Outlook for Financial Markets
May 2010

SwissLife
Asset Management

Interest rates/Bond markets
Investors still have appetite for US treasuries

USA
- 10-year US treasury yields reached 4% on April 5, but moved lower again on heavy demand from Asia
- Forward rates suggest that market is pricing in a 25 basis points rate hike until end of 2010
- The better the economic news in the coming weeks, the more intense the debate on the pace and size of tightening measures will turn

Euro Area
- German Bunds continue to benefit from safe haven flows as Greek government hesitates to accept help from the IMF and the European Union
- Market for corporate bonds is unaffected by sovereign debt problems and we expect a gradual tightening of spreads until end of May

Japan
- Bank of Japan is very likely to upgrade both its outlook for growth and price developments
- Altough its governor claims that the risk of a return to recession is gone, the central bank continues to weigh deflationary risks as substantial

United Kingdom
- The Bank of England had to postpone its upcoming meeting until after the election
- After May 6, rating agencies are likely to insist on fiscal measures to come with the new government's first budget
- Should fiscal measures presented in the budget fail to convince, rating agencies will come under pressure to downgrade UK sovereign debt

Switzerland
- As house prices in the Zurich area have gained almost 10% in the past 12 months, the Swiss National Bank is right to prepare homeowners for normalising rates
- Flight to quality may reverse once Greece decides to tap the money offered by the EU and the IMF
- This should result in slightly higher bond yields until mid year

US 10-year treasury yields capped at 4%

Source: Thomson Datastream

We continue expecting yields to trend slightly higher as the economic recovery has legs and risk appetite remains strong. The upside potential for yields remains limited as we do not see a great risk of inflation. There is sufficient demand for US treasuries once 10-year yields are approaching the 4% area. Anectodal evidence shows that Japanese investors are willing to buy US paper at these levels as they believe that the US economy will go through a period of deflation similar to their own country's recent experience. In the meantime, the clocks are ticking to measure how long it will take the central banks to react on the marked improvement of key economic indicators. In the US, the last nine tightening cycles started with an average lag of 6 months after the peak of the unemployment rate. As the current cycle's peak dates back to October 2009, the Fed would typically start tightening its monetary policy during this quarter. This is not what we expect as the pronounced job losses in the US justify to expect a longer reaction time. At present, we think that the market is right to price in a rate hike by the last quarter 2010. The discussion on the appropriate timing of tightening measures could intensify in the case that economic data continue to surprise to the upside in coming weeks, which would also support our expectation for higher yields. Central banks in China, India and Australia, countries where the recovery progresses at a fast pace, are already in a tightening mode.

Stock markets
Strong reporting season

USA
- The SEC fraud case depresses financial stocks temporarily
- The steep interest rate curve environment however is a strong supportive factor for banks' earnings
- Earnings reports for Q1 provide tailwind to the stock rally – sales revenues surprise to the upside

Euro Area
- Sentiment toward Greece has continued to deteriorate as investors' concerns have moved on from the near-term liquidity issue to the medium-term solvency issue
- Markets nevertheless moved higher over the past four weeks
- We expect the positive momentum to continue underpinned by favourable macro data

Japan
- Economic momentum is at elevated levels not least due to strong demand out of emerging Asia
- Domestically oriented businesses should benefit from rising consumer confidence and a recovery of the labour market

United Kingdom
- After the first televised election debate, a hung parliament seems the likely outcome for the election to be held on 6 May, yet investors seem to be less concerned about it
- The conservatives openly talk about potential cuts in corporate taxes should they come to power

Switzerland
- Financial conditions have tightened in Switzerland due to the fact that the Swiss Franc appreciated markedly
- Swiss equity indices underperformed over the past month, possibly due to the more defensive character
- IPO activity is back on the agenda triggering a new composition of the SMI

