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Trends



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Feel the crunch

PATRICK SÉGAL

Standard and Poor's, Fitch and Moody's have started a scalp dance, whooping and brandishing their hatchets around a hapless Europe bound by its differences and contradictions. Not a day goes by without one of the big three ratings agencies adding another gory scene to their masterpiece, «Apocalypse Now for Europe». They may have missed the cracks in the facades of Enron and Worldcom, but this time it is plain to everyone that European government bonds are not worth the paper they are printed on. Nor is there any rhyme or reason to the scoring system: after lauding these countries as top-notch borrowers for years while they dug themselves into an ever deeper hole, the Big Three are suddenly dispatching them one by one even as they try to claw their way out by cutting unproductive public spending and raising taxes. Is this because the agencies think they can read the medium-term economic outlook as well?

Germany, sitting in judgment, still has an AAA rating. So does France (for the moment), even though it has not done much to rein in expenditure. Italy, on the other hand, is about to be hurled from the Tarpeian Rock. We could have worried back in 2000, when its national debt was 110% of GDP. Now, with a ratio of 118% and a small budget deficit (3.5% with no primary shortfall) Italy is considered on the verge of bankruptcy. Like Japan, Italy mainly relies on domestic savings to finance its debt and does not borrow much internationally. Its underground economy probably amounts to 30% of GDP. Italian industry is bustling and its exports are thriving. Only its productivity is creaking. Yet the hypertrophic world of finance has decided that Italy is doomed. Tottering banks are dumping their Italian government bonds, and hedge funds are selling them short. How, in the face of manipulation and false rumours, can fair value be made to hold sway?

France and Germany over the past decade have seen their public debt surge. The French government has adopted minor reforms now and then to keep its top-flight credit rating but is already preoccupied with next spring's elections. The German authorities, lording it over the rest of the Continent, forget that choking Euroland economically will bring on a deep recession. They too have an election coming up that in their case has blinded them to the usefulness of creating liquidity. While the US Federal Reserve, the Bank of

England and the Bank of Japan churn out money at a dizzying rate, the European Central Bank's hands have been tied by the Merkel government. Yet the Germans are confusing the issue: lending to Euroland's weakest members that give nothing in return will not lead to hyperinflation like in the Weimar Republic. The aim is to avert a credit crunch like in 2008, when banks stopped lending to each other. Chancellor Merkel's electoral qualms are leading to a dangerous loss of confidence and, in

Euro crisis



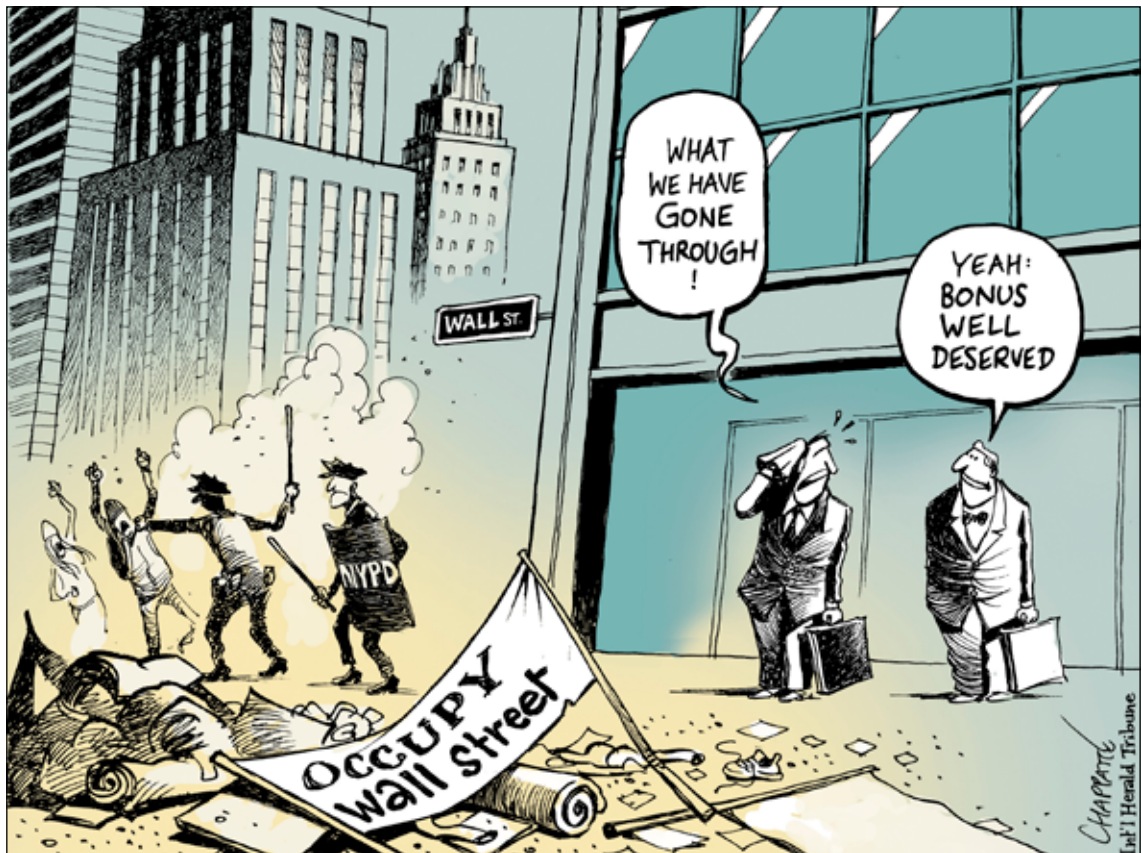
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all likelihood, the crisis will force European leaders to break ranks. But what should we make of the ratings agencies' attitude? While busily executing patients throughout the euro area, they ignore the 9% unemployment and 10% budget deficit in the US, the recession in the UK and Japan's 220% debt-to-GDP ratio.

The Swiss National Bank has successfully trounced speculation on the Swiss franc by acting with bold determination. Here is proof that the punters can be stopped in their tracks, giving the authorities time to tackle the underlying problems and correct the defects. But it takes unwavering resolve to stand up to the markets. Let's hope that Merkel's obstinacy bends before it is too late, i.e. before German banks, too, are dragged into the melee.



After the evacuation of? Occupy Wall Street?



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Undermined by the IFRS2 and Basel 3 rules, the financial sector needs to raise fresh money just when investors are steering clear of banking and insurance stocks. Thus the timing of the increase in capital adequacy requirements is disastrous for the financial industry. It would be helpful—and reasonable—to phase in these changes gradually so that players could deleverage over time. Have regulators and legislators worsened the crisis? If the euro falls apart, banks' reserves will be totally insufficient. And if the currency zone manages to get out of this jam in one piece, there will be no point having all that money locked away in the vault. The dilemma is a sign of our times.

Actually the best news will probably come from banks during the next reporting season. As Marc Faber, a hedge fund manager based in Hong Kong, said a few months ago, his clients' portfolios contained no government bonds and no Greek paper, in particular. The only ones holding these issues, he noted, were banks, which after the 2008 financial crisis had been cajoled by law into buying high-yielding sovereign debt. So the prospect that still provides a gleam of hope these

days is banks' year-end window dressing. No lending institution wants to be seen as trapped, so they are all selling German Bunds and French OATs to cover losses on Portuguese, Italian and Spanish debt that they are dumping in huge quantities. As you will see, their end-2011 balance sheets will be considerably lighter. Moreover, in the end their books will almost be sound, with the turpitudes gone. In the meantime pressure on sovereign bonds is currently at its climax. We expect yields to ease by mid-December and to go on declining in January. But before switching we would wait for the crisis to be defused. The markets are still too volatile to be sure. Otherwise, as ever, there is gold.

PS: The defunct MF Global had \$6 billion of PIGS debt. Other American financial institutions also piled into it, leaving US banks vulnerable to stress from their European counterparts. Meanwhile, as we had expected, America's supercommittee disbanded without reducing the budget deficit. Fortunately the US Bureau of Engraving and Printing is equipped to issue new banknotes however fast the Fed needs them.

Good news lurking behind the scenes

PIERRE-YVES BRACK

Themes...

Amid the ongoing financial turmoil, 2012 is likely to be another year driven by political events, with key elections scheduled in some of the world's leading economies.

In advanced economies, France followed by Germany and the US will elect leaders. Equally active will be emerging economies, with Vladimir Putin set to take back his presidential role in Russia and a new president and prime minister due to take office in China, in late 2012.

The political agenda, or specifically whether politicians can enact the structural reforms that are needed, will be a regular source of stress to investors going forward amid the squeeze on national budgets and the resulting austerity measures (even China is facing huge challenges in managing its provincial governments). On the other hand, high unemployment — which has the potential to create social unrest and economic pressures — would actually justify stimulus measures (a job left largely to central banks whenever the public purse is tight).

Next year will not be amazing, but neither will it be disastrous. The adjustment process will be long, and markets are likely to swing between peaks of aversion to (plausible) risks and flurries of optimism as, at last, the international crisis is managed more pragmatically and effectively, and the solid (and equally tangible) fundamentals of many US companies — which are currently going for a song — are acknowledged.

This is no time for «buying and holding». We advise stringent stock-picking, quick reactions (for making frequent adjustments to the risk profiles of investment portfolios) and a solid dose of opportunism for taking advantage of relief rallies (supported by strong micro-economic fundamentals), while standing clear of the fierce corrections that are likely to hit markets in the same way as in 2011.

