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Sarasin-Alpen & Partners House Report

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SARASIN-ALPEN & PARTNERS HOUSE REPORT
is a quarterly publication providing informed analysis
and advice on topics of interest for the private client
and institutional investor.

Introduction



Paul Cooper
Managing Director, Sarasin-Alpen & Partners Ltd.

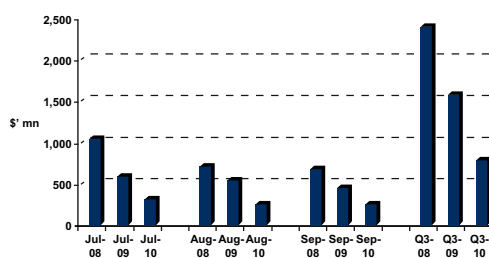
It is with great pleasure that I enclose the ninth edition of the Sarasin-Alpen & Partners Quarterly House Report. The main body of the report is once again written by Guy Monson, Chief Investment Officer of Sarasin & Partners; the UK subsidiary of Bank Sarasin. Guy's ability to explain some of the most complex financial issues has made his "Market View" essential reading for clients and friends of the Sarasin Group. I am also pleased to include a short report by my colleague, Licha Abdullah, on the key investment issues impacting the Gulf.

After a traumatic 2nd quarter, in which US equities fell by 12% and the credit quality of government debt throughout peripheral Europe was questioned, the 3rd quarter was reassuringly strong. A 10% increase in the quarter maintained the region's outperformance versus global equities in 2010.

Unfortunately, trading volumes continued to trend downwards. Although the summer and Ramadan are traditionally quiet periods, Q3 2010 was clearly the "slowest" for many years. The chart below shows Q3 volumes per month over the past three years. Overall, volumes were 51% lower than Q3 2009 and 44% lower for the 1st nine months of the year. This caused financial difficulties for many brokers and some were forced to stop trading. This negatively impacts the coverage and breadth of the market and is a further disincentive for people to invest, especially from outside the region.

Another reason international investors are reluctant to invest in the Gulf is its lack of representation in the major global indices. As a consequence, when international investors invest here they are exposing themselves to

Q3 GCC Trading Volumes



"non-benchmark" risk. Not surprisingly, they are more willing to accept non-benchmark risk if the region is performing better than their benchmark. It's a "catch 22" situation - people won't buy the market until it's performing well and it won't perform well until people buy it.

However, the situation is improving. Effective 17 September, 2010, the UAE was added to the FTSE All World Index. FTSE classifies countries as Developed, Advanced Emerging or Secondary Emerging based on factors such as wealth, stock market capitalization, breadth & depth of market, restrictions on foreign investment, free flow of foreign exchange and reliable and transparent price discovery.

The UAE market was classified as a Secondary Emerging market and it is the only country in the GCC to be included in FTSE's Emerging Market series. Although the initial impact will be small - the UAE's weight in the index is 0.5-0.6% - it nevertheless adds to the growing number of reasons to favour UAE equities. These include low valuations, recent outperformance, low correlation with global equities and improving visibility on the fundamentals.

Moreover, it may suggest a favorable review by MSCI next year which, by account of the greater value of funds that track it, would have a much larger impact. The recent appointment of a stock market regulator in Kuwait and a proposal to increase the level of foreign participation in Qatar is evidence of the efforts being made around the region to gain international recognition and acceptance.

Markets were also supported last quarter by the successful conclusion of Dubai World's debt restructuring, with more than 99% of creditors accepting the proposal. Although some write-downs are required, rating agencies have made it clear that they regard the banks to be strong enough to withstand them. This view is shared by the IMF, which said "challenges in the financial sector may restrain growth in the short-term, but they remain manageable and should not undermine long-term prospects." The Dubai

credit default swap, which reflects the risk of a borrower defaulting, fell sharply as a result.

We share this optimism. Over the last 10 years the GCC has been one of the fastest growing economies in the world and the region is destined to show good growth again in 2010. The IMF recently upgraded its forecast for growth in the non-oil economy this year to 4.3%.

