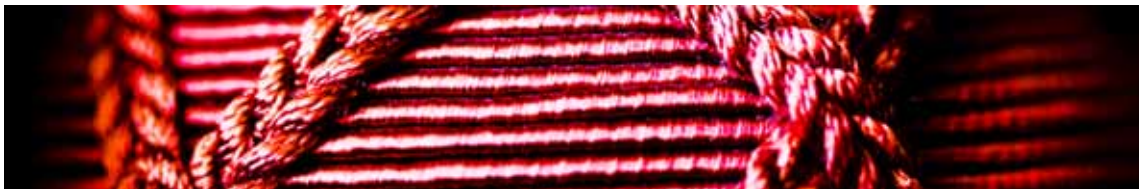


September 2011

Trends



BANQUE PRIVÉE
EDMOND DE ROTHSCHILD



Close up of a curtain at Banque Privée Edmond de Rothschild, Geneva - ©Tobias Regell

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Politicians haven't changed

PATRICK SÉGAL

In the October 1996 edition of *Trends* we wrote this about the embryonic euro area:

«The alchemy behind the strong euro: 2.9%»

The creation of a single European currency has been hailed by all the EU governments as a kind of wonder drug to ensure long-lasting relief against economic stagnation. As 1997 budgets are submitted to national parliaments for approval, it is amazing to see how they all provide for a deficit of exactly the same proportions: 2.9% of GDP. And the accounting used to arrive at this monolithic shortfall is creative indeed. Sales of state assets are treated as recurrent revenue and economic growth is cheerfully forecast at 2.5% a year, even in countries that are backsliding into recession. Government officials throughout the Union are counting on a strong currency and tame inflation to make the difference. Only Germany is considering structural reforms. Even Italy and Spain, which have just experienced a steep downturn, are presenting themselves as paragons of virtue. Yet one need not be a financial comptroller to surmise that even the cooked 1997 budgets will be about the same size as the ones for 1996. Tax revenues are down, pointing to a weakening trend in domestic demand.

In Switzerland, where a sixth quarterly drop in GDP hammered home the fact that we are still in recession, the SNB has lowered short-term interest rates to bedrock level and injected huge quantities of liquidity into the banking system to force down our overvalued franc. Deficits at every level of government—federal, cantonal and municipal—continue to climb precipitously as unemployment worsens.

In France the Juppé government is holding its course, convinced that next year's recovery will prove the wisdom of its policies in time for the 1998 election. Yet voters are weary of waiting for the promised land, a fresh vision of which is forever being painted for the next six months. Consumption has been kept artificially high by heavy discounts on sales of new cars. Joblessness is rising and there is concern about possible new layoff plans.

Raymond Barre contends that the jobs situation in Europe will not improve until workers are worse off staying home than working for the minimum wage. Sadly, the political courage needed to put this idea to work is lacking.

Germany has been the one country brave enough to adopt deep-running reforms, though they only address some of the problems. Thus, a pleasant surprise for Europe can only come from its economic powerhouse with help from an upturn in the UK, provided exports of capital goods remain strong.»

U.S. Deficit



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September 2011 will be a crucial month for Europe. Germany now has to face up to its responsibilities: in the midst of an export boom driven largely by euro weakness, will it torpedo the Union's babelish unity for the sake of lowly domestic politics? On 7 September the German Constitutional Court will rule on the lawfulness of the bailout funds set up by the European Union. Then, on 23 September, Germany's upper house of parliament will vote on the expanded powers of the European Financial Stability Facility (EFSF). If either body says no, Europe will face an unprecedented financial crisis. Even with Germany's blessing, we will see several years of economic stagnation in which national budgets will have to be balanced. No



Have a good vacation!



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matter who wins in the various elections slated for 2012, the new governments will be walking a tightrope. Confidence, that all-important ingredient for reviving growth in consumption, can only be restored—and gradually at that—by cutting public spending and raising taxes. Not until then can the lunacy of running up debt at any cost be put to rest. Many European governments have already courageously set a virtuous example. There is scope for optimism medium term in that European governments have understood the markets' message, a message dictated by common sense.