Outlook remains positive from several angles

Since the end of the summer, US industrial data has pointed to a decrease in inventories, a rise in orders, stronger productivity gains and a drop in

sourcing costs. As a result, business volumes and margins have remained in good shape.

An even more encouraging signal is that job creation (which is vital to consumer spending, accounting for 70% of the economy) has turned upwards. The figures themselves are not amazing, with 130,000 new jobs added per month since July, but the trend has been steady over the past five months and has, broadly speaking, topped estimates.

These are important considerations. Huge disparities exist, but domestic activity still represents some 70% of the combined business volume of S&P 500 companies. This small sign of economic recovery is particularly beneficial in that inventories are low on the whole (due to risk aversion and optimisation of working capital by virtually all economic agents), with the result that the slightest increase in demand automatically results in an uptick in production, which in turn provides operating leverage.

Further afield, while the situation in Europe remains chaotic, the monetary policy cycle in emerging economies seems to have reached a turning point following a phase of tightening aimed to forestalling runaway inflation. Brazil recently cut key rates for the second time in a row, and China has started «walking the talk». After voicing its intention to make the «necessary adjustments» in its monetary policy, authorities have for the first time cut reserve requirements for banks. Lastly, should India decide to hike rates further, it would make no secret that this is the last tightening move for now. Emerging economies have never given up their role as growth niches. Even during the downturn, their GDP was growing three times faster than industrialised countries. It appears that investors are once again starting to take their qualities into account.

Some companies are in extremely good shape

One of our constant themes is that when we invest in the stockmarket, we are not buying an economy but a company with its own features. Of course, no company can remain inoculated against the economic and financial conditions of the day, but many US firms boast solid micro-economic credentials that have not been taken fully into account by investors.



As illustrated by third-quarter figures, the level and composition of S&P 500 company earnings remain solid. There are several reasons for this:

First, blue-chip firms in the US have been able to win market share from companies that have either forcibly or voluntarily reduced the scope of their business (or in some cases shut up shop) on account of the economic slump and the

a recovery (however slight) in business volumes, particularly after cost bases were cut to the bone during the post-Lehman crisis.

Lastly, on the cost front, companies are gaining from the delayed effect of the drop in commodities prices during the second and third quarters, coupled with lower financing costs as a result of low debt burdens and low interest rates.

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RESULTATS 3eme TRIMESTRE	% Publié	% Ventés Supérieur Estimations	Croissance Ventés An/An	Variation vs Estimations	% BPA Supérieur Estimations	Croissance BPA An/An	Variation vs Estimations
S&P500	93%	58%	10%	1%	73%	15%	6%
Ex-Financières	92%	60%	10%	1%	75%	19%	5%
Energie	100%	60%	23%	2%	71%	56%	7%
Matériaux	97%	53%	15%	2%	73%	31%	7%
Industriels	92%	65%	9%	0%	82%	17%	4%
Consommation discrétionnaire	86%	62%	11%	2%	69%	18%	3%
Consommation de base	83%	62%	11%	3%	62%	7%	4%
Santé	96%	71%	7%	1%	82%	7%	3%
Financières	99%	51%	1%	2%	64%	0%	17%
Technologie	89%	67%	9%	0%	85%	13%	2%
Svc télécom	100%	38%	6%	0%	38%	17%	9%
Svc aux collectivités	100%	21%	2%	-6%	76%	5%	2%

Source : Bloomberg



financial crisis. Such companies can also gain from the flexibility of their operations and their quick reactions, especially compared to firms with extensive operations in Europe, where it is well known that red tape hurts competitiveness.

Second, low inventories help operating leverage, which exerts its effect on margins in the event of

Moreover, when digesting earnings releases, remember that markets react more to the notion of "better" or "worse" than expected than to figures that are intrinsically "good" or "bad". With this in mind, the fact that 60% of revenues and 75% of earnings have been higher than expected is likely to fuel a rerating in share prices relative to their generally depressed levels.

ESTIMATIONS 2012	Croissance Ventes 2011 An/An	Croissance Ventes 2012 An/An	Relativement au S&P500 2012	Croissance BPA 2011 An/An	Croissance BPA 2012 An/An	Relativement au S&P500 2012
S&P500	8.8%	4.2%		16.5%	10.9%	
Ex-Financières	10.4%	4.3%		19.3%	9.2%	
Energie	18.4%	-0.3%	n.s.	37.1%	3.9%	n.s.
Matériaux	15.2%	6.5%	1.55	39.0%	12.6%	1.16
Industriels	8.6%	6.7%	1.60	17.7%	14.7%	1.35
Consommation discrétionnaire	8.8%	6.0%	1.43	18.0%	10.8%	0.99
Consommation de base	7.9%	5.6%	1.33	7.8%	6.2%	0.57
Santé	4.7%	2.6%	0.62	7.8%	5.7%	0.52
Financières	-2.6%	3.0%	0.71	78.0%	9.0%	0.83
Technologie	73.0%	14.4%	3.43	23.8%	14.1%	1.29
Svc télécom	7.6%	2.7%	0.64	29.0%	11.7%	1.07
Svc aux collectivités	5.5%	2.9%	0.69	1.5%	-0.2%	n.s.

Source : Bloomberg

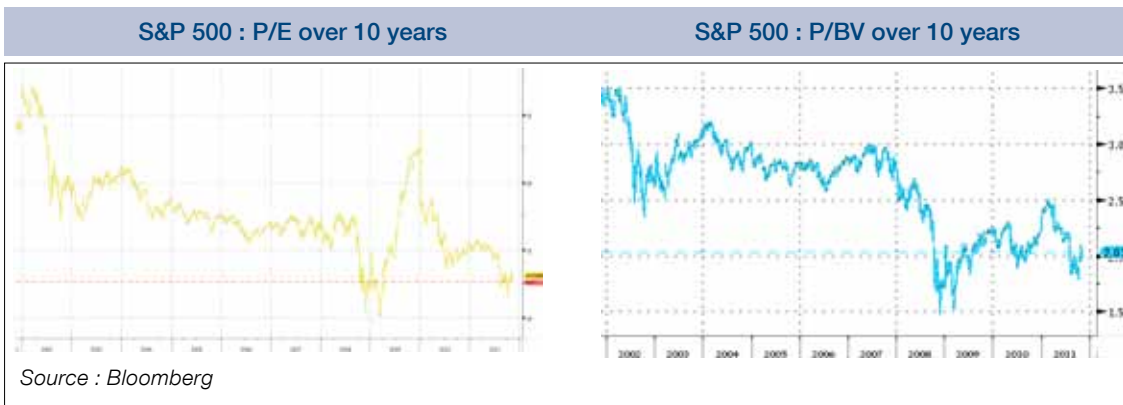
Valuations price in a bleak scenario

We can only reiterate that the multiples implied by current share prices factor in a moderate recession in major industrialised countries and a small downturn in emerging economies.

However, we should bear in mind that, in periods of stress, differentiation is not the fashion, and the valuation in itself is not enough to halt a risk-off move. Yet valuations will become important in the long run, as deep fears gradually dissipate.

with a specific benefit, so that pricing can be differentiated. Or it may be that the corporate model locks in business through long-term contracts (which provide visibility), subscriptions (generating steady revenue streams), clauses tying prices to costs (which safeguard margins) or supplier-customers partnerships (with reduce the risk of substitution).

Being exposed to positive long-term trends that either cushion the effects of upcycles or compensate for downcycles. For example, this



Stringent stock-picking criteria

In a business environment blighted by poor visibility, it is vital to use stringent criteria for stock-picking. We have pinpointed four qualities that we think are necessary in order for companies to have above-average momentum and visibility:

Standing out from the pack, through either techniques or products/services, as a means of guarding against pressure on costs and/or prices. This may involve proprietary processes that yield a cost advantage or endow end products

applies to (1) farming, a sector that has to feed more and more people with better ingredients using increasingly scarcer arable land, (2) healthcare, which has to care for more people, who are living longer, and (3) the power industry, either in renewable forms or green technologies (e.g. energy efficiency, prevention, filtration and pollution control).

Have sizeable, growing and profitable exposure to emerging economies, which even when losing traction outpace mature markets. However, this criterion must be applied wisely.



Taking into account emerging-market exposure based on revenues alone can lead to huge disappointments. Equally important to bear in mind are (1) the costs incurred to gain exposure, (2) the profitability of the business generated in these markets and (3) as far as possible, local competition (i.e. do not focus solely on business opportunities).

(or increasing) shareholder payouts, which account for 40% of total returns from US stocks over the long run.

Everything hinges on renewed confidence

The bottom line, however, is that positive factors and stock-picking criteria cannot be taking into account for any meaningful length of time until fears of a systemic blow-up (which would tie the hands of banks, leading to a shortage of credit and an economic double dip) are allayed.

The Fed may have made no secret of its intention to take further action if needed. But whether risk appetites can be whetted again depends mainly on how things pan out in Europe. For disaster to be averted, clear-cut, pragmatic measures must be implemented, not simply talked about.

