

# Investment Policy Committee Bank Leumi (Switzerland)

Third Quarter 2010

GDP growth				Inflation			Monetary Policy
	2009	2010E	2011 E	2009	2010E	2011E	end of 2010
United States	-2.4	3.4	3.3	-0.3	2.4	2.5	0.75
Euro Zone	-4.1	0.8	0.6	0.3	1.6	1.8	1.00
Switzerland	-1.5	2.0	2.0	-0.5	0.9	1.0	0.50
UK	-4.9	1.3	2.5	2.2	3.3	2.3	0.75
Japan	-5.2	2.0	1.7	-1.4	-1.3	-0.6	0.10
China	8.7	9.0	8.0	-0.7	4.0	4.0	5.58

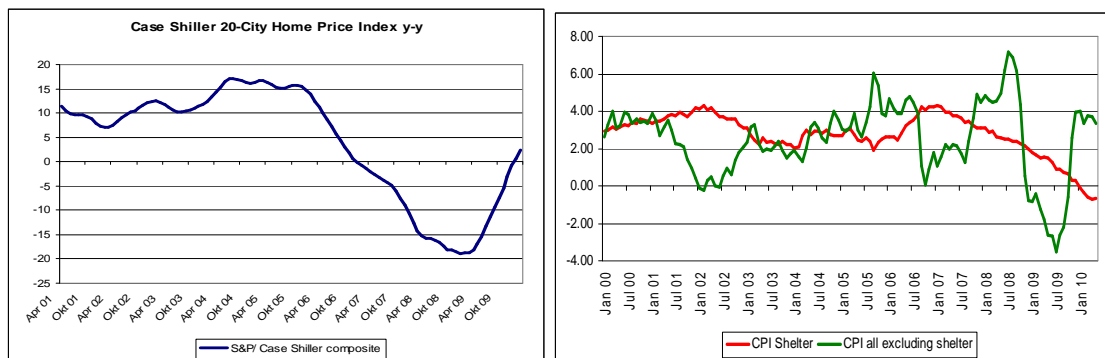
## 1. Economic environment

### United States

We continue to expect the US to remain on a sustainable recovery path, but anticipate the expansion to lose some momentum in the second half of this year mainly due to the winding down of fiscal stimulus and a somewhat weaker contribution to growth from exports against the background of a stronger US currency and a less powerful global economy. The impact of the Gulf oil spill is still unclear at this point. Personal consumption represents again the pillar of the economy. It contributed 2.4 percentage points in 1Q. We anticipate personal expenditure to increase at a moderate pace for the remainder of this year and to show positive contribution to economic growth. Admittedly, an important leading indicator for the labor market, initial claims, suggests no real progress, but the benefits had been extended beyond the standard 26 weeks, which may distort the statistical proposition. While the momentum in the creation of private payrolls in May was less pronounced than expected, it is important to note that the upward trend in hiring is still in place. The Labor Force Participation rate oscillated around 65 since March, staging a turnaround. It is an important positive signal if more people are encouraged to look for a job. The most telling leading indicator, temporary help services, continues its unabated upturn. The increase in average weekly hours also reflects an enlarged need for labor. A private company survey showed that a majority (53 %) of small-to-mid-sized companies, which usually have a large impact on the job market, plan for the first time since 2Q08 additions to their work force. It is also interesting to note, that number of workers quitting their jobs exceeded the number laid off, according to the Bureau of Labor Statistics. Disposable personal income rose only at a moderate pace since the start of the year. Consumer credits seem have stopped their downturn. The savings rate currently stands at 3.6 %. Consumer confidence reflects the improved outlook.

Business investment showed a positive contribution for the second consecutive quarter. Equipment and software continue to grow in double digits. The thesis of accelerating business spending seems in tact on rising demand for computers, communication gear and semiconductors. Factory orders sustained their acceleration, rising by 18 % y-y in April. Also the core capital orders, excluding aircrafts and defence showed virulent growth on a y-y basis. The ISM order sub-index oscillates around 65 for the second month in a row, signalling powerful future expansion in manufacturing activity. The index may however top out at these elevated levels. 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, but with the caution that commercial real estate continues to drag on growth. Exports started to contribute somewhat less to growth, albeit after two quarters of vigorous growth. Prospects of economic developments outside the US have deteriorated, notably with the situation in Europe. In addition, some of the world's fastest economies, such as China and India have initiated steps to prevent the economy from overheating. Some domestic strength in Canada and Brazil, which are crucial trading partners to the US, will keep up demand, however. The sharp increase in the USD against major currencies will also impact the competitiveness of US goods. As American export goods generally incorporate a high level of know how and brand recognition they may be less price sensitive, however. In sum, we anticipate only a slight positive contribution to GDP from exports. Government consumption contributed negatively to growth. Given the tenuous situation on some state and local government levels, we expect this sector to weigh on the economic expansion. Nonfarm inventories showed a strong contribution of 1.58 percentage points to growth. The participation of inventories to the expansion will increasingly diminish.

Residential investments impacted growth by 0.3 percentage points at the start of this year, but this still compares very favorably to the negative 5.3 percentage point effect in 1Q09. The expiration of the homebuyers' tax credit end of April sharply increased once again the volatility in housing activity. A considerable run-up in April was followed by a pronounced plunge in May. Inventories in existing homes still remain at an unconstructively high level due to elevated foreclosure activity, but home prices seem to bottom out. On a y-y basis, the Case Shiller 20-city home price index continuously moved up since the low in January 2009 and is in positive territory for the second consecutive month. The homebuyer affordability index, which is close to record highs, in conjunction with gradually rising consumer income and confidence should support improvement in home sales for the remainder of the year. We therefore expect residential investment to contribute slightly positively to GDP over coming quarters.



