China, which is significantly more difficult to unwind than commodity-related price increases. Many coastal areas have reportedly raised minimum wages by 10-15 % and companies show difficulties in retaining their work force without hiking salaries. Additionally, the government has raised public pensions in January. House prices continue to accelerate on a monthly basis. Pressures in the pipeline are also mounting: Inflation at the producer level surged by 5.4 % y-y, reflecting partially base effects that are likely to drive the rate up further over coming months and purchasing prices jumped by 8 %. Despite the increases in the reserve requirement ratio and credit quotas, liquidity and credit growth are still hyper-expansionary. We therefore expect aggressive tightening to continue with multiple RRR hikes and a first increase in the benchmark interest rate around April.





Bank Leumi (Switzerland)

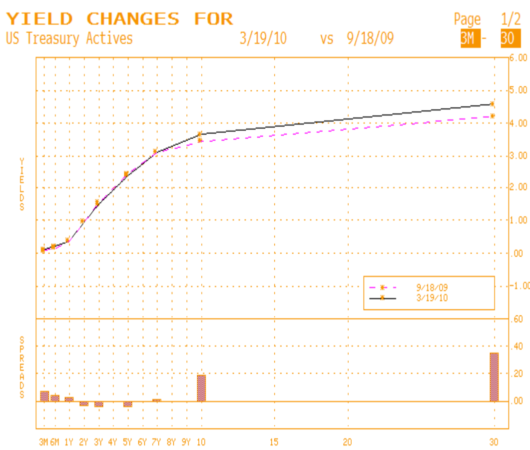
Bank Leumi Switzerland
Claridenstrasse 34
8002 Zürich Telefon 044/207 95 66 Telefax 044/207 95 75 e-Mail emeier@leumi.ch

2. Market Outlook 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 monetary banks, with exception of the BoJ, to turn to interest rate hikes. Those, which have used bond buying as a measure of quantitative easing, will reverse it; the exception here seems also to be Japan. The current abundant liquidity will decline during the course of the year. We consider government bonds as outright unattractive. Corporate bonds seem the most appealing at the high yield level. Since we expect interest rates to rise, we position ourselves at the very short-end. We keep our investments in inflation-linked instruments and still favor Floaters.

a) Fixed Income USA

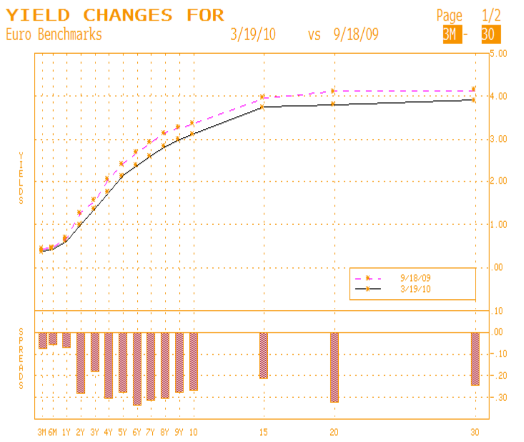
The Treasury yield curve remains relatively steep. We expect the curve to flatten less explicitly than the consensus. The short-end will increasingly envision rate hikes by the Fed. The long end might, at least temporarily, fear inflation pressure. The end of quantitative easing should put upward pressure on bond yields.
We underweight bonds, particularly Treasuries and favor the very short end of the curve as well as Floaters and TIPS. We like instruments, which allow us to short Treasuries.



b) Fixed Income Europe

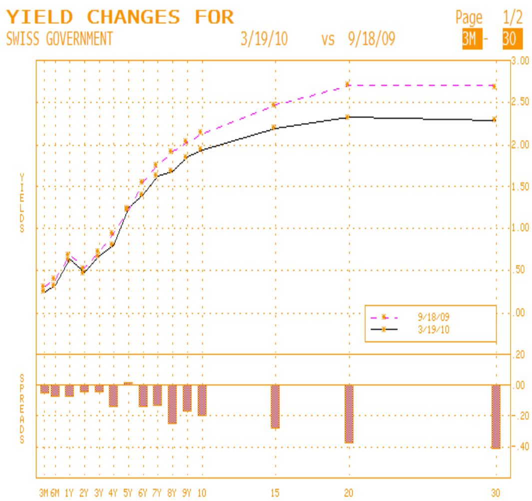
As we expect the euro area recovery to lag the global upturn, we tend to favor Eurobonds.

We anticipate the ECB to raise interest rates only later in the year, lagging other central banks. The yield curve should remain relatively steep. Since yields are currently unattractive, we would be very prudent in establishing new positions at current prices, though.



c) Fixed Income Switzerland

The relatively flatter yield curve in Switzerland reflects a very pro-active policy by the SNB and a historically low level of inflation. We expect the SNB to be among the first major central banks to raise benchmark interest rates. Given the extraordinary low yields offered in an environment of raising rates, we generally consider the bond market as unattractive.