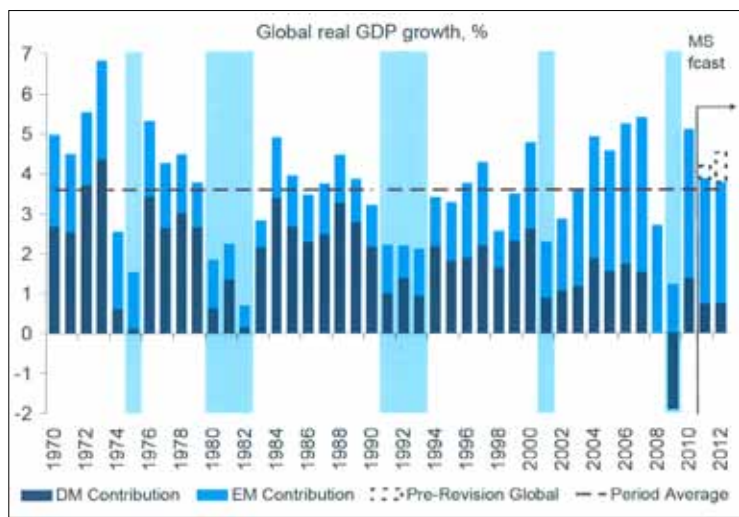
If emerging markets stick to their proposal of participating in stability and subsequent recovery drives, this would certainly cheer investors, happy that the world economy can pull together at such an important time.

In view of the political timetable, conditions are likely to remain tumultuous. However, some good news is lurking behind the scenes.

Tactics

If we forecast considerable uncertainty on economic and financial fronts in the coming months, this means that we are likely to see red-hot rallies (supported by solid corporate fundamentals) alternating with sharp corrections, resulting from political timetables and complications.

Investors will frequently need to adjust cyclical exposure in their portfolios. As investment bedrocks, we advise relying on stocks that can be considered defensive from different angles



Enjoy healthy finances. This consideration is by no means the «icing on the cake» that some believe it to be. Sound finances make it possible to (1) continue operating normally (or, better still, optimally), even when fresh funds are tight, while being able to (2) seize the opportunities arising because of struggling competitors (by extending good or services offerings, or regional coverage, via organic growth or acquisitions) and (3) sustain

(not only in terms of sensitivity to global economic conditions) and then injecting extra returns by trading in and out of a carefully selected list of cyclical stocks, settling for modest returns through regular profit taking.

Bedrock stocks and opportunity-driven enhancements

Precious metals (bedrock) and base metals (extra returns)

Physical gold is the only real safe haven when risk aversion is at its worst. Silver as well as platinum and palladium are mainly used in industry and therefore — unlike gold — have exposure to economic conditions.

However, there are ways to diversify once the pressure lets up. Several attractive options are available, with varying degrees of risk/reward depending on appetite.

Cautious investors can diversify into other precious metals that have industrial applications, or move into gold miners, which are leveraged by the price of gold.

The most active play would be to diversify into producers of base metals, which have priced in a recession and which offer larger and more direct exposure to emerging markets. Restrictions on supply (arising from lacking infrastructure, environment and tax-related constraints, and a shortage of skilled personnel and specialised equipment) are reflected in prices as soon as expectations for economic recovery emerge, especially in copper, thermal coal and iron ore.

Agriculture (bedrock) and industrials (extra returns)

The farming cycle does not correlate tightly with the business cycle. A host of other considerations have a greater influence: growing areas, production mixes, yields per hectare, weather conditions, and global stock levels in relation to consumption. In this industry, all lights are flashing green. The shares of farming-related companies (seeds, crop protection, and fertilisers) are not completely inoculated against market vagaries but their downside risk is lower and upside potential is above average. This represents our bedrock investment.

Industrials are a mixed bag on account of the wide variety of client markets. Attractive opportunities exist but we advise being choosy. When the market mood is one of «relief», we would advocate investing in stocks exposed to the capex cycle in the extraction of natural resources and, as a diversification play, niches enjoying long-term growth such as express delivery

High yielders (bedrock) and financials (strong extra returns)

Over the long term, more than 40% of total returns generated by US equities (S&P 500) stem from dividends. Dividends should therefore have pride of place in portfolios, once one has analysed whether they can be sustained. We particularly recommend REITs, which are benefiting from low interest rates, whose prices are much less volatile than financials as a whole, which are trading at book value and which often pay attractive dividends.

Whenever risk aversion is at a low ebb, we would advise highly selective diversifications into financial stocks (which remain underweighted on the whole). The prospect of low interest rates for a long time to come, coupled with improved credit risks, faster growth in deposits relative to lending and recessions pricing in an acute global recession are helping fuel spectacular but short-lived rebounds in a industry hampered by new regulations.

Healthcare (bedrock) and consumer discretionary (extra returns)

Until recently, the healthcare sector had been considered as a dead end (both politically and financially) with no scope to innovate. However, with people living longer and requiring ever better care, there is a definite long-run trend, and innovation remains alive and well. All the while, valuations are at rock bottom.

It is worth diversifying from time to time into discretionary niches because of their scope to gain from pressures on consumers (discounters gaining market share in times of trouble), or because their specialisation attracts investors when the pressure is off (hybrid vehicles and building energy saving).



Will 2012 be the year of the benevolent – or destructive – dragon?

PHILIPPE LEDERREY

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Themes...

2012: will the dragon be benevolent or destructive?

2012 is the year of the dragon on the Chinese calendar. The dragon is a very popular zodiac sign in China, the symbol of the emperor and associated with highly prosperous periods of history. (Birth rates rise significantly, as many parents try to have children during the year of the dragon.) In the western world, on the other hand, the dragon is a winged reptilian monster. It is a cruel, fire-breathing destroyer that heroes or gods must vanquish in order to restore world order. The reappearance of this mythical creature in 2012 is apt: while the West struggles vainly with its secular demons, high-growth emerging markets are investors' last hope to offset the negative consequences of the economic slump in Europe (which has never appeared so old and frail).

2011: a real *annus horribilis*

2011 was the worst year ever experienced by investment professionals. Market declines were not particularly spectacular (in early December, the European benchmark was off around 15%, which is two to three times less than during other recent bear cycles). Rather, the speed and strength of the sequence of events driving the downturn were more erratic than ever. They were also piloted by an intrinsically unpredictable factor, i.e. market sentiment about the credibility of political decisions. Good corporate fundamentals, the low valuations of a number of high quality stocks, and rigorous stock-selection were of little help in the presence of such extreme volatility. This period is surely one for the books: the investing world ended up losing confidence in the very concept of a risk-free asset, as European sovereign bonds became just another group of financial products to be treated as weapons of mass destruction. Indeed, the efforts of monetary and political authorities now appear a little desperate in their lopsided battle against the negative consequences of rampant debt, which

had been the main driver behind several decades of growth. The western world believed they could rely on debt to prosper – at no personal cost. Now that the truth has been aired, the old middle class dream has been supplanted by the need for sacrifice. This lack of certainty is preventing the equity markets from putting together any sort of sustainable uptrend in the near term.

The markets are described as cheap (here: P/E): it is indeed below the long-term median but not at all-time lows



The dividend yield of more than one fifth of European companies is above their bond yield



Working out the kinks: a single currency without a federal state

The roots of the problem lie in the fact that when the single currency was created it was presumed that its very existence would spur increased

integration (without any need for fiscal federalism or budgetary harmonisation). Yet the national will to hold onto as much sovereignty as possible was more powerful. More than a decade into the experiment, the European Union finds itself with a stateless and aimless currency that has the same status as gold a century back: an external standard that imposes theoretical discipline but that lacks the identity factor needed to inspire natural rigour. In this political desert, European governments initially attempted to save their banking system. But out of self-interest they chose not to act in a focused and collective manner. Owing to their procrastination in dealing with Greece, speculators were able to profit from fears of a contagion effect on other European countries – and eurosceptics were looking smart. But we must not lose sight of the bigger picture: even though leaders have been unable to speak with one voice, the overall debt situation in Europe is less problematic than on other continents. We must also bear in mind the argument underlying the European project in the wake of the devastating Second World War: the European Coal and Steel Community was devised by Robert Schuman and Jean Monnet to “make war not only unthinkable but materially impossible”. It led to the creation of European democracy and laid the foundation for the current European Union. In this light, the need to take one step closer to unified governance is rightly seen as just a minor problem.

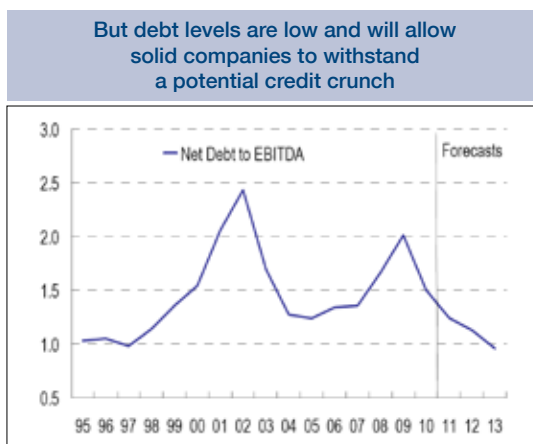
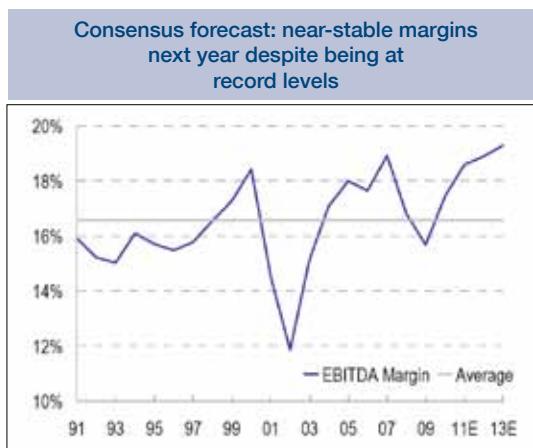
Macroeconomic situation not very encouraging going into 2012

Accumulated imbalances on both sides of the Atlantic together with diverging views on how best to absorb them and kick-start growth do little to encourage economic optimism. The economic outlook for 2012 is not highly promising. The sovereign debt crisis in the eurozone will almost certainly have a negative impact on the real economy: shrinking demand will spread across the continent, while financing terms will only get stiffer. European banks are already struggling to maintain the necessary refinancing, and they have yet to meet lawmakers’ drastic requirements to reduce their financial leverage. In the end, economic considerations do not always determine the course of the markets, and we feel that other factors will be more important in 2012.