Inflation indices remained subdued. The decline in the headline index was entirely due to lower energy prices, with gasoline falling particularly sharply most recently. Core prices stabilized at low levels. We anticipate that the core inflation rate is at or close to a bottom. Declining shelter costs, which account for more than 40 % of the index, have been principally responsible for the descent in the core CPI since 2007. This key shelter category shows now, however, first signs of stabilization. This was mainly attributable to a surge in hotel rates. Other components of shelter, namely the Owners' Equivalent Rent and the Rent of Primary Residence, both indicate also some stabilization. While the expiration of the homebuyers' tax credit may have a slight negative short-term influence, rental markets across the country nevertheless reflect encouraging trends. Additionally, import prices manifest considerable gains on a y-y basis. While this is mostly explained by higher energy prices, the increase in Chinese salaries may also have a slight impact in future prices. In addition, capacity utilization has steadily moved up and is now at 74.7%, which is the highest level since October 2008. While a normal level is closer to 80 %, it nevertheless reflects some normalizing trend.

The Federal Reserve has practically disentangled from most initiatives which have been created to support markets during the crisis. The only remaining program, the Term Asset-Backed Securities Loan Facilities, is scheduled to close on June 30. Additionally, the normalization of the discount rate is now in process, forcing depository institutions to borrow in private markets rather than from the Fed. After having raised the rate already once, various Federal Reserve Banks push for further adjustments. Other measures of normalizing monetary policy and reducing the Fed's balance sheet are also in progression. The Fed has begun tests of some of these policy tools, including reverse repurchase agreements and auctioning term deposits. Term deposits are a tool to soak up excess bank reserves. The way is increasingly clearer in order to address also the federal fund rate.

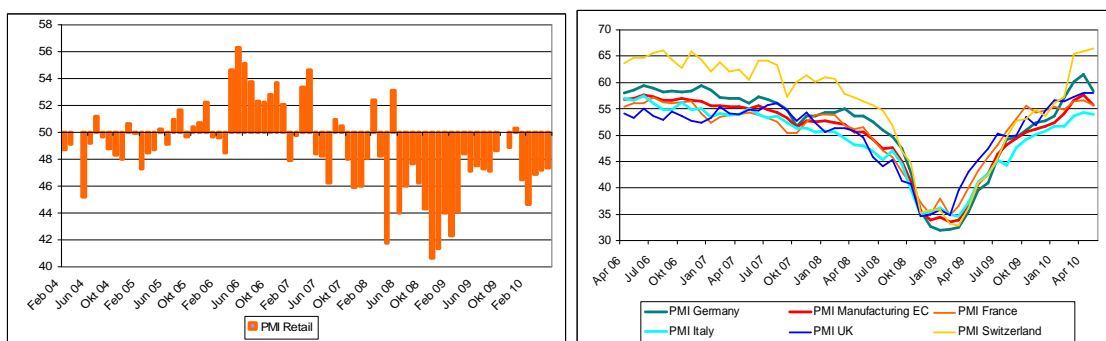
The FOMC statement still carries the notion that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations were likely to warrant exceptionally low levels of the federal fund rate for an extended period. But other voices raise concern 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. 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 in 4Q.

**Eurozone**

Admittedly, the outlook for the Eurozone economy is particularly clouded as the future depends on the individual policies and dynamics in each and every member state. It seems however save to state that the simultaneous restrictive financial policy in almost all euro countries will have a dampening effect on the economy. While the weak euro should offset some of the negative dynamism, it will mostly benefit export-oriented economies. The most pressing problem will however even accentuate: weak private consumption. Eventual economic growth is becoming solely dependent on exports. Given the enormous fiscal challenge some countries encounter, social unrest or political unwillingness to adhere to these measures are quite probable. Questions also remain about the ultimate willingness and capability of Germany to finance the rest of Europe. The probability of a renewed debt crisis will strongly depend on the solidity of the financial system. We expect the Financial Stabilization Facility to be tested at a certain point – with a negative outcome. A double-dip scenario for the Eurozone seems highly probable.

For some time we have been wondering why the terminology “peripheral” is still used when addressing the problems of the Eurozone: the economic core has long been reached and with this also the “heart” of the European ideology. The crisis demonstrated that national interests are at the forefront. This is highly significant in a system, which will be determined by political decision taking. Additionally, the crisis openly showed that the powers of the ECB have its limits, particularly due to its impotency to influence fiscal policies in the member states. Consequently, the viability of the euro can be questioned.

GDP grew a modest 0.2 % q-q at the beginning of the year. Private consumption declined 0.1 % q-q with automotive sales accounting for most of the drag following the phase-out of scrapping programs for older vehicles. Retail sales data point to subdued consumer activity in 2Q. The prospects of consumption deteriorated even further due to the planned austere fiscal consolidations, which will additionally pressure already elevated employment rates. Consumer confidence started to deteriorate. Surprisingly, net exports subtracted half a point of GDP. This is mainly explained by imports growing 4 %, while exports rose 2.5 %. Normally, strong import activity would point to healthy domestic demand. In this case, strong imports rather involved intermediate goods, which would feed into the production process. This would also explain the large inventory contribution of 0.8 % to GDP. Germany's exports rose 2.6 % in 1Q, continuing to benefit from the ongoing recovery of global trade. Close to 50 % of Germany exports are destined to other Eurozone countries and 5 % are delivered to China. Given the weak consumption profile in the Eurozone and increasingly cautious capital expenditures by companies, exports will represent the key engine of growth. While export activity will remain healthy shorter-term, we expect the pace of export and imports slowing down, which would also have inventory contribution to flatten out. Gross fixed capital formation declined 1.1 %. While factory orders and production expectations would point to increasing capital spending, the sovereign crisis appears to have already negatively affected business sentiment, thereby deteriorating the prospect of positive impulses from this segment. Government expenditures rose 0.3 % in 1Q. In light of the planned cuts in state expenditures, growth prospects seem limited. In sum, 2Q GDP growth should accelerate as some adverse effects from 1Q will be unwound and exports look strong, but the expansion will increasingly face headwinds, particularly in 2011.



