

Interest rates/Bond markets

Insecurity feeds demand for “safe” bonds

USA

- The latest FOMC statement was more dovish than the one issued in late April
- The tempered growth outlook and downward trending inflation gives policy-makers time to await a solution of the debt/banking crisis in Europe
- With risk aversion still at high level, US Treasuries should be well supported and yields may decline further

Euro Area

- Spain will have to refinance a huge amount of their sovereign debt end of July – the success of this refinancing may be a crucial mark to decide where markets will be heading from then on
- As German Bunds are sought after as a safe haven investment, 10-year yields plunged again below 2.6%
- Inflation readings remain benign and well below the ECB’s target

Japan

- The chances of an early exit from present monetary policy are slim, but the central bank will likely continue its indifferent attitude towards tackling deflation.

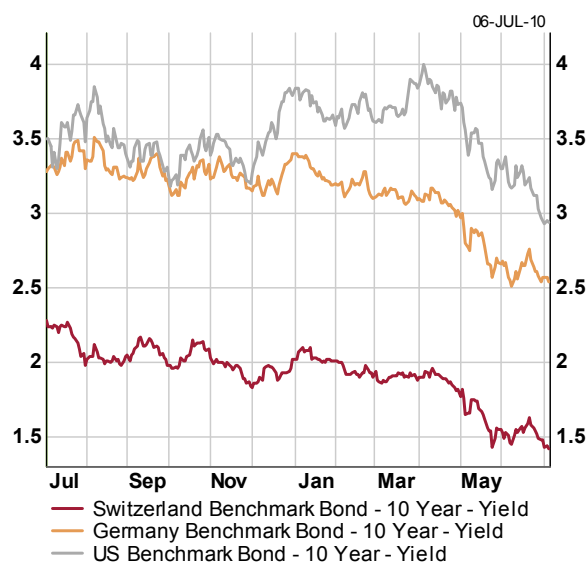
United Kingdom

- Cuts in government spending will shoulder the burden of fiscal consolidation but the detailed breakdown of where cuts will be made will wait until the autumn spending review
- MPC member Sentance opted for a tightening of the target rate given that inflation remained sticky

Switzerland

- Swiss government bonds are once again a favourite asset class of investors shying away from risk - 10 year paper still below 1.5% - this trend will not reverse over the next four weeks
- Central bank’s rhetoric may well signal a change in interest rate movements at the short end of the curve

Yields of safe assets under renewed pressure



As the global recovery loses some momentum and uncertainties in the financial markets persist, fears of a “double dip” recession have recently risen and triggered massive safe haven flows yet again. However, we believe this is an unlikely scenario. Other than in the last financial crisis, the macro environment is intact and growth is increasingly broad-based and driven by international trade flows. The Swiss National Bank generated a turnaround in rhetoric by stating that they would abstain from currency interventions in the future which caused safe haven flows not least in long-dated Swiss government bonds and of course the Swiss Franc. In its monetary policy assessment, the SNB left its target range for the 3-month Libor unchanged at 0%–0.75%, as expected. At the same time, the SNB expressed optimism regarding the ongoing economic recovery. Moreover the central bank reiterated “the current expansionary monetary policy cannot be maintained over the entire forecast horizon (2013) without compromising medium and long-term price stability.” As a matter of fact, we would not be surprised if the SNB initiated a rate-hiking cycle towards the end of the year – in advance of the European Central Bank – which may however increase the interest-rate spread further in favor of the Swiss Franc. They have repeatedly uttered their concerns about an overheating in the Swiss real estate market and mortgage lending standards.

Stock markets

Focusing on the negative news

USA

- The upcoming earnings season will give more evidence on corporate health and their business outlook – analysts are lowering their exaggerated earnings expectations
- Tax receipts and economic activity however signal that earnings momentum remained elevated in Q2

Euro Area

- Real economic data out of the region still manages to surprise positively – the weak Euro supports order inflow at export-oriented companies
- Investors started to differentiate on a regional basis between debt-plagued economies and those faring better – outperformance of the Dax
- On an aggregate level, the EuroStoxx managed to edge higher over the past 4 weeks despite a simultaneous strengthening of the Euro

Japan

- Earnings dynamics of Japanese companies seem intact in a strong growth environment
- Incoming order flows remain strong and export-oriented businesses benefit from strong external demand