Indeed, the GCC is one of the most interesting regions in the world from a "top down" perspective. It has \$34 trillion of oil reserves, a massively expansionary fiscal policy and strong growth in consumption, backed by a young & fast growing population. In addition, the US\$ currency pegs in the region will ensure that interest rates remain low even when economic growth accelerates. Rates will be set by the needs of the high debt low growth United States rather than the low debt high growth GCC. The long-term risk here is too much growth not too little growth.

The markets are cheap and their strong performance recently bodes well for the future. As investor confidence continues to improve and international investors return to the region we believe the extraordinary value will be realised. There are signs that it has already started.

As Western liquidity washes against the walls of Asian managed currencies, financial markets can continue to rise. Global equity income should be the risk-adjusted winner...



Visit www.sarasin.co.uk to access a special webcast, presented by our Chief Investment Officer Guy Monson, released for this House Report.

Guy Monson
Chief Investment Officer, Managing Partner
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As the West readies its anti-deflationary defences, much of the emerging world by contrast is fighting to contain asset and food inflation. The battle is being fought out in world currency markets, with equities the unintended beneficiaries...

The global economic temperature is still warm enough to keep inflation, food and property prices above target in Asia, but uncertain enough to leave indebted Western governments ready to grasp at any monetary tools to try and ward off deflation. In Japan's case, the new government of Naoto Kan chose 'shock and awe', in the form of two trillion yen (US\$23 billion) of currency purchases in the first Japanese intervention since 2004. While such unilateral action is not normally successful, the fact that the Japanese economy does not need to 'sterilise' these vast purchases means they can buy in larger volumes and for longer than many may have considered possible. To reinforce this, the Bank of Japan announced a new programme of securities purchases which interestingly include not just government and corporate bonds, but also a commitment to buy exchange traded funds, and potentially even Japanese real estate investment trusts!

Another radical new chapter in quantitative easing (QE), and the Japanese are in good company...

In pursuing a strategy of such determined and deliberate monetary reflation, the Japanese are in very good company. In the same week as the BoJ announcement, the Swiss National Bank reminded investors that, with the franc near to all time highs, they too could reactivate currency intervention - their language was blunt:

"Economic recovery is not yet sustainable. Downside risks predominate. Should they materialise and result in a renewed threat of deflation, the SNB would take the measures necessary to ensure price stability."

Monetary Policy assessment - Swiss National Bank
Zurich, 16 September 2010.

Rather than selling their own currency, the Bank of England's September policy minutes make clear a similarly determined intention to resume the purchase of government bonds in their own QE 'classic' style. At the end of September, in an extraordinarily radical speech, Adam Posen (the MPC's newest member) argued not only for a larger QE programme 'now', but also for the assets purchased to favour those in the private sector, rather than government bonds (gilts). There are echoes, here, of the Japanese.

Meanwhile, of course, at the September 21st FOMC meeting, the Federal Reserve not only confirmed that it would continue to reinvest any principal payments from its securities holdings into longer-term

"In fact, my instinct, and I believe that I am not alone in this view, is that purchasing private assets should have a larger macroeconomic impact than purchasing government bonds, ceteris paribus, because then one is going after risk spreads..."

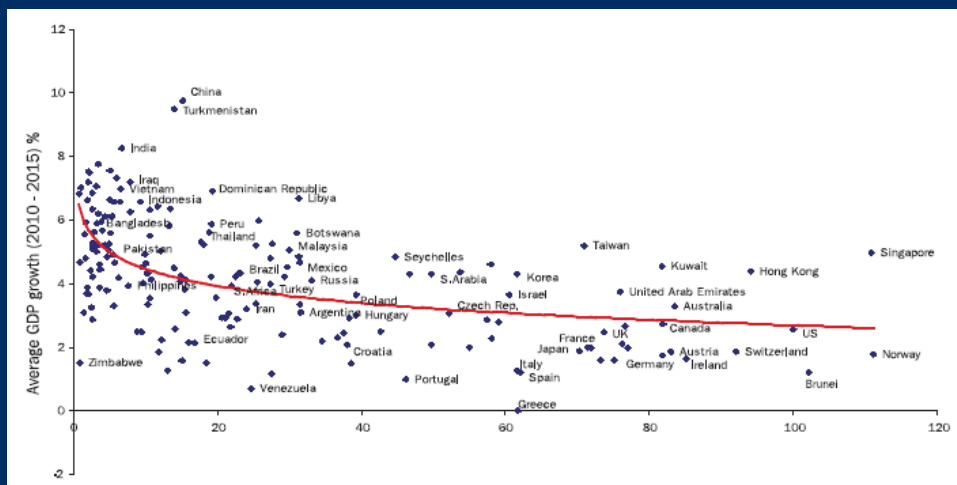
Adam S. Posen, External Member, MPC, Bank of England
'The Case for Doing More', Hull, 28th September, 2010