In 2009 we wrote that while governments had rescued the banks, they were now thrust into the front lines. They are still there. The financial collapse of any large government would bring down the entire banking system. In this respect there seems more to fear from the US than from Europe. Given the bitter struggle between the Democrats and the Tea Party ayatollahs, failing a huge blow-up no one looks ready budge until 2013. With the annual deficit running at 10% of GDP, debt held by the public will exceed GDP in

two years' time. Manhattan's top 100 billionaires pay 7% in taxes, on average, while an executive with an income of \$250,000 pays 25%. Most US companies pay no taxes and even receive subsidies or tax credits. Won't Google receive \$700 million in annual tax credits for several years if it buys Motorola Mobility? What does the Tea Party hope to gain, other than a social upheaval, by eliminating unemployment benefits and overtaxing the middle class? In Las Vegas, the former pinnacle of gambling and real estate, the queues at soup kitchens lay bare a system run amok and dying. If the US continues to deflate consumption by slashing social security benefits while freezing taxes on the ultra-rich at rock-bottom, then obviously it will end up in a severe recession with violence in the streets. America cannot withstand long-term unemployment exceeding 10% while at the same time the big companies pay more to their CEOs in bonuses than they do in corporate tax. The hundreds of billions of dollars kept abroad by affiliates of US firms to avoid taxes would easily suffice to balance the federal budget. Consider Michele Bachmann, whose clinic was subsidised

by the government. Listening to her preach, as if she was chosen by God, brings back pre-war memories. Taxation, a normal practice done away with by Washington lobbies and lawyers paid to find loopholes, must be urgently restored in the US and in Europe as well. Otherwise we will be headed towards a collapse of all paper currencies and an explosion in the price of gold.

Switzerland too has become a major source of instability

A bit of common sense and professionalism on the part of our politicians would soon bring back that modicum of confidence that has vanished. It is sad how upcoming elections can drive political animals crazy.

Meanwhile Switzerland too has become a major source of instability. The Swiss National Bank's miscues have prompted unparalleled speculation around the world. Our franc has been knocked about as wildly as sugar, cocoa and pork bellies. It is now 30% overvalued and is sending the Swiss economy to the bottom. Machine tools, tourism, banking and farming are entering a deep crisis the consequences of which, by the year's end, will be dire for a country that sells 75% of its exports to the European Union. The franc's surge against the dollar is equally devastating. Suggestions from various quarters include lowering wages and paying frontier workers in euros. The only effective solution would be to take radical action

by setting a euro peg at 1.30, with all the risks that would entail. If the situation continues as it is now, Switzerland will be in recession before 2011 is over and unemployment will shoot up dramatically.

Orphaned traders

The markets are volatile. High frequency trading now accounts for 60% of dealing in equities on the New York Stock Exchange, most of it generated by index rebalancing, options and ETFs. The business has turned virtual, and everyday investors have fled for fear of being taken to the cleaners. The sell-off in August was one of the most savage since 1950. It pointed up the absurdity of today's hypertrophic world of finance, a world that has been severed from economic fundamentals but that lobbies in America and the UK prevent from being dismantled by financing the campaigns of politicians bent on re-election. In conditions like these, gold is a must in any portfolio, along with shares in well-managed international companies that pay a high dividend. Once September is over we will be able to think about 2012.

PS – Glencore has plunged 30% since its IPO at a pumped-up price. Paulson has had a disastrous month and is down 30% year to date. Even the best pros are being hammered by the markets' hellish volatility. Rumour has it that the loan granted by the Bankia group to Real Madrid to buy Kaka and Ronaldo has been tendered as collateral to the European Central Bank to raise cash. If Bankia runs into difficulty, would the ECB president, Jean-Claude Trichet, find himself as Real Madrid's centre-back?

All the best to everyone as we get back to the grind.

Don't bounce back into a wall!

FRÉDÉRIC BINGGELI

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2011 has turned out to be a year fraught with dangers. Cracks have opened up everywhere, the ground is shaky, the signposts have vanished and politicians have not provided a single credible solution to the problems facing us. Decidedly, our environment looks more and more like the Dirty Thirties, with economies hobbled by overproduction and authorities struggling desperately to avert deflation and depression. The real issue is that for 12 years now the developed countries have relied almost entirely on monetary policy tools while taking minimal structural measures. Interestingly, to contain the effects of the technological revolution and its main offshoot, globalisation, the US and Europe have chosen different options.

The EU has plumped for monetary integration. However, by completely disregarding the concurrent need to integrate budget and fiscal policies and harmonise framework conditions in the labour market, the Union has missed the point and tacitly encouraged countries that already had a penchant for living on credit to do so. Borders were opened and currencies abandoned without for a minute considering new safeguards. It was believed, in particular, that enlarging as fast as possible would save the continental economy (including services) from being hollowed out by globalisation. Finally, the social safety net woven by Europe's social democracies will be so expensive that governments will end up crushed by their credit lines. The whole system is fatally flawed!

