SARASIN

Global View

Research

4th Quarter 2010

Sustainable Swiss Private Banking since 1841.

Contents

Lost time?

Marcel Proust's fictional autobiography *In Search of Lost Time* (*À la recherche du temps perdu*) is between 3,200 and 4,000 pages long depending on the translation, and it weaves a plot around cast of more than 2,000 literary characters. His monumental seven-volume novel ranks among the major literary works of the twentieth century. The literary-historical importance of Proust's novel lies principally in his pioneering thorough portrayal of the subjectivity of human perception with all of its drawbacks and possibilities. But if you lack the time to read this once-in-a-century masterwork, you can always listen to *Le temps perdu* «Lost Time» in English), a song recorded last year by Nicolas Sarkozy's wife Carla Bruni.

But does «lost time» also apply to the stock markets? The answer of course depends on the angle of observation. But it probably feels like lost time for many investors. US and Swiss stocks are currently trading slightly below where they were ten years ago. European stocks are even down 20% from their year 2000 level. In comparison, from 1982 to 2000 these stock markets advanced more than 1,000%. But it's Japanese stocks that top that misery league table; on aggregate they have lost almost 40% of their value over the last ten years and are already looking back on two «lost decades». Only the emerging markets have avoided a lost decade, with Asian stocks advancing more than 100% and Latin American stocks climbing more than 300%. Government bonds have been the most reliable winners alongside gold and other commodities. The Financial Times recently noted that government bonds have beaten the S&P 500 since the start of 2010 as well as over the last three, five, ten, fifteen and twenty years. And a recent Wall Street Journal headline declared that in «a post-Lehman world, bonds, gold and emerging markets are in and stocks are out». The notion that stocks are a good long-term investment is evidently looking outdated. Temps perdu?!?

Meanwhile, fear of deflation is putting the bond markets in a festive mood. Large corporations are loading up more than ever on cheaper debt, and yield-hungry investors fearing deflation are snapping up entire new bond issues within mere minutes. The fact that the same dreaded deflation might later backfire on borrowers – and thus also on creditors – doesn't seem to be bothering investors, just so long as the yield is positive with a fixed coupon. IBM, for example, placed a USD 1.5 billion bond issue with an annualized yield to maturity of 1%. And for the first time ever, European banks are placing 100-year bonds with low fixed-rate coupons.

But what to do with all that «cheap» money? Microsoft CEO Steve Ballmer is under mounting pressure to return part of the company's USD 37 billion of surplus cash to shareholders via dividends or stock buybacks. For many companies, in fact, buying back stock has seldom been more attractive than right now. I don't know if the situation in the aftermath of the 1930s Depression was similar to the one today, but I doubt it. A comparable wave of liquidity from yield-seeking investors could hardly have formed in the wake of the massive loss of wealth that occurred during the Great Depression. And yet deflation fears in Europe and the USA appear to be more powerful than ever today.

And that's exactly what this edition of Global View is all about. What are the cases for and against deflation? And what does this mean for our investment policy for the fourth quarter of 2010? I wish you exciting reading.

Yours sincerely,

Dr. Burkhard P. Varnholt, Chief Investment Officer
Member of the Executive Committee

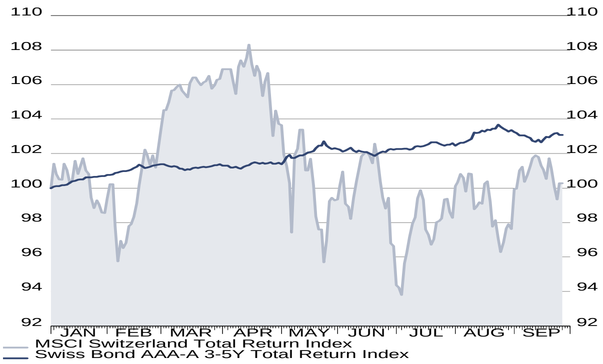
Preserving capital is the first priority

Despite several signs of a slowdown, the global economic engine is still humming and corporate earnings are sizzling. Nonetheless, various factors indicate that global economic growth will weaken significantly in the coming quarters. A double-dip recession and deflation are therefore likely to become the key themes in the financial markets in Q4 2010. As a consequence, risk aversion will increase and a setback in risky investments is very likely. We therefore focus our strategy on preserving capital and favour cash and safe bonds.

Review: Equities are lagging behind bonds

As expected, risk assets, especially equities and commodities, staged a recovery in the third quarter of 2010 on the back of good corporate results and decreased concerns over the euro debt crisis. But since this coincided with nascent fears of a recession, bonds also posted a positive performance on falling interest rates. Equities were unable to catch up with bonds and have lagged far behind bonds since April.

Switzerland: Outperformance of bonds since April 2010



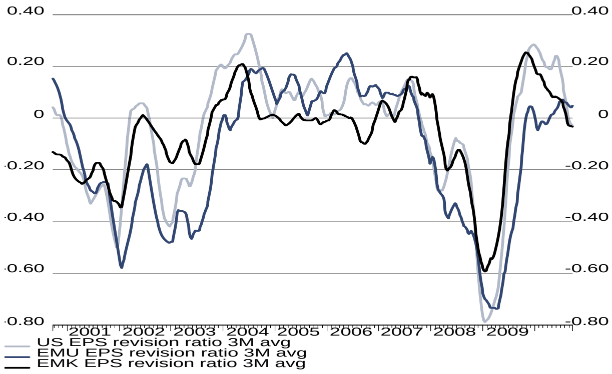
Source: Datastream

Due to the rising risks of a double-dip recession, the US Federal Reserve Bank announced in Q3 2010 that it would continue its expansive monetary policy and, if necessary, even increase it. As a consequence, investors fled to safe havens. So not only were European interest rates at record-low levels in Q3 2010, the Swiss franc reached new record highs against the euro and the US dollar.

Macro outlook: Economic slowdown ahead

The global economic cycle has passed its interim peak. Despite the robust economic data to date, leading indicators suggest a powerful economic slowdown that is likely to fuel recession and deflation fears until the end of the year. A self-supporting upswing in the US economy presupposes a stabilisation in the labour market, lending and house prices. The US economy will reaccelerate only in H2 2011, once the excesses of the credit bubble have been absorbed. In China, the soft landing is likely to occur slightly earlier, but the Chinese economy should also remain in a deceleration phase until the end of the year. Although the economic slowdown will probably begin slightly later in Europe, it should extend even further into 2011 as a result.

Consensus earnings estimates



Source: Datastream, Sarasin

Equity strategy: Strong cyclical headwind

The expected slowdown in economic growth means that future earnings estimates will have to be revised significantly downwards in the coming months. Since the downside risks to equities until the end of the year are much greater than the upside potential, we have taken a defensive position in both our regional and our sector strategy. Despite major risks of recession, market conditions favour US equities, which are often sought-after assets in uncertain times. In Europe, we expect the euro crisis to flare up again in Q4 2010 and, as a consequence, we focus our attention on the defensive markets of Switzerland and the UK. Despite the extremely positive fundamental data, the emerging markets will be unable to avoid a negative global stock market development. Defensive equities with a high dividend yield should fare the best in a climate of rising risk aversion. We favour the relatively stable sectors of consumer staples, healthcare and telecommunication.

Defensive sector strategy

Overweight	Consumer Staples Health Care Telecom. Services
Neutral	Energy Industrials Information Technology Utilities
Underweight	Consumer Discretionary Financials Materials

Source: Sarasin

Bond strategy: Economy supportive of bonds

Whereas US recession fears were the main reason for the decline in global bond yields in Q3, recession concerns should be joined by deflation fears in Q4. For bond yields, this means a continuation of the downtrend, as well as big fluctuations in yields, due to the high level of economic uncertainty. Only when leading indicators stabilise, which we expect will happen in H1 2011, will the downtrend be broken and lead to a rise in yields. Corporate bonds continue to show potential; however, a strong increase in recession fear poses a risk.

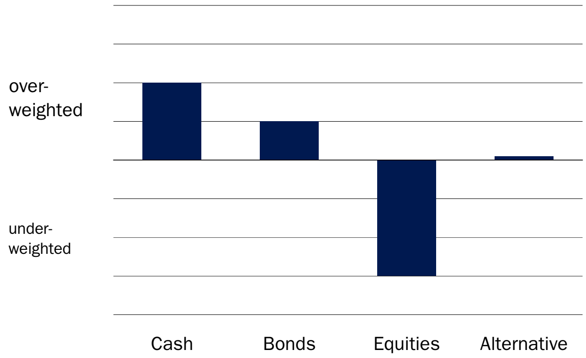
Currencies: Pressure on the CHF to appreciate

Based on our expectation of heightened risk aversion in Q4 2010, safe havens are likely to be in demand: the Swiss franc, Japanese yen and US dollar. Upward pressure on the Swiss franc should increase because as yet the Swiss National Bank has not set any limits on the Swiss franc appreciation. The yen should also weaken in Q4 2010 as a result of interventions by the Bank of Japan, while the US dollar will suffer as a result of the US Federal Reserve's expansive monetary policy.

Alternative assets: Dampened prospects in Q4 2010

Since the economic headwind is picking up, we no longer expect to see rising commodity prices in Q4. Gold is the only asset with the potential to stand out positively because the price of gold normally profits from a rise in risk aversion. There are significant regional discrepancies in the real estate market. Real estate assets with equity characteristics profit from low interest rates, but should suffer as a result of dwindling risk appetite. Only total return products offer potential, in our opinion. Option-based investment strategies in this area can earn attractive excess returns with an acceptable risk.

Asset allocation in Q4 2010: Underweight equities



Source: Sarasin

Asset allocation: Cautious investment strategy

After we cut back our equity allocation significantly at the beginning of Q2 2010, we took another step toward reducing the risks in our portfolios in Q3 2010. We are now underweight equities, real estate and commodities. As recession fears and deflation concerns intensify, they should lead to an above-average performance for safe bonds in Q4 2010. Thanks to our cash cushion, we have the flexibility to exploit any excesses in the market to our advantage. However, we do not expect to see a lasting improvement in the conditions for risk assets until next year.

Philipp Bärtschi, CFA

Deflation fears and their consequences

Scarcely has the upturn begun than the economy is starting to slow down again. Global inflation rates have not risen at all and remain at a low level. Concerns about a slide back into recession will thus fuel deflation fears in the coming quarters. In our special topic we examine deflation fears and their impact on the financial markets. In the first part we look at the macroeconomic side and explain why economists fear nothing so much as deflation. In the second part, we discuss why concerns over deflation affect the valuation of financial markets. In the third part we examine the criteria for equity selection in periods of deflation and recommend individual stocks.

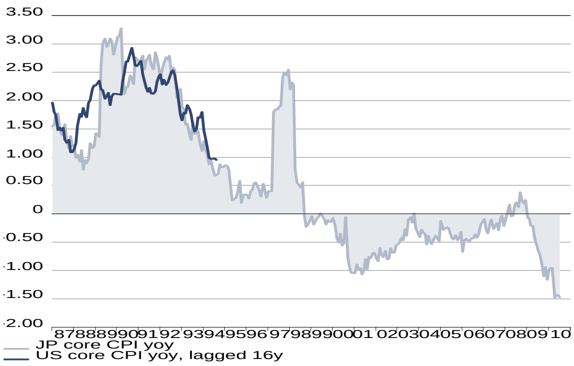
A thin cushion of inflation

Despite the sharp rise in the money supply, which has been largely responsible for rescuing the world economy from the deepest crisis for 80 years, the core inflation rates of the large industrial nations remain on a continuing downward trend. This is because, while the money supply has increased the scope for inflation, price pressure is ultimately determined by the existence of real final demand from consumers and companies. Inflation can only emerge if the growth in the money supply boosts demand through higher lending and if industrial capacities subsequently approach their limits. However, the stimulus-driven upswing is not sustainable; households, banks and governments all over the world are too busy nursing their balance sheets back to health. Price pressure is easing again due to the imminent economic slowdown. Therefore it is entirely logical that fears of recession in this phase fuel fears of deflation. Given the low level of inflation, it is clear that only a thin cushion currently protects us from the onset of deflation.

Can deflation be a good thing?

Deflation is commonly defined as an economic situation in which prices fall. However, falling prices are not problematic by themselves. On the contrary, falling prices can be a blessing for consumers, because they increase real purchasing power. A drop in prices is often said to have a negative impact because it makes consumers hesitate before buying. This is only a temporary effect, however, because while consumer sentiment remains intact they will go on consuming. Computers are a good example: despite falling prices, demand for IT products remains as strong as ever. The reason why this drop in prices is not a threat is that it is caused by technical progress rather than falling demand. Another example of «benign deflation» is that of Britain during the Industrial Revolution.

Will the USA follow Japan into deflation?



Source: Datastream, Sarasin

The spectre of Japan

By contrast, one country offers a sobering example of the modern spectre of deflation: Japan. The lesson from Japan is that deflation turns into a threat when it becomes long-lasting, widespread and part of the national mentality. Japan did not immediately fall into deflation after the bubble burst in 1990. It took 7 years before prices started to fall across a broad front. At first sight the conditions appear similar to those prevailing in the USA and certain European economies such as the UK, Ireland and Spain. The bursting of a property price bubble led to a banking crisis and a deep recession, from which the economy only recovered very slowly. A persistent headwind caused by weak lending and falling asset values dampened growth to such an extent that a deflationary spiral developed from 1997 onwards, in which the country remains to this day.

Deflation reduces nominal income…

How does a deflationary spiral come about and how does it operate? There are two mechanisms: an income effect and a wealth effect. The starting point for both effects is always weak consumption which forces companies to compete on price. However, falling prices also reduce companies' profits and trigger restructuring measures and layoffs. Because of rising unemployment, households increase their savings ratio and limit their consumption, which in turn leads to falling prices.