The rise in inflation over recent months reflects higher energy prices. Changes in commodity prices could lead to further slight increases in HICP inflation during the second half of 2010. Looking further ahead, inflation rates should overall remain moderate. Increases in taxes and administered prices may lead to some additional inflation pressure. Importantly, inflation expectations over the medium to longer term continue to be firmly anchored.



## Bank Leumi Switzerland

Claridenstrasse 34  
8002 Zürich

Telefon 044/207 95 66

Telefax 044/207 95 75

e-Mail [emeier@leumi.ch](mailto:emeier@leumi.ch)

Monetary developments revealed some positive trend in bank loans to the private sector for several months. Loans to non-financial corporations remained negative, which seems however normal, given the lagging nature of this component. The ECB extended the full allotment for its 3-m operation until September by means of a fixed rate tender. This additional liquidity for banks just represents a slight extension of the measure decided at the beginning of March and does not represent a major change. The ECB remained quite vague in respect to the controversial bond purchases. Mr. Trichet was keen to emphasize that these purchases were sterilized on a week by week basis using one week term deposits and that the bond purchases were a temporary measure. Rising yields for Spanish, Italian, Portuguese and Irish bonds demonstrate that investors are questioning the ECB's response to the crisis. By purchasing government bonds, the central bank president Trichet is trying to win time for governments to gain credibility in their thrust to tackle their indebtedness and/or deficits. He also tries to prevent by any means Europe's monetary union from tearing apart. Bond purchases may however be interpreted as bail-out of Eurozone states, which is not foreseen in the Eurozone constitution. It may also raise inflation pressures, particularly if sterilization should no longer be successful. Even more problematically, several Governing Council members openly opposed bond purchases. What is additionally worrisome is that the total liquidity provided by the ECB, i.e. open-market operations and covered-bond purchases, has now again reached record levels. While short-term liquidity risks were apparently successfully addressed, banks increasingly face medium- to longer-term financing difficulties. They are therefore forced to roll near-term liquidity over instead of financing themselves adequately. Recent media news stating that interbank lending to Spanish banks had dried up and the enormous amount of money which is parked with the ECB are indeed strong indications that commercial banks are reluctant to lend to each other. BBVA's comment that debt markets are shut to most companies in Spain reflects similar symptoms than in the most recent credit crunch. Monetary policy is expected to remain expansionary for a long time.

European finance ministers agreed on the structure of a EUR 440 billion European Financial Stability Facility (EFSF), which represents the main part of the EUR 750 billion rescue package announced on May 10, to counter the crisis. The additional assistance to countries in need is therewith provided via a special purpose vehicle rather than the bilateral loans used in the Greece drama. The allocation reveals that Germany as the main economic power in the Eurozone will contribute EUR 122.8 billion, representing 5.1 % of national GDP, followed by France with EUR 92.3 billion, representing 4.8 % of national GDP. Place three and four, Italy and Spain, however demonstrate the inherent problem with this Facility: Some of the largest contributors are in fact the ones, which may most likely need assistance. What amount would ultimately be available? What rating will be attributed to the EFSF? Would Germany eventually have to contribute even more? This brings us right to the point of the German position within the Eurozone. Admittedly, Germany has been, through exports, a main beneficiary of the spending-keen Southern countries for years. Restrictive financial policies in almost all euro countries transform Germany into a major financier. Given the fact that Germany was more than hesitant in offering support to Greece, which required the provision of bilateral loans of EUR 8 billion in the first year, equaling to 0.3 % of Germany's GDP, how readily will Germany really deploy EUR 122.8 billion, or 5.1 % of their national GDP? Furthermore, the help would go to countries, which comfortably lived beyond their means, enjoying their lives, whereas Germans at the same time took wage hits to finance the reunification with former East Germany. Public opposition is fierce, which has already led to changes in the political landscape. Remarks by some German ministers pointing to the direction of certain member states leaving the EMU have damaged credibility even more. Uncertainty about the political commitment remains extremely high and the true efficiency of the EFSF is therefore questionable. When could the EFSF be activated? A failed auction might be sufficient for a member state to ask for borrowing. The relatively "smooth" auctions may indicate that the ECB was involved out of fear that alternatively the EFSF would be tested.

How we judge the success rate of austere plans of individual countries:

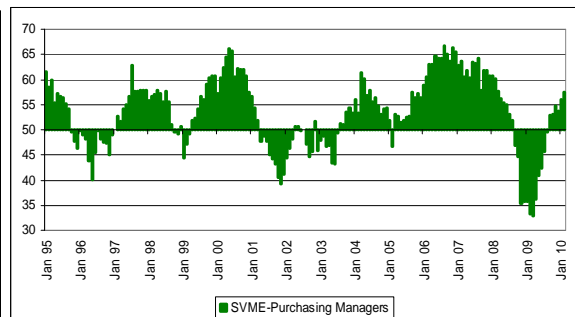
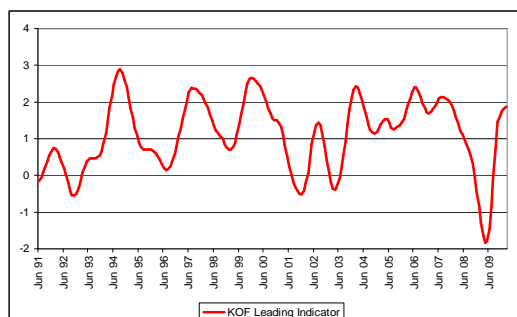
Country	Probability of success	Comment
Germany	high	should spend instead of save
France	fair as program "light"	mainly counts on economic upturn
Italy	low	no structural changes planned
Spain	low	political support weak
Portugal	fair	drastic measures
Greece	low	not enough discipline

