

Weekly Report

De-pegging the Yuan - what is the impact ?

China's move toward currency flexibility is very significant for the world economy as it allows trade flows on more realistic prices and will contribute considerably to normalize currency reserves. The latter will have the potential to influence even interest rate levels in the US, as lower Chinese currency reserves will create less demand for US government bonds. On a short-term basis, it reduces pressure for the People's Bank of China to aggressively tighten monetary policy. This will support the stock market, which declined over 20 % so far in 2010. It will also be beneficial to inflation, which represent one of China's biggest problems, particularly now that even salary costs risk to push up core inflation. A higher Yuan would reduce import costs, thereby depressing import prices. Since most imports are traded in USD, this will have a significant impact. Today, many commodity sensitive assets reacted very positively to the currency appreciation. We are less convinced that commodities will benefit in this environment as most of them are used for future export goods. There are strong indications that export growth will slow over coming months. The Eurozone constitutes approximately 20 % of Chinese exports and will undoubtedly show less vivid demand. The widely held view of an imminent Yuan appreciation also led to anticipated purchases by overseas buyers, which will have an attenuating effect on exports over coming months. The decline in volume of imported commodities and preliminary products is an additional sign for potentially ebbing growth. We consider Asian stocks and currencies as well as TBF/TBT to be the most attractive opportunities.

Foreign Exchange

The EUR experienced a strong revival over the past week. The notion that the prior strong decline was too extreme and some renewed risk-taking as well as intense short-covering action have favored this trend. We consider this the "second chance" to lighten up EUR positions. While the outlook for the Eurozone is particularly clouded as the future depends on the individual policies and dynamics in each and every member state, it seems nevertheless safe 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 accentuate: weak private consumption. Eventual economic growth is becoming solely dependent on exports. For reference reasons, the export champion, Germany, sells close to 50 % to other Eurozone countries. We expect the Financial Stabilization Facility to be tested at a certain point - with a negative outcome. We remain bearish on the EUR.

	Short-term trend	Last
EURUSD	↓	1.2337
USDCHF	↑	1.1110
USDJPY	→	91.008
GBPUSD	→	1.4795

Fixed Income

Fewer bond purchases due to declining Chinese currency reserves and a sustainable recovery of the US economy are not the only reasons why Treasury yields may increase from these extraordinary low levels. We anticipate that the core inflation rate in the US 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. While the expiration of the housebuyers' tax credit may have a slightly negative short-term influence, Owners' Equivalent Rent and the rent of primary residence, both show some indication of bottoming. 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.

	Forecast end 10	Last
US 10y T %	4.80	3.24
Fed funds	0.75	0-0.25
Bund 10y %	3.70	2.77
ECB rates	1.00	1.00

Stocks

In light of the China's move toward currency flexibility we have been investing in the MSCI Asia. The Shanghai index has lost over 20 % since the start of this year on fears of aggressive tightening by the People's Bank of China. This anxiety may temporarily calm down given the currency action. Additionally, other economies in the region will benefit from this initiative. We recently also invested in General Electric (GE) as the US remains our favorite region. The share price has corrected far more than the S&P or competitors in the industrial sector. GE reflects through its exposure to various sectors the trend in the US economy. As we do not anticipate a double-dip, we expect the company to benefit from the solid upturn. FX is expected to have a minimal earnings impact due to natural hedges in their manufacturing/funding base. Orders are anticipated to turn positive in 2Q. We also count on an eventual improvement in the late-cycle business. Persistent skepticism in respect to GE Capital seem not justified as this entity is funded into 2011. We consider GE as very attractive at current prices.

	Forecast end 10	Last
S&P 500	1200	1123
NASDAQ	2400	2314
DJ STOXX 600	250	258
SMI	6700	6520