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Weekly Report

Deflation, inflation or worse ?

Statements by the president of the Kansas City Federal Reserve bank seem at odds with the current market thinking. According to his view, the federal fund rate should rise from close to zero to 1 % by the end of summer, arguing that even at that level monetary policy would remain extraordinarily stimulative. After assessing the outlook, rates ought to be moved to 3 % reasonably quickly. In the final stage, fed funds could reach 4.5 %. While Thomas Hoenig was the only FOMC voting member which openly dissented for the last three meeting, statements by other Fed Banks presidents seem slowly to move in his direction. The main argument is based on the assessment that extraordinary low rates are dangerous to the outlook and caused high cost in the past: Inexpensive money in the 2003-04 period, when deflationary fears reigned, have substantially contributed to the housing bubble and led to a general misjudgment on investment risks. While most central bankers acknowledge the necessity to raise rates, the timing seems most important, particularly given the troublesome clutter in Europe and the loan bubble in China. Importantly, low interest rates also support the financial industry. Additionally, still low inflation rates and well-anchored inflation expectations are cited. The crucial role of inflation expectations has been documented in various studies. The problem is that market expectations can change within hours. Economic systems which are flooded with liquidity when such sudden alternation in assessment occurs will be especially vulnerable to inflation fears. A timely normalization of interest rates in the US is hence desirable.

Foreign Exchange

The devaluation of the EUR continues after a short time of consolidation. Considering the fact that the Eurozone is still evaluating new members, such as Estonia which has been approved for entry in 2011 only a few weeks ago and showed the second worst economic growth amid the EU-27 members or even more troublesome, Hungary, which apparently elected a headline-catching communicator as the prime ministers spokesperson, the troubles with the EUR seem far from over. Given the massive problems in the Eurozone the best outcome seems a further significant devaluation of the EUR and the worst outcome a strong alteration of the member states, or alternatively, the dissolution of this currency all-together. Of course, this is a process, which might occur over several years. Nice words out of China (it became an important holder of EUR investments) and central bank interventions may periodically lead to a countermove. USD, CHF and JPY are for the time being the currencies to hold.

	Short-term trend	Last
EURUSD	↓	1.1966
USDCHF	↑	1.1630
USDJPY	→	91994
GBPUSD	→	1.4484

Fixed Income

US government debt once more fulfilled the role as safe haven. Investors accept ridiculous low yields again for the sake of preserving their capital. We are somewhat concerned about the ease investors show when considering bonds, particularly of longer duration. It seems out of question that interest rates may rise and bond values slide as a consequence. But this is exactly our scenario (particularly in the US) - increasing interest rates for years to come. We therefore strongly advise to choose short duration, despite the apparent unattractive yields. The FOMC 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. After having raised the rate already once, various Federal Reserve Banks push for further adjustments. The way is increasingly cleared in order to address also the federal fund rate. We currently prefer some corporate bonds, which corrected in recent weeks and we like TBF/TBTs.

	Forecast end 10	Last
US 10y T %	4.80	3.22
Fed funds	1.50	0-0.25
Bund 10y %	3.70	2.57
ECB rates	1.00	1.00

Stocks

The name of the game seems to be where to lose the least among volatile moves, full of emotions, empty of volumes. Johnson & Johnson (JNJ) is considered a more defensive investment in these uncertain times. The company hosted the bi-annual review of its Medical Device and Diagnostics (MD&D) unit last week, which is the largest, fastest growing and highest margin business in medical technology worldwide. MD&D is anticipated to show top line growth of 6-7 % over the next five years based on an impressive pipeline and focus on emerging markets. Double-digit growth from Ethicon (recent acquisitions of Omrix, Acclarent and Mentor offer a promising pipeline) and high single-digit growth from Ethicon-Endosurgery, DePuy as well as Diagnostics represent the main drivers. The MD&D division has already received approval for a dozen new products and should add about 80 submissions between 2010 to 2012. In their pharma unit, growth is anticipated to accelerate after patent expiration of important products (Risperdal and Topamax) last year. A weakening EUR and a product recall seem well discounted in the current share price.

	Forecast end 10	Last
S&P 500	1200	1066
NASDAQ	2400	2208
DJ STOXX 600	250	243
SMI	6700	6291

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