Back to Schengen controls



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Meanwhile the United States, influenced no doubt by the post-industrial model inherent in Facebook and Google, has opted instead for a more open economy. Menial manufacturing has been consigned to sweatshops in the emerging countries while engineering, marketing and socialising have been kept at home. But with the emerging regions now aping America's lust for consumption, prices of raw materials, food and energy have surged and are boomeranging back into the supersize products that US consumers love to load up on. America too has seen its economy hollowed out by offshoring. And its housing market has yet to recover from the unravelling of pay-later mortgages on clapboard shacks, just as Japan has failed to recover since its real estate industry collapsed 20 years ago though without touching off a global financial crisis.

Politicians on both sides of the Atlantic have been painted into a corner by a process they launched over a decade ago. Bent on re-election and completely overwhelmed by a situation requiring the courage to make incisive, deep-running reforms, they have come up with nothing better than focusing public opinion via media attention on finance and banking as the source of all our woes. Admittedly there has been intemperance, indulgence and excess, but it is the logical consequence an unbridled expansion of money supply and asymptotic, Japanese-style interest rates (i.e. tending towards zero).

2011 has clearly seen the paths of these two wayward comets, the US and Europe, converge. But it is also a year of major political upheavals. The Arab Spring and its toppling of tyrants stands as a legitimate peoples' revolt, and our point here is not to throw a wet blanket on the movement. Yet one wonders what to make of this chain of convulsions that has ripped through entire countries. In such a geopolitically sensitive area, it will take time for them to crystallise into political stability and economic growth. If we add to this the risk of crisis-bred social unrest in the developed world and the enormous strains caused by inflating food budgets in many emerging regions, there is little doubt that our planet has seen so much social, political and geopolitical instability at once for a very long time. The danger lies in the conjunction of these three factors.

A lot of things are happening right under our noses. They happen but go unnoticed. One senses a deeply unsettling indolence about events in general, a total inability to grasp their essence and construct a broad view of the problems at hand.

Europe goes forward



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All financial markets seesaw between phases of hope and horror. They behave as if David Copperfield were manipulating the dangers, alternately making them vanish and suspending them over a void.

The main problem at present is waning confidence in the world's two leading currencies and the desperate flight into safe havens. The second issue is artificially low interest rates and the continual injection of liquidity into the financial system. Equities are not overvalued: many companies are healthy, and dividend yields are not only reasonably foreseeable but also tend to be astronomical. So like sound bodies in a sick world, stockmarkets are being bled by would-be creators of alpha and by the superstructures that they have built to generate returns unavailable in money markets. Wracked by fear of a global recession and churned by changes to leverage and risk arbitrage, shares have returned to levels of volatility that raise the spectre of systemic risk.

In an environment like this it is hard to see anything but emotional logic, which poses a glaring challenge to our most deeply seated certainties. To respond professionally, one has to put things in a general perspective, stop looking about short term and stay on course for the long haul. We have diversified our investment policy with a view to providing a strong frame for our clients' portfolios. These moves are also irons in the fire that can be shaped to fit the various crisis exit strategies. A political solution must be found or there will be chaos. But the politicians concerned do not inspire confidence, and in such times it is public administrations that see their power grow.

Actually we should only allow our survival instinct to guide us in situations as complicated and technical as this one. As the recent past has illustrated, anything is possible—not only the worst scenario but also the most outlandish one.

Economy back on a knife edge

PIERRE-YVES BRACK

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Themes

One year on and the same doubts and fears are returning to the fore. What is more, the causes are the same and so are the effects. Will this period in which anxiety and risk aversion are maxing out end in the same fashion as 12 months ago? This is the question on everybody's lips, to which our in-house economist would answer "it could go either way".

Let us cast our minds back to the spring of 2009: The systemic risks threatening the international banking industry (resulting from the subprime crisis) dissipated following mammoth intervention by governing authorities that even included the de facto nationalisation of mortgage lenders Freddie Mac and Fannie Mae and insurer AIG. Following a record-breaking injection of liquidity (through a mixture of conventional and less conventional measures), economic activity levelled out and started recovering. Investors, relieved, greeted the turnaround with requisite cheer, sending US equities up by more than 80% between that spring and May 2010.

Remember May-September 2010: After climbing by 80% in the space of 15 months, doubt, anxiety and greater risk aversion returned to centre stage (in May). US household debt, the sovereign debt crisis affecting several European countries and expectations for a rise in inflation (in response to large-scale injections of money) stoked fears for the swift onset of a double dip. Markets took a beating, falling by 17-18% in the space of two months, with cyclical spaces bearing the brunt and falling by 20-25% (see chart below).