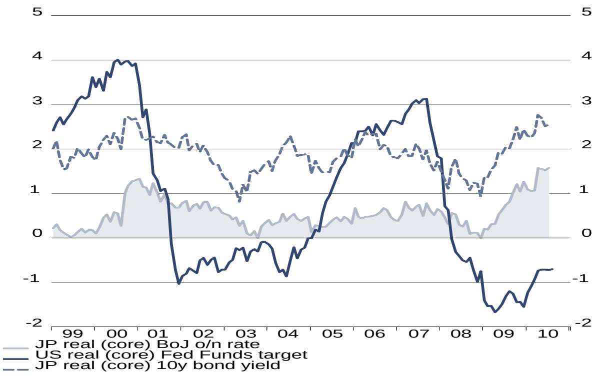
…and increases the real debt burden

The second mechanism is the wealth effect. While wages and prices fall, the debts of households and companies remain the same. This means that the debt burden increases in real terms, taking borrowers to the brink of insolvency. If the number of bad debts increases, banks may advance less credit and force households and companies to liquidate their assets. Property and share prices come under pressure as a result. The negative effect on asset prices in turn dampens consumer sentiment. Both the income effect and the wealth effect lead to a spiral in which consumer prices fall continuously; in a word: deflation.

There is no escape from deflation

Economists such as Chairman of the US Federal Reserve Ben Bernanke are afraid of deflation because there is hardly any way out of it. During recessions the central banks stimulate the economy by offering cheap money. If real interest rates (nominal interest rates minus inflation) are negative, they are virtually giving away money for free. However, in a deflationary situation the interest rate weapon is blunted because key interest rates cannot be negative in real terms. Whereas real interest rates in the USA after allowing for core inflation are currently negative, real Japanese interest rates are at their highest level since the year 2000. Long-term real interest rates in Japan are also close to their peak of the year 2000. If, in addition, the currency appreciates, as is currently happening in Japan, the monetary policy has a very restrictive effect. Fiscal policy cannot help either. In any case, as the number of stimulus programmes increases, so their effectiveness decreases, because repeated incentives to buy houses and cars always produce diminishing returns. Secondly, deflation means that the debt burden of the state keeps on growing in real terms and the interest burden increases. For over 10 years Japan has been running structural budget deficits averaging 5% of GDP. The only effect seems to have been to increase the debt-to-GDP ratio to 200%.

In a deflationary environment, the real interest rate is no longer negative



Source: Datastream, Sarasin

Comparison with Japan is misleading

However, it is an exaggeration to compare the US economy today with Japan in the nineties. Essentially there are a whole host of differences which cannot be ignored. Firstly, US economic policy responded far more quickly than was the case in Japan. The Fed cut interest rates almost to zero within a year of the recession starting; the Bank of Japan took 4 years. In Japan the fall in property prices was nearly 80% compared with only 30% in the USA. The US banks have already written off 85% of their bad debts arising out of the property crisis, whereas Japan took 13 years to do the same. If there is a lesson to be learnt from the Japanese debacle, it is that reforms and stimuli should be started as soon as possible and should not be delayed. The USA has taken these lessons to heart. We do not believe the USA or other parts of the world economy are set to fall into deflation. However, the risk is there and investors should acquaint themselves with the impact of deflation fears on the financial markets.

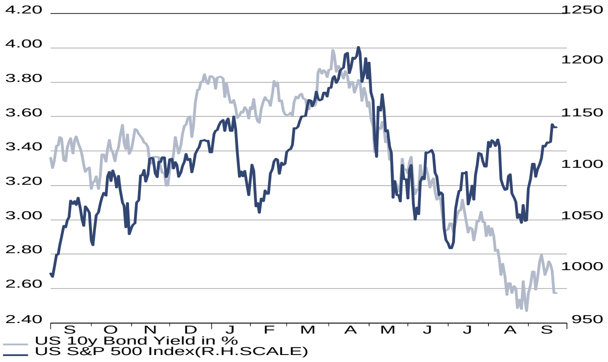
Dr. Jan Amrit Poser

Deflation worries weigh down equity markets

The US Fed was quick to respond to initial deflationary concerns that flared up in financial markets in the third quarter, and promised to do its utmost to combat deflation if necessary. The example of Japan shows that share valuations come under pressure when deflation threatens, even if interest rates are very low or even fall further. In the current climate, low interest rates should be viewed as a warning signal.

Only temporary decoupling between bonds and equities
At the moment equities and bonds do not seem to be singing from the same hymn sheet. While bond yields have fallen sharply in the third quarter, equity markets have staged a modest rally.

USA: Decoupling of yields and equity market



Source: Datastream

Bond markets have recently benefited from the US Fed's announcement that it would buy up more Treasuries in a move to relax monetary policy even further if necessary. Equity investors in turn put their faith in the «Bernanke Put», i.e. the ability of the US Fed to avert another downturn and reflate the economy. We believe that these two views are at best only compatible in the short term. We expect bond yields to remain low in the fourth quarter. But share prices are likely to come under pressure as the risk premium should increase in response to the threat of deflation.

Effect of expansive monetary policy is short-lived
Because the US economy is only one recession away from deflation, according to our estimates, investors are likely to focus their attention increasingly on the discussion about deflation towards the end of the year. As explained in the previous article, it is difficult for a central bank to stimulate the economy with an interest rate instrument when deflation looms. We therefore think that a further loosening of monetary policy by the US Fed could only provide at the most a temporary boost to stock markets. Such a program would actually act as a signal that the deflationary risks have increased significantly and that recession is imminent.

The Fed model in the Japanese context
Japan is a prime example of the effects that a deflationary environment can have on financial markets. Although the comparison between the US and Japan does not quite match up, the development of the valuation of bonds and equities with a 10-year time lag reveals astonishing parallels.

USA and Japan: The Fed model

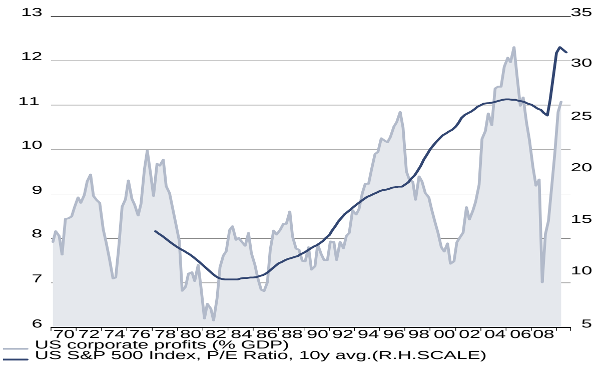
Source: Datastream, Sarasin

Observers have frequently argued that equities are a strong buy now because the valuation today is cheaper than it has been in decades. More specifically, a comparison of the equity earnings yield and the yield on long-term government bonds (the so-called «Fed model» used to evaluate the equity markets) indicates equities are at a significant discount to bonds. However, the example of Japan in the above chart suggests this ratio of bond yields to equity yields will continue to head lower in a deflationary environment. In other words, it means that the risk premium on equities will rise and the valuation will fall.

Structural de-rating in a deflationary environment

The main reason for a structural de-rating of the valuation of equity markets is that the profitability of companies declines in a deflationary environment. Because weak demand and existing excess capacities put prices under greater pressure more quickly than costs can be adjusted, profit margins shrink. For most companies, salaries represent the biggest cost item. It is often particularly difficult to make any significant savings in wage costs, for example due to resistance from trade unions. If labour costs remain the same, the profit margin shrinks when prices drop. The example of Japan shows that it is very hard for companies to escape from this negative profits spiral. Since western companies are already very lean compared with their Japanese counterparts and have very little additional cost-savings potential, they are likely to be worse hit by deflation. Just as rising profit margins have pushed up share valuations over the past decades, so would lower margins result in lower valuations in a deflationary climate.

USA: Profit margins and stock market valuation

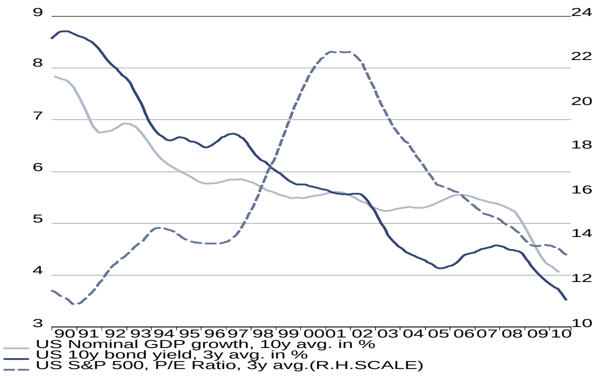


Source: Datastream, Sarasin

Weaker growth also drags down valuation

Even if the USA manages to stave off deflation by implementing new fiscal and monetary policy measures (as we expect it will), lower growth rates over several years are still likely to drag on the equity market valuation. Aside from the interest rate and the risk premium, the long-term expected growth rate is the major factor for the equity market valuation. In the short term, companies can offset weak growth with higher profit margins. This year is a good example of this: despite relatively low sales growth, companies were able to increase their earnings dramatically, thanks to higher margins. But margins are already at a record level and cannot climb indefinitely. On the contrary, due to the global fiscal consolidation measures likely to be undertaken in this decade, one should expect the corporate earnings share of the gross domestic product (GDP) to decline. A decreasing margin means that corporate earnings are growing at a slower pace than the aggregate economy. This factor, which led to a higher equity market valuation in the last decades, should result in a structural de-rating in the equity markets, with or without deflation. The following chart shows that such a de-rating is already underway.

USA: Growth, yields and share valuations falling



Source: Datastream, Sarasin

While many stock market players see low interest rates as being good news for equities based on their experiences over the past decades, they are likely to have a change of mind in view of the acute deflationary threats. We think that falling yields at the current level should not be interpreted as a good omen for equity markets, but rather as a warning signal. Although we do not expect the economy to slide into recession, the next few quarters are likely to be overshadowed by fears of deflation. The impact that this will have on the various sectors and individual stocks is discussed in the next article.

Philipp Bärtschi, CFA

Sectors put to the deflation test

In the coming months, concerns over deflation are likely to become an important theme for the equity markets. Although we do not believe that the world economy or any part of it faces the threat of deflation, we have identified those sectors and companies which have the best chance of coping with a deflationary environment and thus are able to improve their competitive position. This depends on various factors, such as pricing power, cost structures or the proportion of sales achieved in the fast-growing emerging economies.

Success factors for overcoming deflation

Deflationary economic developments in the major industrialised countries would impact on individual sectors and companies in different ways. Below we outline the criteria for choosing the sectors and companies likely to be among the relative winners in a deflationary scenario.

Pricing power

A company with strong pricing power is in a better position to survive the prevailing price pressure. This usually depends on having a unique characteristic, such as a local monopoly or an excellent brand. Companies which operate in markets with regulated prices generally also have strong pricing power.

Elasticity of sales and earnings

If a company makes products that offer the customer a significant benefit and at the same time cost little, such as medical consumables or foods, demand pressure is reduced. This results in a low elasticity of sales and earnings.

Cost structure

While raw material costs fall rapidly in a deflationary environment, more highly regulated personnel costs are far less elastic. Sectors and companies in which raw materials account for a larger proportion of overall costs therefore have an advantage over those with a high manpower cost percentage.

Innovation capacity

Products with a high degree of innovation have a shorter lifecycle. This stimulates sales and reduces deflationary pressure. At company level, however, efficient development and production processes are needed to keep costs in check.

Proportion of emerging countries

The large emerging economies, such as China, India or Brazil, should continue to grow. We therefore think it unlikely that these countries will face any deflationary tendencies. Having a strong presence in these markets is therefore another success factor for beating deflation.

Capital structure

Deflationary times are uncertain times. A solid balance sheet structure ensures the necessary operational flexibility. High borrowing and large pension fund obligations are particular burdens in a deflationary environment. Even low borrowing rates are less of an advantage against a background of low investment yields.

Dividend yield

Potential returns are limited in times of deflation. Investors therefore prefer sectors and companies with high dividend yields in order to maximise their income. Moreover, the sectors with the highest dividend yields usually have defensive characteristics.

Value stability

Deflation often goes hand in hand with high risk aversion among investors. Therefore they invest more heavily in categories which hold their value well, such as precious metals, e.g. gold, and prime residential property. At the same time, the proportion of equity capital tends to be high.

Effect of deflation on individual sectors

This section looks at the impact of deflation on the individual sectors and highlights attractive companies.

Energy

Shrinking economic output means lower energy prices. However, it is debatable how quickly energy prices respond to a sharp drop in demand against the background of price agreements and supply curbs. This makes it difficult to say whether the energy sector is among the relative winners or losers. In view of their ability to set prices and make internal adjustments, the large integrated oil and gas producers are likely to cope better with a deflationary scenario than pure oil-service, refinery or exploration companies.

Stock recommendation Chevron:
- One of the world's largest oil and gas groups with above-average oil reserves
- Dynamic business performance in Asia
- Excellent balance sheet, share buy-back programme

<u>Financials (including real estate)</u>
Deflation is poison for banks. Mortgages and loans nominally remain at the same level, but property and other collateral assets decline in value. Also, long-dated bond yield levels come under pressure. Real estate companies face similar challenges to banks. Companies with a high proportion of commercial properties in their real estate portfolio are particularly vulnerable. In the case of insurance companies, a distinction is made between life companies on the one hand and non-life and reinsurance companies on the other. A deflationary scenario is unfavourable for life insurers, who have guaranteed clients an income on life policies but now face falling investment yields. For the latter group, on the other hand, deflation can have positive effects, as claim losses are reduced due to lower rebuilding costs, while premium adjustments are delayed.

Stock recommendation Allianz:
- Leading non-life insurer in its home market of Germany with a strong brand name
- Good operating performance
- Strong balance sheet and high dividend yield

<u>Health Care</u>
We regard the health care sector as a relative winner in a deflationary environment. Apart from a few areas whose products are not refunded by the health insurance system but have to be paid for by consumers themselves (dental implants, non-prescription medications and most hearing and vision aids), prices are regulated and fall only slowly or not at all in a deflationary situation. The higher the degree of innovation and the medical necessity of a medication, the stronger the protection against price pressure.

