

Interest rates/Bond markets

Flight to safety prevails

USA

- US Treasuries remain well supported by safe haven flows which cancel out upward pressure on yield from strong macro data
- Should worries about the European debt crisis persist, US yields may even go lower from these levels
- The latest inflation print has surprised market participants to the downside limiting the potential for higher yields further

Euro Area

- Spreads of peripheral countries to German Bunds continued to widen – even French paper starts to be burdened with a higher risk premium
- Volatility is likely to remain high
- German Bunds will continue to be a highly favoured asset pushing yields further down

Japan

- Japanese economy has had the strongest growth print of the economies reviewed in this paper
- Nevertheless, deflation continues to weigh on the economy and keeps interest rates low

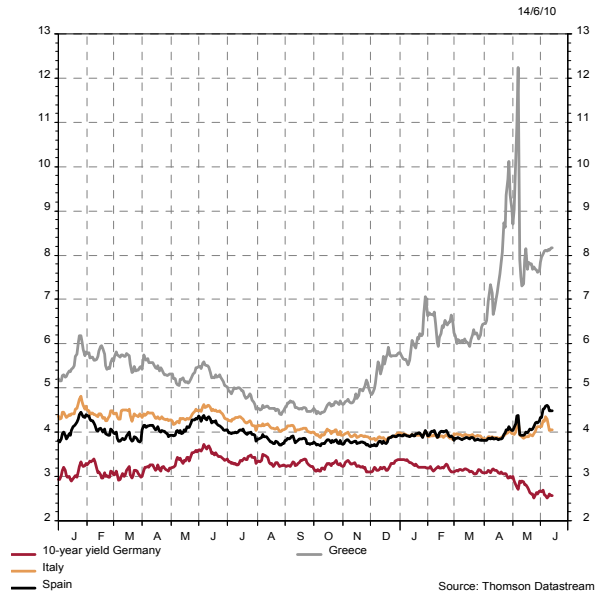
United Kingdom

- OECD urges the Bank of England to start hiking rates soon
- Fiscal austerity measures will probably contain a VAT rate hike early next year

Switzerland

- Swiss government bonds follow their traditional role as a safe haven investment which keeps the yield on 10 year paper below 1.5% - this trend will not reverse over the next four weeks
- Without the debt crisis and Euro depreciation, the Swiss National Bank would be in a position to lift their target band at the short end of the curve

Divergent trends in sovereign yields



The recovery continues to gain traction, so that market movements and actual economic data continue to diverge substantially. Investor unease over sovereign debt and potential bank problems looks unlikely to dissipate any time soon. As a matter of fact, most spread products have widened, Libor has spiked, equities have dropped and continue to do so, and the VIX volatility index has nearly doubled. This causes us to expect slightly lower yields even from here, particularly so in the markets which serve as safe havens, i.e. the US, Germany and of course Switzerland. Fundamentally, our views have not changed substantially. We still argue that rates at current levels are too low given the cyclical momentum and should rise over the coming months. Yet, downside surprises of inflation prints in the US have also played their part in pushing yields lower, with core inflation in particular coming in weaker than expectations. The dominating debt concerns in peripheral Europe and the associated market volatility have likely postponed monetary tightening globally, but we do not believe that central banks are behind the curve. Some tightening of financial conditions in the US has been happening due to the stronger US Dollar. Credit spreads widened across all sectors and rating categories in recent weeks. As investors avoid risky assets, this trend should also hold in the medium term.

Stock markets

Focusing on the negative news

USA

- Investors shy away from risky assets although the corporate earnings outlook remains intact and business optimism remains on high level
- Macro data have consistently come out above expectations in most cases, did not manage to impress markets however
- Stock prices move in line with the Euro

Euro Area

- Certain European stock indices were outperforming over the past 4 weeks
- Potential tax hikes in the context of fiscal austerity got priced into the markets, yet fear seems overdone as the current situation does not compare to the one during the Lehman crisis
- Major drivers remain the lack of confidence in governments and the ECB

Japan

- Japan's GDP grew at a rate of 5% in the first quarter – the highest reading of all industrialised countries
- Incoming order flows remain strong and export-oriented businesses benefit from strong external demand