Sharp contraction in lending to worsen the situation

The lacklustre economic outlook is not the main concern of European manufacturers, but

rather their access to credit through the financial (especially banking) system. The requirement for banks to reduce balance-sheet leverage will further restrict lending. Many companies will be shut completely out of lending markets and face severe cash shortages. Increasingly scarce liquidity may eventually affect the creditworthiness of the entire manufacturing fabric. In the end, a problem of financial liquidity could cause widespread insolvency. The prospect of such a crisis, far worse than the one following the Lehman bankruptcy, means business leaders will not take any risks at this point.



Some assumptions are necessary before developing a strategy for 2012

Given all these ambiguities, the task of preparing a long-term equity investment strategy for 2012 has become a real challenge. For starters, we need to establish some assumptions in which we have at least some confidence:

- Regardless of how the debt crisis is resolved, relentless pressure on the sovereign debt markets will force European governments to impose

austerity programmes on their populace. The programmes will have to cut government spending and further increase the tax burden, especially for captive segments (e.g. banks, retail, telecommunications and utilities).

■ Emerging markets, although expected to slow considerably, will remain the main driver for global GDP growth. This is surely one of the most important bets to take, which is at odds with most consensus analysts. We are taking it for now, in view of the broad monetary leeway available twelve months after China first raised interest rates, and already high real interest rates in Latin America. Still, developing countries are the last support for earnings growth among manufacturers, and if these countries were to grind to a halt the impact would be considerable.

With economic growth only moderate at best in developed countries, most companies would no longer be able to rely on additional operating leverage to maintain margins (which could in any event decline to average levels given the economic slowdown). We thus expect a gradual decline in operating margins. In the longer term, they will be increasingly penalised by more direct competition from emerging-market companies. We are thus appropriately wary of companies with excessive operating leverage: the high proportion of fixed costs relative to operating income will hurt them.

Even if these assumptions bear out, we are far from the promised land

We can make some other observations on the basis of the above assumptions:

■ Beginning in 2008, most European companies showed that they learned their lessons from prior recessions. They took advantage of low interest rates to lengthen their debt maturities, while at the same time using the relatively buoyant market sentiment in 2009-2010 to raise capital. Thus, despite excessive margins and the contracting earnings outlook in 2012, European companies at least have solid balance sheets.

■ Equity valuations are relatively low compared to historical levels and interest rates, but they are still not low enough to be considered truly attractive. This is even more apparent given the fact that consensus earnings estimates have not really priced in the impact of the structural decline in earnings trends (i.e. over a long period, three to five years at best).

Against this backdrop, conventional forecasting methods – i.e. those designed for normal business

conditions – are ill-equipped to predict earnings and target prices on stockmarkets. Business leaders and consumers alike think logically (and in their own interest): with the recession appearing set to last for a long time, why should the former take the risk of investing in projects, and why should the latter engage in major spending?

The German stockmarket, more cyclical, is even cheaper than during reunification (in relative terms)



Very large caps have underperformed since the turn of the century, and this is becoming irrational



Is there a light at the end of the long tunnel for the equity market?

Will the European equity outlook remain dismal indefinitely? Our comments so far suggest as much. But this is not necessarily true. Over-indebted governments will have to find a way to force pension funds and other institutional investors to hold government bonds, which no one else really wants to buy. This would signal a de facto return to a period of «financial repression» not unlike what several major markets experienced in the wake of the Second World War. Financial history shows that one of the characteristics of this period was the progressive change in allocation towards equities from other asset classes. The reasoning is logical: with negative

real returns on a certain proportion of bonds that is required to be held, returns on cheap yet solid company stocks can only improve portfolio income. This rebalancing will take a very long time, since investors (now, as then) will first opt for strategies based on stockmarket momentum (however lacklustre). Of course, comparisons only go so far: growth in the 1950s was certainly higher than it will be in 2012. But the markets were also more domestic-oriented at the time. With such widespread globalisation nowadays, if most emerging markets can somehow keep their growth rates up then the situation would not be that different.

Tactics...

A broad bailout is plausible but will probably be slow to take shape

Governments may wait for the entire eurozone to teeter on the verge of bankruptcy before agreeing to real budgetary consolidation and greater integration. But this would be a high-risk strategy. It would represent a breakdown within the financial system that could asphyxiate it and drive Europe into recession. In addition, banks' liquidity situation has become so dire that the risk can now be considered systemic. Our main worry stems from the fact that it is impossible to estimate how long it will take for events to push leaders to the limit and lead to a salutary collapse (e.g. Lehman went bankrupt around one year after tensions on the US interbank market rose significantly). The situation could conceivably be resolved this week...but it is more likely that tensions in the eurozone will last much longer. If so, stockmarkets may not be able to bear even greater uncertainty without some major damage.

2012 could present a real buying opportunity – but we must be patient

It is conceivable that investors will be presented with an excellent buying opportunity in 2012. But we are not convinced that we have reached that point yet. It is very likely that the sovereign crisis will worsen before being resolved through an ambitious political response. All it takes for a significant and quick short-term rally (like the one in October) is a novel political move. But until a real structural political solution is devised, any rally will almost assuredly be short-lived. Also, despite the marked deterioration in the economic outlook, strategists at major European brokers

have staked out a relatively neutral position between defensive and cyclical segments. This suggests some persistent optimism about global growth, not overly weighed down by Europe. So either European growth will improve rapidly – surprising us and confirming brokers' theses – or expectations on the rest of the world are too high and these “consensus-makers” will have to rotate in some additional defensive segments.

Nothing new: we favour defensive segments and solid balance sheets

As we await better days, we still advise overweighting only defensive sectors. This includes healthcare, where companies – despite being hit by the rise in generics and cuts in public spending – still have significant room to reduce costs and reorganise their manufacturing processes for increased efficiency. In such a challenging environment, only a small proportion of companies will be able to at least maintain stable earnings and thus continue outperforming their benchmark indexes. Still, most of them are already trading at a significant premium to the market, which means they are not as attractive as they were at the end of 2010.

The same is true about balance sheets: this year, companies' financial leverage had no real impact on their stockmarket performance, as those with high leverage (i.e. with the most debt) performed in line with the others. We are more convinced than ever that this will change quickly in 2012, and we strongly advise a position with the lowest possible exposure to the leverage effect.

At this point it is only possible to invest in northern and central Europe

We still have a distinct preference for central and northern Europe. Growth there is higher, as it is driven by exports more than by consumer spending (which is affected by unemployment, low purchasing power and limited access to credit). We are staunchly avoiding peripheral Europe. Even if some sort of solution is found for the refinancing situation (although it will probably take some time), future growth in these countries will be overly constrained by restrictive measures imposed by creditor governments. More than their debt problems, these countries' main weakness has to do with their lack of competitiveness. In any event, despite significantly underperforming over the past 18 months, the stockmarkets of the PIGS countries are no less expensive than those of their



northern counterparts. This is hardly consistent, especially as regards defensive markets (like Switzerland).

We are also still wary of a number of countries considered solid but with limited visibility on long-term equilibria (typical of France). On the other hand, some southern European countries (like Italy) now on overly shaky ground but with generally healthy fundamentals could provide a positive surprise – but not in the near term.

for investor reticence. But with earnings estimates heading downward, a bird in the hand is worth two in the bush. We advise, more than ever, a solid weighting in stocks with a high and safe dividend.

Big is increasingly beautiful

We also still prefer large caps to mid caps. The total lack of visibility favours international blue chips: solid balance sheets, much more cash (or much better access to the capital markets), more export-oriented towards emerging markets, and less likely to be slapped with new taxes by over-indebted governments. And with institutional investors likely to return one of these days to more “normal” weightings in European stocks, we would not exclude the possibility that they will tend to focus on a small number of companies that they know well rather than spread their investments over smaller, expensive stocks that they have not been following (similar to the “nifty fifty”, i.e. around fifty stocks, like General Electric, Coca-Cola and IBM, which in the 1960s and 1970s gradually gained the favour of US institutional investors, becoming increasingly expensive core portfolio holdings). Bear in mind that the biggest companies do not often fare well on the stockmarkets during the first three or four months of the year, and so our view is more strategic than tactical.