## Switzerland

The Swiss economy slowed down notably in 1Q, growing by 0.4 % q-q albeit after a very favorable final quarter of 2009, which showed strong expansion of 0.9 %. Growth has averaged 0.6 % q-q over the past three quarters. Positive stimulus continued to emerge from the trade balance and private consumption. Exports of goods and services experienced a boost of 4.8 % and contributed 1.5 percentage points to GDP. Exports of goods jumped 5.6 %, benefiting from an extraordinarily strong impact from precious objects, such as precious metals, gems, objects of art and antiques. Excluding this category, exports grew by 2.5 %. The export of services also grew strongly, rising by 2.9 %. Imports saw rapid growth as well, supported mainly by goods, which rose 2.5 %. Imports of services, however, stagnated. Despite strong indicators, exports will face headwinds, notably due to the crisis in the Eurozone. Close to 60 % of Swiss merchandise is destined to the euro area. The increase in the value of the Swiss franc against the euro could have an additional dampening effect as price competitiveness is affected. In respect to the currency, it might be worthwhile to consider that in the long-term context, a pronounced strengthening of the Swiss franc in real terms has not yet occurred. Since the introduction of the EUR in 1999, the real exchange rate, despite the revaluation recently, does not lie above-average level. Additionally, the CHF has depreciated in relation to other important currencies, such as the USD and the JPY since the start of 2010. A more pronounced strengthening of the CHF has however been prevented by extreme interventions by the SNB, which are impossibly be upheld at that level. Exports are anticipated to decelerate, but should still contribute positively to economic growth, although to a sensibly smaller extent particularly in 2011.

Private consumption continued to support economic growth and even picked up momentum by expanding 0.5 % over 4Q, despite weaker real wage increases. The strength of household spending compares very positively to the anemic growth in the Eurozone. It can be explained by the low unemployment rate and far better credit as well as housing environment than in the rest of Europe. In fact, signs of a turnaround in the job market have increased. Employment prospects of companies have brightened and the unemployment rate has slightly fallen since the start of the year. Further progress should, however, be relatively slow as the employment decline during the last recession was quite mild and many companies chose the short-time formula instead of outright lay-offs. The headcount is now therefore rather high in comparison to still low capacity utilization. Short-time work has recently fallen sharply and leading indicators for labor demand are pointing upward. Private consumption is anticipated to continue to contribute positively to economic growth.

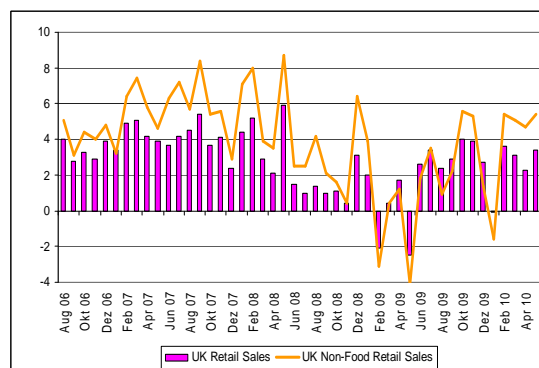
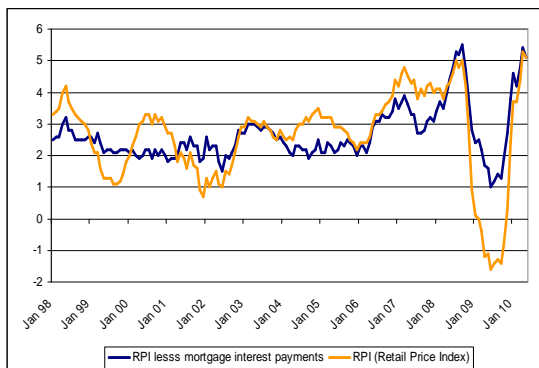
Surprisingly, investments declined by 0.8 %, which was mainly driven by software and equipment spending as well as investments in metal products and machinery. The decrease in capital spending followed two quarters of solid increases. We expect the decline to be of temporary nature, given the general state of the economy and the significantly improved business climate among companies. Some slowing tendencies become increasingly apparent in construction investments, whereas the momentum of public construction is likely to be supportive in 2010. Government spending declined 1.4 % in 1Q following three expansive quarters. Contrary to other countries, changes in inventories continue to weigh on the Swiss economy. Stocks contributed negatively to GDP for the fourth consecutive quarter. In 1Q they cut 1.1 percentage points of growth. On the production side, the upward momentum was widespread, with the exception of financial and public services, which both suffered a slight decline.



Headline inflation displayed a rising trend since the start of the year, but was exclusively driven by oil price effects. Inflationary pressure is likely to remain low and the CPI is anticipated to ease in the remainder of 2010. It may pick up modestly in 2011 as a VAT increase will take effect by then. Long-term inflation expectations continue to be firmly anchored. Monetary policy continues to be expansionary. The SNB kept the target range for the three-month Libor unchanged at 0.00-0.75 % in June and reiterated its intention to hold the Libor in the lower part of the target range, at around 0.25 %. Importantly, the Swiss central bank stated that deflationary risk had largely disappeared. It expects inflation to amount to 0.9 % in 2010. For 2011, the CPI is estimated at 1.0 % and in 2012 at 2.2 %. The SNB described short-term price stability as “guaranteed”, which is rather remarkable. At the same time it increased its economic forecast for 2010 to about 2 %. The SNB admitted that current expansionary monetary policy could not be maintained without compromising medium and long-term price stability. The economic-supportive central bank policy is also reflected in monetary conditions. The fall in Libor below the targeted 0.25 % level is, however, indicating that the banking system is currently holding a very large amount of liquidity and low capital market interest rates reflect a higher demand for “safe” Swiss government bonds. The expansionary monetary policy is reflected in monetary aggregates with M2 rising at double-digit rates. Credit growth also increased further. There are still no signs of any credit crunch in the survey on bank lending conditions, quite on the contrary. For the first time, a few banks reported an easing in 1Q10. Movements in real estate prices and a considerable increase in loan volumes for residential mortgages are observed with suspicion, however. The Swiss central bank has expanded its balance sheet in a dramatic fashion over recent weeks, which is primarily attributable to the increase in foreign exchange reserves. These have more than quadrupled since the crisis in the Eurozone erupted. The SNB states it had sufficient equity capital to withstand even large losses. We expect the SNB to start raising interest rates at the end of this year or the beginning of next year.

