



# Weekly Strategy Update

2 February 2012



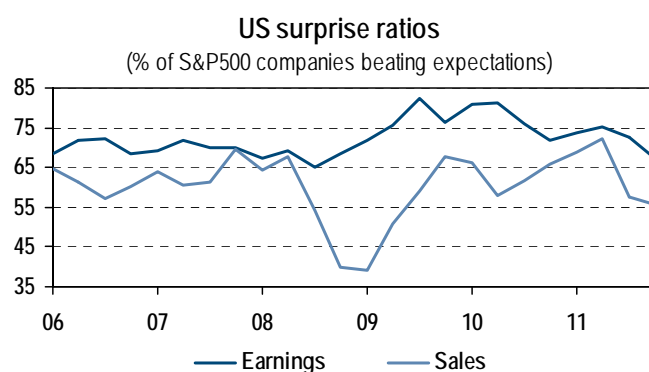
## SUMMARY

- Fed sees low rates for longer
- Eurozone leading indicators improve
- Asset allocation team increases overweight emerging market equities and swaps overweight emerging market local currency debt for hard currency debt

By 31 January, the US S&P500 equity index had fallen for four days in a row, the longest losing streak since the middle of December. European and emerging equity markets generally did better. Overall, financial markets remained quiet. The selloff over those four days in the US pushed the S&P500 down by only 1% in total after its 14.5% rally since 15 November. Eurozone sovereign risk spreads declined, with the exception of those of Portugal. Although we expect to see another wave of risk aversion before the sovereign debt problems in the eurozone are fully solved, we have taken slightly more risk in our asset allocation for now by increasing our exposure to emerging equities. To prevent too large an exposure to emerging currencies, we swapped our overweight in emerging market debt in local currency to an overweight in emerging markets debt in hard currencies. We closed our overweight in US small caps versus large caps.

## QUIET EQUITY MARKETS

Equity markets have generally been quiet for this time of the year. Trading volumes were relatively low in January, especially in the US. Volatility measures, such as the VIX for the S&P500 index and the VDAX for the German Dax index, have continued to trend lower.



The fourth-quarter US earnings season has been mixed so far. Almost 200 companies in the S&P500 index have reported to date. In total, earnings per share have been 2.7% above expectations, less than in the third quarter; even though estimates had been revised lower ahead of the start of the reporting season. Sales have surprised positively by 1.6%, about the same as in the third quarter. In terms of the number of companies that have so far surprised to the upside – a better gauge of the breadth of earnings surprises – the current quarter is so far quite weak. Only 67% of the companies that have reported



have been able to beat earnings expectations. This is the lowest since the third quarter of 2008. The number of companies that have been able to beat sales expectations is so far 56%, the lowest since the first quarter of 2009. Earnings estimates are still being lowered, but the fact that markets were rising shows that some of the pessimism was discounted.

We are still cautious on developed equities. In our investment strategy, we have kept our negative recommendation. In our asset allocation, we have recently increased our exposure to equities from underweight to neutral, but we are currently more inclined to sell when the rally continues than to increase exposure. We see monetary policy and liquidity as positive for equities, but the economic cycle as neutral to slightly negative. We also think that earnings downgrades are a potential drag on equities. Finally, we see the sovereign debt problems in the eurozone as an element that could at some point lead to another wave of risk aversion.

## BOND YIELDS STAY LOW

Two-year yields in the US are currently only just above 0.2% and 10-year yields are at 1.8%. In Germany, yields are even lower: 0.15% for two-year yields and just below 1.8% for 10-year yields.

Ten-year government bond yield

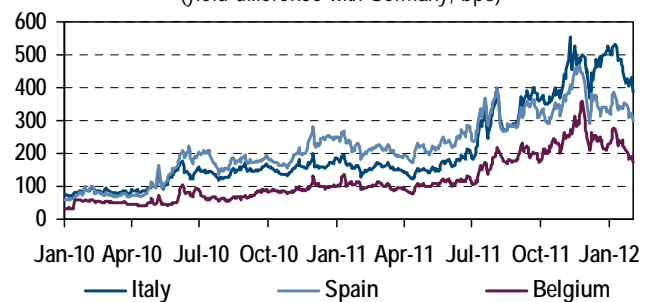


In recent weeks, yields have shifted lower to near-record lows, mainly due to changed perceptions of monetary policy. In the US, the Federal Reserve for the first time published the FOMC members' expectations for the fed funds rate at the end of each year through 2014. By far the majority of the members (17 in total) expect the rate to stay at 0.25% through to the end of 2013. And 11 members forecast the Fed's official rate to be at 1% or lower at the end of 2014. Accordingly, the Fed changed its media statement after the FOMC meeting of 25