High dividend yield is the best possible insurance

With risk-free rates set to remain (albeit artificially) low for a while, companies keen on and capable of delivering at least stable dividends will be particularly sought after. Nevertheless, the strategy built around high dividend yields did not outperform the broad index in eight of the ten years of the last decade. Investors were more inclined to favour faster-growing segments (or stocks) rather than segments that are most generous with their shareholders. This preference can also be attributed to the inversely proportional relationship between dividend yields and earnings growth: in most cases, the higher a company's dividend, the weaker its short-term earnings growth capacity. At this point, concerns about future dividend payouts may be legitimate (at least for certain companies) and account in part



The European debt crisis: there is more to this than meets the eye

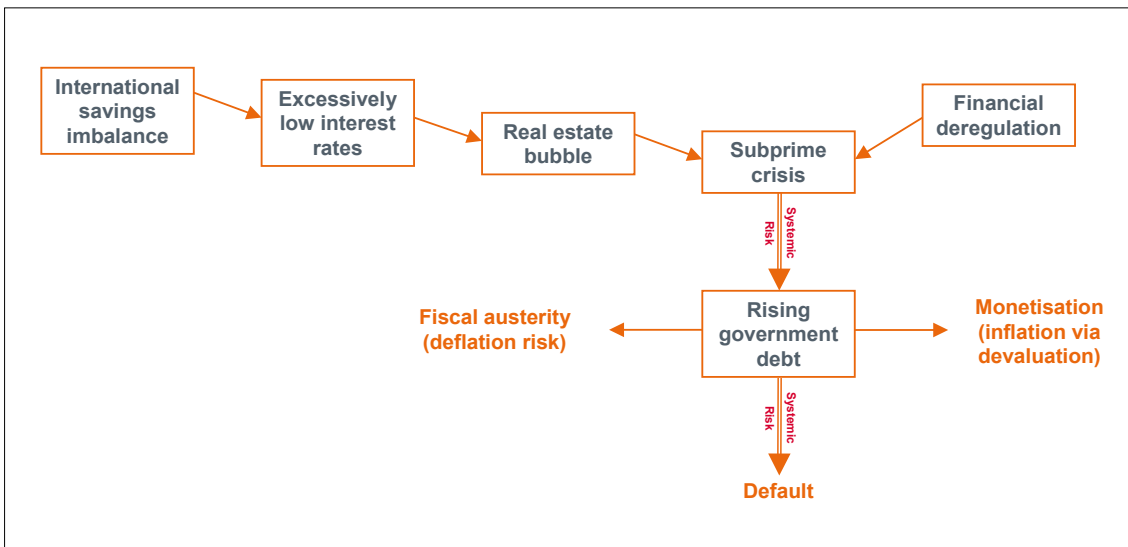
BRUNO JACQUIER

Over the past two years we have written extensively on the issue of sovereign debt. To cover the topic fully would require a book of several hundred pages, but this article should suffice to capture the highlights and summarise the recommendations that are most useful to investors.

We should start by pointing out that the present crisis is merely the logical consequence of the subprime implosion. Between 2007 and 2009, fearing a depression and a collapse of the financial system, governments across the developed world ran up huge deficits to spur economic growth and bail out beleaguered banks (see diagram below). These new shortfalls came on top of already heavy debt burdens and sent debt-to-GDP ratios soaring to the point of no return. Experts on the subject, such as the economists Carmen Reinhart and Kenneth Rogoff, believe that a ratio above 90% already weakens growth to the point where default becomes highly probable.

inflation) or default (by arbitrarily erasing all or part of the sums owed). As with the Three Musketeers there is actually a fourth method, financial repression, that we will delve into another time. Here let's simply say it means passing legislation that forces banks and other investors to hold sovereign debt with a view to driving down interest rates.

Finally, the current situation is not so much a debt crisis as a financial one. If commercial banks' balance sheets had been healthy enough to stomach a Greek default at end-2009 when concern about the issue began surfacing, we



It is also worth noting that there are basically three ways for countries to solve a nagging debt problem (see diagram above). They can balance the state budget (by slashing expenditure and raising taxes), monetise debt (by printing new money, causing depreciation and imported

would not be fretting about it now. But since that was not the case, European leaders have been trying to buy time. They have set up loan-guarantee facilities to bail out first Greece, then Ireland and Portugal, so that banks in the meantime would be able to dump some of their toxic assets (see

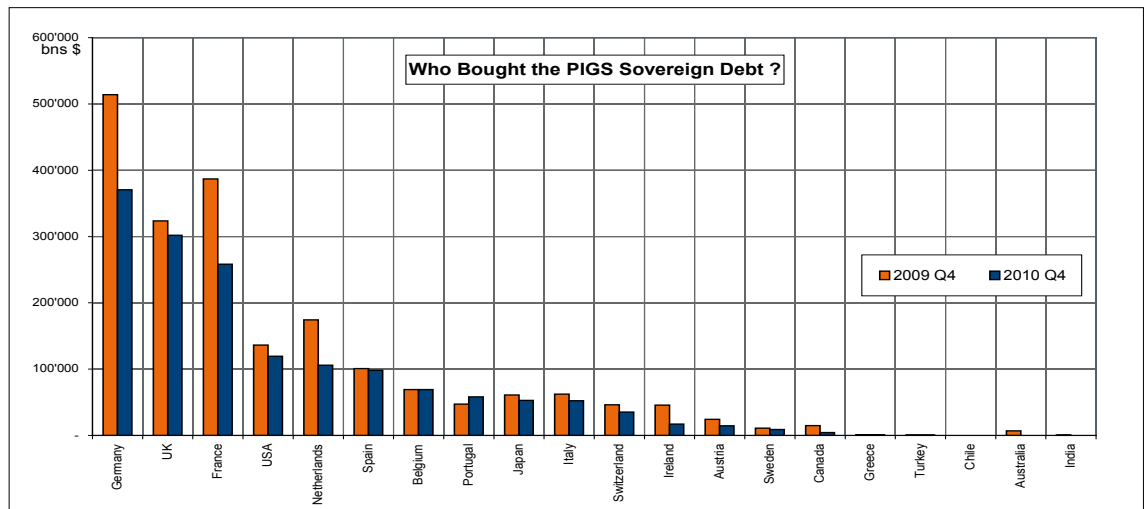


chart below). This pooling of risk was meant to prepare for orderly defaults by Greece, Portugal and Ireland that were bound to come eventually.

Sadly, politics does not march to the same beat as the markets, which have been in a far greater hurry to address the debt issue than heads of states, governments or even banks. The question now is, **how to avoid systemic risk**.

B. A less ideal solution that might nevertheless be agreed to would be international:

— **The EFSF and the ECB could deal with the solvency issue by managing the sovereign debt of Greece, Ireland and Portugal** and could recapitalise tottering commercial banks.



A. The best solution, in our view, would be effective action on the part of Europe's institutions:

— **The European Financial Stability Facility (EFSF) could deal with solvency-related problems** by organising the default of countries (not only Greece but also Portugal and Ireland) whose debt has spun out of control. The remaining debt could be guaranteed by issuing joint Eurobonds, and the EFSF should also recapitalise banks that risked going under as a result of book losses arising from the country bailouts. Finally, the European Central Bank would have to be held harmless for any losses it would incur.

— **The job of the ECB in all this would be to maintain liquidity** via quantitative easing on a massive scale. It would use the money thus created to buy the debt securities of countries like France, Italy, Belgium and even Spain that came under pressure owing to speculation but that would be able to pay their creditors back in the long run. The ECB would also provide credit lines to banks unable to borrow in the interbank market.

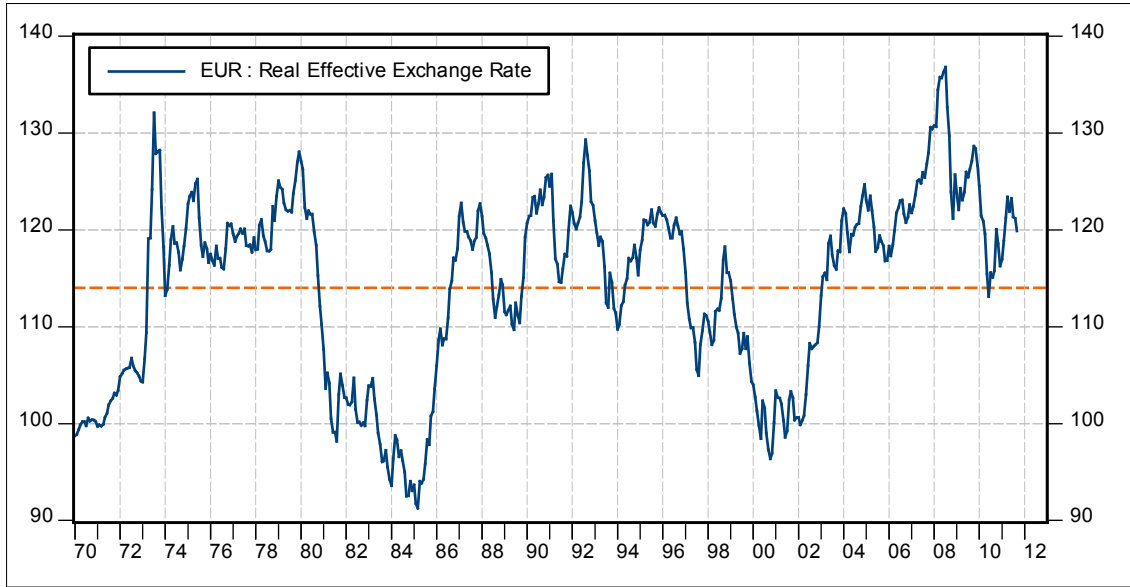
But even if the authorities could agree on this comprehensive solution, it would be difficult to implement for political, administrative, legal, ideological and even behavioural reasons. Fortunately there is an alternative.

