



SARASIN

# Strategy Outlook

Quarterly Newsletter

No. 02 | April 2009

## Editorial



**Burkhard Varnholt**  
Chief Investment  
Officer



**Guy Monson**  
Chairman of the  
Investment  
Policy Committee

As we approach the end of a tumultuous quarter it feels almost “other worldly” to be reporting on nine out of ten “up-days” across global equity indices beginning on 10 March. Extraordinary gains in US and European bank stocks, mining stocks and Emerging Market equities have led the rally along with the first tentative signs of a narrowing of corporate bond spreads. A robust rally in commodities (oil and copper prices were up more than 20%) and a weaker US Dollar now completes this surge of reflationary interest. There certainly remains healthy scepticism among investors about the durability of the rally, but also a feeling that the scale of the fiscal and monetary stimulus of the global economy is so extreme that some response in real asset values has been overdue.

## Is this the beginning of global reflation?

Three things seem to have been behind the change in sentiment: first, statements from banks across the US and UK, and indeed globally, that profitability in 2009 will be positive albeit before extraordinary items and write-downs. With interest rates effectively at zero, and a “managed yield” curve that really should surprise no one, bank operating profitability, especially where there is a strong deposit base, is going to be robust if state-backed insurance programmes efficiently cap the worst of bad loan charges. Second, with the advent of “Quantitative Easing” policies (although active purchases still look to be very modest), central banks have quite effectively drawn a line in the sand, in terms of the theoretically infinite support that they could offer to government bond markets and, ultimately, to the corporate, agency and mortgage-backed markets. Indeed, the response to the crisis now looks much better “scripted” both from the US Treasury and globally. Finally, there is a sense that the rate of decline may be lessening – commodity prices are rallying, Emerging Market equities and cyclical stocks are among the best market performers, and even US housing starts, the strongest last month (February 2009) since July 2003, may be forming a base as mortgage rates fall.

### A War on Savers

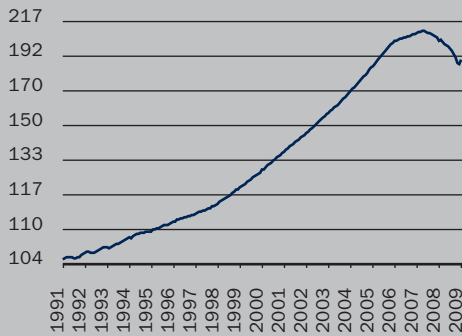
The “War on Savers” continues under the broad umbrella of “Quantitative Easing” with direct central bank bond purchases in the US, UK, Japan, and Switzerland (the latter has the added twist of weakening the CHF). In committing to these programmes central banks are effectively underwriting the bond market at extremely low yields with the goal of forcing savers into higher risk assets. In the first instance, this will be a good thing – government expenditures will offset private savings government employment will offset private unemployment, private savers will be encouraged to take risk, and the depth of economic contraction will be cushioned. By firmly moving beyond zero interest rate policies (ZIRP), policy makers are sending a strong signal that that they are willing to use the printing press to ward off the pernicious cycle of debt deflation. From a psychological perspective, this sends a strong signal to market participants.

The longer term consequences of such policies, however, are unknown and must carry significant risks. First, there is circularity about policy, very well described by Ludwig von Mises, the 20<sup>th</sup> century Austrian economist, when he said: “It may sometimes be expedient for a man to heat the stove with his furniture. But he should not delude himself by believing that he has discovered a wonderful new method of heating his premises.”

**After declining for 15 of the past 16 months US house prices may be the first to stabilise...**

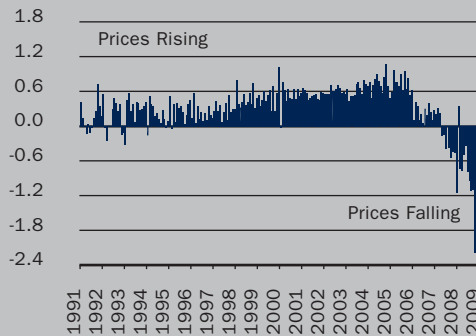
**US House Prices**

Monthly Data 1/31/1991 – 1/31/2009 (Log Scale)  
Chart title has been changed.