"The Committee will continue to monitor the economic outlook and financial developments and is prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate."

FOMC, September 21st, 2010

Chart 1: It's a two-speed world, built on the dynamics of economic convergence

**A stylised representation of world growth
GDP per capita (2010) vs. GDP growth (avg. 2010-2015)**



Source: Sarasin & Partners, IMF and WEO April 2010

treasuries, but also announced that they stand ready to act, potentially through further bond-purchases, in what is being dubbed "QE II". The power of even talking about "QE II" was shown in last week's downbeat US jobs report - bonds, equities and gold all rallied upon the news, viewing

this as making the Fed's printing presses more likely to run.

In Asia and the emerging world, extra-liquidity is almost the last thing their economies need...

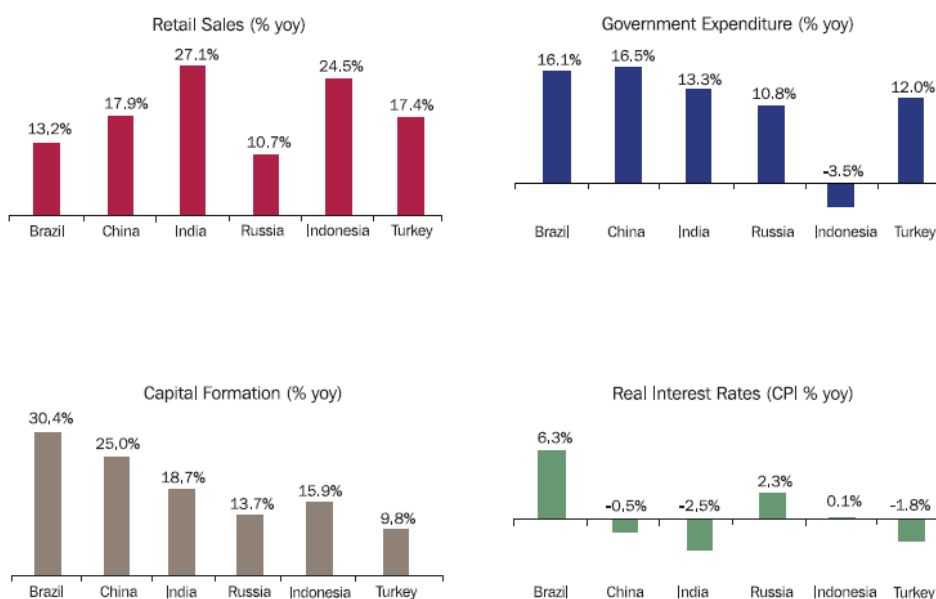
In the emerging world, by contrast, the

result of the West's QE is already outright appreciation of all currencies versus the US dollar, leading Guido Mantega, the Brazilian Minister of Finance, to describe the current status quo as an overt 'currency war'. These imbalances between the developed and emerging world, though, will remain sizeable, as long as stubbornly undervalued dollar pegs across Asia and the Middle East not only supply low dollar interest rates today, but also promise them in the future - an anaemic US recovery is expected to delay interest rate normalisation well into 2011/2012. Below the rhetoric at the IMF meetings, there is probably still a will to change - the first move must come from China, but it will be slow, with the near 2% appreciation in the renminbi/dollar rate in September (and 0.3% since then) still probably too little, too late.

This 'positive' interest rate shock is difficult for the young, emerging world asset markets to manage...