Stock recommendation Abbott Laboratories:
- Interesting combination of pharmaceuticals and medtech with good product diversification
- Strong presence in emerging markets (India)
- Balance sheet indicates low borrowing

Stock recommendation Novartis:
- Broad product diversification of proprietary drugs and generics
- Promising product pipeline
- Healthy balance sheet and attractive dividend yield

<u>Industrials (including renewables)</u>
Industrials are a very heterogeneous sector. In a deflationary situation there are winners and losers. However, the sector tends to be among the relative losers. Important factors in this regard include the high elasticity of sales and earnings, substantial labour intensity, generally weak pricing power and low dividend yields. However, positive factors in recent years are the increased proportion of emerging markets and healthier balance sheets, though the quality of the latter remains distinctly uneven. Within the sector we prefer innovative companies offering a defensive exposure such as those operating in the areas of safety and security and in healthcare, and those with a high percentage of sales in the maintenance and service industry. We are cautious with regard to wind and solar energy companies. Government subsidies are likely to fall rapidly. At the same time these companies are hampered by low pricing power and often high borrowing.

Stock recommendation Siemens:
- High emerging market percentage
- Strong presence in the defensive healthcare sector (imaging diagnostic systems)
- Restructuring potential

<u>Materials</u>
For the purposes of our analysis we divide this sector into chemicals and construction on the one hand and metals and mining on the other. The areas of chemical and construction historically performed much better in an inflationary than in a deflationary environment. But since the more flexible raw material costs are a larger cost item than personnel costs, they can also be relative deflation

winners. Lower raw material costs are passed on after a time lag if possible. However, deflation has a negative impact on labour-intensive building and civil engineering enterprises. The metals and mining industry is sensitive to the economic cycle and raw material prices are depressed by falling demand. On the other hand, the high exposure to emerging markets and stronger balance sheets are positive factors in our opinion. Reduced capital expenditure would lift raw material prices in the medium to long term. However, mining companies have historically underperformed the market during periods of falling commodity prices. Therefore we regard the industry as a relative loser. An exception is gold, which has served as a refuge in periods of crisis since a long time.

Stock recommendation Barrick Gold:
- World's largest gold producer with long-lasting, cost-effective reserves
- Strong pipeline of development projects
- Solid balance sheet

Stock recommendation BASF:
- World's largest integrated chemical company with cost leadership and high economies of scale
- Broad control of the chemicals value chain
- Strong position in important emerging markets

<u>Technology</u>

To assess the effects of deflation on the technology sector, we divide it into hardware, software and services, as the three segments react differently on many criteria. Hardware has weak pricing power and customers are very price-sensitive. On the other hand the emerging market percentage is high. Software is characterised by high pricing power, long-term agreements and high conversion costs for the client, resulting in lower elasticity of sales and earnings. However, the emerging market percentage is still low and falling raw material prices just offer minimal relief on the costs side. Services enjoy the most stable cash flows. What the three segments have in common are: a high level of innovation, good capital structures and low dividend yields. In a deflationary scenario we regard the technology sector as a relative winner, our preference being for services and software.

Stock recommendation Microsoft:
- Debt-free
- Pricing power thanks to high market shares and substantial switching costs for customers
- High innovation factor

Stock recommendation SAP:
- Good brand name and product diversification
- Pricing power
- More stable value than the industry average

<u>Telecommunications</u>

We regard telecommunications as a relative winner in a deflationary environment, as the sector enjoys comparatively stable revenue flows. Consumers seldom economise on telecommunication and are tied into long-term contracts. An expected fall in replacement investment by consumers in new mobile phones is unlikely to harm profitability, as handsets are mostly subsidised by the telecom operators. Although the sector has above average-borrowing owing to the cost-intensive infrastructure, refinancing and dividend payments should not pose any problems in view of healthy cash flows.

Stock recommendation AT&T:
- Healthy cash flow
- Attractive dividend yield
- Below-average borrowing on a sector comparison

Stock recommendation France Telecom:
- Healthy cash flow
- Attractive dividend yield
- High proportion of prepaid business in growth markets

<u>Consumer Staples</u>

The consumer staples sector is a relative winner in a deflationary scenario. Important factors in this respect are: relatively low elasticity of sales and earnings, high pricing power thanks to strong brands (tends to be greater among large as opposed to small companies), low operating leverage due to low capital intensity (in retail), scope for cost-cutting and an attractive dividend yield. Another important selection criterion within the sector is low borrowing. Falling raw material prices reduce production costs. This positive effect is especially pronounced in the case of food processing. The retail segment on the other hand is likely to come off worst within the sector in view of intense competition and weak pricing power.

Stock recommendation Nestlé:
- Good brands and pricing and purchasing power
- Attractive dividend yield
- High percentage of sales in emerging markets

Stock recommendation Procter & Gamble:
- World's largest producer of household products
- Pricing and purchasing power
- Falling oil price has a positive impact on costs

<u>Utilities</u>
In a deflationary scenario we regard the utilities sector as a relative winner, because in a difficult economic environment it is seen as a defensive investment with attractive dividends. Falling raw material costs relieve pressure on the cost base. Regulated utilities are likely to benefit from the continuing stability of cash flows initially, as price reductions are only passed on to end-consumers after a time-lag. In the case of non-regulated utilities, on the other hand, demand for energy should remain relatively stable among private customers, but decline among industrial clients. Therefore, within the sector we prefer (to some extent at least) regulated to non-regulated utilities on a short-term view.

Stock recommendation GDF Suez:
- Around 40% of business is regulated and 60% non-regulated
- Healthy balance sheet (despite the recent acquisition)
- Attractive dividend yield

<u>Consumer Discretionary</u>
The consumer discretionary sector is a relative loser in a deflationary environment. Buyer reticence in the expectation of further price falls, rising unemployment, weak lending and falling asset values dampen demand. Nor are the dividend yields attractive to investors. Pricing power, emerging market percentage and the influence of lower raw material costs vary depending on the industry. We therefore divide the sector into three industries: automotive, retail and luxury consumer goods. Among the car manufacturers, personnel costs, production location and the question of production flexibility (platform strategy) are important factors. In a deflationary environment selling prices come under pressure, though premium companies and raw-material-intensive suppliers (tyre manufacturers) should be less affected than volume suppliers. In the retail segment, deflation has negative implications for profitability: Even if sales volumes remain at virtually the same level, revenues fall while fixed costs hardly change. Luxury consumer goods companies benefit from a high emerging market percentage, low borrowing and good pricing power, but they also suffer from general buyer reticence.

Stock recommendation McDonald's:
- One of the world's ten strongest brands; corresponding pricing and purchasing power
- Healthy cash flow
- Attractive emerging market percentage

Stock recommendation Michelin:
- Leading tyre manufacturer benefits from falling rubber and oil prices
- Price-resistant replacement tyre business
- Attractive geographical mix

Dr. Philipp Gamper and Ute Haibach

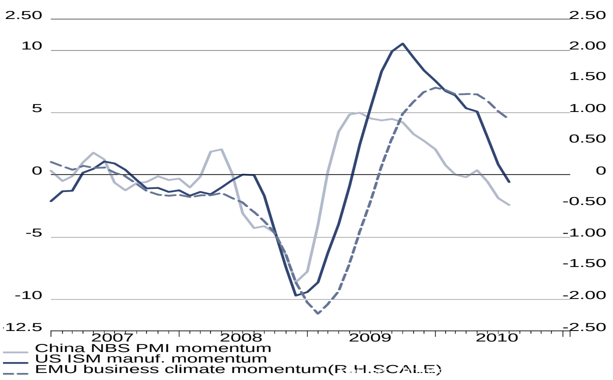
Sharp economic slowdown ahead

The global economic cycle has passed its interim peak. Whereas the Chinese economy slowed before the USA, Europe follows this development with a time lag of one quarter. Despite the robust economic data to date, leading indicators suggest a powerful slowdown in growth, which should fuel recession and deflation fears until the end of the year. A self-sustaining upswing in the US economy presupposes a stabilisation in the labour market, bank lending and house prices. The US economy will reaccelerate only in H2 2011, once the excesses of the credit bubble have been absorbed.

Growth has peaked

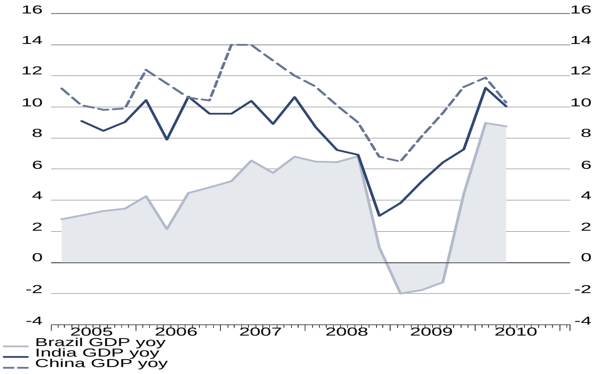
The macroeconomic data published in Q3 confirm our expectation that the global economic recovery has passed its peak. The global economy has just entered a slowdown phase, which should last several quarters. Leading indicators for the major regions of the world have indeed lost momentum in recent months, as the following chart shows. China was the first country in 2009 to put the so-called Great Recession behind it. Due to China's command economy structures, the Chinese authorities were able to directly intervene in the economy. The USA followed China with a small delay, while Europe has lagged behind, as usual. But when the Chinese central bank started to throttle lending at the beginning of 2010, the momentum of the Chinese leading indicator turned negative. The chart below shows that US indicators follow China. While Europe enjoys strong growth rates still, the slowdown in economic growth predicted by the business climate index should feed through to the real data by the end of 2010 at the latest.

Economic momentum decreases worldwide



Source: Datastream, Sarasin

Growth in emerging markets also peaks



Source: Datastream, Sarasin

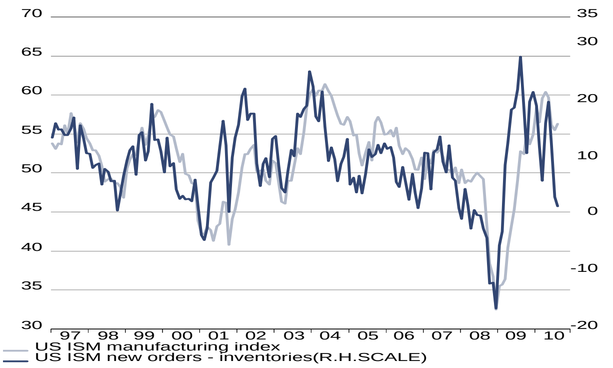
Globalisation takes the slowdown worldwide

Globalisation has led to the synchronisation of the business cycle. The economies of the world are globally linked via exports and imports. This means that the cyclical development of the industrialised countries is translated to the emerging market countries and back again. Although emerging markets posted much higher growth rates than the industrialised countries in the credit crisis, they show the same cyclical pattern of acceleration and deceleration. The above chart shows that in a parallel development to China, growth in Brazil and India also peaked in Q1 2010. The gross domestic product (GDP) data for Q2 2010 confirm that the emerging markets have also entered a slowdown phase. This confirms that the slowdown in growth expected by us is a global phenomenon, from which there is no escape.

Not a soft patch, but an inventory cycle downturn

Why are we not facing a soft patch that will be over in a few months? Strong upswings and downswings in the business climate reflect the inventory cycle, i.e. the interaction between sales and inventories and their effects on production. If sales start to pick up again after a deep recession, companies' inventories are usually not high enough to meet the unexpected high level of demand. If inventories are filled, strong industry upswings occur, like the recovery of 2009/10. Inevitably, however, there comes a time when final demand cannot keep up with the rapid inventory restocking. The inventory-to-sales ratio rises to such an uncomfortably high level that inventories and production have to be reduced. This tends to happen when final demand is suddenly throttled. This can be compared to a busy highway with cars travelling at high speeds. When one driver suddenly applies the brakes, it can cause a tailback. Due to drivers' delayed reaction, the drivers behind the first car have to apply their brakes with more force and, in some cases, this can bring the traffic to a standstill. The tailback clears only gradually, even when the driver who applied the brakes in the first place has continued on his way. In the economy, it takes 9 to 15 months to clear an inventory-based tailback.

US ISM: Details suggest a downturn

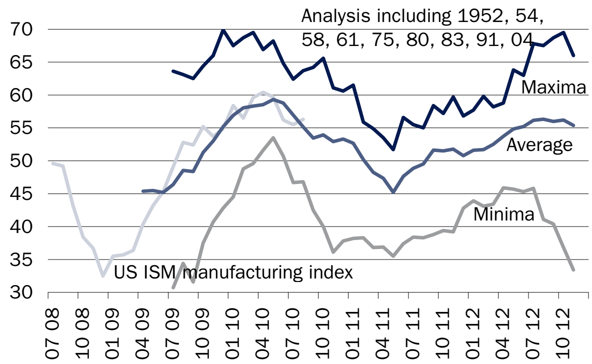


Source: Datastream, Sarasin

Leading indicators suggest a sharp slowdown

The question that needs to be addressed is: how deep will the economic slowdown be? Several indicators suggest the inventory cycle will slow growth perceptibly in the coming quarters. Special attention is paid to the US business climate, the ISM manufacturing index. Its subcomponent for new orders has decreased very noticeably in recent months, whereas that for inventories has increased. This development not only shows that the inventory cycle is in decline, the difference between the two subindicators is also a good leading indicator for the US ISM manufacturing index itself. As the above chart shows, it suggests an unusually strong decline in the ISM from its current level of over 55 to a level near 45. Readings below 50 are associated with a contraction in the manufacturing industry, which is the flywheel of the economy.