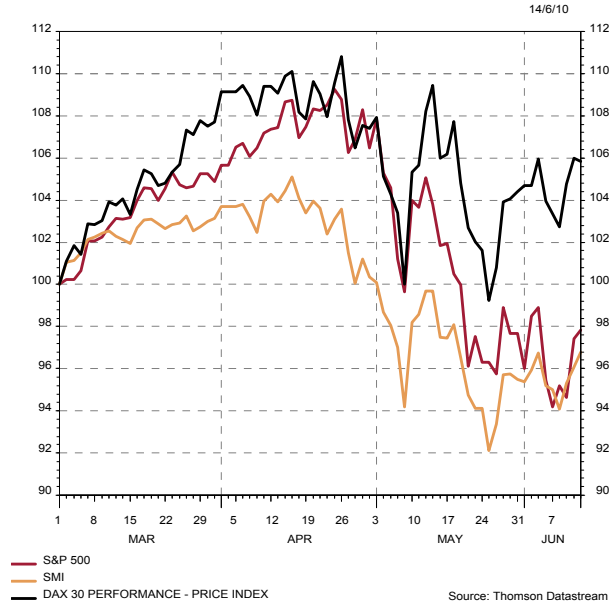
United Kingdom

- In view of severe fiscal tightening, the central bank may abstain from monetary tightening for longer
- The coalition government has agreed to cut £6.25bn of spending during the current fiscal year

Switzerland

- A stronger CHF versus Euro does not impress the Swiss corporate sector too much – the purchasing manager index reaches new record highs
- Swiss equity indices outperformed over the past month as risk aversion prevailed
- Sound economic growth overcompensates the disadvantages of a strong currency

German Dax outperforms thanks to weak Euro



The southern European debt concerns, the associated needs for fiscal consolidation, tensions in the Middle East and North Korea all added up over the past four weeks and caused market volatility to stay on elevated levels for an extended period. Such persistently high volatility levels only occurred during the Lehman Brothers crisis before. This is however, where the similarities end in our view between the current environment and the financial crisis which began in 2008. The funding stress in the banking sector is nowhere near the extent of the last crisis and the macro- and micro-economic backdrop is in a clear recovery phase whereas the economy was already heading into a severe slowdown in September 2008. Yet, the last crisis is still very fresh in investors' minds and uncertainty as to who is holding endangered sovereign paper prevails. Some institutions such as the IMF and the World Bank warn of a double-dip recession, an opinion which we do not share and which unnecessarily heightens fear among market participants. Due to this, institutional investors are hedging their exposure driving hedging costs back up to crisis levels and retail investors are selling risky assets outright. Given the strong correction of the markets over the past weeks and the continued positive macro- and earnings outlook, we expect equity indices to find a bottom soon and to edge higher again until year-end.

Currencies

Negative risk sentiment pushes USD

USA

- USD looks overbought versus the Euro even if the general bearish market sentiment is taken into account
- The macroeconomic picture in the US has strengthened yet again over the past four weeks
- Some central bank representatives did strike fairly hawkish tones which should support the USD

Euro Area

- Euro suffers from the announced fiscal austerity measures and potential negative impact on GDP growth – investors seem to doubt the viability of the common currency
- Despite all obstacles, we consider the Euro oversold and expect it to appreciate slightly

Japan

- The prevailing risk aversion lifted the Yen on elevated levels – will those worries subside, the Yen should accordingly get under depreciation pressure

United Kingdom

- The Pound suffered from the dovish Bank of England stance and safe haven flows into the USD
- We see upside potential for for the Pound given the political resolution, inflation and attractive valuation

Switzerland

- While the Euro vs CHF has now plunged clearly below 1.40, the Swiss National Bank still absorbed some of the Euro correction via interventions
- On a trade weighted base, the Franc's appreciation is a less severe problem, although 40% of Swiss exports go into the Euro region
- We expect the Swiss Franc to weaken slightly versus Euro once risk aversion subsides

Released and approved by the Economics Department

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Euro and stocks are closely correlated



Source: Thomson Datastream

The nervousness on FX markets remains very elevated for now. Therefore, since the last publication of this document, we have experienced a huge correction in the exchange rate of Euro versus the USD. We believe that this particular cross is now trading on oversold levels, i.e. the Euro has been punished excessively, even if the negative sentiment towards all risky assets is taken into account. The relative growth and inflation outlook, however, continues to look favourable for the USD as macroeconomic data out of the US still manage to post upside surprises and signal a broadening recovery. Although recent macroeconomic data out of the Euro Area equally signal an ongoing strong cyclical momentum, it is policy uncertainty and loss of confidence in European institutions, which weigh on the single currency. We are aware that our projection of a stronger Euro is a heroic one, given that the leeway for fiscal and monetary measures seems exhausted in some member countries. The fact that the private corporate sector in the Euro Area is cheering a weak Euro and thus increased competitiveness vis-à-vis other exporting nations does not help our case for Euro appreciation.