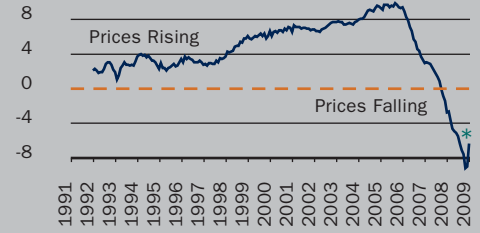
**One-Month % Change**

1/31/2009 = 202.7  
1/31/2009 = 1.7%



**Year-to-Year % Change**

1/31/2009 = -6.3



\*With housing starts, is this the second piece of good news?

Source: Federal Housing Finance Agency  
Ned Davis March 2009

**FHFA Purchase-Only House Price Index**

The index tracks average house price changes in repeat sales on the same single family properties. The HPI measure uses both conforming and conventional mortgages.

**The Economist's house-price indicators**

% change

	Q4 07 – Q4 08	Q4 06 – Q4 07	1997 – 2008
Switzerland	3.7	2.0	24
Italy	1.1	5.1	104
France	0.8	5.7	152
China	-0.9	10.2	na
South Africa	-1.3	12.2	389
Sweden	-1.6	11.3	145
Japan	-1.8	-2.8	-33
Canada	-1.9	5.9	66
Germany	-2.5	-4.2	na
Spain	-3.2	4.8	184
Australia	-3.3	14.0	163
United States (OFHEO)	-4.5	0.6	84
Singapore	-4.7	31.2	na
Denmark	-4.9	1.2	119
Netherlands	-5.2	2.8	90
New Zealand	-8.9	8.0	102
Ireland	-9.8	-6.0	193
Hong Kong	-14.0	21.4	-35
Britain	-17.6	7.1	150
United States (Case-Shiller national index)	-18.2	-8.7	66
United States (Case-Shiller ten-city index)	-19.2	-8.3	102

Sources: ABSA; ESRI; Hypoport; Japan Real Estate; Nationwide; Nomisma; NVM; OFHEO; Quateable Value; Stadim; Swiss National Bank; Standard & Poors; government offices

Indeed it may simply be that the expansion of the Federal Reserve and other central bank balance sheets is simply a gift to holders of Treasuries and other assets included in the programme who've been contemplating an exit strategy (including the USD 700 billion of Chinese reserves). Ultimately, unwinding vast central bank holdings of Treasuries surely has the potential to create a multi-year bear market in bonds. With such an unprecedented response to the threat of deflation, we are probably engineering a massive inflation snap back/backlash in due course. Policy makers are certainly not worried about that yet as they're busy putting out the fires right in front of them. If we do get some inflation sooner than expected (and printing money on such a global scale suggests that we will), it is probably better news for equities in the long term than bonds – explaining some of the reaction we have seen in markets over the last weeks.

**So should we prepare for Inflation or Deflation?**

Recent economic data has been very poor – no doubt a result of the complete freeze in economic activity that took place after the bankruptcy of Lehman Brothers. Virtually every advanced economy is contracting sharply and the pace of contraction is greater for those with higher export dependence. The synchronised global downturn is projected to create an output gap in excess of

6% globally, which is undoubtedly disinflationary in the near term. But there are strong opposing factors.

First, unprecedented economic contraction has been met by unprecedented policy action – as central banks adopt radical policies to combat an adverse feedback loop in which falling collateral values (of houses initially and now of equities) force the financial system to withdraw credit, which in turns raises insolvencies and further depresses asset prices. Second, the radical policies being adopted today are certain to carry a cost. Most obviously, we cannot be certain that governments will be able to withdraw their tentacles from the economy once it stabilises. There is also a significant risk that central banks will become subservient to political pressures once the printing press becomes the domain of the Treasury. This week, the US Treasury and the Federal Reserve released a statement trying to demarcate their responsibilities. But it is clear that this extraordinary crisis, which can only be resolved through the seamless cooperation of the Treasury and the central bank, will create a behemoth government entity that proves difficult to disentangle. In the post "Quantitative Easing" world, inflation risks and economic volatility are certain to be higher.