US ISM drops 15 points after powerful upswings

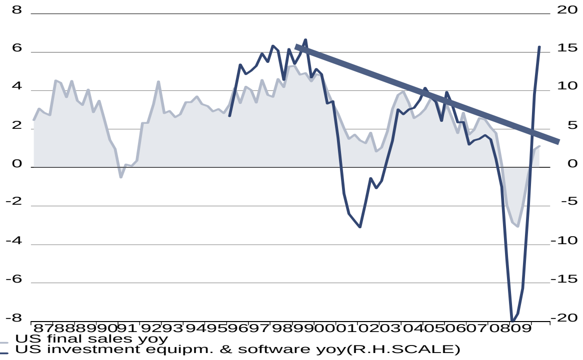


Source: Datastream, Sarasin

Upswing in Q2 2011 at the earliest

Such a strong slowdown in economic growth is not uncommon after strong upswings. There were nine phases between 1950 and the present day that showed a similarly strong rise in the US business climate. If we overlay the cycles and compute the average for the US ISM manufacturing index in these upswing years, we can determine the cyclical pattern of the inventory and industry cycles. The above chart shows the averages, the minimum and maximum performance of the ISM purchasing managers index after the peak is reached in each strong upswing. On average, the indicator dropped in the following 12 months from its peak near 60 by almost 15 points to a level near 45. Only two of the nine phases relate to double-dip recessions. The maximum and minimum readings also paint a similar picture: no matter where the slowdown begins, the indicator declines on average by 15 points. That said, the chart also shows that the average finds a floor after about a year and then resumes its ascent. If the current cycle follows this pattern, a new expansion phase should begin in Q2 2011. Till then, however, we should be prepared for uncertainty to fuel recession fears.

USA: Final demand is not yet self-sustaining



Source: Datastream, Sarasin

The global economy has feet of clay

These recession fears are justified because the economy is still fragile. Although the upswing is one of the strongest in decades, it is mainly driven by government stimuli and a rise in inventories. While investments have picked up, final demand has hardly increased (see above chart). In the USA, it even appears to be on a medium-term downtrend. A similar development can be observed in other countries, where consumption in recent years was artificially boosted by a real estate bubble. While households have reduced consumer and mortgage debt or banks have written them off, final demand growth remains below its potential. Even worse, consumption remains vulnerable to a decline in house prices or a rise in unemployment. The following chart shows that the University of Michigan Consumer Sentiment Index has weakened again.

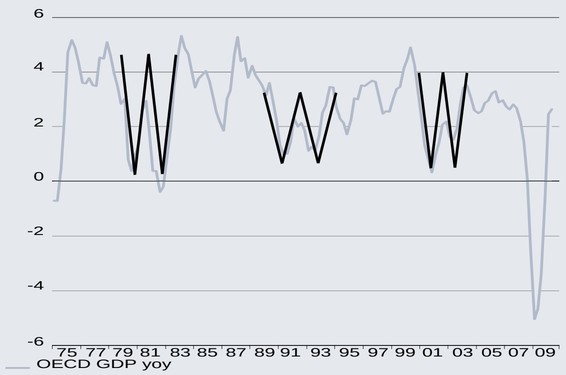
USA: Consumption remains vulnerable

Source: Datastream, Sarasin

Double-dip recessions triggered by policy mistakes

If we adopt a rigid definition of recession as two consecutive quarters of negative growth, double-dip recessions are very rare. But if we widen our scope to include industrial production and the equity markets, the last three global recessions were W-shaped economic events. Detailed analysis of the causes of these economic contractions shows that they have one thing in common: they are all preceded by a policy mistake. In 1982, it was the unreasonably resolute stance taken by Paul Volcker, in 1993 it was the Bundesbank's Germany-centric interest rate hike and in 2003 it was the Bush administration's plans to go to war. The upswing that follows an initial recession is not yet sustainable, which means that an economic shock can quickly destroy the green shoots of recovery. At the moment, however, no triggers are in sight. Monetary policy is expansionary, but the big danger comes from exaggerated austerity measures. We expect a soft landing, which is a common phenomenon after powerful upswings.

The last three global recessions were W-shaped

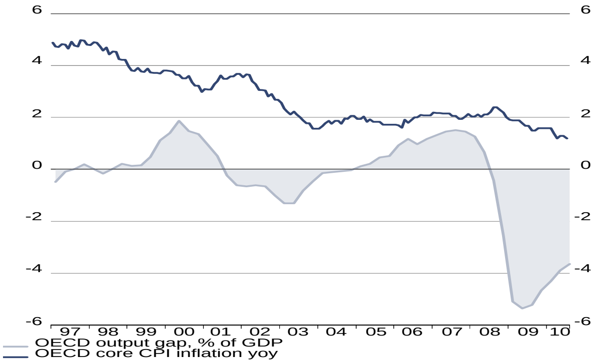


Source: Datastream, Sarasin

Deflation fears but no deflation

Given the fact that inflation throughout the OECD region is at a historical low, double-dip recession fears soon lead to deflation concerns. Industrial capacity is still nowhere near full utilisation and the GDP is still below its potential. Alone the fact that supply is outstripping demand implies downside pressure to prices. Another recession would help to widen the output gaps and put even more pressure on prices. We expect deflation to be a theme in the coming quarters.

OECD: Underutilised capacities dampen inflation



Source: Datastream, Sarasin

As we mentioned in the Special Topic of this Global View, we do not expect the global economy to sink into deflation. On the one hand, the state of the global economy is not the same as that of Japan in 1990, which is now mired in deflation: real estate prices and equity prices had increased less significantly than in Japan prior to the crisis. On the other hand, the reaction of the monetary and fiscal authorities to this crisis was much more resolute. Bank reforms were completed more forcefully, interest rate cuts followed more quickly and fiscal policy was more expansive than it was in Japan. The Japanese experience highlights the harmful effects of a deflation spiral. Although the crisis in Euroland has shown the limits of further fiscal stimulus, we assume that in some cases, the authorities will have to undertake more fiscal programmes as the economy slows.

USA: Lending and real estate prices still sinking

Source: Datastream, Sarasin

Conditions for a sustainable upswing

The injection of new fiscal and monetary stimuli will help the global economy overcome this critical phase of the cycle. In this phase, the upswing is not yet self-sustaining, but growth is already starting to weaken again. In the export-dependent economies of the world, domestic demand is still too low. They are still too dependent on demand from countries with structural current account deficits. Deficit countries, on the other hand, are battling the long-term effects of the credit bubble. It is going to take a while before the excesses are eliminated. A lasting economic performance is feasible only when consumption rids itself of its shackles. The following three conditions must be met first. First, the labour market has to recover and help to generate income. Second, real estate prices must stabilise in order to stop the devaluation of assets. Third, lending has to find a floor before household financial flexibility can increase.

Macroeconomic forecasts

		2008	2009	2010	2011
World	GDP (% YoY)	3.2	-1.3	4.5	3.5
USA	GDP (% YoY)	0.0	-2.6	2.8	1.8
	Unemployment (%)	5.8	9.3	9.7	10.3
	Inflation (CPI, %)	3.8	-0.3	1.6	1.4
Euroland	GDP (% YoY)	0.3	-4.0	1.9	1.5
	Unemployment (%)	7.6	9.4	9.7	9.5
	Inflation (CPI, %)	3.3	0.3	1.5	1.1
Japan	GDP (% YoY)	-1.2	-5.2	3.0	0.9
	Unemployment (%)	4.0	5.1	5.0	5.2
	Inflation (CPI, %)	1.4	-1.3	-1.0	-0.4
Switzerland	GDP (% YoY)	1.9	-1.9	2.7	1.3
	Unemployment (%)	2.6	3.7	3.9	3.8
	Inflation (CPI, %)	2.4	-0.5	0.7	0.8
China	GDP (% YoY)	9.1	8.9	10.0	9.5
	Inflation (CPI, %)	5.9	-0.7	3.5	3.1

Source: Datastream, Sarasin

According to our analysis, bank lending, real estate prices and the labour market will finally stabilise in H2 2011 at the earliest. We expect to see the first signs of a fresh upswing in Q2 2011.

Dr. Jan Amrit Poser

Global downturn supports bonds

During the third quarter, fears of recession in the US were already the main driver for the decline in global bond yields. During the fourth quarter, deflation concerns are likely to compound the fears of recession. As far as bond yields are concerned, this will exacerbate the downward trend on the one hand, while on the other creating significant fluctuations in yields due to the high level of economic uncertainty. Not until leading indicators stabilise during the course of the first half of 2011 will the downward trend eventually halt, and yields start to rise again. Corporate bonds still have some potential, but a sharp rise in recessionary fears does pose a risk.

Concerns switch from EMU debt levels to US recession

While worries about debt levels in Euroland countries were the main driver for the downward trend in global bond yields in the second quarter, these concerns moved out of the spotlight at the start of the third quarter. The safety net provided by the EU, interventions by the European Central Bank (ECB) in the sovereign bond market for peripheral Euroland states and strong economic data initially removed some of the urgency from the Euroland debt crisis. Nevertheless, global bond yields continued to fall during the third quarter as investors shifted their focus from the Euroland debt crisis to the possibility of a double-dip recession in the US. Weak labour market data and disappointing housing market figures from the US have raised doubts about the sustainability of the US recovery. The prospect of another US recession and the associated danger of another sharp dip in global growth in the near future encouraged investors to take flight into US Treasuries. At the end of August, however, it turned out that fears of US recession were a bit premature. A raft of US economic data that failed to confirm the recession thesis caused a setback in global bonds.

Global downturn exacerbates recession worries

Fears of recession and possibly even deflation as well on the one hand and renewed attention on Euroland's debt crisis on the other will continue to be the main themes dominating bond markets in the fourth quarter as well. Until it can be shown that the danger of double-dip recession in the US has definitely passed, the bond market is likely to continue to be affected by the «flight to safety» trend. As the economy continues to slow down over the next two quarters, these fears are likely to intensify even further through to the first quarter of 2011.

Bonds continue to decline up to the end of August

Source: Datastream

This has two repercussions for global bond markets. Firstly, bond yields are likely to fall even further. Secondly, there is likely to be a high degree of volatility on bond markets. In such an uncertain environment, even modest surprises in macroeconomic data could significantly affect investors' fears of recession and trigger substantial movements in bond yields.

Deflation fears support «strong» government bonds

Aside from recession fears, markets are also set to be increasingly plagued by worries about deflation. The next box explains how deflation can affect government bonds. In the peripheral Euroland countries, fears of deflation could push up yields further. In fiscally «strong» countries (Switzerland, Germany) fears of deflation should continue to support bonds.

Deflation, Japan and bond yields

Previous experience in Japan shows that deflation tends to encourage three trends: a sharp decline in inflation expectations, a lower growth potential and a deterioration in a country's fiscal position, thereby triggering higher risk premiums on the countries sovereign bonds. The first two factors (lower inflation expectations and growth potential) certainly have a positive impact on government bonds. Countries that already find themselves in a difficult fiscal position are likely to experience another sharp rise in their risk premium in the event of deflation. This rise in the risk premium should be more pronounced than the fall inflation expectations, so that its overall effect will be to push up yields even higher. The risk premium will probably rise in strong countries as well. However, this effect will be compensated by the flight of capital from fiscally «weak» countries to «strong» countries. If deflation affects fiscally strong countries, we expect yields to be significantly lower.

Central banks take the threat of deflation very seriously

The predicted threats of recession and deflation will not only preoccupy investors, but cause headaches for central banks as well. All the leading central banks have signalled their intention to maintain a zero interest rate policy. In addition, the US Fed has announced it will expand its unorthodox monetary policy in the event that the deflation risks it identified for the US economy at its meeting of 21st September should intensify. Back in June the Fed forecast an average core inflation rate of 0.9% for 2010 and 1.1% for 2011. The fact that the Fed has become so concerned about deflation risks since its September meeting suggests that it will revise its inflation forecast significantly downwards at the next meeting on 3 November. This would mean that the Fed's inflation forecast would be significantly lower than our own estimate of 1.4% for 2011. But it also means that the Fed could well be surprised by a sudden jump in inflation over the coming quarters. From this perspective, the Fed ought to decide not to expand its unorthodox monetary policy.

High probability of unorthodox instruments

Even so, it is very likely that the Fed will decide to expand its use of unorthodox instruments, for two reasons. Firstly, the rapid change in the Fed's perception of deflationary risk in the period from June to September implies that it would like to take swift action without first waiting to see which way inflation is actually heading. Since the risks for the US economy are on the downside (we also believe there is a 30% chance of US recession) the Fed will be running the risk of making a policy error on the expansionary side. Secondly, the Fed's announcement that it was considering the use of new unorthodox instruments has encouraged the expectation in the market that it will actually put them into practice. As a result, yields on US Treasuries fell sharply after both the August and September meetings. If these expectations are not met, it could cause unrest on capital markets, which is something that the Fed would definitely like to avoid. The Fed must have a very convincing reason to disappoint markets. One such reason could be a significant improvement in the labour market. This is still languishing at the level of recession. If the labour market were to substantially improve, this would be good enough reason for the Fed to refrain from unorthodox measures. Given that interest rates are already at record lows, any purchasing of long-term Treasuries in an attempt to cut yields further would probably only have a modest impact. But closer coordination of monetary and fiscal policy is a possibility. Another large government program of measures to stimulate the US economy could push up interest rates given America's already tight fiscal situation. The Fed can counteract this effect by buying up bonds.