3. Market Outlook Equities

We continue to overweight stocks, but not 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 has altered dramatically. Positive surprises will get scarcer. Yet bonds became very unattractive as an asset class or involve a much higher level of risk to reach an appealing yield. Many investors may therefore opt for equities. Also, after the initial indecisive reaction to policy changes, investors will eventually concentrate on the improved profit picture and take the market ultimately higher.

a) US Stock Market

According to our economic scenario, top-line growth is anticipated to resume. 2010 earnings are expected to rise 25 % offering strong support to stock valuation. While increased volatility might temporarily favor defensive names, cyclical stocks should still be overweight, particularly in anticipation of a further upturn. At a P/E of 12.5x estimated 2011 earnings the market seems still attractively valued.

> ➢ **S&P 500 target 1230**

b) European Stock Market

While the market has already discounted part of the new growth cycle, the anticipated strong profit upturn of approximately 20 % still justifies a relatively positive view on stocks. At a P/E of 10.8x estimated 2011 earnings, the European equity markets are considered attractively valued.

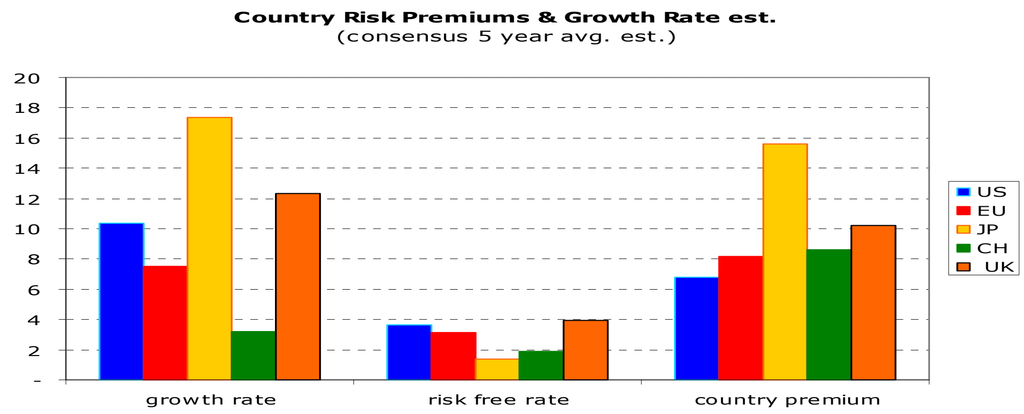
> ➢ **DJ STOXX 600 target 270**

c) Swiss Stock Market

The slightly more defensive posture of the Swiss market will likely lead to an outperformance when nervousness about policy changes will occur. The estimated P/E of 11.7x estimated 2011 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 7000**

Conclusion:
We keep a slight overweight equity exposure



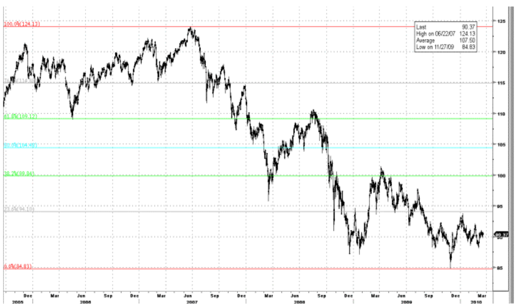
Bank Leumi Switzerland
Claridenstrasse 34
8002 Zürich Telefon 044/207 95 66 Telefax 044/207 95 75 e-Mail emeier@leumi.ch

4. Market Outlook Foreign Exchange

EURUSD: We continue to have a positive opinion on the USD. As we expect the economic upturn to be sustainable the Fed will take stronger action as currently foreseen by investors to absorb liquidity from the markets and eventually raise benchmark rates. The USD will also lose its status as the preferred funding currency in carry trade operations. The ECB is expected to lag benchmark rate increases, widening the interest rate gap versus the USD.

➢ **EURUSD seen at 1.30 at year end**

USDJPY: We are bearish on the JPY. While it could become once more the favored funding currency for carry trade operations, fundamentals are less positive. The still grave deflation problem will hinder the BoJ to take any action on interest rates for the foreseeable time.

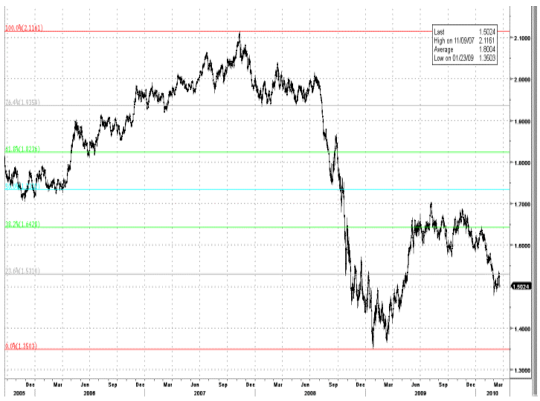


➢ **USDJPY seen at 100 at year end**

EURCHF: The SNB continues to fight the strength of the currency, particularly against the EUR. Yet the economic dynamism and the seemingly too easy monetary policy will trigger benchmark interest rates hikes well in advance of the ECB. We would avoid taking EUR positions in this delicate setting.

➢ **EURCHF seen at 1.40**

GBPUSD: Market estimates in respect to the UK economy are overly bearish, in our opinion. Inflation prospects have improved. The BoE is very proactive and might react much earlier than the market currently anticipates in rising rates. Risk to a further appreciation of the GBP is mostly of political nature.



➢ **GBPUSD seen at 1.70 level**