— **The international community** (e.g. the G20, the IMF, the BRICs and Switzerland or a group comprising some of them) could deal with the liquidity issue by buying the bonds of countries like France, Italy, Belgium and even Spain that were embattled but still capable of paying back their debt eventually.

Under this scheme Europe would manage a small part of the problem but would shoulder the financial losses. The international community, for its part, would be left to tackle the bulk of the problem while facing much tamer risks. **Compared with the ideal solution, this one entails a huge drawback for Europe:** since it does not involve printing money, it would not result in euro depreciation. Actually the monetary impact would be quite the opposite as other countries would buy euro-denominated securities by selling their own currencies. **With the euro already overvalued by about 10% compared with the Continent's trading partners** (see chart below), **the added appreciation would create deflationary pressure.** This would drive down nominal wages, aggravating the social unrest that already jeopardises economic and financial solutions at present. So with growth now at a standstill, by abetting euro appreciation Europe would be shooting itself in the foot. And yet, European officials keep harping that the

sovereign debt crisis requires a joint response by all the G20 countries. This illustrates that they are in favour of an international solution, however imperfect it may be.

A. In the first case scenario, default would mean a purely financial crisis. Banks holding Greek debt securities would suffer book losses that would weaken their balance sheets, causing

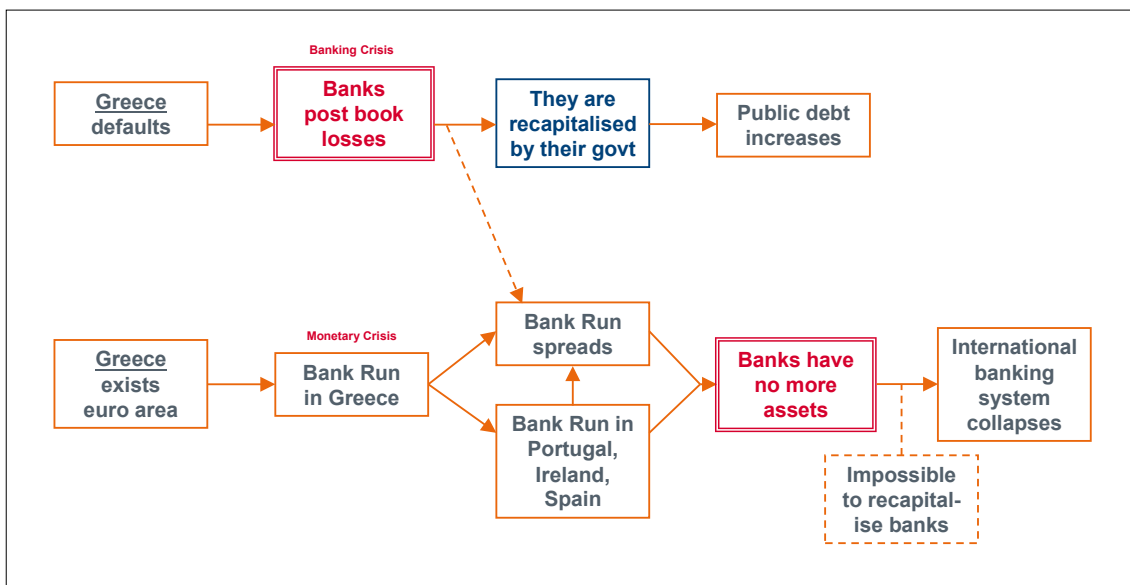


A flawed response would nevertheless be better than the dithering that has been dragging on for over two years and has left the international banking system threatened with a cascade of failures.

some institutions to go bankrupt and bring down others in turn. To stop the dominoes from falling, national governments would recapitalise the banks at risk by pumping hundreds of billions of euros into them. This would increase the debt burden, but it is a conceivable way out.

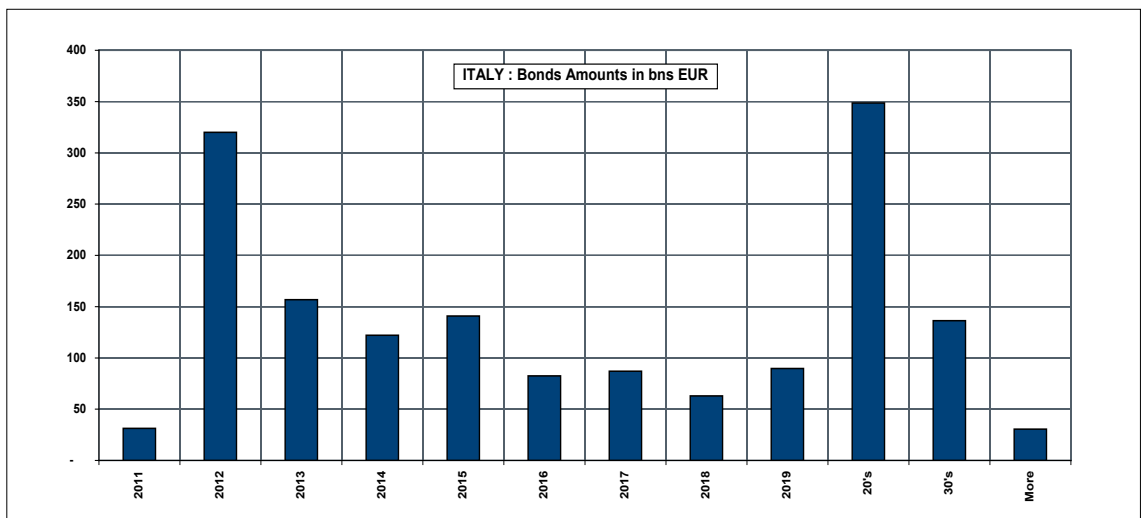
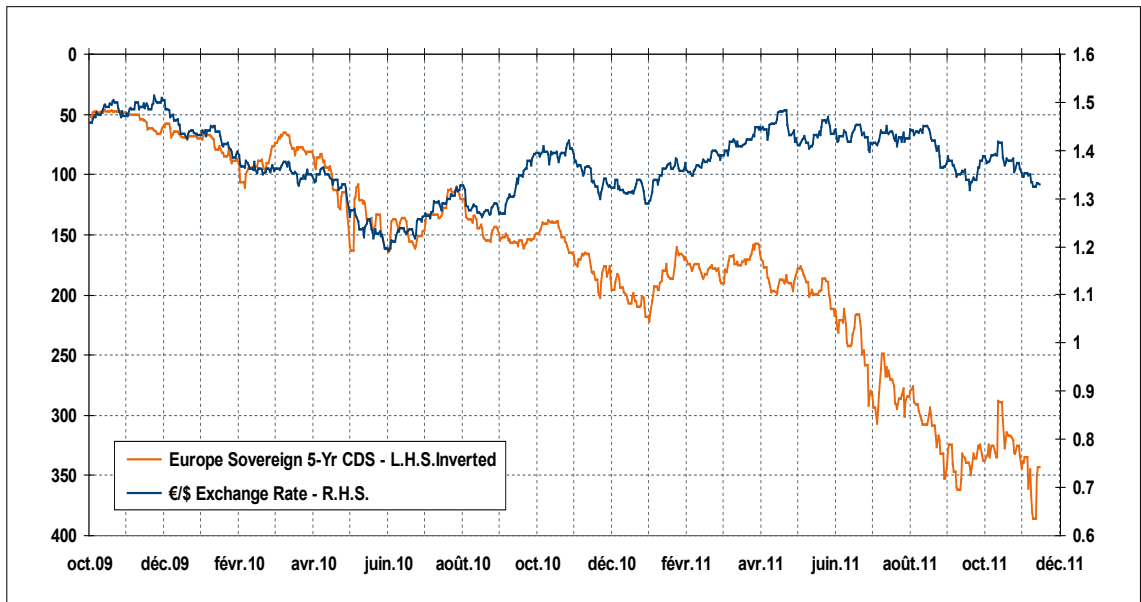
Since we have broached the subject of systemic risk, it is vitally important to understand what a Greek default or an exit from the euro zone would mean. The difference between these two contingencies is huge (see diagram below).

B. In the second case scenario, an exit from the euro area would mean a currency crisis. Greeks, having no confidence in the future value of their bank deposits and other assets, would



rush to transfer their money to another country or would simply withdraw it in cash and stuff it in a mattress. The government would declare a freeze on capital flows but to no avail: people with euros stashed away would never convert them into drachmas, since doing so would involve a devaluation. Thus the euro, being an international currency, would continue to circulate in Greece after the country left the euro area. Worse, the run on banks would not be confined to Greece. Citizens of other Euroland countries, fearing that they might soon be in the same predicament, would queue up in turn to withdraw their savings. And this time the cascade of bank failures would not be limited to Europe. Unlike a default, an exit

from the euro area would not mean banks writing down assets but banks with no more assets at all, and it would be impossible for governments to step in as it would take trillions of euros to compensate the flight of deposits. To prevent an implosion of the financial system, a way would have to be found to stop the bank run spreading from Greece to Portugal, Ireland, Spain, etc. Government leaders could sign a treaty vowing that their countries would never leave European Monetary Union. But who would believe them after all the flip-flopping, backtracking and muddling that has tarnished the union's history? The latest agreement on bailing out Greece lasted just five days before falling apart.