Interest rate forecasts (%)

		30 Sep	4Q10	1Q11	2Q11	3Q11
USD	Fed Funds	0.25	0.25	0.25	0.25	0.25
	3m LIBOR	0.29	0.30	0.30	0.30	0.30
	10y Bond	2.50	2.50	2.50	2.75	3.25
EUR	Repo	1.00	1.00	1.00	1.00	1.00
	3m LIBOR	0.85	1.00	1.10	1.10	1.10
	10y Bond	2.25	2.25	2.25	2.50	2.75
CHF	3m Target	0.25	0.25	0.25	0.50	0.75
	3m LIBOR	0.18	0.10	0.25	0.50	0.80
	10y Bond	1.37	1.25	1.25	1.75	2.25
GBP	3m Target	0.50	0.50	0.50	0.50	0.50
	3m LIBOR	0.73	0.55	0.55	0.55	0.55
	10y Bond	2.89	2.75	2.75	3.25	3.50
JPY	3m Target	0.10	0.10	0.10	0.10	0.10
	3m LIBOR	0.22	0.20	0.20	0.20	0.20
	10y Bond	0.91	0.75	0.75	0.75	1.00

Source: Datastream, Sarasin

ECB also pursuing unorthodox measures

The European Central Bank (ECB) will be forced to continue its unorthodox measures as well. Even if the debt crisis in Euroland countries has disappeared from the media spotlight for the time being, there can still be no question of credit spreads reverting to normal. Worries about the Irish banking sector once again triggered a sharp rise in credit spreads in September. The fact that it could cost the country as much as 25% - 30% of its GDP to restructure its distressed banking industry has raised serious doubts about the sustainability of Ireland's efforts to cut its public deficit. As the economy continues to slow and the fiscal situation deteriorates (lower tax revenues and higher social benefits) credit spreads are likely to remain high or even rise further during the fourth quarter. Rising credit spreads in the Euroland's peripheral countries and the associated risks for the European banking sector will once again force the ECB to inject more liquidity into the system and buy up sovereign bonds. The policy of zero interest rates and the possibility of further unorthodox measures should continue to provide support for bonds.

Interest rates set to rise during 2011

However, there is likely to be a time limit on the period of low interest rates. We expect to see a trend reversal in leading economic indicators from 2Q11 onwards. Once these signal the normalisation of GDP growth and an inflation trend that could potentially be higher than anticipated by the US Fed, fears of recession and deflation in the capital market should ease again. From 2Q11 onwards this will result on the one hand in higher bond yields, and on the other in less volatility in bond yields, as there will be less uncertainty surrounding the outlook for the global economy.

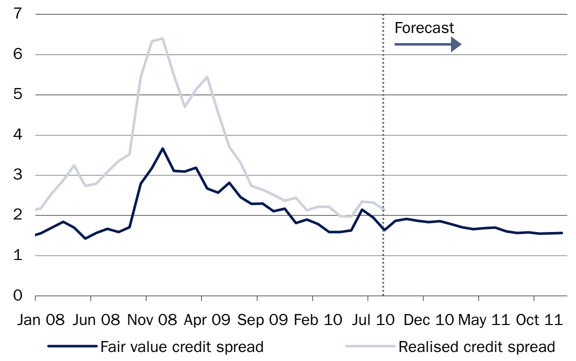
No threat of a bond bubble

Record-low interest rates have kindled fears in many circles that a bubble could form in the market for government bonds - in other words a price trend that is decoupled from the fundamental data. But a look beyond the economic cycle shows that the high bond prices are justified by the fundamental economic data and that there is therefore very little threat to bonds in the longer term. Over the next few years, nominal interest rates are likely to be held in check by record low inflation rates and significant underutilisation of capacity in industrialised nations.

Corporate bonds attractive if soft landing succeeds

The outlook for corporate bonds is also dominated by the question of whether or not the global economy is on the brink of another recession. If the economy does achieve a soft landing, our model shows (see chart below) there is additional potential for the credit spreads between corporate and government bonds to narrow further. This is down to fundamental factors such as a continuing decline in the default rate for bonds, steady deleveraging by companies and the lack of appetite for corporate acquisitions. The solid financial position of companies is also likely to support corporate bonds. This should limit the supply of newly issued bonds and keep prices high as a result.

Credit spreads have further potential to narrow



Source: Sarasin

...but recession fears still pose a threat

Even so, the potential that exists for corporate bonds could be severely impaired by fears of recession. If recession does hit, credit spreads would widen in response to increased risk aversion and the subsequent possibility of another rise in the bond default rate.

Dr. Alessandro Bee

Concerns persist about the euro

As long as the peripheral EMU countries are unable to show any real progress in the measures taken to consolidate their debt, doubts will persist about the sustainability of their state finances. Through to 1Q11 the main factor driving currencies will be the increased risk aversion of financial market participants: there will be strong demand for safe-haven currencies such as the Swiss franc, the Japanese yen and the US dollar. Despite healthy state finances, the Swedish krona will also weaken as the pace of economic growth in Europe slows.

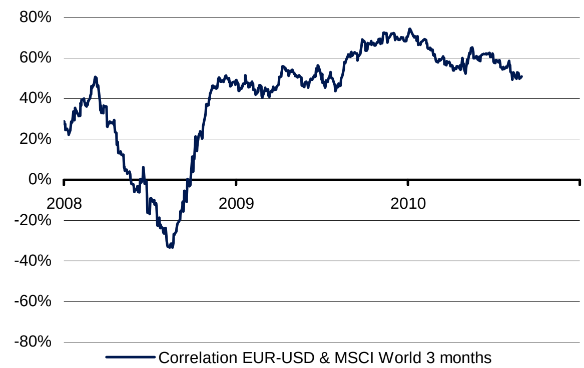
Still some niggling doubts about the euro

The concerns about the single European currency have still not disappeared entirely from the market. As the risk aversion of financial market players has increased, attention has shifted back to the precarious condition of state finances in some peripheral Euroland economies. This has triggered a rise in the long-term interest rates of countries running high deficits. As long as the peripheral EMU countries are unable to show any real progress in the measures taken to consolidate their debt, doubts will persist about the sustainability of their state finances. But the panic that gripped markets last May about a potential sovereign bankruptcy or the collapse of the euro is unlikely to return with such intensity. The European Financial Stability Facility (EFSF) is already in place. In the event of a crisis, this special-purpose vehicle can raise up to 366 billion euros and pass this on to countries experiencing financial difficulties which can no longer finance themselves on the capital market, or can only do so at prohibitively high interest rates, thereby exerting a stabilising effect. The 16 countries belonging to the European Monetary Union (EMU) guarantee the loans. If money is provided to a country in difficulty, strict controls will be imposed on its economy and budget, with the involvement of the International Monetary Fund (IMF). The EFSF means that no false incentives are created to allow state finances to get out of hand. The EFSF therefore provides a safety net that did not previously exist, which decreases the risk of contagion spreading among peripheral Euroland economies during the euro crisis.

Euro still fragile in the mid-term

So far concerns about a double-dip recession have been focused on the US economy. US economic growth has already dipped sharply in the second quarter, and 2Q10 GDP growth has been revised downwards from the original figure of 2.4% to 1.7%. By contrast, Germany's economy achieved record growth over the same period, with an impressive expansion rate of 9% providing the main motor of growth for Euroland as a whole. But the production-driven upturn will soon lose momentum in Europe as well. Euroland will follow the global cycle with the usual time lag. While financial markets are already factoring in a further relaxation of monetary policy by the US Fed, they do not expect additional monetary stimulus from the European Central bank (ECB). As soon as recessionary fears spread to Europe, financial markets are likely to expect the ECB to relax its monetary policy as well, which will relieve some of the pressure on the euro.

Negative correlation between US dollar and equities



Source: Datastream, Sarasin

Risk aversion is the main driver for the US dollar

In recent weeks positive news on the US economy has generally been bad news for the US dollar, and vice versa. This once again demonstrates that the main driver of the EUR-USD exchange rate is not the relative macroeconomic data, but rather the risk tolerance of financial market players. In a «risk-on» climate, the greenback comes under pressure, while it generally benefits from a «risk-off» climate. The extent to which the dollar depends on the sentiment in equity markets is illustrated by the positive correlation between the EUR-USD exchange rate and the global stock index MSCI World. At the moment the correlation stands at 0.50 (a perfect correlation would be 1). As long as there is no sign of leading economic indicators bottoming out, fears of recession are likely to continue to grow. The «risk-off» climate is therefore likely to persist for some time, which leaves the US dollar with a certain amount of upside potential up to 1Q11 versus the euro and the Aussie Dollar, which is the more risk-sensitive currency.

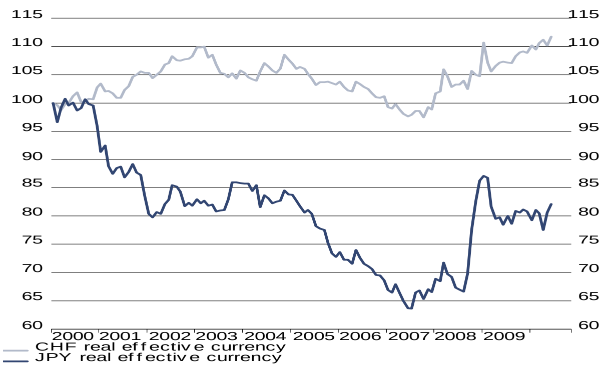
Bank of Japan intervenes in the currency market

Japan’s Ministry of Finance has followed up its verbal threats with concrete intervention. For the first time since 2004, the Bank of Japan (BoJ) has been instructed to purchase foreign currency to prevent the Yen from growing even stronger. The yen has appreciated significantly in recent months as fears about a possible US recession have mounted. In mid-September the Japanese currency dropped to a record low of 83 versus the US dollar, equivalent to an appreciation of around 11% in the year to date. The Yen always benefits during phases of economic uncertainty because carry trades are wound up and Japanese investors tend to repatriate their investments. The strong yen not only makes it more difficult for the Japanese export industry to compete on price, but also increases the threat of a downward deflationary spiral. During the first quarter of 2009, Japan's core inflation rate was already in negative territory. Given the poor level of capacity utilisation in Japan's production, deflation is still an endemic threat.

Japanese yen still strong despite interventions

The USD-JPY exchange rate reacted promptly to the BoJ interventions and jumped from a level of 83 to more than 85 in the space of a few days. Japan's finance minister Noda has already given assurances that the Japanese authorities are prepared to take additional bold steps if warranted by the economic situation. Despite these interventions, we doubt whether the yen will weaken in the mid-term. As long as the global economic indicators are pointing downwards, which is likely to be the case until 1Q11, demand for the yen as a safe currency will persist. Because the BoJ is intervening in the currency market without the support of the US Fed or the European Central Bank, its interventions carry political risks. The competitiveness of its main trading partners is weakened, which might convey the impression that Japan wants to solve its problems at the expense of others. Due to the threat of retaliation, the BoJ will only be able to stop or at least slow the upward trend of the yen. Even during the last round of interventions in 2003 and 2004, when the BoJ made currency purchases totalling JPY 36 trillion (equivalent to roughly 7% of its GDP), the yen still appreciated against the dollar. Despite the lower exchange rate versus the dollar, the Japanese export industry should not come under too much pressure. Ultimately the real effective trade-weighted exchange rate, which is the crucial factor for deciding price competitiveness, has held steady last year and is lower than its long-term average (see next chart).

Japan's price competitiveness has not deteriorated as much as Switzerland‘s

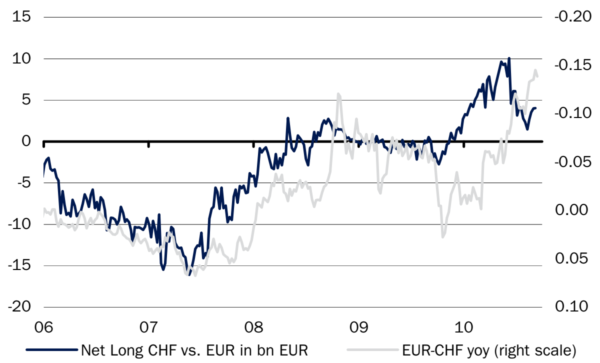


Source: Datastream

Upward pressure on Swiss franc continues up to 1Q11

The competitiveness of the Swiss export industry has significantly declined over the past year (see prior chart). Because of the fears of global recession and the debt problems in peripheral EMU countries, the franc is under permanent pressure to appreciate. The money will continue to flow into what are seen to be safe-haven currencies as risk aversion is likely to remain high in financial markets up to 1Q11. The intervention by the Bank of Japan also increases the risk of the franc becoming even more popular as a safe-haven currency. After all, since mid-June the SNB has given up making active foreign currency purchases in an attempt to prevent the Swiss franc from getting any stronger. This means it is placing no constraints for the moment on the franc’s appreciation. As the data from the Chicago Mercantile Exchange show (see chart below), investors are building up their net positions in Swiss francs versus the euro. These long positions in Swiss francs are not disproportionately high by historical standards. From a positioning viewpoint as well, there are no signs of the franc weakening against the euro very soon.

Speculative positions build for the franc



Source: Bloomberg, Sarasin

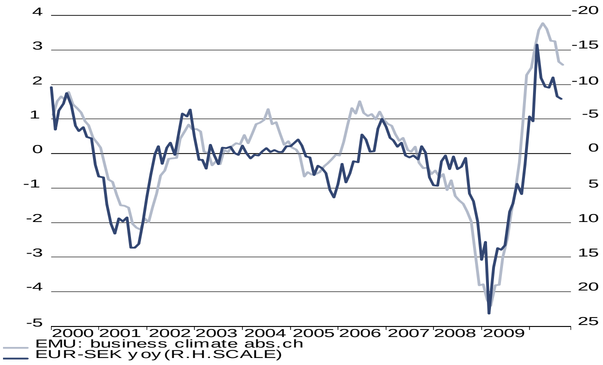
SNB leaves the franc open to free market forces

In view of the franc's strength and the slowing momentum of the global economy, the SNB significantly scaled back its inflation forecasts at its September meeting. The SNB now expects inflation to reach +1.2% in 2012, compared with a forecast of +2.2% in the previous quarter. The main reason for the downgrade is likely to be the sharp appreciation in the franc's external value. The strong currency makes imports cheaper which in turn puts downward pressure on consumer prices. Despite very modest inflation expectations, the SNB is maintaining its low-key rhetoric on future currency interventions. The SNB will not intervene in the currency market for the time being. But if downside risks do appear and raise the spectre of deflation again, the SNB will «use any measures needed to ensure price stability». If the Swiss franc continues to appreciate up to the end of this year, the SNB is likely to step up its threats at its December meeting. The SNB will not hesitate to intervene again should weaker inflationary data threaten to make a negative impact on households' expectations.