It took news of a second round of stimulus, dubbed "QE2", and some less alarming economic data for the market to level off, as it did until the end of September. After this, investors gradually became convinced that Armageddon had been avoided and the economic (and financial) recovery would receive new wings.

And May-September this year: Following a rally of 35% between September 2010 and May 2011,

suspicious, anxiety and risk aversion once again became the watchwords. The anxiety relating to sovereign debt (this time round encompassing the US, which has lost its triple-A rating), the stranglehold of much-needed fiscal austerity and the listless job market (in comparison with earlier recoveries) together suggest that the worst is in store.

Identical fears trigger an identical reaction. This time the market has slid by 17-18%, with cyclicals once again dropping by a more substantial 20-25%.



Hope must «change sides» for equity markets to level off and produce a recovery. Investors are hanging on every word uttered by central banks, hoping for another stimulus package ("QE 3") and paying close attention to political authorities, equally in the hope that the sovereign-debt issue will henceforth be managed more credibly. Right now, our economist assigns a 50/50 chance to the prospect of another recession occurring.

In the same way as this time last year, the uncertainty is at fever pitch.

BUT SIZEABLE PROGRESS HAS BEEN MADE OVER THE PAST 12 MONTHS

The uncertainty is just as real as in the summer of 2010 and is resulting from similar issues. However, sizeable steps forward have been made since then:

Healthier bank balance sheets: Banks first received an injection of government money. Then they were able to tap financial markets again. Finally, growth in deposits (a cheaper source of funds) started outpacing lending. Consequently, US banks have been able to shore up capitalisation and capital-adequacy ratios even though the rules for calculating these ratios have been tightened considerably.

Forecast-beating earnings growth: In Q2-11, 72% of S&P 500 companies delivered forecast-topping revenues and 76% of them reported earnings exceeding expectations. As an aggregate, revenue rose by 13% and earnings by 17%. This was the result of four factors:

- The increasing proportion of business accounted for by emerging economies, which though losing traction are still growing three times as fast as advanced economies. Their impact on the global equation is rising all the time.
- The benefits of restructuring carried out in response to the earlier crisis.
- Gains in market share chalked up “on the back» of companies that chose or were forced to scale back business (or, for that matter, cease trading) in response to economic and financial hard times.
- Interest expense reduced by smaller debt burdens and low interest rates.

Lastly, for many industries, one should bear in mind that the **impact** (both direct and indirect) of the disasters unfurling in **Japan** this spring **has undoubtedly peaked**. Disruptions to supply chains, production and distribution are being resolved and reconstruction is being undertaken.



CONCLUSION: RENEWED CONFIDENCE A SINE QUA NON

Everything hinges on confidence. New measures are not what is needed. What is required is that measures must be deemed credible by investors in order to underpin market valuations of bonds and equities.

This will not happen overnight, of course. Even if investors have priced in a zero-growth scenario, exaggerated moves are still possible due to the pervading mood of anxiety.

As the old saying goes, wait for the falling knife to hit the ground and then pick it up by the handle.

While patience and caution are necessary qualities, there is no need for gloom. In the longer run, if investors can actively manage their positions, overselling will give rise to opportunities – as was the case in both 2009 and 2010. **And while there is a 50% risk of recession, there is also a 50% chance of no recession!**

Tactics

Major uncertainty over the economic and financial outlook (as in the months ahead) calls for a **reduction in the cyclical exposure of investment portfolios**, especially since our economist assigns a 50% probability to a further recession. At prevailing market prices, however, **this is easier said than done.**



	% Ventés Supérieur Estimations	Croissance Ventés An/An	% BPA Supérieur Estimations	Croissance BPA An/An
S&P500	72%	13%	76%	17%
Ex-Financières	71%	13%	76%	17%
Energie	76%	31%	69%	42%
Matériaux	73%	18%	67%	48%
Industriels	68%	8%	79%	17%
Consommation discrétionnaire	73%	13%	86%	10%
Consommation de base	74%	10%	74%	7%
Santé	78%	6%	84%	5%
Financières	75%	4%	78%	9%
Technologie	73%	17%	83%	27%
Svc télécom	50%	8%	50%	-3%
Svc aux collectivités	52%	8%	50%	2%

Valuations pricing in a recession: Despite two shockwaves in the market (we are currently experiencing the second), the S&P 500 is priced 80% above its level in March 2009. Even so, this remarkable progression has trailed growth in corporate earnings. Today, therefore, the market’s P/E is lower than in the worst moments of 2009 (recession) and 2010 (anticipation of a double dip), as illustrated by the following chart.