**Green Shoots of Stability?**

Despite universal gloom, there is a tentative sign of stabilisation at the very heart of the

crisis – the US housing market. Housing starts and sales have begun to stabilise from extremely depressed levels. With affordability improving dramatically on the back of lower prices and lower interest payments on mortgages, the case to own a home for an employed worker is getting very strong. There have also been signs of stabilisation in Global PMI's (Purchasing Manager Indices). After dramatic collapses at the end of last year, indicators are stabilising and improving across the US and Europe. The dramatic collapse in world trade depleted global inventories to such a large extent that, should demand stabilise, there is scope for a sharp recovery in production.

Furthermore, things are looking better in the Emerging Markets. The IMF's resources were increased by more than USD 1 trillion at the G20 meeting in London on 2 April. The IMF aims to backstop a full blown funding crisis in the Emerging Markets that could further exacerbate the crisis of confidence in developed markets. This could be an important source of funding for many emerging markets that were facing a funding shortfall in global capital markets, leading to an improved economic outlook for this year.

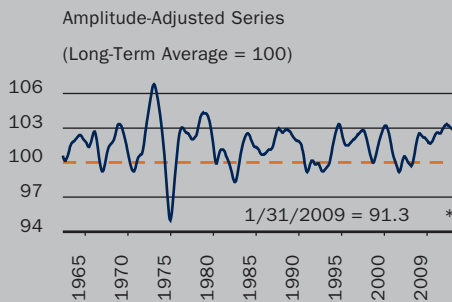
Europe is in the midst of a delicate balancing act. On the one hand, dark clouds are gathering which could destabilise the European economy. First, the European economy typically lags the US and UK and is more volatile. This means that the worst is potentially yet to come. Second, the structural rigidities of the Euro, such as limited labour and capital mobility and a "one size fits all" monetary policy, don't help the outlook. Finally, the Eastern European situation appears worse than the 1998 Asian crisis. The Asian economies were more flexible and there was much less of a synchronized downturn across the global economy than now so that, the Asian countries could export their way out of trouble. Additionally, in 1998 the IMF and World Bank had more money available for support packages. On the other hand, the ECB has so far avoided dramatic fiscal and quantitative easing in the hopes of riding on the coat tails of trading partners with more active policies. Is it luck or skill that relative ECB inaction has worked so far? With the Euro still holding up, exports depressed and creeping deflation, a change of heart at the central bank may be near.

## The Worst Global Downturn in Post-War History has been particularly cruel to exporters...

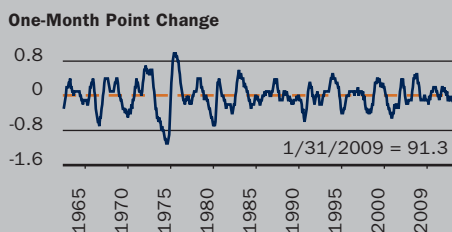
### OECD Plus Non-Member Economies Composite Leading Indicator

Monthly Data 6/30/1962 – 1/31/2009 (Log Scale)

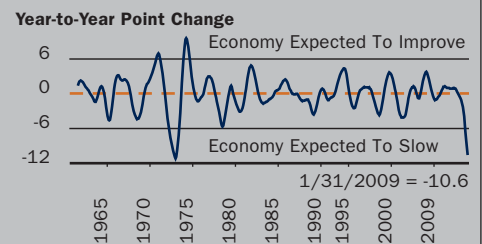
This weighted index covers 29 OECD member countries plus Brazil, China, India, Indonesia, Russia, and South Africa.



\* Record low



Source: Federal Housing Finance Agency, Ned Davis March 2009



Source: OECD, Main Economic Indicators (MEI), www.oecd.org, Ned Davis March 2009



\*Collapse in world trade could have exaggerated the global inventory cycle: There could be scope for a snap back

### Strategy Outlook Implications for our Clients

1. Despite the extraordinary downward momentum in February we continued to retain a core of high quality global equities. Valuation, technical and volatility signals as well as low interest rates have been increasingly supportive of a widespread equity market revival and, in March, we were finally rewarded with a rebound. We are still deliberately underweight core banking names, reflecting a continuing nervousness about how much of their vaunted return to profitability will ultimately accrue to private shareholders, in what have essentially become government-controlled institutions.
2. We have continued to make steady increases in our Emerging Market equity exposure from the very low levels at the beginning of the year. Returns in China and the Gulf markets have been strong and it's pleasing to see even the frontier

markets rallying. We expect to make structural increases in these markets over multi-year periods.