So in either case there is a risk of multiple bank failures. But recapitalising Europe's banks would be possible if Greece only defaulted, not if it opted out of the euro area.

Governments would be able to absorb banks' book losses but would be helpless in the face of an international run on banks. For this reason we believe that no country will leave Euroland: **members in difficulty will default inside the currency zone.** Since August 2010 the markets have clearly dissociated the default risk from the risk of a Euroland break-up (see chart below), and they are right.

Italy has now become the focus of investor fears and the accompanying speculation.

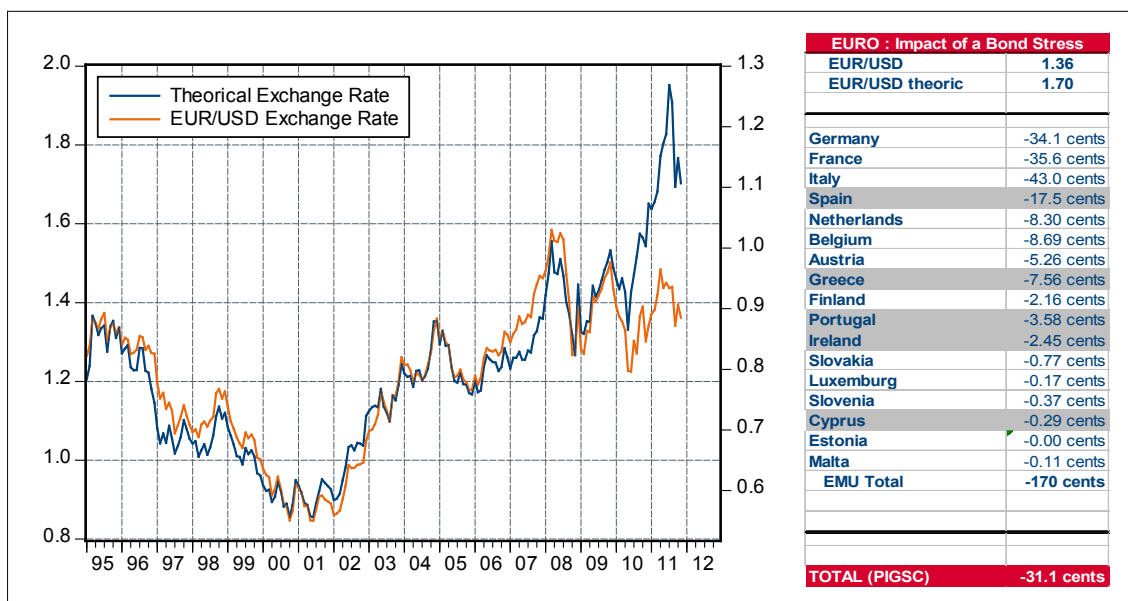
The problem is that the market for Italy's debt securities is the third-largest in the world. **On the face of it the Italian state is too big to fail.** Political leaders and central bankers are going to have to get together to combat the financial crisis, which as we have seen they have the means to do. What is more, they are going to have to tackle the issue rather sooner than later because Italy must renew 20% of its sovereign bonds next year, totalling more than €320 billion (see chart below).

According to recent rumours the IMF could provide credit lines totalling €400-600 billion that would keep the Italian government afloat for 12 to 18 months. Yet IMF spokesmen deny

that negotiations for such assistance have taken place, and in any case even a lifeline of that size would not reassure the markets. Until a decision commensurate with Italy's yawning debt is taken, investors will continue to envisage a nightmare scenario. During this period of intense stress, which could last another few months, the euro will be under pressure and the euro/dollar exchange rate will see increased volatility.

We have estimated Italy's value in the theoretical EUR/USD rate to be 43 centimes (see chart below). Put bluntly, if Italy were to default, the euro would trade slightly below parity with the dollar. Although that will not happen, the thought of it will haunt investors in the coming months. Thus, **the single currency could very well fall below 1.25 against the greenback before bouncing back to our target of 1.57 by end-2012.**

That may seem odd but once the systemic risk has been dispelled, provided the ECB maintains its fierce opposition to quantitative easing the euro is bound to surge against the dollar. The US currency's fundamentals are flimsy: an undisciplined monetary policy, a yawning budget deficit, high inflation and an overstated credit rating. **More than ever, timing is now crucial for those looking to invest in the euro/dollar rate.**



Economic forecasts

GDP growth and contributions to global expansion (BPER estimates)

Country	GDP 2010	GDP 2011 BPER Estimates	GDP 2012 BPER Estimates	Country weights	Contribution 2011
United States	2.8%	1.5%	2.2%	23.1%	0.51%
Canada (IMF estimates)	3.2%	2.1%	1.9%	2.5%	0.05%
Euro Area	1.8%	1.4%	0.0%	19.3%	0.00%
United Kingdom	1.4%	0.6%	-0.1%	3.6%	0.00%
Switzerland	2.7%	1.7%	0.2%	0.8%	0.00%
Russia	4.0%	4.7%	4.5%	2.3%	0.11%
Japan	3.9%	-0.5%	2.0%	8.7%	0.17%
China	10.3%	9.0%	8.0%	9.3%	0.75%
India	10.1%	7.5%	7.0%	2.7%	0.19%
Brazil	7.5%	3.5%	4.0%	3.3%	0.13%
Mexico	5.5%	4.0%	3.5%	1.6%	0.06%
Others (IMF estimates)	6.8%	6.8%	6.3%	22.6%	1.41%
WORLD	4.7%	3.5%	3.4%	100%	3.4%

Comments

- The GDP growth rates shown above are final for 2010. Projections for 2011 and 2012.
- Each country's weighting has been translated into US dollars and is based on the principle of purchasing power parity, which takes account of differences in prices and standards of living.
- The countries are ranked by the size of their economy, in decreasing order.
- Contributions to global growth are calculated as follows: the GDP growth of each country is multiplied by its size, with the total adjusted to the aggregate weighting of the countries listed. The sum of the contributions works out to 3.4%, a good estimate of global GDP growth for the current year.

Real estate – problem or solution?

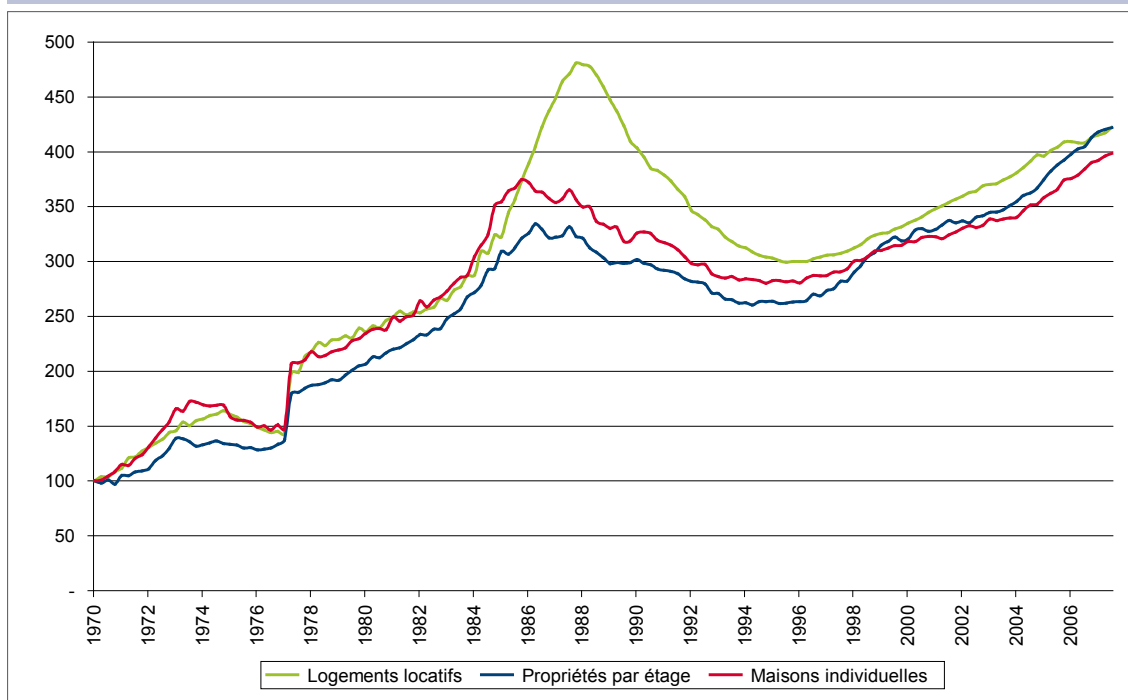
JAUME SABATER

There is increasing talk of a real-estate bubble in Switzerland. We have recently heard a number of warnings and alarmist comments. However, we have been hearing similar statements for years, since prices started rising after the early-1990s recession. At the same time, high-quality properties are retaining their appeal for investors. In the circumstances, should investors be wary of real estate, or take an interest in it?

real-estate market. Switzerland and its real-estate market have a number of comparative advantages. The investor's adage that «trees do not grow to the sky» remains true, and given today's historically low interest rates it is possible or even probable that real-estate prices are close to their limit. However, today's general uncertainty is both supporting prices and stoking fears of a correction.