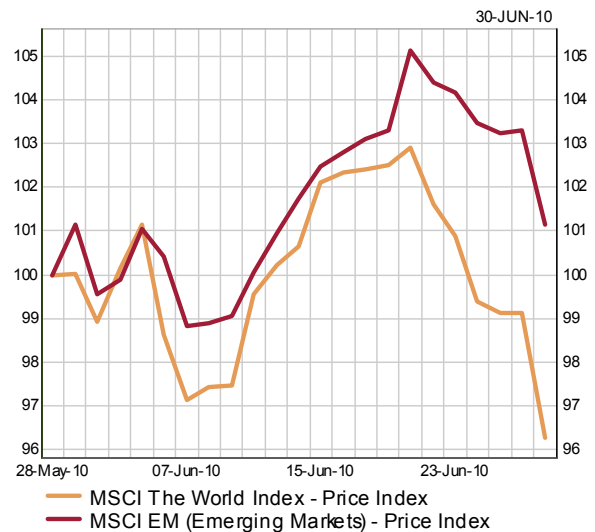
United Kingdom

- Over the past four weeks, the UK stock index largely underperformed other markets
- Damage to the public finances has been severe and a large structural fiscal tightening may be needed to meet budget targets

Switzerland

- The SNB has shown more flexibility when it comes to Swiss Franc appreciation and surprised market participants
- Swiss equity indices performed relatively well over the past month as risk aversion moderated only slightly
- The strong currency dampens import prices for the Swiss industry

Outperformance of emerging markets



Markets have moved well off the lows printed in May before coming under heavy pressure again recently. In a risky asset comparison, stocks have sold off a lot more than corporate bonds – while much of the increase in corporate spreads has been caused by the rally in government bonds – so that relative valuation has shifted in favour of equities. Moreover dividend yields in the meantime easily beat yields on bonds. One of the main concerns among investors is the extent of a growth slowdown from the transmission of the sovereign debt crisis into the real economy. In the current environment - with the last financial crisis still in mind - risk aversion remains elevated. Early recovery countries such as China and Brazil are tightening monetary policy in an effort to avoid overheating of the economy, however, tighter monetary conditions did not prevent a dramatic outperformance of emerging market equity indices lately. The mix of easy money and tight fiscal policy in industrialised countries should be supportive for equity market performance. Companies operating in the Euro Area, particularly those with a strong export-bias, additionally enjoy the merits of a weak currency. Accordingly, market participants have indeed differentiated clearly on a regional basis, as signalled by the strong outperformance of the German Dax versus other European indices. A positive trigger for equities to move higher could be a successful refinancing of Spanish debt due at the end of July.

Currencies

SNB surrenders to market forces

USA

- USD came under pressure not least due to disappointing news from the housing sector and the labour market
- Safe haven flows into US Treasuries caused yields at the long end to plunge again, flattening the curve – the correlation of 2y-10y yield differentials and the currency held perfectly well

Euro Area

- The risk premium for the EUR remains high given the persisting uncertainties in the Euro zone
- EUR/CHF moved in sync with EUR/USD after the SNB paused with its interventions in June
- The weak Euro is a welcome gift for exporters in the region

Japan

- After pronounced appreciation of the Yen versus CHF in May, the trend reversed – however the Yen appreciated massively versus USD

United Kingdom

- The Pound strengthened versus USD on the back of ambitious fiscal tightening efforts and a good performance of the new government thus far
- The Bank of England adopted a rather dovish stance as of late causing UK short-term rates to remain on depressed levels

Switzerland

- SNB's declared abstinence from further FX interventions led the CHF to appreciate by more than 5% since mid June in trade-weighted terms
- Although we consider the CHF as overvalued versus EUR, ongoing concerns about the debt crisis may cause even more safe haven flows into CHF

Euro in free fall due to SNB rhetoric



The main event since our last investment process has been the market reaction to the public acknowledgment by the Swiss National Bank of its surrender to market forces as regards the exchange rate with the Euro. The SNB reiterated its willingness to take the necessary measures to safeguard price stability if the CHF were to appreciate to the point of reviving the threat of deflation. However, this risk would appear small as long as the Swiss Franc's appreciation against the Euro was offset by depreciation against the USD. Yet, the SNB communication triggered massive flows into the safe haven, causing the Swiss Franc to appreciate versus all major currencies. We expect on-going weakness of the Euro versus CHF, although we consider the current level of the single currency as over-sold and the CHF generally as overvalued. However, there is not only negative news: fundamental data of the Euro Area and Germany in particular surprised positively and the EUR should have upside potential relative to the USD from a fundamental point of view. We don't expect this in the short term as only convincing indications of fading sovereign risks will trigger a sustainable recovery.

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