3. We will continue to supplement returns with ambitious call over-writing and put-sale programmes (across individual stock positions) to harness what is still high volatility by historic standards. In target return accounts we have also tended to deploy portfolio insurance programmes where net equity exposure rises above 35%.
4. Across our Sovereign Portfolios, duration has been extended in the very short term to take advantage of central bank purchases. Note though, that we believe this to be a temporary phenomenon. Ultimately a massive surge in government issuance will ultimately push up the price of that capital. Duration will be shortened in Q2. Yields will tend to rise through 2009 whether governments wish this to happen

or not. Currently our bias remains toward core Euro-denominated issues.

5. The recent increase in risk appetite has benefited most investment grade sectors, but the market's preference is still for cash generative sectors such as food, retail, telecoms, utilities, and pharmaceuticals. The banking sector is still plagued by specific terms and conditions within individual security prospectuses and fears of creeping nationalisation. However, it was encouraging to see UBS announce in March that it will buy back some subordinated (lower Tier 2) bonds, and this, along with rising bank equity prices, has led to signs of improving liquidity and price transparency. Where banks are buying back Tier 1 and Tier 2 bonds, we recommend selling holdings, as these embody equity-like risk with far less liquidity. We will continue, where possible, to focus holdings only on banks with very strong deposit bases and where further government involvement (or even nationalisation) is least likely.

6. We retain our broadly neutral currency weighting, with the exception of the Norwegian Krone, whose strong fundamentals stand out. We also note the risk of longer term US dollar weakness as an aggressive QE policy with large external creditors can be unsustainable.

7. Liquidity remains a key portfolio criteria for us and hence we remain materially underweight in hedge funds, private equity, smaller companies and other illiquid assets.

## Contacts

Burkhard Varnholt  
Chief Investment Officer  
Telephone +41 (0)44 213 97 38  
e-mail burkhard.varnholt@sarasin.ch

Guy Monson  
Chairman of the Investment  
Policy Committee  
Telephone +44 20 7038 7023  
e-mail guy.monson@sarasin.co.uk

## Disclaimer

This newsletter is prepared by Bank Sarasin & Co. Ltd (Switzerland), and Sarasin & Partners LLP (UK) ("BSC") for your information only. It contains selected information and does not purport to be complete. The publication is based on public available information and data ("the Information") believed to be accurate and complete. BSC has not verified and does not guarantee the accuracy and completeness of the Information contained herein. Possible errors or incompleteness of the Information do not constitute grounds for liability, either with regard to direct, indirect or consequential damages. In particular, BSC shall not be liable for the statements, projections or other details contained in the Information concerning the examined companies, their associated companies, strategies, economic situations, market and competitive situations, regulatory environment, etc. Although due care has been taken in compiling this publication, it cannot be excluded that it is incomplete or contains errors. BSC, its shareholders and employees shall not be liable for the accuracy and completeness of the statements, estimates and conclusions derived from the Information contained in this publication. BSC may perform investment banking services or other services for companies examined, and partners, directors or employees of BSC may serve on the board of directors of companies mentioned in this presentation. Although measures are taken to avoid conflicts of interest arising from such services or relationships with partners, directors or employees, BSC cannot guarantee that such conflicts of interest will not occur. BSC shall therefore not be liable for any direct or indirect or consequential damages arising from such conflicts of interest. Opinions or prices expressed in this publication are subject to change without notice. In particular the current investment policy as well as investment decision process are subject to change without prior information or consent. Please take also note that this publication is not produced by BSC's Research Department. Therefore, in particular the "Directives on the Independence of Financial Research" of the Swiss Bankers Association have not been applied. If you are a private investor, you should not act or rely on this document but should contact your professional advisor. This newsletter is for your individual purposes only and not for any kind of distribution.

### **Bank Sarasin & Co. Ltd**

Elisabethenstrasse 62

P. O. Box

CH-4002 Basel

Telephone +41 (0)61 277 77 77

Fax +41 (0)61 272 02 05

www.sarasin.com