



Investment Outlook and Strategy

October 2011

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Global Macro-Economy & Fixed Income

The outlook for the world economy has deteriorated significantly since mid-Summer. Economic indicators are now pointing towards a more severe downturn in the global economy, particularly in Europe and the US.

A “zero growth environment” in Western economies is the most likely scenario. Concerns about a severe “double-dip” recession are however overdone. Led by some pockets of growth in emerging economies (China, India, etc.), the world’s output growth will remain positive but slowing towards 3.0-3.5% in 2012 (IMF forecast : +4.0% for 2011 and 2012).

By rescuing the financial system, governments were the “solution” to the recent economic crisis. Now they are the “problem” with ballooning national debts and fiscal deficits. In the wake of the sovereign debt crisis, fiscal tightening measures will weigh on growth.

Despite the end of “QE2”*, the US Fed “liquidity shop” is not yet closing. Further “Quantitative Easing” remains open. Neither the US Fed nor the ECB are expected to raise key interest rates in the medium term.

The sovereign credit crisis is driving government bond yields** at unsustainable low historic levels, inconsistent with the most likely economic scenario. We continue to prefer quality corporate bonds over government bonds and stay focused on short to medium term maturities.

* “QE2” stands for Quantitative Easing II (unconventional monetary policy measures). ** US Treasury bonds, Bund and Swiss Conf. bonds.

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Equities – Regions & Sectors

The current upheavals in financial markets is fuelled by a crisis of confidence, leading to a huge discrepancy between the “macro-economic fears” and the “fundamentals” of good quality companies. At current levels, a recession with severe earnings contraction seems to be already priced in stock markets.

Given that we cannot say how long it will take for this crisis to be resolved and for the confidence to be restored, we decided in mid-August to scale back equity exposure in portfolios.

Risks to growth have certainly increased as a result of both fiscal austerity plans and “wait and see attitude” of many economic players.

Many companies have restructured their business, enjoy solid balance sheets and still have good financing access at low interest rates (except financials). Corporate earnings published so far this year were in line with expectations, both in the US and Europe. Many companies will continue to come out with fairly solid numbers, but comparisons will become difficult.

Both US and Europe (including Switzerland) continue to be favoured in our asset allocation. Some reasonable exposure to emerging markets is justified (China, India). We have no exposure to Japan (deflationary conditions, unfavourable fiscal, debt and demographic situations).

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Strategic Positioning & Summary

Equities remain fundamentally attractive with low historic valuations (*i.e. low P/E ratios, high dividend yields, free cash flow yields at all-time high relative to corporate bond yields*).

Stock markets are however likely to trade sideways for some time until confidence comes back.

Emphasis on cash generating companies (*i.e. energy/oil, consumer staples, healthcare, selected information technology*).

Very limited exposure to financials (value traps) and “government-regulated” sectors.

Some exposure to cyclical stocks best suited to capture the next market uptrend in light of possibly slightly more resilient economic data later this year.

Bonds are pricing a deflationary environment and look rather expensive in a “low growth” economic scenario. Potential inflation risk in the long-term (associated with an oversupply of money consecutive to money printing practices) is not factored in by market participants. Focus on corporate bonds and short-dated maturities.

Regarding currencies, the US dollar will benefit from its reserve currency status in the short-term (FX targets : EUR/USD 1.25-1.30, CHF/USD 1.00). Long-term, the US dollar will continue to structurally weaken. The CHF/EUR floor set by the SNB looks credible and should not be tested any time soon.

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