SWX – pharma underperforms since March

Source: Thomson Datastream

Economic data continue to raise our confidence that the recovery has legs and that downside risks are receding. Purchasing managers indices continue to climb around the globe signalling a healthy business environment. Besides the macroeconomic dynamics, the underlying profit and value drivers of the equity rally are very much in place. Indeed, the first set of US first quarter earnings announcements is showing impressive growth that is pushing up consensus 2010 projections. 81% of the S&P 500 companies that have reported so far outperformed on revenues and 79% on EPS. 30% of the companies are already above the earnings peak levels last reached in 2007. On the aggregate S&P500 level, 2007 earnings levels should be reached as early as 2011. Despite these impressive numbers, however, scepticism remains abundant among investors which tells us that a massive correction to the downside is not imminent. As a matter of fact, prices for put options have hardly budged from high levels indicating that investors build up exposure only with downside protection. Equally so, one can still observe strong money inflows once markets experience a setback, as triggered by the SEC fraud case for instance. Thus, the "buy on dips" pattern remains intact. Despite technical factors pointing to overbought markets, we believe that any correction should be short-lived.

SwissLife Asset Management

Currencies

Risk appetite speaks for further Dollar strength

USA

- USD is expected to appreciate further as corporate earnings support our view that the economic recovery is sustainable
- In the months to come, the debate on when the Fed will start to tighten its monetary policy is set to intensify

Euro Area

- Speculative positions reveal that majority of investors continues to bet on weaker Euro
- Depending on renewed concerns regarding Southern European sovereign debt in the weeks ahead, we see a risk for further Euro weakness

Japan

- As growing risk appetite continues to dominate investors' decisions, we expect a weakening Yen
- The outlook for global central bank action in the next twelve months is also supporting this view

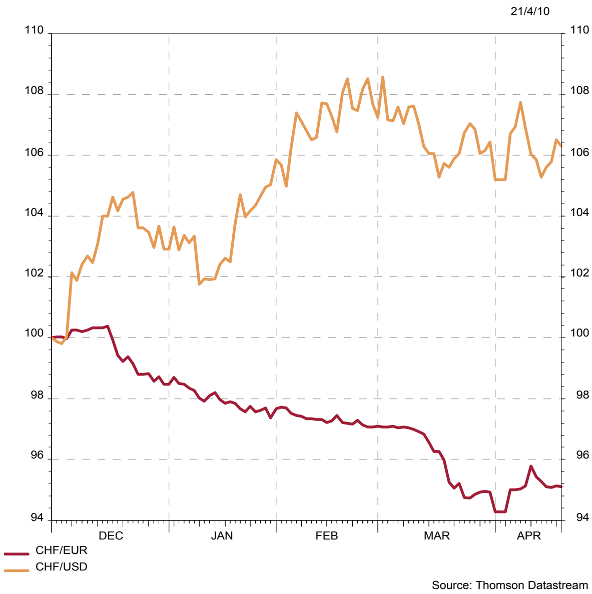
United Kingdom

- Certain comments fear renewed Sterling weakness in case of a hung parliament, but markets did not react accordingly to rising odds of such an outcome
- We continue to expect a strengthening currency on improving economic news and prospects of monetary policy tightening by the end of the year

Switzerland

- 1.4320 versus the Euro seems to be the Swiss National Bank's new defending line
- On a trade weighted base, the Franc's appreciation is a less severe problem, as the expected Dollar stenghtening compensates for the loss in competitveness against neighbouring Europe

Franc between weak Euro and strong Dollar



The marked appreciation of the Swiss Franc versus the Euro continues to trigger occasional intervention by the Swiss National Bank. At present, they seem to defend a level of 1.4320. While the exchange rate to the currency of Switzerland's most important trade partners is of particular relevance, the current debate neglects the fact that the Franc lost considerably in value versus the US Dollar since December 2009. We expect the trade weighted Swiss Franc to weaken over the coming weeks. On the one hand, the Euro is likely to hold at current levels, while Dollar and Sterling should appreciate given the signs of economic recovery and growing risk appetite among investors. In the short-term, considerable risks weigh on the Euro as long as investors consider the Greek debt situation as unsolved. Japan's Yen is currently hugely overvalued. This situation may change in the coming months, as the Bank of Japan is the least likely of the major central banks to start a monetary tightening cycle. The appreciation of such currencies where central banks have already raised interest rates will abate once that monetary tightening comes in sight in the Western world too.