**United Kingdom**

Economic activity in the UK remained muted. 1Q GDP grew a moderate 0.3 %. The underlying rate of growth was probably more robust given that the output was adversely affected by the cold weather and the VAT rise on January 1 to 17.5 %. These two factors have particularly weighing on private consumption. Retail sales, which represent roughly 40 % of total household spending, showed a strong upturn in the non-food component over recent months. May was additionally helped by World Cup related electrical goods sales. A saving rate of 7 % at the end of last year offered some leeway to consumers. The strength in the CPI may also have contributed to the pick-up. Asset price recovery and forward looking consumer confidence measures point to more solid expenditures. In fact, housing prices have spiked up since their trough in February 2009, despite mortgage lending at only a fragment of previous years. Low interest rates and shortage of properties due to slow new construction activity have benefited house prices. Mortgage market activity may lose its momentum over coming months as potential house buyers may first await the outcome of the new administration’s emergency budget. Various fiscal tightening measures later in the year will moderate any upturn in consumer activity, though. The unemployment rate seems topping out, which is also supported by falling claimant counts over recent months. Initiatives by the new administration imply future loss in public sector employment. But these cuts will most likely be spread over several years. It seems highly probable that private sector job creation can more than offset the decline in public employment. Average earnings, excluding bonuses, seem to have passed the trough at the turn of the year but remain way below their pre-crisis level. Earnings including bonuses leapt. Average earnings growth in the public sector, excluding banks, slightly declined, but is anticipated to fall further if the new government will impose wage freezes across large parts of the public sector. We expect private consumption to contribute slightly positive to GDP in the remainder of the year.





## Bank Leumi Switzerland

Claridenstrasse 34  
8002 Zürich

Telefon 044/207 95 66

Telefax 044/207 95 75

e-Mail [emeier@leumi.ch](mailto:emeier@leumi.ch)

Gross fixed capital formation rebounded strongly in 1Q and is anticipated to further strengthen over coming months given the solid growth indication emanating from the purchasing manager survey indices in the service and manufacturing sectors. Industrial production experienced an impressive turnaround. Export indicators, which represent around 40 % of manufacturing output, have been particularly strong. Prospects in respect to foreign trade have however strongly deteriorated, despite the still weak currency, as problems in the euro area have substantially impacted the demand outlook. The Eurozone is UK's main export partner and accounts for 60 % of trade. Stock building contributed approximately 0.4 percentage points to growth and may continue to support GDP, yet to a lesser extent.

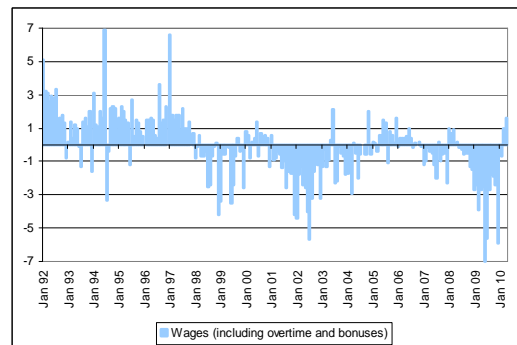
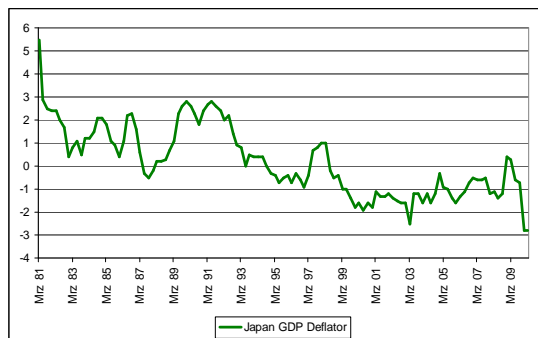
The Interim Office for Budget Responsibility (OBR) downgraded GDP growth forecast to 2.6-2.8 % over the 2011-2014 timeframe. It also revised the estimate of the degree of slack in the economy from 6 % to 4 %. The deficit/GDP is forecasted at 3.9 % compared with 4 % in the March budget and public sector debt is estimated at 74.4 % of GDP versus 74.9 % in the March budget. It follows that a larger fraction of the deficit is deemed to be structural. On the positive side, recent PSNB figures showed that tax receipts were rising again as income taxes have strengthened over recent months. The increase in the VAT rate and one-off bank bonus tax additionally lifted government income. As the deficit and debt situation represents the most urgent issues and PM Cameron prepared the public for severe cuts, the emergency budget will incorporate drastic measures. A further increase in the VAT to 20 % appears to represent a viable option. Changes in various taxes may also be considered. Some sort of a bank levy seems highly probable. At this point, it is impossible to know what impact these possible measures will exert on the economy. Very generally, we would expect a negative impact on growth at the beginning, but positive impulses later on. The degree of fiscal tightening should however not push the economy into negative territory. We anticipate that UK economic growth will compare favorable to the Eurozone, particularly in 2011.

The outcome will, of course, depend particularly on the course of future interest rates. Inflation pressures are sturdier in the UK than in other industrialized nations. The headline CPI reached 3.7 % in spring, which is well above the 2 % central bank target. Core inflation reached over 3 %. Retail prices were catapulted over 5 %. Even worse, persistent inflation pressures seem finally also have impacted inflation expectations. The Bank of England quarterly inflation expectations survey revealed that inflation expectations for the year ahead increased to 3.3 % from 2.5 % estimated in February. A private inflation survey showed similar results for the two-year horizon, where expectations rose to 3.8 %, representing an increase of 0.6 percentage points. For quite some time, the BoE argued that the inflation pressures are of temporary nature. Price increases in energy, adjustments of import prices as a consequence of the weakening currency and the increase in VAT were cited. But the distinct possibility of yet another hike in VAT and the fear that inflation expectations remain at an elevated level for a certain time, thereby starting a dangerous upward price spiral, may leave the BoE less relaxed. Additionally, the revisions by the OBR also offer a less benign inflation picture. The central bank may therefore tighten earlier than the consensus expects.

