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## Media release

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# Global View of Bank Sarasin: Ending fiscal impulses trigger a slowdown in growth

The fiscal and monetary stimuli, which triggered a spectacular economic upswing in recent quarters, will peter out in H2 2010. This should trigger an economic slowdown. Also, since the credit bubble excesses have not been absorbed yet, Bank Sarasin forecasts in the latest edition of the "Global View" Research Outlook for Q3 2010 that another acceleration is likely to take place only during the course of H1 2011. The central banks will continue their zero interest rate policy due to the nascent economic slowdown and the euro debt crisis. Together with an environment of dampened inflation, this likely suggests low interest rates in the long term. Government bond valuations are high as a result of the debt crisis and a setback cannot be ruled out in the short term. Bank Sarasin believes the potential for corporate bonds is still intact, however. The equity market correction that took place in Q2 anticipated a lot of negative news and appears overdone in the short term. Positive corporate results should trigger a summer rally. Emerging market equities are inexpensive and Bank Sarasin has upgraded them to neutral in its current asset allocation. In Europe, Bank Sarasin focuses on core countries, including Switzerland and the UK, while avoiding equities from the Euroland periphery. The expected decline in risk aversion among investors in Q3 suggests the weighting of cyclical sectors will be increased at the expense of defensive sectors.

The financial markets in Q2 2010 were characterized by the euro crisis and a rising level of nervousness. Against this backdrop, the market hotly debated whether the global economy was resilient enough to cope with the high level of debt in Europe and the newly introduced cuts to fiscal policy. Although the concerns about a euro collapse and a debt moratorium appear overdone, their emergence places limits on an expansionary fiscal policy. In fact, the combined forces of monetary and fiscal policy have prompted a strong upswing in investment activity since mid-2009. The recovery in the labour market since the beginning of the year fulfils the first important condition that needs to be met before the upswing can become sustainable.

### **Jan Amrit Poser, Head of Research and Chief Economist at Bank Sarasin**

"We expect concerns over the euro debt crisis to gradually fade into the background and companies with positive results to spring positive earnings surprises. We therefore see a fair opportunity for a recovery in equities in Q3 2010. That said, signs of a global slowdown in growth will likely increase in autumn at the latest. After an interim rally, the equity markets should remain in a downtrend till the end of the year."

### **Philipp E. Baertschi, Chief Strategist at Bank Sarasin**

"Given the immediate prospects of positive corporate results, we have raised the equity allocation back to neutral. We built up the sector weighting in the higher risk profile at the expense of defensive sectors. Due to the decreasing risk premium, which should lead to a higher risk tolerance, the cyclical sectors have greater price potential in Q3 2010. Nonetheless, we retain our cautious stance with a view to the Q4 and the beginning of 2011. With interest rates at record lows, bonds do not have any potential left. We therefore jettisoned bonds in order to finance risky assets. In the alternative asset category, we were able to purchase assets with attractive returns, thanks to the high level of volatility in June. We upgraded real estate assets from underweight to neutral. Commodities remain underweight: here, too, we expect a recovery in Q3 2010."



### **Fading growth impulses cause a slowdown in growth**

The leading indicators definitely peaked in Q2. Most of them are now below their highs. Although they point to record-setting economic growth in Q2 2010, the discontinuance of fiscal and monetary policy impulses and the throttling back of production due to excessive inventory levels will slow economic growth in 2011. The recovery in the labour market will stall and upside pricing pressure will be nipped in the bud. The impending economic slowdown will also stoke deflation fears. However, the deleveraging process remains the biggest brake on consumer price inflation and economic expansion. Also, the real estate market in most countries has not recovered yet. With banks scaling back new lending activities, economic growth lacks an important pillar of support. It will take a while before the credit bubble excesses have been absorbed. Bank Sarasin therefore expects this brake on economic growth to fall out of the picture in H1 2011 at the earliest. That said, we will focus our attention on fiscal consolidation in the coming years.

### **Emerging markets have consumption potential**

Deleveraging, which slows growth, is a global phenomenon. The emerging markets are the sole exception. Their financial systems were not sophisticated enough to participate in the fatal securitisations. This represents an opportunity for the global economy. Whereas lending in the developed world is scaling back, it has scope to expand further in emerging market countries. At the same time, high savings ratios indicate untapped consumption potential. The emerging markets are expected to make another noteworthy contribution to global growth also during the impending cooling. Thus, they should be able to help to stabilise the global economy and ensure that the upswing turns into a sustainable development.

### **Debt crisis drives bonds**

Whereas several peripheral Euroland markets ground to a halt as a result of the European debt crisis and the related panic, government bonds in core euro countries tend to benefit. German government bonds recorded an interest rate of 2.5% at one stage. Switzerland, being a classic low interest rate country, also posted a new record. Several central banks have had their hopes for a gradual withdrawal from the zero interest rate policy shattered. Due to the debt crisis and the approaching economic downturn, central banks will stick to this policy for the next 12 months, which, together with a subdued inflationary development, should ensure low interest rates into 2011. Bonds should receive downside protection against the continuing expansive monetary policy and economic cooling in the coming 12 months. Nevertheless, there is risk potential in the short term. If nothing else, triple A-rated government bonds are expensive, which means we cannot rule out the risk of a setback. Corporate bonds were also affected by the risk aversion associated with the debt crisis. In the medium term, Bank Sarasin sees more potential for corporate bonds after the rise in credit spreads in Q2 2010 and the improvement in fundamentals.

### **Equities: Summer rally looks likely**

Both the stock markets and commodities recorded a significant correction in Q2. The optimism that drove investors in Q1 gave way at the beginning of Q2 due to growth fears linked to the euro debt crisis. However, it was already clear before the crisis escalated that the economic cycle was nearing its peak. Viewed historically, the decline in leading indicators indicates a below-average stock market performance. The current downtrend should come to an end only in H1 2011, together with a stabilisation of the global leading indicators. Nonetheless, Bank Sarasin can identify a number of factors that suggest a countermovement will take place in Q3 2010: first, corporate earnings should spring some positive surprises; second, investor attention should shift from negative to positive news; and lastly, market sentiment indicators are in neutral territory and are thus no longer as optimistic as they were at the beginning of Q2 2010.

### **Emerging market equities are attractive: We favour building up cyclical sectors**

Bank Sarasin upgraded the emerging market equity weighting to neutral after the setback in the second quarter. The emerging markets have held up nicely and outperformed the developed markets in recent weeks. Several indications suggest global investors are steadily building up their emerging market equity weighting and are already using small setbacks to enter the market.

Emerging market equities are inexpensive and stand to profit the most from a decline in risk aversion. Furthermore, the earnings risks are lower than those associated with US equities. Within Europe, Bank Sarasin focuses on companies in core countries, including Switzerland and the UK. Conversely, the equity markets on the Euroland periphery are burdened by the rising level of risk aversion and the weak euro in the medium term. Hence, investors should avoid equities on the Euroland periphery. A rising level of risk tolerance among investors in Q3 2010 and attractive valuations favour building up cyclical sectors at the expense of defensive sectors. That said, close examination of individual business models will play a decisive role in the success of this strategy.

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