

Weekly Report

EU bank resolution fund or fortified Basel regulations ?

With a decline of 12.6 % since the start of the year, the European banking stocks represent the worst performing group within the STOXX 600. It reflects the cyclicity of the sector but even more so the renewed angst of a credit crisis. Despite emergency measures taken by the ECB and other central banks, there are intensifying signs that banks are increasingly unwilling to lend to each other. Financial institutions tend now to hoard their cash or place it with the ECB rather than lending it to banks. Additionally, money market funds seem less willing to consider commercial papers, which are issued by some Spanish, Portuguese and Italian financial parties. The seizure of CajaSur by the Bank of Spain, the news that BBVA was reportedly incapable of renewing roughly \$ 1 billion of short-term funding and the German Bank Regulator reactivating a EUR 10 billion guarantee for Hypo Real Estate are just some examples why trust became so rare. In this context, the discussion to find a solution for future bank failures, which will not destabilize the whole financial system, have quickly rekindled. Yet the discussions highlighted once more how difficult a common solution within Europe has become and with what eagerness national interest are defended. Instead of considering the bank resolution fund, which has been proposed by the Europe's internal market commissioner and faces criticism in respect to potential moral hazard and other impediments, supervisions by bank regulators based on an improved Basel accord might offer a more feasible, quicker and more sustainable solution most participants could agree on.

Foreign Exchange

The JPY, which even outperformed the USD during the recent crisis, showed finally some signs of weakening. One of the reasons was of political nature: the Social Democratic Party left the coalition government and polls showed that the majority of the voters would like the Prime Minister Yuko Hatoyama to resign after he abandoned a campaign pledge to move the US base. The weakness in the JPY may be temporary given the expected continuation of uncertainty and anticipated downward revisions in economic growth. Given our bearish view on the Eurozone we expect EURUSD to further lose after the current consolidation. Canada reported stronger than expected 1Q GDP growth of 6.1 %, which was led by consumer spending and investments. Generally better than expected economic data, including job gains and higher than anticipated price increases should lead the Bank of Canada to raise its benchmark interest rate by 25 bps this week. The USDCAD should therefore fall to the 1.03 level.

	Short-term trend	Last
EURUSD	↓	1.2300
USDCHF	↑	1.1556
USDJPY	→	91.465
GBPUSD	→	1.4518

Fixed Income

The low visibility in the European banking sector has also its repercussion on the credit market: European banks issued only \$ 12.6 billion of debt globally in May, which is the lowest amount in over ten years. But corporate bonds suffered generally from heightened risk aversion, losing approximately 0.65 % in May alone as austerity measures in many countries will lead to dampened growth prospects. Spreads between corporate bonds and government bonds widened by 44 bps to close to 200 bps. Less risk appetite led to a low level of bond issues: Only \$ 66.1 billion of debt have been placed in May, which corresponds to the lowest level in ten years. Many high quality companies have already come to the market last year. The lower quality names that are primarily now on the market would have to pay up in these uncertain times and some companies have therefore decided to pull themselves out. We expect conditions to tighten further, particularly as other economic areas also show signs of trouble building. This is particularly true for the Chinese real estate market, for which yields are increasing considerably.

	Forecast end 10	Last
US 10y T %	4.80	3.28
Fed funds	1.50	0-0.25
Bund 10y %	3.70	2.65
ECB rates	1.00	1.00

Stocks

The reporting season also draws to an end in the Eurozone. Interestingly, Italian and Portuguese companies have shown worse than expected results in 1Q. Banking, construction but also consumer cyclicals unsurprisingly contributed to this negative outcome. Other fiscally challenged countries, such as Greece and Ireland, also performed rather disappointingly. This might support the thesis that the above mentioned countries are suffering from declining competitiveness, which impacts company results as a consequence. Spanish firms surprised rather positively. But given the fact that the deteriorating economic environment in the Eurozone will only be visible in corporate results with time, we are cautiously positioned in our equity exposure. In Europe, companies with exposure to the US and Asia should be favored. In the US, a high degree of domestic sales generation should be preferred. One example would be the do-it-yourself sector and Home Depot (HD) in particular. The company mainly operates in the US with activities also in Canada, China and Mexico. The company reported better than expected results mid May and raised guidance for the full year.

	Forecast end 10	Last
S&P 500	1200	1090
NASDAQ	2400	2257
DJ STOXX 600	250	245
SMI	6700	6326