### Japan

The energetic GDP growth of 1.2 % q-q in the period of January-March was mainly supported by exports and stimulus-induced private consumption. We expect the expansion to slow down, but a double-dip should be avoided. Exports were exceptionally strong and contributed 0.9 percentage points to growth at the start of the calendar year. Vital demand from emerging Asia represented the key driver. With the anticipated slowdown of Chinese exports and the impact this will have to the Asian region, we reckon that this growth engine may throttle to some extent. While we expect exports to the US to hold up, which is supported by the elevated US Purchasing Manager Index, foreign trade to Europe may suffer. Admittedly, Europe only represents 13 % of total Japanese exports, but nearly half of the trade is conducted in EUR and is therefore anticipated to hurt profitability. Strong surge in exports and improving corporate profits incentivized companies to invest. Capital expenditures grew 0.6 % q-q, contributing 0.1 percentage points to GDP in the January-March period, which was somewhat less than in the previous quarter. Various indicators point to a strengthening in investments: Shipments of capital goods are on a strong upward trend and only very recently showed some slowdown in growth. Additionally, machinery orders, which point to capital spending in 3-6 months, reached positive yearly growth rates and also include increasing demand from the non-manufacturing side. Furthermore, the manufacturing capacity utilization operating ratio has significantly recovered, standing now at 90.6. GDP-based capital expenditures might grow modestly, though, as the majority of production capacity will be allocated outside Japan. A strong Japanese currency and superior economic growth as well as return on assets overseas justify this strategy. The low shipment/inventory ratio is indicating that destocking has come to an end. In 1Q, private inventories contributed 0.1 percentage point to GDP.

Private consumption increased somewhat less than in the previous quarter, rising 0.4 % q-q. It contributed 0.3 percentage points to GDP. We expect household expenditure to slow down further as a result of the vanishing effect of stimulus measures, which previously led to strong demand for eco-friendly autos and appliances. From this point on, the employment and income situation will determine consumption. In fact, the labor market shows some encouraging trends. The unemployment rate and the job-to-applicant ratio have improved since last summer, but recently show some fatigue, which may be attributable to renewed uncertainty stemming from Europe and China. Importantly, wages (including overtime and bonuses) are growing for the second consecutive month in April after 21 months of negative y-y comparisons. Further increases in wages seem possible over coming months. In the quarterly confidence survey, consumers express continued optimism in respect to the income and employment situation. An additional support for consumers is offered through the childcare allowances, equaling approximately 0.5 % of GDP. Private housing investment rose 0.4 % q-q and is set to accelerate even further given the sharp increase in housing starts.

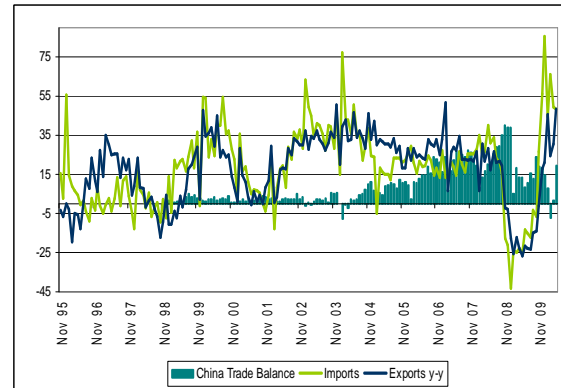
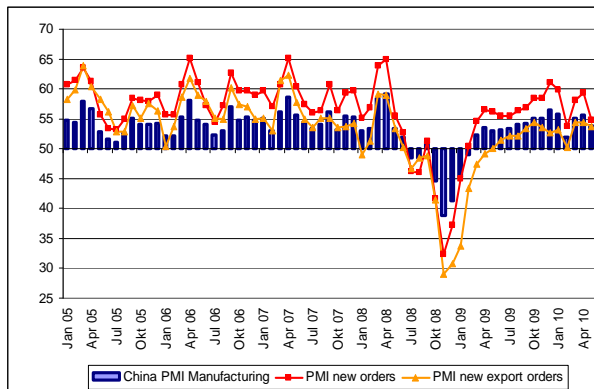


Japan continues to be plagued by serious deflation. The new Prime Minister Naoto Kan, who previously held the position of Finance minister, will first focus on arresting deflation (defined by GDP deflator), which potentially damages growth prospects and makes it difficult to stabilize public finances. To help the recovery the Kan cabinet is favoring rather a weak currency and might even try to pressure the BoJ to ease policy. In fact, the central bank created a \$ 33 billion program to expand credit to companies. It seems most questionable, though, that this program will be effective given the weak private-sector funds demand and the large cash reserves, which are currently held by financial institutions. The problems in Europe have sensitized Japanese voters to the extremely large public debt they face domestically (200 % debt/GDP). The safe haven status of the JPY and the strong preference of domestic financial institutions for Japanese government played so far in favor of Japan. Medium-term, the government is forced to address this problem in serious, particularly should interest rate differentials entail capital to be placed outside of Japan. While the new administration is clearly moving in the direction of fiscal austerity and has officially announced plans to reduce deficits, it might nevertheless try to postpone a consumption tax increase until after the next election, which will have to be called by 2013. Monetary policy in Japan will remain stimulative.