Swedish krona not a safe haven

Given the soaring public debt of major industrialised nations, investors are focusing their attention on the state of public finances. Sweden looks very appealing, thanks to its rock-solid public finances. If state finances are on a sustainable path, the government is no longer forced to take such dramatic consolidation measures. This provides a boost to potential growth and in the long-term results in a stronger domestic currency. But other factors dictate future currency trends in the short term. As a small, open economy with a high export quota, the macroeconomic environment is crucial for economic growth. This can be seen in the close correlation between the EUR/SEK exchange rate and the European business climate. Europe's leading economic indicators are still at a high level for the moment, which gave an additional boost to the Swedish krona during the third quarter. According to our macroeconomic scenario, this tailwind is about to die off, however. This means that the Swedish krona is likely to depreciate.

Economic tailwind for the SEK due to die off soon



Source: Datastream

Exchange rate forecasts

	30/09	4Q10	1Q11	2Q11	3Q11
EUR-USD	1.36	1.20	1.15	1.20	1.25
EUR-CHF	1.34	1.27	1.25	1.35	1.40
USD-CHF	0.98	1.06	1.09	1.12	1.12
EUR-GBP	0.87	0.80	0.80	0.80	0.80
GBP-USD	1.57	1.50	1.44	1.50	1.56
AUD-USD	0.97	0.87	0.84	0.87	0.92
USD-JPY	83.5	85.0	83.0	86.0	91.0
USD-CNY	6.69	6.65	6.58	6.51	6.44

Source: Datastream, Sarasin

Ursina Kubli

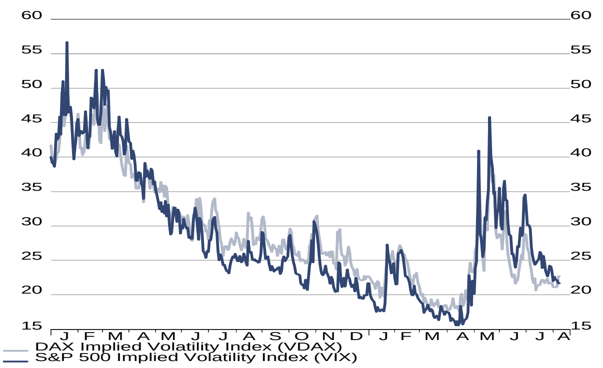
Equity strategy: Strong cyclical headwind

The expected slowdown in growth means that future earnings estimates will have to be revised downward. We expect defensive dividend-paying stocks to perform best under these difficult conditions. Market timing remains important; however, the downside risk is much greater than upside potential in the stock markets. We expect to see a long-term upward trend in the equity markets only in 2011.

Double-dip fears overlap euro crisis concerns

The equity markets have not fully recovered from the euro crisis shock in the third quarter of 2010. Although the euro crisis is not over yet, investors are focusing their attention on fears of another recession, the so-called double dip. And while it is not surprising that risk aversion has decreased as expected, it remains at a historically high level.

Risk aversion has declined substantially in 3Q10



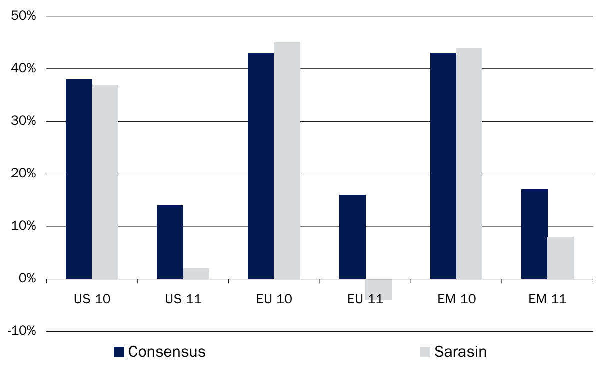
Source: Datastream

Recession fears and associated deflationary risks (see Special Topic) should preoccupy the equity markets in the fourth quarter as well.

Earnings estimates will come under pressure

Stocks will face a strong headwind from the economy in the fourth quarter. Corporate earnings results in the third quarter should remain in positive territory, thanks to robust global growth, but the outlook for companies is probably already very subdued. Since the slowdown in growth will make its presence increasingly felt in the coming months, we expect analysts will soon reduce their 2011 earnings estimates. Based on our own assessment of earnings performance, we think a reduction of 10% by the end of the year is realistic. Historically, negative earnings revisions are accompanied by weak phases on the equity market. Just as rising earnings forecasts boosted the markets in recent quarters, profit warnings will depress the markets.

Earnings growth estimates for 2010 and 2011

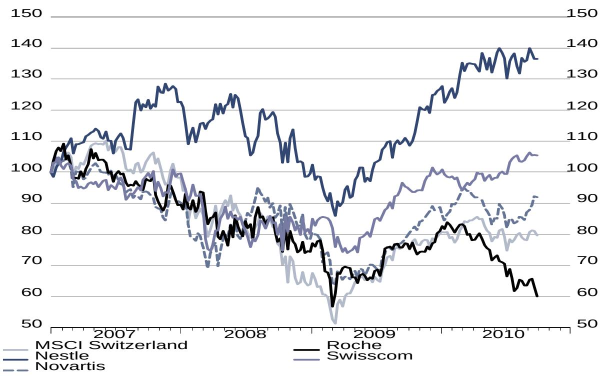


Source: Datastream, Sarasin

Dividend strategy is a winner in a low interest rate environment

In a difficult market environment, investors would do well to adopt the safest possible investment strategy. The dividend strategy, which is very appealing in a low interest rate environment, has proved one of the most successful strategies in the past. When yield expectations are generally low, the role played by dividends in the total return is more important. To protect investments against potential losses, investors should not only look at the level of the expected dividend yield, but also pay very close attention to whether the share price, in addition to the dividend, is relatively safe. A dividend yield of 5% is of little use to investors if the share price drops by 10% during the period in question. Besides the expected overall stock market performance, correlations between individual stocks and the equity market are particularly important. Equities that stand out from the aggregate market and pay high dividends have the potential to outperform precisely during weak stock market phases. These equities are mainly found in defensive sectors. The chart below shows that three of four defensive dividend-paying stocks in the Swiss equity market have clearly outperformed the market index since 2007.

CH: Defensive equities are among the winners



Source: Datastream

Nonetheless, the example also shows that company-specific risks (e.g. Roche) can lead to a significant underperformance, despite a high dividend. The dividend strategy will not protect investors against losses, but with an appropriate degree of diversification and careful stock-picking, it can offer a much higher return than the equity index.

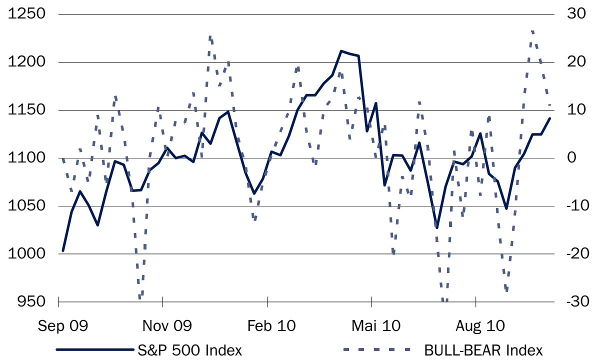
Stock-picking focuses on defensive dividend gems

As we expect economic growth to slow further in the coming months, equity prospects in general look subdued. Therefore, it is all the more important to focus on defensive qualities when putting dividend strategies into practice. In Switzerland as well as in Europe, there are enough shares that combine high dividend yields with defensive qualities. These shares should also enable an investor to do relatively well in difficult times and achieve a positive return in the medium term, which should far surpass the expected yield on bonds in the next five years.

Sentiment-driven market: Good timing is vital

In our macro scenario, we expect the USA as well as China to achieve a soft landing. In this case, the stock market trading ranges that have applied for over a year should also hold. In the US equity market, the trading range for the S&P 500 stock market index is between 950 and 1,250 points. For trading-oriented investors, it still makes sense to sell near the upper end of the range and to buy near the lower end of the range. In recent quarters, tactical market indicators have provided a good indication of the short-term market trend. A survey of small investor sentiment in the USA proved a relatively reliable indicator of the trend reversal in the stock market.

US equities and investor sentiment (BULL-BEAR)



Source: Bloomberg, Sarasin

Nonetheless, everyone knows that a trading-oriented strategy is not without risk. The stock market is basically a zero-sum game because for every winner there must be a loser. Large speculative positions mean that the markets move very quickly in one direction or another for no apparent reason.

Greatest risk to equities is a double dip

Due to the global slowdown in growth, we do not see any upside risks to the equity markets. But if the expected soft landing fails to materialise, the downside risk will be significant. Even with a slight recession, equity prices are likely to decrease by about 30%. Since share price movements lead the economic cycle by 3-6 months, we believe this type of correction represents the biggest danger in the fourth quarter. Due to the current deflationary risks, initial signs of a recession might be all that it takes to trigger a price slide. The stock markets are likely to embark on a long-term upward trend only when it becomes clear in 2011 that a soft landing has been achieved.

Philipp Bärtschi, CFA

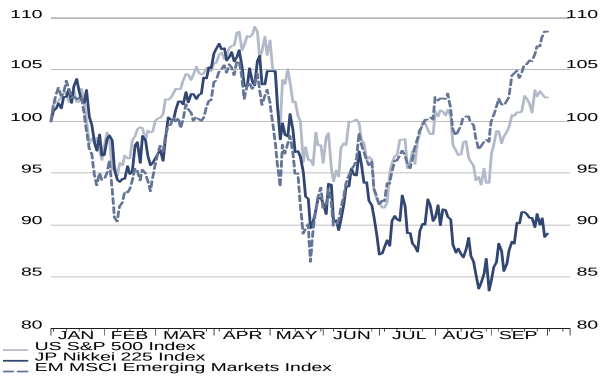
Regional strategy: defensive bias

Although recessionary risks are highest in America, US equities are likely to be sought after in uncertain times. In Europe we expect the crisis surrounding the euro to flare up again in the fourth quarter of 2010 and we therefore favour the defensive markets of Switzerland and the UK. Despite extremely positive fundamentals, emerging markets will not be able to escape the effects of a negative performance by global equity markets.

Strong outperformance by emerging markets

As expected, equity markets in most regions have performed well in 3Q10. The market performance of emerging market countries was particularly strong, with many markets (including Korea, India and Indonesia) climbing to cyclical highs during September. The major disappointment was the Japanese equity market, which suffered from the strong appreciation of the yen.

Performance of leading stock indices in 2010

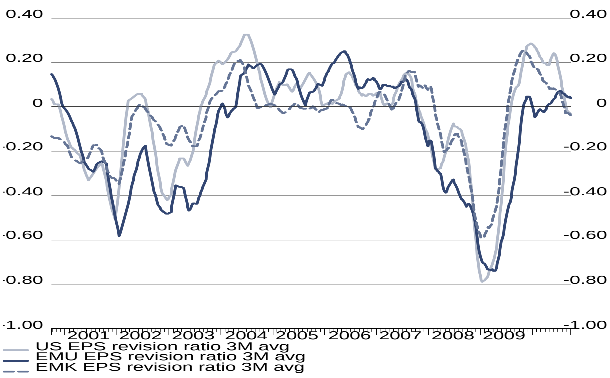


Source: Datastream

Emerging markets unlikely to decouple

With emerging markets performing so well, it's worth considering whether they may manage to decouple from the mature markets. The fundamentals of many emerging markets are certainly better than in Europe or the USA. Emerging markets are seeing dynamic rates of economic expansion and strong corporate earnings growth on the back of that. The cyclical fluctuations in potential growth are very similar, however. Since any change in expectations is ultimately crucial for the development of equity markets, it is very unlikely that emerging markets will manage to go their own way. If growth in China were to slow from 10% to 8%, this would have roughly the same effect on equity markets as a decline in US GDP growth from 4% to 2%. Just as leading indicators show that growth is slowing in all regions since 2Q10, this effect is also apparent in the corporate profit revisions. For the time being, earnings momentum has peaked in the emerging markets, followed by the USA and Europe.

Development of consensus earnings forecasts



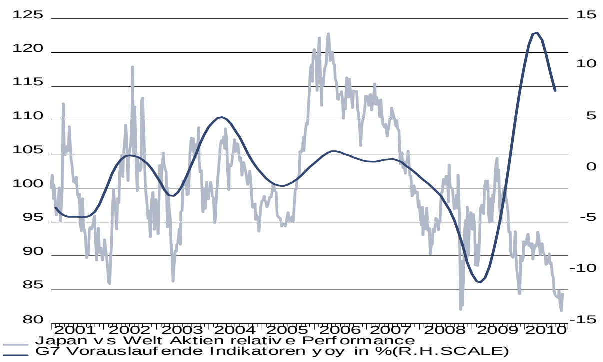
Source: Datastream, Sarasin

Emerging markets: China has the strongest positioning

Since the slowdown in growth is already most advanced in China, this is where we are likely to see whether a soft landing succeeds. In the short term, leading indicators still signal a further deceleration in growth and there is a risk that disappointing growth rates could have a negative impact on the stock market. As far as valuation is concerned, emerging markets are still trading at a slight discount to the global equity market, despite their strong performance in the past. Because we expect this discount to switch to a premium in the longer term, any price dips during the fourth quarter should be used to build up positions in stocks. Of all the emerging market countries, China is best positioned to benefit from the expected decline in commodity prices. It also has a lot of flexibility in its monetary and fiscal policy. We therefore expect a swift and energetic response from the Chinese government to any signs of weakening growth. We take a cautious stance towards Latin America and European emerging markets.