SECTOR ALLOCATION

The most straightforward response is quite simply to cut the weighting of cyclical sectors, which in most cases would mean taking a loss, based on prices at the start of 2011. A more pragmatic approach is therefore needed:

Base metals, which are far more representative of real supply-demand trends (i.e. manufacturing needs) than equities (which concern only financial positions), dropped by only 15% at the market's lowest ebb (10% at the moment) relative to May highs. Equities are down 25-30% on anticipations of a recession. More overselling is not out of the question, but for metals most in demand (copper and iron) as well as for coal, we should not give up so easily ... **Hold positions**

Precious metals (at least 10% of portfolio weightings): The only real safe haven is gold. The prices of silver, platinum and palladium have resisted remarkably well but are close to topping out. This is because these metals are mainly used in manufacturing (platinum and palladium in catalytic converters) and are therefore exposed to economic conditions in a way that gold is not. We recommend **trading these three metals for physical gold** to take advantage of the backstop that is provided by the latter.

Soft commodities: 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**

Financials: After recommending a market-neutral weighting at the start of the year, **we switched to underweighting the sector in spring.**

Despite improved fundamentals and rock-bottom valuations, banks are still feeling the heat from tighter regulations, from the climate of suspicion that surrounds them, and from criticism — all of which is hurting performance. Fundamentals also vary widely between companies within each group, so the wheat must most definitely be separated from the chaff.

In contrast, we advise **focusing on the REIT sub-segment**, which is enjoying low interest rates, is far less volatile in the market than the financial services industry as a whole, is trading at book value, and often pays attractive dividends.

STOCK PICKING

Regardless of business sector, our preference lies with companies that meet if not all that at least most of the **following criteria:**

Healthy finances, which enable companies to navigate today's choppy waters and possibly even seize organic or acquisition-driven growth opportunities arising from hardship afflicting competitors.

Competitive advantages conferring ongoing pricing power, to compensate for competition from emerging markets or upward pressure on supply costs. Such advantages may stem from long-run trends (e.g. population growth or new regulations), cutting-wedge technologies (either in production processes or in terms of end products) high entry barriers, and others besides.

Rising, profitable exposure to emerging economies, which even during slowing economic conditions can deliver growth when mature markets are struggling. But we underscore the notion of "profitable": many companies setting up shop in emerging economies are generating considerable revenue but not much profit in comparison, while others are combining higher margins with their incremental revenue.

Lastly, reliable **dividends** with yields that provide a safety cushion (or extra return) are vital in today's conditions.

Thus, caution is the watchword, but so is watchfulness. A 50% chance of recession also means a 50% chance of business as usual, as in autumn 2010. If that happens, cyclicals will be back in fashion and will need to be overweighted in investment portfolios once again.



"Those beautiful dreams which only leave you in the morning the regret of having believed in them"

Molière

PHILIPPE LEDERREY

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Stock markets hit by wave of panic this past summer

The wave of panic that undermined European equity markets this past summer was more intense and serious than could have been expected in the spring. The financial markets began to grasp the fact that even worse scenarios were plausible: it is increasingly likely that what began as a minor and temporary slowdown will turn into a full-blown recession within OECD countries. Or worse: a depression in the global finance industry not unlike the situation following the Lehman collapse in 2008-2009. These worries are exacerbated by the fact that governments have nearly run out of fiscal and monetary tools to get the system up and running again.

Reality check for investors

We stand by the core scenario we developed a few quarters back: beginning in 2009 a false sense of confidence in global reflation buoyed the equity markets (and high-risk assets). The massive injections of liquidity and the expanded role by governments and central banks were undoubtedly necessary to avoid a deep recession. Still, these measures did not correct the root causes of the fundamental imbalances within the global economy – which were in fact the driving force behind the crisis. They have simply been papered over. Now, with the stimulus tap being gradually turned off and the economic environment deteriorating amid a fragmented political climate, market confidence is set to weaken even further. European companies, which are already playing it overly safe, could become even stingier in terms of capital spending and hiring, and households will not have much reason to spend and consume either. Finally, with banks focussed on shoring up their balance sheets (and thus less than eager to lend), economic activity – and earnings – could enter a downward spiral.

