

Weekly Report

EU stress test: missed opportunity ?

The aim of the exercise should have been to address uncertainty in respect to sovereign debt holdings. As feared, this crucial point was not addressed the way investors were hoping for. The regulators were blatantly reluctant to incorporate the real fear of market participants: a sovereign default. The tests merely applied "light" haircuts and addressed only trading books, whereas the overwhelming majority of Greek bonds are held in the banking books. A few German financial institutions abstained from revealing their sovereign holdings, citing local law. In fact, the testing at national levels also proved problematic and seriously impedes fair comparisons. At first sight, Germany and Italy seem to have "smoothed" results blatantly. The "adverse" macroeconomic scenario assuming a decrease of GDP by -0.2 % in 2010 and -0.6 % in 2011 is judged also as rather timid. On the positive side, the extensive data supplied should increase transparency to a certain degree. In sum, the stress test unfortunately failed to deliver the hoped-for coup. Investors will continue to scrutinize the Euribor-OIS spreads on a daily basis and carefully watch auction results. Better-than-expected economic data from the Eurozone and large participation of non-domestic parties in recent auctions led to a less risk-averse market behavior. We anticipate economic growth in the Eurozone to be particularly fragile as the export engine should start to throttle and harsher fiscal policies will increasingly be applied. Investors still willing to invest in European banking stocks we would advise to concentrate on Barclays, Standard Charter, HSBC, Swiss and Nordic banks.

Foreign Exchange

For once, UK economic data truly surprised positively: 2Q GDP expanded by 1.1 % q-q, which was much stronger than expected and signifies an impressive acceleration from the 0.3 % growth in 1Q. Admittedly, unduly harsh weather conditions at the beginning of the year held back various activities. The broad-based nature of the economic rebound with services rising 0.9 %, manufacturing augmenting by 1.7 % and construction jumping 6.6 %, is nevertheless very encouraging. While leading indicators suggest a slowdown over coming months, GDP growth for 2010 should in any event be more robust than market participants anticipated. This release is very welcome news to the Bank of England, which was rumored of contemplating further easing measures despite uncomfortably elevated inflation gauges. Should inflation expectations and spare capacity measures continue to rise, other monetary policy members than Andrew Sentence may be in favor of tightening steps. Given our constructive view on the UK economy, we remain positive on the GBP.

	Short-term trend	Last
EURUSD	↓	1.2998
USDCHF	↑	1.0482
USDJPY	↑	86.942
GBPUSD	↑	1.5483

Fixed Income

The aim of the stress test was of course to increase trust between banks, which would then alleviate funding costs. The currently elevated rates are however the consequence of cyclical as well as structural factors. On the macroeconomic side, fiscal measures will only show up in releases over time and weigh on already weak consumption. Better than expected figures most recently are very much linked to exports and not sustainable, in our opinion. Bonds spreads may therefore remain elevated from that perspective. Quite encouragingly, CDS spreads for European banks have trended positively already some days before the release as some comforting information has leaked through to the market. The reaction after the publication remained in most cases favorable as more substantial data was released than feared and investors have now a much clearer picture on the exposures to sovereign debts of different banks. Nevertheless, we judge that the financing needs are much more important than the stress test suggests. In light of the uncertain economic environment we expect market participants to remain reluctant to fund banks.

	Forecast end 10	Last
US 10y T %	4.80	3.03
Fed funds	0.75	0-0.25
Bund 10y %	3.70	2.76
ECB rates	1.00	1.00

Stocks

While many investors are fearing a double dip recession in the US, the upbeat reports and outlooks notably from cyclical-sensitive companies do not support these negative views. UPS surprised positively on the top- and bottom-line, leading to much better than expected margins. Management raised the outlook for the year as a consequence. Improving conditions in the freight sectors have been confirmed by FedEx, which also raised its profit forecast for fiscal 1Q and the full year, citing better-than-expected growth at FedEx Express and FedEx Ground volumes. 3M (MMM) exceeded expectations and management raised its outlook, too, on stronger than originally anticipated organic sales volume. Sales rose in all business and geographies with particular strength in emerging markets as well as Electro & Communications at 32 %, Display & Graphics at 30 % and Industrial & Transportation at 23 %. In Europe, ABB (ABBN VX) announced results exceeding expectations with orders rising 5 %. The company cited strength of the global economic recovery. We keep our investments in all the above-mentioned companies.

	Forecast end 10	Last
S&P 500	1200	1111
NASDAQ	2400	2284
DJ STOXX 600	250	257
SMI	6700	6199