The likely result for Asia and much of the emerging world is a period of what we are terming 'hyper-convergence', where already higher growth rates, due to favourable demographics and an ability to leapfrog technology generations (see chart 1), are magnified and propelled even higher by a powerful low interest rate shock, with negative or very low real interest rates creating a virtuous cycle of 'hyper-growth'. There are countless examples; retail sales are rising by an extraordinary 27% in India, 24% in Indonesia, and 17% in Turkey year on year, while capital spending is still rising more than 24% year on year in China, 19% in India, and 16% in Indonesia (see chart 2). All of those economies, along with most of the emerging world, are operating with real interest rates (after inflation) that are at or close to zero or, in China, India and Turkey's cases, actually negative. In fact, with few 'brakes' to stop economies so long as currencies are pegged, growth is almost

Chart 2: For the emerging world, US level interest rates are much too low for the fundamentals



unstoppable, with intra-emerging market trade surging (see chart 3).

Hyper-convergence is not trouble free - it brings with it growing pains in the form of unsustainable increases in asset prices, and surging domestic wages and inflation - in one year inflation rates have risen by 4.7 percentage points in China, 3.6 in Indonesia, and 3 in Turkey. There are rebalancing mechanisms: emerging markets could allow their currencies to appreciate, but most appear reluctant to permit material appreciation and seem happy to continue to accumulate gargantuan current account surpluses. The lop-sided world economy of the past year is likely to become yet more so in the months, and even years, ahead.

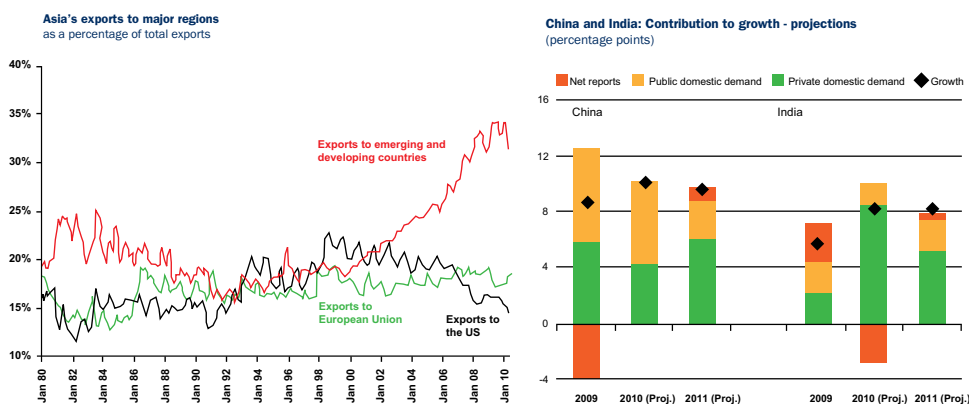
There are some very unexpected winners...

wide GDP) was probably largely offset by surging export activity in the core. The subsequent rebound in the euro to near pre-crisis levels today suggests that one man's currency crisis is normally another's export opportunity!

Corporate M&A also becomes an essential tool, not only in securing sources of raw materials, but also in winning control of intellectual property, technology, brands and distribution...

With the S&P 500 rising 5% last month (this was the best September performance for US markets in 70 years), equity markets are responding rather as we had hoped to both the extremely generous monetary conditions in the developed world, and the 'super-normal' profits from exports to the emerging world. With ultra-low rates of bond

Chart 3: Hyper-convergence is raising emerging market resilience against sustained weakness in the G4



In Europe, ironically, the persistent euro weakness earlier in the year opened the door to super-normal exports for the giant manufacturers of Germany, Switzerland, France, and the Netherlands, as emerging consumers opened their wallets to cheap European products. The result was that the currency crisis triggered by the smaller peripheral economies of Portugal, Ireland and Greece (each less than 5% of euro-

finance, and attractive equity valuations, this is unsurprisingly triggering a surge in merger activity, with more acquisitions in the emerging world than those targeting Europe (China was the largest beneficiary, receiving \$133bn of acquisitions). Issuance is also rising, with Petrobras (the Brazilian energy giant) recently expanding its global share placing (already the world's largest) to more than US\$35 billion. Elsewhere, the news

that Chinese state-owned conglomerate Sinochem is still considering ways of blocking BHP Billiton's dollar 39bn hostile bid for Potash-Corp shows how key strategic assets - wherever they are globally - are being bid up to secure the raw materials for growth. Korea's national oil company also launched the country's first cross-border hostile takeover to win control of UK oil company Dana Petroleum. **We expect further bids for key intellectual property, strategic raw materials and established brands, all of which we aim to target across our global thematic equity accounts.**

So what does all of this mean for our global strategy?