USA: a safe haven in times of crisisUS equities are worst affected by the high risk of a double-dip recession. Although many global companies have a high export quota, America's domestic growth also tends to be critical for the US stock market as a whole. As we expect the pace of growth in America to slow significantly, there are likely to be severe earnings disappointments as well in 2011. One factor in favour of the US equity market is that many investors generally seek it out as a safe haven when risk aversion increases. Demand for US equities could therefore rise during 4Q10 despite the gloomy economic outlook.

Japan: deteriorating leading indicators weigh down equity market



Source: Datastream, Sarasin

Japan: very little potential despite BOJ interventions

With global leading indicators in decline, Japanese equities will continue to struggle. We therefore retain our negative stance on the Japanese equity market. Although currency interventions by the Bank of Japan could trigger a short-term recovery of export-driven stocks, the cyclical headwind is too strong to allow a sustained positive trend.

Europe: disappointments likely in 4Q10

The European economy, especially Germany, has performed exceptionally well during 2Q10. The weak euro has also helped to boost earnings forecasts. European equities offer the most potential for positive surprises in company results during the third quarter. But we reckon that forward-looking factors will become more important over the coming months than past earnings performance. Growth is also likely to have already peaked in Europe, so most of the surprises will be on the negative side. As soon as the economic outlook deteriorates, the focus will once again revert to the excessive public deficits in some countries. Rising risk premiums will drag down the financial sector especially.

CH and UK: overweight in defensive markets

Given the high risks within Europe, we prefer to focus on the defensive markets of Switzerland and the UK. These markets offer a broad selection of defensive shares paying attractive dividend yields. A further argument in favour of Swiss shares is the expectation of a stronger US dollar should risk aversion increase.

Price targets and valuation

Market	Index	30-Sep	Dec-10	Jun-11
US	S&P 500	1 141	1 050	1 150
Trailing p/e ratio		14.7	12.8	13.9
JP	Nikkei 225	9 369	9 000	10 000
Trailing p/e ratio		18.7	15.0	16.0
Emerging Mkts	MSCI EM$	1 076	950	1 100
Trailing p/e ratio		13.7	11.4	12.8
Euroland	DJ E Stoxx	264	250	280
Trailing p/e ratio		12.0	10.2	11.9
DE	DAX	6 229	6 000	6 600
Trailing p/e ratio		11.8	10.9	12.5
UK	FTSE 100	5 549	5 200	5 500
Trailing p/e ratio		12.8	10.8	11.0
CH	SMI	6 296	6 200	6 600
Trailing p/e ratio		13.0	11.9	12.7

Source: Datastream, Sarasin

Defensive stance for 4Q10

As our price targets for the various stock indices show, equities hold very little upside potential up to the end of the year. On the contrary, we think there is a high risk of temporary and significant falls. For this reason we are taking a cautious approach to regional positioning. The one exception is our neutral rating for emerging markets, which also carry significant risks in the short term but offer the biggest return potential in the longer term.

Philipp Bärtschi, CFA

Sector strategy: Reaction to deflation fears

Good second quarter results and higher annual targets by companies led to a pronounced share price recovery in the third quarter of 2010. Although we do not anticipate a deflationary economic environment, the unusually high deflation risks hang like the Damocles sword over the equity market. Historical observations cannot be directly applied to the current situation. Our recommendations in the current market environment focus on defensive sectors.

Review of Q3 2010 sector performance

The first half of the year saw a disappointing sector performance. Only the cyclical sectors Industrials and Consumer Discretionary, together with the defensive Consumer Staples sector, entered single-digit negative territory. The picture for the third quarter looks more positive. The situation between July and September was marked by almost uniformly double-digit price increase – with the exception of Healthcare. Consumer Discretionary leads the way for the full year, on the back of the good performance of automotive stocks and Industrials. The Energy sector is bringing up the rear due to the events in the Gulf of Mexico.

Review of sector performance in 2010

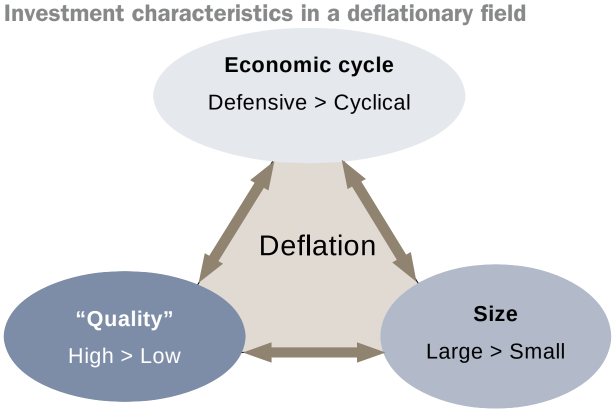
	H1	Q3	2010
Energy	-18.1	15.0	-5.8
Materials	-14.5	18.7	1.5
Industrials	-4.7	14.7	9.3
Consumer Discretionary	-5.0	16.8	11.0
Consumer Staples	-5.7	11.7	5.3
Healthcare	-10.7	9.1	-2.6
Financials	-13.0	11.7	-2.8
Information Technology	-10.3	10.6	-0.9
Telecommunication	-13.7	18.9	2.6
Utilities	-14.7	10.7	-5.6
MSCI World	**-10.9**	**13.2**	**0.9**

Source: Datastream, Sarasin; Universe: MSCI sectors; data as of 30.09.10

Deflation: General observations

Increasingly, deflation fears are depressing the performance of the stock markets. High inflation as well as deflation point to a disruption in the economic environment. Investors demand a higher equity risk premium in both scenarios. Deferring consumer spending into the future in a deflationary environment burdens industries in different ways and, hence, share price performance. Based on past experience, we identify the following general investment characteristics.

Investment characteristics in a deflationary field



Source: Sarasin

Roughly speaking, the following conclusions can be drawn: Defensive sectors perform better than cyclical areas of the economy. Quality characteristics such as a solid balance sheet and company size are favoured by investors, whereas small or highly indebted companies are avoided.

Detailed analysis at sector level

We have refined this preliminary analysis further. In our special theme, entitled «Sectors tested for deflation», we provide a detailed description of the factors outlined below and the relative winners in a deflationary environment. Altogether, we offer a detailed analysis of the impact of nine individual factors – pricing power, sales and earnings elasticity, capital and cost structure, innovation factor, emerging market share, stable value and dividend strength – on sector performance in a deflationary environment. The stronger the factors, the greater their influence on sector performance. The following table provides an overview of our analysis. In some cases, the correlations between individual factors are very high. The dividend yield, debt (net indebtedness in relation to equity), pricing power and operating leverage represent a concentration of the aforementioned factors. Whereas the dividend yield was viewed in relation to a global bond yield, we evaluated the other factors based on the historical level and the current trend. While «+» is considered a positive factor, «-» indicates a negative influence on performance in a deflationary environment.

Factors under the microscope

	Dividend yield	Net debt*	Pricing power	Operating leverage
Energy	+ +	+	=	- -
Materials	=	=	=	-
Industrials	+	=	=	-
Cons. Discretionary	=	=	=	-
Consumer Staples	+	=	+	+ +
Healthcare	+	+	+	+
Financials	+	-	=	=
Technology	- -	+ +	=	=
Telecommunication	+ +	-	=	=
Utilities	+ +	- -	=	+ +

* Net indebtedness in relation to equity; Source: Sarasin

Current challenges for different industries

The current challenges call for a modified sector approach. Energy and Utilities are the classic winners in a deflationary environment. Nonetheless, the current discussion about a special tax on utilities' profits (e.g. to keep nuclear power plants in Germany running longer) has raised questions over the size of company profits and their dividend policies. The final report on the Gulf of Mexico oil disaster is expected to be published in mid-December (Presidential Commission) and January 2011 (Marine Board). Higher safety standards as well as a general improvement in preventative measures will increase the costs for companies. We cannot say at this stage how high these will be or to what extent they will be passed on to end-users. Banks' Basel III capital requirements are moderate. Banks should cover the capital needed to support lending on their own using retained profits. The situation looks different for public service banks (savings banks and so-called Landesbanken or regional banks), however. These require large capital contributions due to their low net worth. Life insurers will feel the pinch in a deflationary environment (interest rate guarantee is higher than the investment return). The current rise in claims for natural catastrophes is also likely to depress sentiment toward non-life insurers. We underweight the Financials sector as a consequence.

Implications for sectors

The economic outlook has deteriorated. At the same time, the increasing debate on deflation is unsettling investors further. In this environment, we regard defensive sectors such as Health Care, Telecommunication and Consumer Stables as relative winners, while Financials, Materials and Consumer Discretionary are likely to fare less well because they are more susceptible to the economic cycle. On the whole, we focus on quality features (e.g. a solid balance sheet, capital structure and pricing power) and on large companies which are better able to offset fluctuations in demand (diversification effect), thanks to a wider product range. Other qualities such as a stable value and high dividend yield perfect the picture.

Sector allocation Q4 2010

Overweight	Consumer Staples Health Care Telecom. Services
Neutral	Energy Industrials Information Technology Utilities
Underweight	Consumer Discretionary Financials Materials

Source: Sarasin

Rainer Männle, CFA

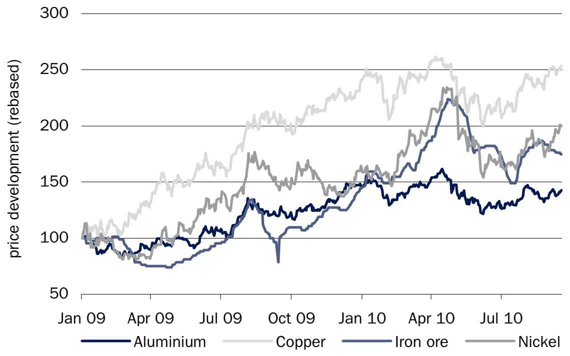
Risk appetite is the key driver for commodities and real estate

The return of investors' appetite for risk in the third quarter has provided a positive boost to both commodity and real estate investments. But since the economic headwind is increasing, we do not expect commodity prices to rise any further during the fourth quarter. The only exception might be gold, as the price of gold generally benefits from increased risk aversion. There are major regional differences in the real estate market. Although shares in property companies should benefit from low interest rates, they are likely to suffer more when investors start to lose their appetite for risk.

Commodities: prices rise in the third quarter

After commodity prices were generally weaker during the second quarter, most of them have rallied again in the third quarter. This is mainly attributable to improved market sentiment underpinned by strong quarterly results and positive economic data from Europe at the start of the quarter. Strong economic data from China provided a boost towards the end of the reporting period. In addition, emerging market countries pushed ahead with major infrastructure projects.

Industrial metals: Price trends since 2009



Source: Datastream, Sarasin; all data as of 30.09.2010

Industrial metals: macroeconomic headwind ahead

The prices of industrial metals such as aluminium, nickel, copper and zinc picked up again during the third quarter, as predicted. The price of copper rose particularly sharply due to the structural supply bottleneck combined with an acceleration in demand. This development is likely to continue. The contract prices of iron ore and metallurgical coal for the fourth quarter fell for the first time since the quarterly pricing system was introduced in April 2010, mainly due to weaker demand from China. Even so, prices are still higher than they were in the second quarter. We do not expect prices to collapse either in iron ore or metallurgical coal since they are likely to continue to be in short supply over the next two to three years. In the short term, however, the planned reduction in power and steel production in China in order to meet energy efficiency targets will probably put pressure on demand for iron ore up to the end of the year. Overall, demand for industrial metals is likely to flatten out in sympathy with the slowdown in the global economy, with a few exceptions, and this will likely put pressure on prices.

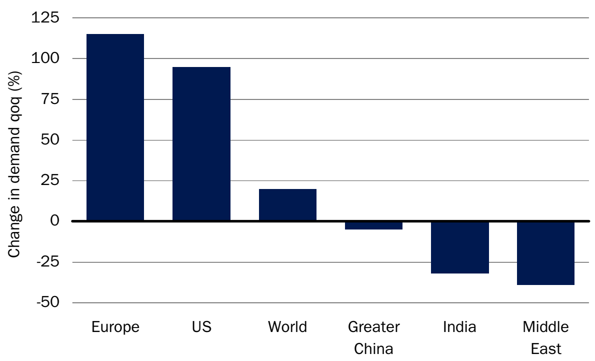
Precious metals: Price trends since 2009

Source: Datastream, Sarasin; all data as of 30.09.2010

Precious metals: benefiting from mounting risk aversion

Our prediction that precious metals would lose some of their attraction has turned out to be true to some extent. While the spot price for gold has only slightly increased over the last three months, the price of silver has risen sharply. Nevertheless gold has climbed to new record highs and even silver rose above USD 20 per troy ounce for the first time since 2008. But the silver price still has some way to go before reaching its historical peak. We expect gold especially, as well as silver, to retain their safe-haven status for cautious investors. When risk aversion remains high, as we expect it to over the next few months, the gold price in particular should be a major beneficiary. Private European investors are especially keen on gold as an investment instrument given soaring government deficits and renewed concerns about the euro and the banking system. Low interest rates, an inflated money supply, massive state deficits, gold purchases by exchange traded funds, reduced gold sales or even purchases by central banks, topped by a high level of risk aversion, are likely to keep the gold price firm in the coming months. We only expect a moderate rise on the supply side, even though the high price of gold is likely to provide a boost to recycling activities. One of the curbing factors, however, is that demand for gold in the past years has benefited from the closing of hedging books of mining companies. But meanwhile many of these trades have already been wound up.