## China

A GDP growth rate of 11.9 %, which was attained in 1Q10, is not sustainable. We expect a more pronounced slowdown than the consensus. Growth in industrial production, accounting for 40 % of GDP, has already moderated somewhat. While continued weakness was expected in the heavy industry as a direct consequence of the gradual exit of stimulated infrastructure projects, the observed retreat in the light industry was surprising. The Manufacturing purchasing manager index, representing the most telling leading indicator for future industrial activity, has been slowing down moderately, but remained in growth territory. The significant decline in the new orders subcomponent combined with a sharp increase in inventories points however to a further weakening in industrial production over coming months. Additionally, should China adhere to its energy consumption plan, the government would have to shut-down some energy-intensive production sites, resulting in some additional weakening of manufacturing activity. Exports, benefiting so far from the global cyclical recovery, may also lose momentum over coming months. The Eurozone constitutes approximately 20 % of Chinese exports and will undoubtedly show less vivid demand for the remainder of the year. Increasingly difficult comparisons with 2009 and slowing fixed asset investments represent additional reasons for a deceleration. The widely held view that a Yuan appreciation was imminent led to anticipated purchases by overseas buyers, which will have an attenuating effect on

exports over coming months. Some signs of an ebbing in growth are flagged by the decline in volume of imported commodities and preliminary products. The rapidly rising salaries in the export sector pose a threat to Chinese competitiveness - particularly should it be combined with a Yuan appreciation. The huge trade surplus is therefore unlikely to be sustained. Retail sales remained solid, but growth decreased to some degree when inflation is taken into account. Waning stimulus-induced auto sales could exert a dampening impact on future data, which might be offset by rising salaries.



The effects of the unprecedented credit expansion might become less controllable. New Yuan loans still grow at an untenable level and have to decrease further to reach the CNY 7.5 trillion goal set by the PBoC. Real estate continues to be the favored destination for investments as bank deposits continue offering negative real returns. In May, investments in real estate jumped 43.5 % and newly started construction in floor space rose over 100 % despite stringent property tightening measures introduced mid April. House prices continue to increase at double-digit rates y-y. May marked, however, the first deceleration in the annual rate of property price gains in eleven months. Still, the speculative nature of real estate investments becomes increasingly visible: Many of the sold-out apartments remain unoccupied. Officials may therefore further strengthen purchasing conditions and even introduce a property tax. Some of the expected sharp sales decline in private property may be somewhat offset by aggressive government plans in the construction of welfare housing. The annual report of the Chinese banking regulator summarizes key concerns. It considers the Chinese credit risk as still high on quantity of lending and uncertain quality of loans attributed to questionable oversight. It notes growing risks in the property sector but observes also risks emerging outside the real estate segment. It sees the possibility of rising default rate under higher credit risk and sees potential pressure on non performing loans. Interestingly, it perceives factors driving China growth as still weak. Of course, this authority has to assess risks in a most prudent and conservative way.

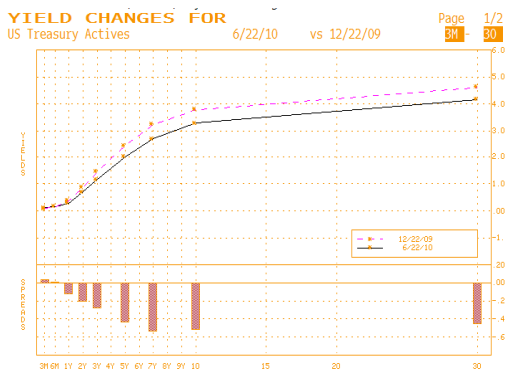
CPI currently exceeds the government target of 3.0 %, mainly on increasing food prices. More recently, also the core inflation started to rise as a consequence of markedly higher residence prices. At 1.6 % this indicator remains at a moderate level, though. Steep salary increases at two multinational manufacturers and recent strikes will likely have a signaling effect across industrial sectors and start a period of consistent and large wage increases. This trend will be amplified by the fact that the number of new workers entering the labor market is declining, thereby forcing companies to pay up for their workforce. Furthermore, a number of local governments recently announced a fairly large hike in minimum wages. Salary increases will propel firms to raise prices for their final products. Alternatively, margins would have to shrink. Continuous rising house prices, higher utility costs and public pensions, which have been increased by the government at the beginning of the year in addition to rising medical costs push all up core inflation. Such increases are more tenacious than commodity-induced inflation effects. Pressures in the pipeline are also mounting: Inflation at the producer level surged by 7.1 % y-y in May, reflecting to a large extent the base effect from earlier swings in commodity prices. Despite the increase in the reserve requirement ratio and credit quotas, China's policy is still expansionary. We anticipate a more stringent approach towards loans and real estates. Over coming months, we would also expect the Yuan to be traded in a more flexible bandwidth. A benchmark interest rate increase could occur at the end of 3Q.

**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 in most regions. Exceptions are likely the ECB and the BoJ. Unwinding of exceptional measures, drainage of liquidity as well as increases in benchmark interest rate rates will shape the perception of the investors. Those, which have used bond purchases as a measure of quantitative easing, will reverse it. The current abundant liquidity will decline during the course of the year. Given the marked differences of the economic cycles, fiscal policies and political environment in various regions, investment decisions should incorporate those factors.

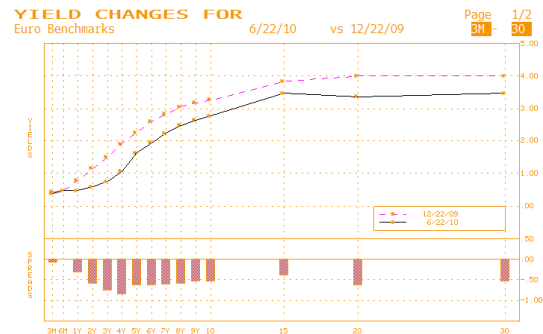
**a) Fixed Income USA**

The Treasury yield curve has become somewhat less steep. Low expectations in respect to interest rate hikes by the Federal Reserve have kept the shorter end at extremely low levels. We anticipate the short-end to incorporate with time a benchmark interest rate increase. The long-end benefited from the flight to safety. We expect the long end to be influenced by liquidity drainage, less significant purchases by the Chinese due to their less important currency reserves and be a change in inflation expectations. 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. High-yields are also an option due to the relatively sound economic environment.