More of a roadblock than a crossroads

With sovereign debt problems spreading to Spain and Italy, the eurozone finds itself at an impasse that it is no longer equipped to handle. The shackles of the common policy are not the only problem. Disagreement over decisions made by the leaders and the slowness in implementing the decisions shows that “buying time” is no longer an option for the equity markets. The only possible recourse would be widespread agreement to take European integration further: unconditional support for struggling countries, a pan-European agency for monitoring public deficits, joint bond issues, financial federalism, etc. However, this type of agreement would require the consensus of the 17 members of the eurozone and the political support of opposition parties in all member states. With major elections upcoming in the next year in several of the larger countries, this would be no mean feat.

Valuations geared towards a (short and crisis-free) recession

The good news is that, even if earnings estimates were slashed (especially for 2012, where analysts still expect the same double-digit earnings growth as at the start of the year), current valuations already price in the second part of a double-dip in the global economy. In other words, earnings would have to drop by over 30% to justify prices much lower than those currently observed.

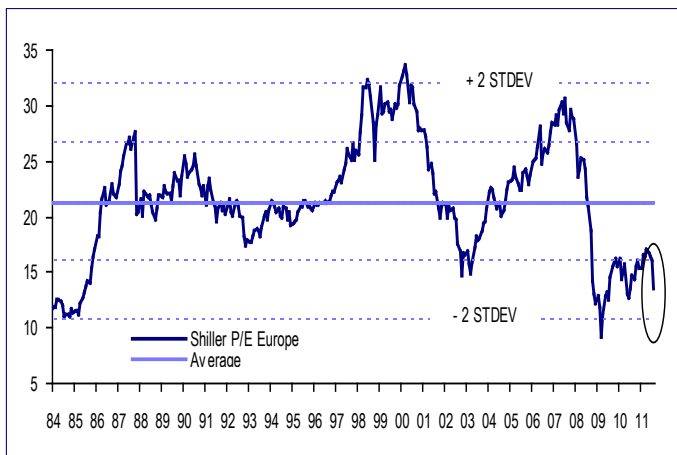
The bad news is that valuations normalised over a longer (10-year) period still do not show a W-shaped scenario like the one experienced in Europe in the early 1980s. This would imply that the floor is 25-30% below current levels. And that is not even the worse-case situation, which would be a combination of recession and deflation together with a systemic crisis in which



the interbank market freezes up completely. In any event, the inability to fully grasp the nature of the risks renders questions of valuation less meaningful: most investors are simply prevented from investing by the most basic rules of prudential management (or, more prosaically, by fear).

Still, after such a steep drop – which still has economists and analysts ruminating – a further downward phase is plausible if, as expected, growth estimates are sharply cut. At the risk of sounding like a doomsayer, if indexes contract further, legitimate concerns could arise about a return of systemic risk in the finance industry (the financial system is currently far too fragile to easily absorb sizable asset writedowns).

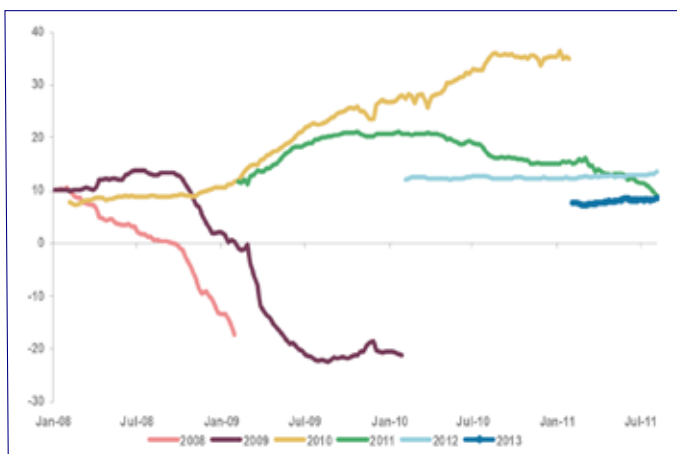
European markets are not expensive, but normalised P/E ratios are high in the event of a recession



Still looking to the north

Regionally, we still have a distinct preference for northern Europe. Growth there is higher, and 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 avoiding southern 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 too constrained by austerity measures imposed by the lending states for earnings cycles to get back on track. More than their debt problems, these countries' main weakness has to do with their lack of competitiveness (and the resulting decline in growth potential).

Earnings growth estimates were slashed in 2011, but remain unchanged in 2012



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, southern European countries now on shaky ground but with generally healthy fundamentals could provide a positive surprise (such as Italy).