January. It now sees exceptionally low levels for the fed funds rate at least through to late 2014. Previously, the Fed had pledged to keep rates low until mid-2013. It continued to see modest growth in coming quarters with downside risks. With inflation below its adopted formal target of 2% and unemployment still high, the Fed left the option of further quantitative easing open. The minutes of the FOMC meeting, to be published in a few weeks, may reveal what individual members thought of this option. All in all, the Fed sounded quite dovish. Nothing has changed with regard to the ECB in recent weeks, but with low or negative growth in the eurozone, the sovereign debt problems and an increasing number of banks relying on the ECB for their funding, it looks likely that the ECB will cut rates further.

Eurozone spreads

(yield difference with Germany, bps)

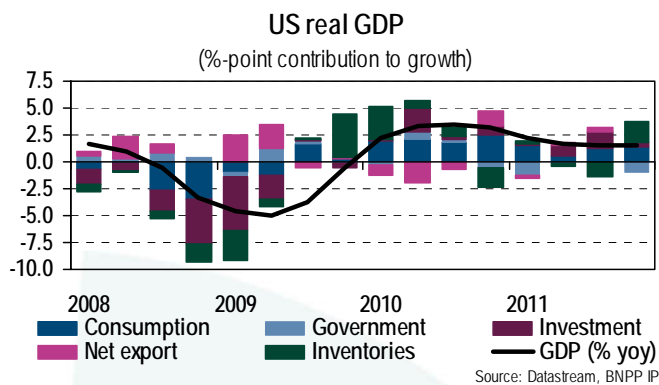


Sovereign risk spreads in the eurozone have continued to decline for most countries. In Italy, yields have now fallen below 6% and in Spain below 5%. Yields have also declined in Belgium and France. However, Greek yields have stayed extremely high. Portuguese 10-year yields have surged to 16% and two-year yields to 20%. While politicians have stated that Greece is unique in the sense that it will be the only country for which the private sector is asked to take a voluntary haircut on its bond holdings, investors apparently increasingly believe that this could also happen in Portugal. Furthermore, it is still not clear how the situation in Greece will develop. Meanwhile, austerity in Italy and Spain has only just begun. The Spanish central bank now expects the economy to shrink by 1.5% this year. The consensus among economists for Italy is -1.3%. In this environment, it will be challenging to reach deficit-reduction goals. We continue to see the sovereign debt problems in the eurozone as a downside risk for equities. Investors may be patient and may look through the short-term deterioration caused by austerity measures, but we do not take this for granted.



## ECONOMIC DATA BECOMING MORE MIXED

Fourth-quarter 2011 GDP growth in the US looked healthy at first sight: the economy grew by 2.8% QoQ annualised, up from 1.8% in the third quarter. However, the underlying data reveal a weaker picture. An increase in inventories added 1.9% to growth.



As consumption slowed throughout the quarter, at least some of this increase in inventories may have been involuntary. Thus, this positive effect will probably not be repeated in the first quarter of this year. Consumption rose by 2.0% QoQ annualised, but this was mainly due to positive overflow from the third quarter, as consumption ended that quarter on a strong note. In fact, consumption hardly grew in the fourth quarter itself. With some modest gains in real disposable income, this enabled consumers to increase their savings rate. Declines in federal defence spending and state and local spending were a drag on growth. Business investment almost came to a halt in the fourth quarter, but residential investment grew at the strongest pace since the third quarter of 2009. However, due to the low level of residential investment, the contribution to growth was limited. External trade was a minor drag on growth. Taken together, consumption, investment and government spending grew at a modest 1.0% QoQ annualised. Interestingly, the GDP deflator, the broadest measure of prices in the economy, gained only 0.4% QoQ annualised, the slowest pace in more than two years.

The ISM-manufacturing index increased further in January, albeit a bit less than expected. According to the Institute of Supply Management, the current level of 54.1 points to 3.9% GDP growth. We don't expect this level to be reached any time soon, but the ISM-manufacturing index at least points to solid growth in the manufacturing sector.

Capital goods orders and shipments rebounded strongly in December, after falling in November and October. We doubt that this is the start of a strong trend though. A tax credit to stimulate investment ran out at the end of 2011 and this may have led to a temporary surge in orders and shipments.

US consumer confidence fell in January according to the Conference Board, but increased according to the University of Michigan. The Conference Board measure had surged more strongly in November and December, so the developments in January brought both measures more in line. From an historical perspective, consumer confidence stayed subdued.

