

## Weekly Report

### EFSF: Should non-AAA be assessed as AAA ?

The sophisticated products which represented low quality papers as AAAs played a major part in the just experienced grave world recession and brought the financial systems close to a collapse. It seems unbelievable and alarming when politicians now try to apply the same "miracle mechanism" to ailing sovereign debt that investment bankers used for their structured products. But this is just what seems to occur to the European Financial Stability Facility (EFSF). Officials for the EUR 440 billion Eurozone sovereign rescue fund expect to obtain a AAA credit rating in August, even though only a minority of the Eurozone countries that are backing the fund enjoy such a rating. A surplus "cushion", requiring countries to guarantee an additional 20 % above their ECB contribution, has been designed to cover the risk of an individual guarantor not fulfilling its obligation. It is important to note that the guarantees are not joint. Additionally, an unspecified cash reserve is anticipated to offer extra support. Technically, if 16.7 % of guarantors (representing roughly Greece, Portugal, Spain and Ireland) are unable to finance their part, lenders to the EFSF will be exposed to losses. If a larger member, such as Italy, is financially challenged, the existence of the EFSF would be in danger. Of course, statistically it is highly unlikely that the point will be reached at which losses are triggered. But given the very recent history, it seems more than cynical to solve a critical debt crisis with such an instrument. In light of the perilous state of several European governments, the uncertain outlook and the potential contagion, a AAA should really not be awarded.

### Foreign Exchange

The EURUSD touched very briefly the 1.30-level on Friday after Chinese authorities assured visiting German Chancellor Angela Merkel that they would continue to diversify their abundant foreign exchange reserves and invest also in EUR. European markets remained one of China's key investment areas. But y-y growth rates in China's reserves have decreased drastically over recent months. Indeed, foreign exchange reserves are set to weaken further in light of the anticipated slow down of the export sector, which can be attributed to the EU debt crisis and the end of tax rebates as well as a strengthening trend in the Yuan/USD. Also lower import levels are expected as a consequence of slower domestic demand and a leveling out of commodity prices. These trends could potentially offer less support to the EUR and lead to gradually higher US Treasury yields. The observed risk aversion of investors led to a further strengthening of the JPY. The point has been reached, at which market participants are questioning if Japanese authorities may considered interventions.

	Short-term trend	Last
EURUSD	↓	1.2948
USDCHF	↑	1.0523
USDJPY	↑	86.816
GBPUSD	→	1.5222

### Fixed Income

Risk reduction represents again the preferred stratagem of investors. The profound sovereign debt crisis, the imminent release of vague stress tests on European banks, the noticeable slowdown in important Chinese economic data, disappointing US releases and the uncertainty in relation to the concrete consequences of the financial regulation all together have resulted in very low visibility. The 10-year US-Treasury has fallen below 3 %, reflecting the flight to safety. Deflation angst has also reemerged, very similar to the situation end 2008/beginning 2009. Admittedly, the US economy faces many headwinds, but we still consider actual trends as solid enough to avoid a double-dip. More importantly for fixed income: We observe a bottoming process in core inflation. The CPI ex energy and food remained at 0.9 % for the third consecutive month. The key shelter sub-category, which accounts for over 40 % of the core inflation, has been moving sideways since March. We expect shelter-related sub-indices (primary rent, lodge away and owner's rent) to gradually rise in 2H. We consider Treasuries as outright unattractive at current levels.

	Forecast end 10	Last
US 10y T %	4.80	2.94
Fed funds	0.75	0-0.25
Bund 10y %	3.70	2.66
ECB rates	1.00	1.00

### Stocks

The start of the reporting season has generally been quite encouraging with the exception of the large banks. While profits of reporting financial institutions (JPM, BAC, C, FHN and SCHW), were all much stronger than expected, revenues were impacted by smaller balance sheets. Investment banking, which was leading banks out of the crisis, experienced a setback due to less vigorous trading activity and capital increases. Additionally, net interest margins weakened. Importantly, the global regulatory framework remains uncertain. On the positive side, the credit cycle is definitely improving. We remain constructive, particularly on large US banks, as they have substantially worked through capital increases. Our favored sector remains technology, though. Intel (INTC) reported better than expected results and offered an upbeat outlook. Sales have been driven by a favorable server product cycle and evidence of IT investments by enterprises. Additionally, tight capacity helped pricing, which allowed INTC to increase its gross margin target. In technology, we also like Applied Materials, Microsoft, Jabil Circuit and EMC.

	Forecast end 10	Last
S&P 500	1200	1065
NASDAQ	2400	2181
DJ STOXX 600	250	246
SMI	6700	6157