Futility of gauging fair prices

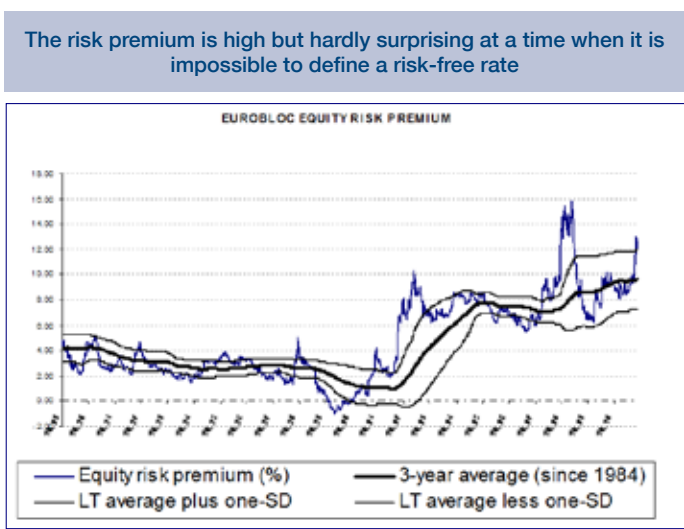
In the short term, unless some coherent monetary and/or political decisions are made, disoriented investors will continue to focus on the risk of recession. This is understandable, since it is impossible to calculate a risk-free rate or the cost of capital, or to identify trends among currencies and commodity prices. We are faced with an erratic and aimless market at best. This lack of certainty is preventing the equity markets from putting together any sort of sustainable uptrend.

With government debts so high, beware companies with high domestic exposure

Governments with a high debt burden have an inexorable need for rapid fiscal consolidation plans, and this is an obvious investment theme. Additional screw tightening this fall will further weaken a number of sectors. This includes those that are exposed to anaemic domestic markets (food retail), those that could be hit by tax hikes (utilities, telecoms), those that could be subject to new taxes (banks, with the potential financial

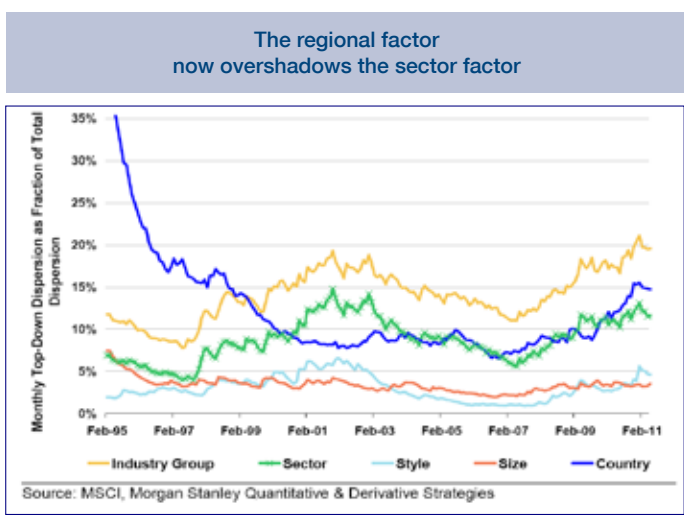
transaction tax currently under discussion), and those that could lose tax advantages (like the reduced VAT for construction, leisure, restaurants and hotels).

Other sectors stand to gain from the evolving situation: those related to government outsourcing (such as recruitment agencies, catering services, and pre-paid coupons), and those that are in a position to pay for infrastructure investments themselves (such as through public/private partnerships with concessions or builders, and through new certifications)



Growth is overvalued

As an investment style, growth stocks have fared well in recent years. In a risk-filled environment in which the growth outlook is soft (yet positive), investors have preferred to seek out the rare gem: groups likely to generate firm structural growth. As always, in so doing they have had to set aside the question of valuations, which ended up overstretched, especially when compared to the rest of the market. As a result, stock rotation – with investors shifting from high-growth stocks to value stocks – began this past summer. This phenomenon is probably far from over.



Hunt for high dividend yields?

The strategy built around high dividend yields did not outperform the broad index in eight of the ten years of the last decade. It is clear that 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. But with earnings estimates heading downward, a bird in the hand is worth two in the bush.

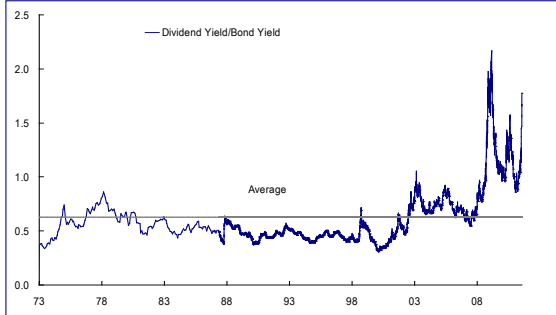
Investors could focus on a small number of companies that they know well

Big is beautiful

We 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



The dividend yield is not a guarantee, but it is quite high and generally safe



Defensive segments are preferable, unless leading indicators pick up (which we consider unlikely)



investors likely to return one of these days to more “normal” weightings in European stocks, we believe they could focus on a small number of companies that they know well rather than spread their investments over smaller, expensive stocks that had fallen off their radar. This would be a

nod 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.