Investment Policy:

1. So powerful is the desire for reflation in the West, and the wish to manage currency in the emerging world, that we view rising global inflation as a bigger risk than Japanese style, multi-year deflation for the world economy. With this in mind, we are naturally cautious of today's super-low bond yields, and would look to equity income or emerging world currencies and short-dated bonds as preferable to developed world bond markets.

In the short term "QE II" and associated currency intervention is a tide that will lift all boats (gold, equities and bonds are all rallying), but with every major developed equity market yielding more than 10-year government bonds (even in the US using the Dow Industrials), our risk adjusted preference remains global equities.

2. Ultimately, euro, US and Japanese competitive devaluations are a zero sum game. The Japanese yen appears moderately overvalued, and supported by unsterilised intervention (see above) is likely to weaken. Sterling, by contrast,

looks cheap, and barring a break down in credible coalition spending plans (due to be announced October 20th) looks likely to strengthen. Our stronger conviction calls clearly relate to emerging world currencies, where we see further appreciation as inevitable. We continue to favour Western issuers and super-nationals issuing in emerging market currencies, and would advise Asian investors to hedge Western bond and equity portfolios back into home currencies where practicable.

3. In our August strategy update, we somewhat glibly advised investors to "be patient, sit back and enjoy the unusually strong cash flow and dividend growth of our cash rich 'Nifty Fifty' equity selection". That advice has broadly proved correct, with equity markets rising sharply over the month and yields stocks as selected in our Global Equity Income Fund outperforming this classic 'high beta' rally. We expect this trend to continue, and still see global equity income as protected in a deflationary outcome by strong cash flow and cash-rich corporate balance sheets, and in the face of an inflationary outcome by strong dividend growth prospects. This 'each-way' bet will increasingly be favoured by income hungry endowment, retirement and even sovereign wealth investors.

4. Our thematic research team finds an environment of 'hyper-convergence' very fertile ground for our thematic opportunity sets, covering both emerging and developed market equity opportunities. The rise of the emerging consumer stretches from luxury goods (China and Hong Kong are already the largest markets for luxury watches) to the massive emerging market for Indian hair care. The demand for base load electricity - with US per capita consumption still five times Chinese levels and 25 times Indian levels

- offers opportunities in coal and power technology, while the massive growth in port handling and inter-Asian shipping trade means a boom for companies such as A P Moller MAersk, Cargotec and Boskalis: three global leaders interestingly all based within a couple of hundred miles of each other in northern Europe. Similarly, a new age of rail beckons across East and West alike, and with it massive export opportunities - once again, industry and country borders are blurred, as procurement and production becomes truly global.

5. Spot gold touched a new record of US dollar 1364 on October 7, while silver has moved to its highest since September 24 1980. We continue to hold our physical gold positions, despite the obvious speculative activity in the market - as evidenced by the explosion in ETF demand (up by 414% year on year to June 30 according to the World Gold Council) - because of the unique role precious metals continue to play as an 'insurance policy' against a disorderly currency realignment.

Guy Monson

Chief Investment Officer and Managing Partner

Subitha Subramaniam

Chief Economist and Partner

GCC Equity Market Update



Licha Abdullah
Vice President
Sarasin-Alpen & Partners Ltd

The GCC equity market enjoyed a strong run in the third quarter (up 10.4%), helped by a staggering performance from Kuwait (+25.5%). Despite this, on a year-to-date basis, the MSCI GCC has underperformed the MSCI Emerging Markets Index by around 2%.