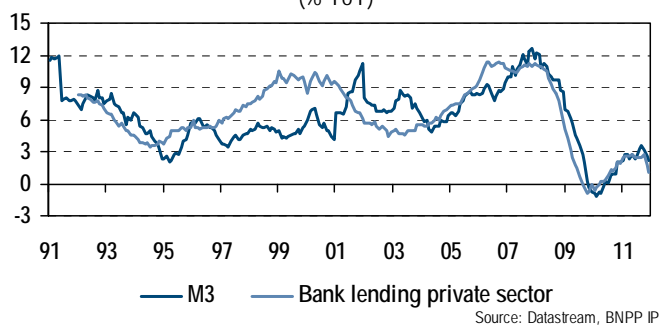
In the eurozone, several leading indicators improved. The PMIs for the manufacturing and the services sectors both surprised positively in January. The services sector PMI even rose above 50, indicating that this sector is growing again. As a result, the composite of both indices also rose above 50. The Economic Sentiment Index, another important leading indicator for the eurozone, and the German Ifo index also increased in January. Consumer confidence in Germany improved in January as unemployment declined further.

Real indicators from the eurozone paint a less positive picture. Retail sales in Germany and consumer spending in France fell in December. In France, where unemployment is rising, consumer spending has weakened significantly in recent months. For the eurozone as a whole, industrial new orders fell in December. The annual growth rate turned negative for the first time since November 2009, when the economy was recovering from its deep recession. M3, the broadest measure of the money stock, continued to fall in December, due to another drop in bank lending. These data underline the importance of the ECB's three-year loans to the banking sector, as it looked like a credit crunch was starting to develop.

When considering all the data, we think the US economy will continue to grow, but modestly. The improvements of the leading indicators in the eurozone point to a shallow recession for the whole region, while some core countries could escape this fate. However, the sovereign debt problems and austerity measures do not argue for a quick rebound.



**Eurozone money and bank lending**  
(% YoY)



## INVESTMENT STRATEGY RECOMMENDATIONS

We did not change our investment strategy recommendations. The team stuck to its negative recommendation for developed equities and its neutral view on emerging equities. Moderate growth in the US, a likely recession in Europe and a mid-cycle slowdown in emerging markets do not provide a favourable background for equities in our view. Structural fears about the balance of debt in mature economies, which will endure beyond the short-term economic climate, may lead to market volatility and risk aversion from time to time. In view of the considerable threats to future earnings from currently high margins, high operating leverage and slower sales growth ahead, we think developed equities are not as cheap in valuation terms as they seem. Emerging equities' valuations could be attractive and monetary easing could support emerging equities' performance versus that of developed equities, but our investment strategy team thinks the main drivers for emerging equities are still risk aversion and cyclical headwinds.

The team is neutral on bonds, including government bonds, credits and emerging bonds. Government bond yields are too low to be attractive and we do not expect them to change much. Credits should be attractive in a low-growth environment, but the team sees the downside risks from the eurozone crisis and possible higher default rates as too great to recommend credits.

Year-end rebalancing of investor portfolios and the strength of the US dollar weighed on gold late last year. However, we continue to expect investor demand to be strong in 2012, keeping prices well supported.

## GBS ASSET ALLOCATION

In our asset allocation, we have slightly raised our exposure to risky assets. We increased our overweight to emerging equities given that inflation is falling sharply and monetary policy is being loosened in the BRICs (Brazil, Russia, India and China). These should be important drivers for this position. Moreover, we have become less negative in our economic outlook and we foresee stronger growth in emerging markets.

However, we did not want to increase our emerging market currency exposure much further; this is embedded in our emerging equities and emerging local debt positions. As such, we chose to swap the emerging local debt position for an emerging hard currency debt position. We stay positive on emerging debt, but this switch locks in the recent relatively good performance of local debt compared with hard currency debt.

We decided to close our overweight in US small caps versus US large caps. We think the positive momentum of US data surprises is discounted, while the valuations of small caps have remained unattractive on a relative basis. Although these factors have not changed that much, we decided to take profits after the recent outperformance of small caps.

In very broad terms, the model portfolio is neutral on all major asset classes. Within bonds, we overweight credits, which should do well in a low-growth environment and which should be supported by strong corporate balance sheets. As said, we swapped our overweight emerging market bonds in local currencies to an overweight emerging market bonds in hard currency. We are underweight government bonds, but long duration to limit risk in our overall portfolio. We see this as a hedge against our increased exposure to equities. We are underweight inflation-linked bonds since we see generally muted inflation and the relatively large exposure of the inflation-linked bond index to eurozone 'peripheral' countries as the main negative factors.

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