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Swiss real-estate prices. Source BPER and Wuest & Partner.



Rising Swiss real-estate prices are the result of both macro- and micro-economic factors. The real-estate market's fundamentals are solid and healthy, and although the outlook is uncertain, the Swiss economic situation remains stable. Switzerland remains highly attractive in terms of business, taxation and tourism, and this underpins its real-estate market. The global economic slowdown is having an impact. However, when economic uncertainty increases, comparisons with other countries become more important in justifying the appeal of a given

Widespread concern about the quality of moveable assets is prompting investors to put part of their wealth into high-quality real estate generating regular cash flow. Prices in this market category are unlikely to fall significantly. If a property's yield is at least 4%, then even an increase in interest rates is unlikely to damage capital values. Asset classes with «safe-haven» status are in short supply, which makes these properties especially attractive. Demand for such properties is consistently strong, whereas supply is currently low. In addition, investors have a lot

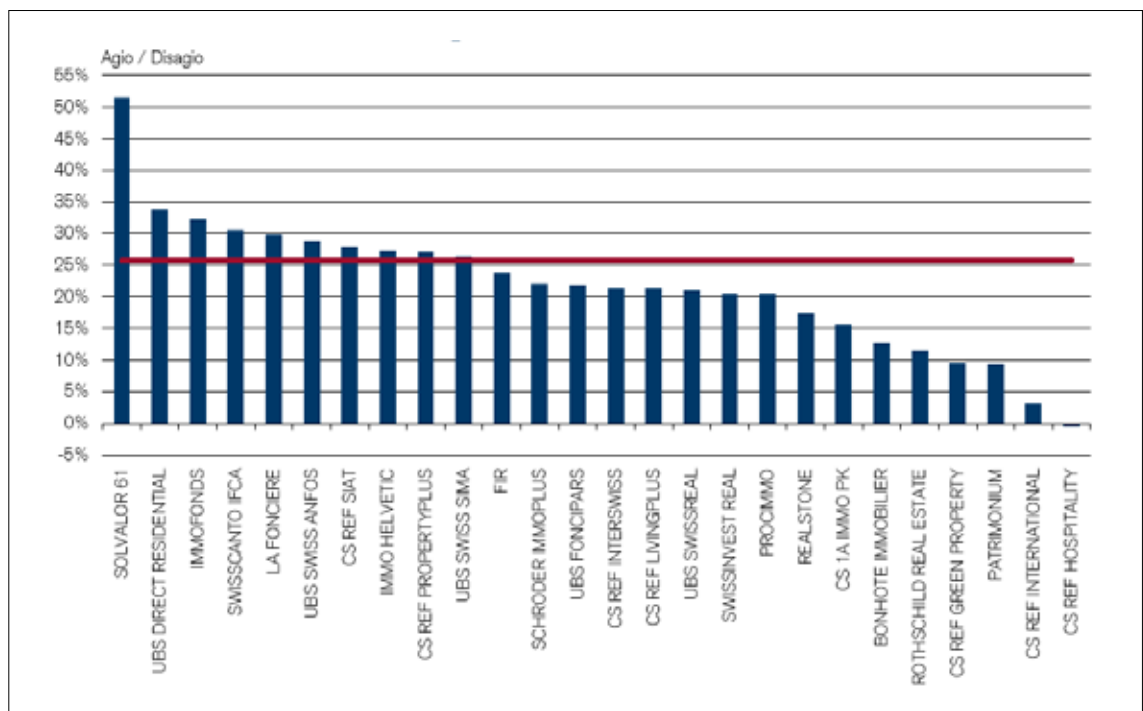




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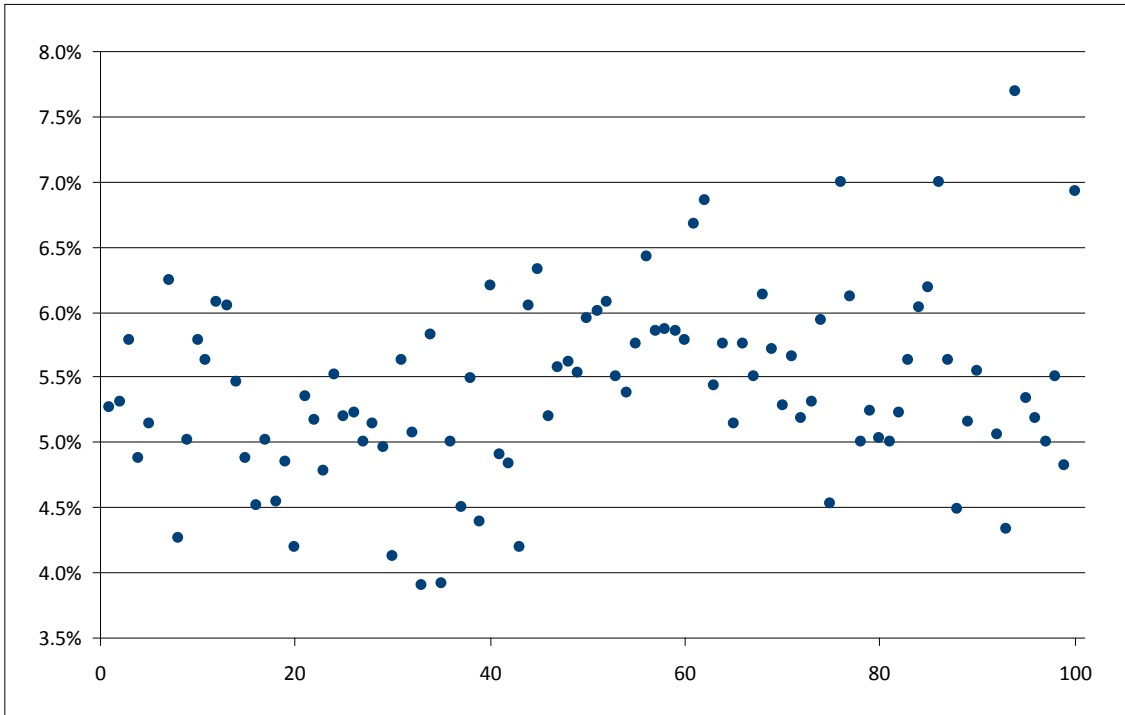
of money to invest at the moment, particularly institutional investors, and there is a limited number of real-estate vehicles through which to access the market. Strong demand has meant that listed Swiss real-estate funds are currently trading at an average premium of 25%.

The extent of demand for this asset class, combined with the lack of available products, was demonstrated by our successful launch of Switzerland's first real-estate SICAV in March 2011. The initial size of the fund was CHF300m, and the issue was almost three times oversubscribed.



Source : Credit Suisse

Gross yields on a sample of properties analysed as part of investment research performed by Edmond de Rothschild Real Estate SICAV- Swiss.



Properties can be regarded as having long-term appeal if their yield is in the 4-6% range. We have analysed a large number of individual properties, portfolios and transactions in the last few months, involving a total value of almost CHF3,000bn. We have concluded that this level of yield remains achievable in the Swiss market.

However, the situation may be different for assets that do not fall into the high-quality category. In future, we may see a greater divergence of prices between «risk-free» properties and ones that are riskier because of their location, their condition or their tenants.

In the residential market, the same economic uncertainties are leading to a gloomier jobs outlook, and this is prompting individuals to put

off buying a home. However, there is no surplus housing stock across all markets as there was in the early 1990s, and there is still demand in the market.

On a medium-term view, therefore, today's recessionary conditions in most developed economies are unlikely to affect the ongoing appeal of real-estate investments. Longer-term, if we look at 3- to 5-year inflation projections, real estate could be useful as an inflation hedge.

As a result, the best investment profile could consist of a very high-quality property with a secure long-term yield, funded by a large but not excessive mortgage, at a very low interest rate that is locked in long-term.



Tactical allocation (%)

CHF PORTFOLIO

Asset class	Switz.	Europe	UK	USA	Japan	Asia/other emerging regions	Commod.	Precious metals	Sundry or global	Total
Short-term	9									9
Fixed income	19	2								21
Equities	10			2	2	3				17
Directional hedge funds		5								5
Nondirectional hedge funds	25									25
Property	6								7	13
Commodities, Precious metals								10		10
Total	69	7	0	2	2	3	0	10	7	100

EUR PORTFOLIO

Asset class	Switz.	Europe	UK	USA	Japan	Asia/other emerging regions	Commod.	Precious metals	Sundry or global	Total
Short-term		15								10
Fixed income		19							2	21
Equities	6	4		2	2	3				17
Directional hedge funds		5								5
Nondirectional hedge funds		25								25
Property									7	7
Commodities, Precious metals								10		10
Total	6	68	0	2	2	3	0	10	9	100

USD PORTFOLIO

Asset class	Switz.	Europe	UK	USA	Japan	Asia/other emerging regions	Commod.	Precious metals	Sundry or global	Total
Short-term				15						15
Fixed income				21						21
Equities	6			8		3				17
Directional hedge funds				5						5
Nondirectional hedge funds				25						25
Property									7	7
Commodities, Precious metals								10		10
Total	6	0	0	74	0	3	0	10	7	100

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