The relatively modest rally in absolute terms this year ensures that the market is still trading at a discount to its historical norms. For example, the GCC is currently trading on a 2010 P/E of 10.2, which is substantially lower than its 5-year average of 20.2. Global emerging markets, on the other hand, trade on 12.8x 2010 earnings compared to a 5-year average of 14.5. This valuation discount leaves us confident that the market should at least keep pace with earnings growth in the coming quarters. Consensus is looking for around 18% earnings growth in 2011, which bodes well for equity markets in the GCC next year. On a similar note, a dividend yield of 3.9% makes the region attractive for income-related investors. Many companies offer high single digit yields with the potential for future dividend growth.

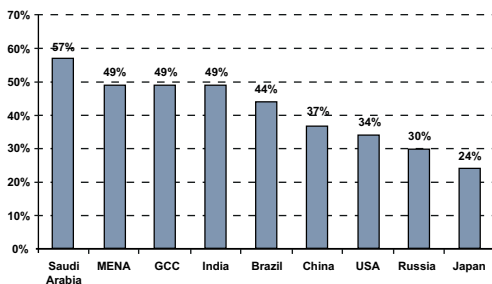
The high weighting of financials and “cyclicals” in the index (>50%) means that the future performance of the market will be highly dependent on the performance of these sectors. We expect Materials and Industrials to continue to benefit from the GCC’s low input costs. Access to fixed price

natural gas or discounted butane/propane gives GCC producers a close-to 50% cost advantage vs. their international peers. This translates into superior returns and higher profitability, even in tough market conditions. For instance, in Saudi Arabia natural gas is priced at US dollar 0.75/mmBtu (US dollar 1.75-2.25/mmBtu in Qatar) compared to spot rates of US dollar 4-4.5/mmBtu. At the same time, chemical companies have the ability to fund large projects in an environment where capital funding has become more challenging. Regional players generally have strong balance sheets and stable and recurrent cash flow, even in tough conditions, so they do not face funding issues for their capacity expansion.

We believe the banks have rerating potential driven by improved regional liquidity and easing concerns on asset quality, as well as structural themes such as macro recovery and government support. GCC banks have started to perform well as the three regional themes of top-line growth, falling provisions and government spending have started to gain traction. With the negative effect of low interest rates already in the earnings,

improving loan growth will be the main catalyst for 2011. We expect loan growth to improve on the back of strong demographic trends, continued public sector spending and improving private sector borrowing. Loan growth is already showing some signs of revival, albeit unevenly across the region.

Percentage of population below the age of 25



Demographics support credit demand - c.50% of the population is below the age of 25 and an additional 1 mn people are set to enter the workforce by 2013
 Source: IMF and EIU

In Qatar, while public sector credit expansion continues on the back of a sustained increase in government spending, private sector lending is yet to rebound. We expect it to recover in 2011 as government led stimulus trickles down to the corporate sector. Deposit formation has remained supportive, helped by the private sector. In Saudi Arabia, where the government enjoys a substantial windfall on the back of rising oil prices, the government continues to invest in infrastructure (the government's development plan anticipates investment increasing at double digit rates over the next five years). This should stimulate a strong recovery in corporate loan growth. At the same time, relatively low consumer finance penetration, new legislation and attractive demographics should result in robust retail loan growth. Endowed with strong capital, low leverage and substantial excess liquidity, we believe Saudi banks are set to enjoy attractive growth trends.

In Oman, while a recovery in loan growth remains a timing issue, banks offer

attractive valuations even after accounting for a slow loan growth environment. Asset quality trends are stabilizing, non-performing loan coverage remains high and balance sheet liquidity has improved. In Kuwait, we expect credit activity to pick up next year supported by government spending plans. In the UAE, the outlook for financials has improved since the resolution of the Dubai World debt problems. We think that UAE banks are able to absorb the necessary impairment charges without materially impacting their capital positions (a view shared by the rating agencies and the IMF). Valuations in the UAE are especially attractive.

Given the increase in liquidity, improving visibility on fundamentals, the improved asset quality of the banking system, near record high oil prices (2008 was the only year oil prices averaged more than they have so far in 2010) and historically-low valuations, we are confident that markets will rally into the year-end and beyond. The increasing role of international investors should provide an additional stimulus to the region.



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