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%	19.7%	0.30%
Euro Area	1.8%	1.7%	0.8%	14.6%	0.25%
China	10.3%	9.0%	8.0%	13.6%	1.22%
Japan	3.9%	-0.5%	2.0%	5.8%	-0.03%
India	10.4%	8.2%	7.8%	5.4%	0.44%
Russia	4.0%	4.7%	4.5%	2.9%	0.14%
United Kingdom	1.3%	0.9%	0.6%	3.0%	0.03%
Brazil	7.5%	4.5%	4.5%	2.9%	0.13%
Mexico	5.5%	4.5%	4.0%	2.1%	0.09%
Canada (IMF estimates)	3.1%	2.8%	2.6%	1.8%	0.05%
Others (IMF estimates)	5.2%	4.7%	4.9%	28.2%	1.31%
WORLD	5.0%	3.9%	4.0%	100%	3.9%

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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 3.9%, a good estimate of global GDP growth for the current year.
- The list is limited to the 10 countries that contribute most to world economic expansion.

Tactical allocation (%)

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CHF PORTFOLIO

Asset class	Switz.	Europe	UK	USA	Japan	Asia/other emerging regions	Commod.	Precious metals	Sundry or global	Total
Short-term	4									4
Fixed income	19	2								21
Equities	8	2		2	3	7				22
Directional hedge funds		7								7
Nondirectional hedge funds	23									23
Property	3								7	10
Commodities, Precious metals							3	10		13
Total	57	11	0	2	3	7	3	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		7								7
Fixed income		19							2	21
Equities	3	7		2	3	7				22
Directional hedge funds		5		2						7
Nondirectional hedge funds		23								23
Property									7	7
Commodities, Precious metals							3	10		13
Total	3	61	0	4	3	7	3	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				7						7
Fixed income				21						21
Equities		4		8	3	7				22
Directional hedge funds				7						7
Nondirectional hedge funds				23						23
Property									7	7
Commodities, Precious metals							3	10		13
Total	0	4	0	66	3	7	3	10	7	100

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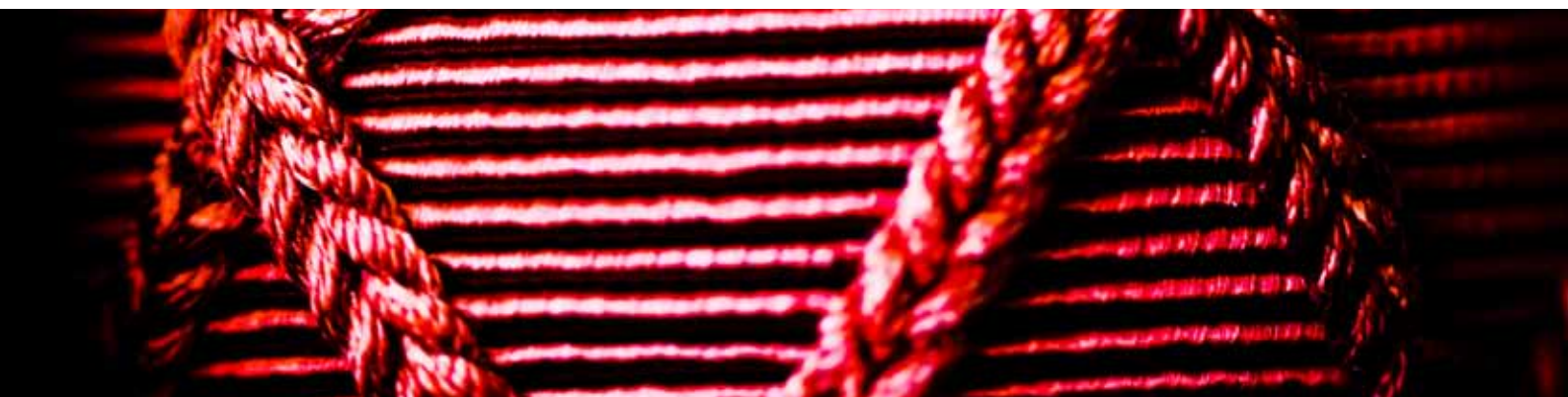
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