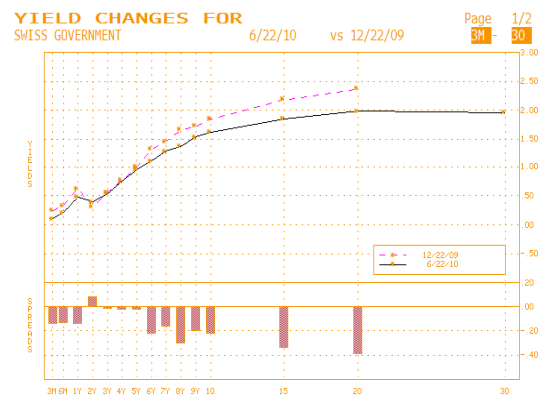
**b) Fixed Income Europe**

In light of the grave problems the Eurozone faces, we expect interest rates to stay low for a longer period than previously thought. Due to this fact, Eurobonds are favored in a global approach. The quality of the issuer is however of greater importance due to the difficult economic environment. We therefore would increase the duration.



**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. An interest rate hike by the SNB could occur towards the end of this year. Given the extraordinary low yields offered in an environment of raising rates, we generally consider the bond market as unattractive.



### 3. Market Outlook Equities

The problems in Europe will lead, through softer economic expansion, to somewhat less robust earnings growth than previously expected. While stocks theoretically seem more attractive than bonds in most regions, we consider that consensus expectations are still too high and have to be revised down. Substantial moves in main currencies also demand a deepened analysis in respect to the currency exposure of different companies and their hedging strategies. Upcoming quarterly reports should provide more clarity in this respect.

As central banks will unwind their extremely loose policy, liquidity will be less abundant, thereby challenging equity markets. We would also expect investors not be willing to push up market multiples in the current environment.

We currently favor the US and Asian markets.

#### **a) US Stock Market**

According to our economic scenario, top-line growth is anticipated to progress. 2010 earnings are expected to rise in double digits offering support to stock valuation. Sector-wise we prefer technology and industrials. At a P/E of 11.7x estimated 2011 earnings the market seems still at a relatively attractive valuation.

➤ **S&P 500 target 1200**

#### **b) European Stock Market**

As our scenario anticipates a strong probability of a double-dip, we consider that expectations in respect to Europe have still to be drastically reduced. We would therefore be very cautious in regard to the European markets. Export-oriented companies should be favored. Revenue generation outside the Eurozone should also offer some opportunities. At a P/E of 9.9x estimated 2011 earnings, the European equity markets looks attractive, but we expect profit expectations to be revised to the downside and highlight the cyclical nature of the European markets. We therefore see no real potential here.

➤ **DJ STOXX 600 target 250**

#### **c) Swiss Stock Market**

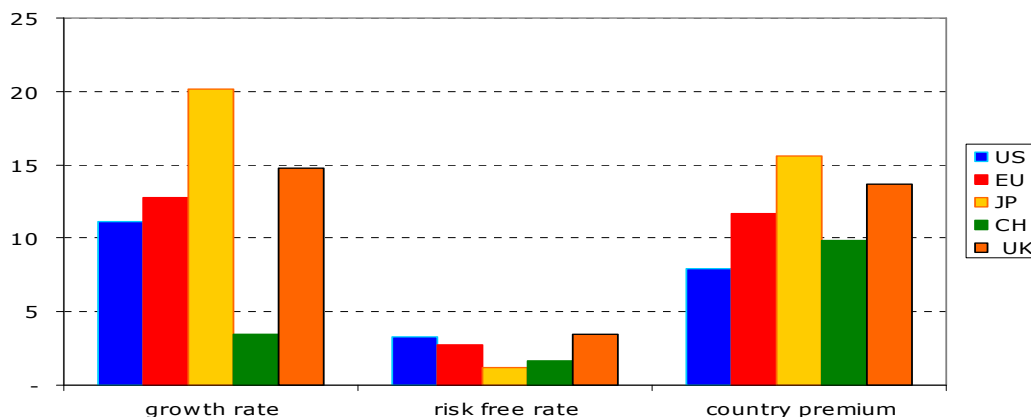
The slightly more defensive posture of the Swiss market seems to be favorable in the current environment. The estimated P/E of 10.7x estimated 2011 earnings seems alluring. Due to the heavy weighting of some strongly international-oriented companies (Novartis, Nestle, Roche, UBS, Credit Suisse) the index is less sensitive to developments in Switzerland.

➤ **SMI target 6700**

#### **Conclusion:**

**Given the heightened volatility a more flexible approach is needed. For now, we have a rather neutral positioning.**

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



**4. Market Outlook Foreign Exchange**

**EURUSD:** The prospects of the EUR have sharply deteriorated. Given the difficulties in the Eurozone, the European currency has to undergo a further sharp devaluation. Additionally, we continue to have a positive opinion on the USD as we consider the economic environment as robust. At a certain point, the USD will also benefit from more favorable interest rate differentials due to a marked divergence in monetary policy between the Fed and the ECB.



➤ **EURUSD seen at parity over the next 6 months**

**USDJPY:** The heightened uncertainty and volatility in the markets plays in favor of the JPY. The still grave deflation problem will hinder the BoJ to take any action on interest rates for the foreseeable time, which will put pressure on the currency with time. Key over the next several years will be if Japan is successful in fiscal consolidation.



➤ **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 EURCHF positions.



➤ **EURCHF seen at 1.30**

**GBPUSD:** Market estimates in respect to the UK economy are overly bearish, in our opinion. Inflation pressures are more present in the UK than in any other industrial country. The BoE might be forced to take action, despite the delicate macroeconomic environment, which is complicated by fiscal policy.



➤ **GBPUSD seen at 1.60 level**



## **Bank Leumi Switzerland**

Claridenstrasse 34  
8002 Zürich

Telefon 044/207 95 66

Telefax 044/207 95 75

e-Mail [emeier@leumi.ch](mailto:emeier@leumi.ch)