Gold demand from private investors in 2Q10



Source: World Gold Council, Sarasin

Grain prices surge

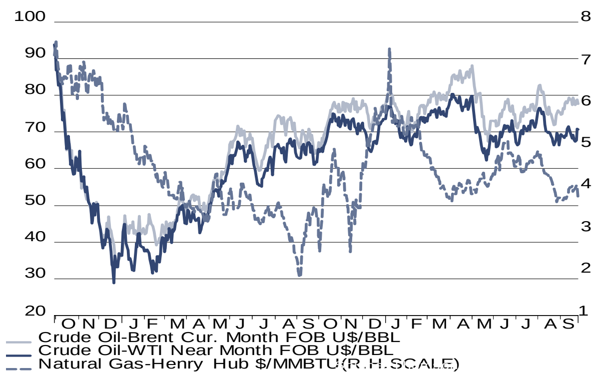
The reasons for the rapid 20% price hike in wheat futures at the start of the third quarter were mainly result of weather conditions: fears of extensive harvest failures triggered by heat waves and fires in Russia, and heavy rainfall in other regions across the globe. Prices were also driven higher by Russia's ban on wheat exports imposed at the start of August and due to continue until the beginning of December 2010. Russia is the world's third largest producer of wheat. The price of futures contracts for other soft commodities, such as corn and soybeans, also shot up in sympathy with wheat, climbing as much as 40% and 20% respectively over the course of the quarter. Although global grain stocks are still adequate at the moment, the sensitive price reaction shows that the situation is very tense. Rising demand from emerging markets is likely to keep volatility high on global grain markets.

Ute Haibach

Energy commodities stagnating

Oil and natural gas prices are currently moving sideways in tandem with trends in the economy. The diverging economic trends in the world's main consumer regions of the USA, Europe and China are keeping prices flat at least for oil, and to a lesser extent for natural gas as well. In the third quarter of 2010 unfavourable US economic data initially kindled fears of recession, which pushed the price per barrel of WTI or Brent crude towards the threshold of USD 70. Even so the average price for the most important oil types, Brent and West Texas Intermediate (WTI, the US benchmark) settled around USD 76 per barrel (1 barrel = 159 litres). This still corresponds to an increase of more than 10% on last year. A sequential comparison, however, shows the average prices have settled slightly below the 2Q10 level (USD 78 per barrel). During the third quarter, the price of Henry Hub natural gas averaged around USD 4.30 per MBtu (million British thermal units). The temporary convergence of natural gas and oil prices during the summer was only short-lived and caused by weather conditions. Persistently weak demand, high inventories and an ample supply of gas maintained pressure on prices (see chart).

Oil price holds up well – Gas weakens again



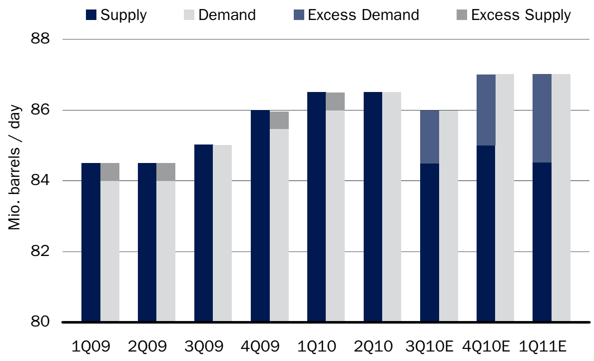
Source: Datastream

So far this year there have been hardly any major swings in the oil price as there were two years ago, and this concurs with our annual forecast for oil of USD 75 – 85 per barrel. Each time this bandwidth was undershot or overshot, it acted as a buy or sell signal. Prices were kept in check by changing economic perspectives. At the moment the world's biggest producers (40% of global supply), represented by the Organisation of Petroleum Exporting Countries (OPEC), have big enough production capacities. The «spare capacity» – production capacities that can be called upon relatively quickly mainly by Saudi Arabia – currently amounts to around 6 million barrels of oil per day or 7% of current oil demand. This value is significantly higher than the average over the last five years of 2% to 5%, and was only ever higher in 2002 (8%).

Balance between supply and demand is short-lived

The supply situation has not been affected by the disastrous oil catastrophe in the Gulf of Mexico (GoM) in the early summer and the subsequent moratorium imposed on deepwater drilling (due to continue until the end of November at least). The GoM region only accounts for a third of US production, which in turn represents just 5% of global production. In the mid- to long-term this calamitous event is unlikely to stand in the way of the search for oil reserves in deep waters and in other areas that are difficult to access. These oilfields are responsible for the majority of estimated reserves which private companies can still tap into. However, the industry is being forced to take on board an increasing number of risks in oil and gas exploration. It is therefore inevitable that safety standards will be tightened in the USA especially, but also in other regions, and harmonised worldwide. According to the International Energy Agency (IEA) the global supply and demand picture for oil during the current year has mainly been characterised by surplus production capacities, which is encouraging a steady build-up of inventories. According to the latest IEA report, the situation could change rapidly, however, if demand for oil remains robust.

Production glut to be followed by supply bottleneck?



Source: IEA, August 2010

Economic outlook keeps energy prices in check

As far as the development of the global economy during the fourth quarter is concerned, we are somewhat more sceptical than the IEA and its forecasts for demand. In the short term there are therefore no significant factors to suggest that oil prices are likely to break out of their price bandwidth of USD 75 – 85 per barrel. Another factor to take into consideration is OPEC's efforts to keep prices above USD 70 per barrel. It should also be noted that Chinese oil imports show a negative response in terms of volume once oil prices move significantly above USD 80 per barrel. Up to the start of 2011 oil prices will continue to track the direction of the global economy and financial markets (excluding geopolitical events such as the expansion of Iran's nuclear program and possible tightening of UN sanctions as well as political tensions in Iraq). On the supply front, we do not expect OPEC to raise their production quotas at the next meeting in mid-October as the compliance rate is still very poor, at 55%.

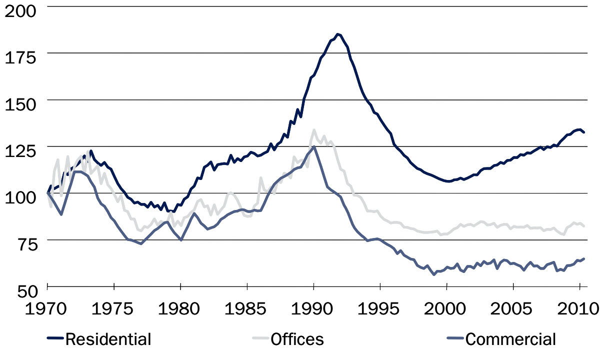
As far as gas prices are concerned, we do not expect any significant recovery in the coming quarters. In the short and mid-term, the market for liquid natural gas (LNG) seems to be well covered due to declining demand in the USA and the high level of extra supply. How long the excess gas supply will persist depends on the economic recovery, the dynamic of the LNG market and the further development of unconventional gas exploration (shale gas). Although pressure is likely to remain on gas prices in 2011, it should be remembered that in historical terms the gas price should stand as a ratio of 1:6 versus the oil price. Although the current decoupling is down to fundamental reasons, the current ratio of 1:19 seems overdone. We think the current price of USD 4 MBtu is too low, and leave our forecast unchanged at USD 5 MBtu.

Michael Romer

Real estate: mixed prospects
International real estate markets paint a very mixed picture and are thus virtually a mirror image of the general economic state of a particular region or country. After initial signs of recovery, the US real estate market has turned negative again due to the glut of properties on the supply side. The same applies to the UK, Ireland and Spain, where the effects of the financial crisis are still evident and likely to persist for some time. Running down excess capacities is a laborious process. In the USA, for example 25% of homeowners are in negative equity, i.e. their mortgages are higher than the market value of their properties. Since the peak of the property boom in 2006, market values have fallen by a total of approximately USD 6000 billion. Even so, it is predicted that prices could fall by another 5-10% in the winter months. By contrast, property markets in Hong Kong, the boom regions of China, Singapore, Canada, France and Switzerland are all in positive territory. The discrepancy is likely to widen if monetary policy and interest rates revert to a normal level and above all the fiscal policy measures to reduce the budgets of many European countries significantly reduce disposable incomes and subsequently the ability of households to meet their payment obligations. Although this will not play a key role in the short term due to the overriding uncertainties presented by the global economy, it does affect general expectations about the future.

Steady demand for Swiss residential property
A closer look at the latest reports on the Swiss housing market leads to the conclusion that the era of excessive prices in localised areas such as around Lake Geneva and Lake Zurich is more or less over. But at the moment there is no question of a price slump, as being claimed in certain circles. It is correct to assume a more orderly development in future which gives more consideration to macroeconomic parameters such as economic growth, immigration and general interest rates. The resilient Swiss property market, which has been relatively free of price bubbles so far, has been one of the reasons why Switzerland has withstood the latest financial and economic crisis more successfully than most other industrialised countries. As a result, Switzerland has not only been spared any price slump, but has benefited from substantial price hikes in residential property, depending on the region in question, as can be seen in the chart below.

Development of Swiss property prices
Real property price indices, 1Q 1970 = 100



Source: SNB, Swiss Prime Site (September 2010)

Recently however, doubts have arisen about how sustainable this positive trend is and whether Switzerland - given the construction boom in individual regions coupled with the simultaneous decline of immigration - will be able to seamlessly absorb the generous supply of property flooding on to the market in the next few years. The Financial Stability Report published in June 2010 by the Swiss National Bank (SNB) provides some interesting insights in this respect. Despite the steady rise in property prices for some years, the SNB still does not see any signs of general overheating. There are some isolated examples in the owner-occupied housing segment and in individual regions (especially around Geneva). The SNB thinks that a general bubble is unlikely to form unless the recent price hikes continue. In fact the situation in the property market would certainly justify raising interest rates, were it not for the persistent weakness of the economy and above all the upward pressure on the Swiss franc. But the SNB has made absolutely clear that it will be monitoring events on the Swiss property market and will not hesitate to intervene if there is a threat of overheating. We think this is both positive and stabilising for the future development of the Swiss property market. Given this backdrop, our overall stance on the Swiss residential property market remains positive, while we take a more neutral stance on commercial property due to specific price determinants.

Rainer Skierka

A	actual value
abs.ch	absolute change
ASW	asset swap spread
avg.	average
bn	billion
bp	basis points
corp.	corporate
CPI	Consumer Price Index
Div. yield or DY	dividend yield
E	estimate
EBIT	earnings before interest and taxes
EPS	earnings per share
EV/EBITDA	enterprise value to earnings before interest, taxes, depreciation and amortisation
excl.	excluding
FY	financial year
GAAP	Generally Accepted Accounting Principles
GDP	gross domestic product
GNP	gross national product
gov.	government
m	million
M&A	Mergers & Acquisitions
mavg	moving average
N.A.	not available
p.a.	per annum
P/B	price-to-book ratio
P/E	price-to-earnings ratio
P/NAV	price/net asset value
R&D	Research & Development
R.H. Scale	right hand scale
ROE	return on equity
SAA	Strategic Asset Allocation, long term strategy based on investment profiles
TAA	Tactical Asset Allocation; short term strategy based on return/risk expectations
vs.	versus
yoy	year over year

Research

Dr. Jan Amrit Poser Tel. +41 44 213 92 81
Head of Research jan.poser@sarasin.ch

Economic Research

Dr. Jan Amrit Poser Tel. +41 44 213 92 81
Chief Economist jan.poser@sarasin.ch

Dr. Alessandro Bee Tel. +41 44 213 92 83
Fixed Income Strategist alessandro.bee@sarasin.ch

Ursina Kubli Tel. +41 44 213 92 80
Forex Strategist ursina.kubli@sarasin.ch

Benoît Robaux Tel. +41 44 213 97 91
Corporate Bond Analyst benoit.robaux@sarasin.ch

Strategy Research

Philipp Bärtschi, CFA Tel. +41 44 213 95 72
Chief Strategist philipp.baertschi@sarasin.ch

Peter Bezak Tel. +41 44 213 90 80
Portfolio Strategist peter.bezak@sarasin.ch

Eliane Tanner Tel. +41 44 213 92 54
Commodity Strategist eliane.tanner@sarasin.ch

Dr. Jianyong Wen Tel. +41 44 213 97 40
Quantitative Analyst jianyong.wen@sarasin.ch

Fund Research

Irene Huber, CFA Tel. +41 44 213 93 13
Fund Research irene.huber@sarasin.ch

Equity Research

Rainer Männle, CFA Tel. +41 44 213 94 99
Head of Equity Research rainer.maennle@sarasin.ch
Sector Strategist, Industrials

Patrick Hasenböhler Tel. +41 44 213 94 81
Head Swiss Equity Research patrick.hasenboehler@sarasin.ch
Consumer Goods, Media, Misc. Services

Daniel Bischof Tel. +41 44 213 94 83
Financials (International) daniel.bischof@sarasin.ch

Dr. Philipp Gamper Tel. +41 44 213 94 97
Capital Goods, Chemicals, Construction, Automotive philipp.gamper@sarasin.ch

Ute Haibach Tel. +41 44 213 96 76
Metals & Mining ute.haibach@sarasin.ch

Dr. David Kägi Tel. +41 44 213 94 82
Health Care david.kaegi@sarasin.ch

Michael Romer Tel. +41 44 213 94 84
Energy, Utilities, Consumer Goods michael.romer@sarasin.ch

Oskar Schenker Tel. +41 44 213 94 88
Chemicals, Construction, Technology, Industrials oskar.schenker@sarasin.ch

Rainer Skierka Tel. +41 44 213 94 98
Financials (Swiss) rainer.skierka@sarasin.ch

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Bank Sarasin & Co. Ltd
Sarasin Research
Löwenstrasse 11
P.O. Box
CH-8022 Zürich
Switzerland
T: +41 44 213 94 76
F: +41 44 213 92 66
research@sarasin.ch

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