Outlook for Financial Markets
August 2012

SwissLife
Asset Management

Interest rates/Bond markets
Driven by Europe's debt crisis

USA

- On the back of recent data disappointments, many market participants revised their growth forecasts downward – we were positioned below consensus forecasts anyway
- Uncertainty about fiscal policy next year does not deter investors from buying Treasury bonds – safe haven flows depress yields further

Euro Area

- The ECB cut the main refinancing rate by 25basis points to 0.75%, as expected and the deposit facility by 25basis points to 0.0% - many sovereign yield curves thus turned negative at the short end
- We expect the ECB to reduce rates further going forward and to come up with more unconventional measures as the European sovereign debt crisis is intensifying

Japan

- In contrast to other regions, the underlying trend in domestic activity shows resilience
- The Japanese export industry should benefit from revived demand in China as the central bank continues easing monetary policy

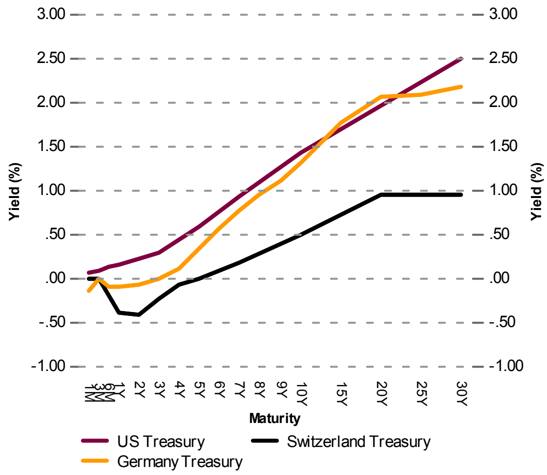
United Kingdom

- The long-term challenges for UK public finances remain daunting as tax receipts were disappointing as of late
- The BoE's Funding for Lending scheme provides funding for banks for four years at a price substantially below market rates, with the aim of increasing the availability and cutting the price of credit to households and non-financial businesses

Switzerland

- Swiss 10-year government bond yields have corrected the least to the downside among the markets discussed herein, simply because they are closest to the zero line already

German & Swiss curves negative at the short end



Developments in the Euro Area remain in the driver seat for financial markets. Political leaders seem increasingly reluctant to support the Greek economy, should they not adhere to the agreed conditions for continued financial transfers. The IMF actually considers to end its support for Greece which would lead to a sovereign default by September and the ECB announced that it will stop accepting Greek bonds as collateral. An exit of Greece from the currency union seems more likely than not in the meantime. Given that the banking sector got rid of most of the Greek debt on the balance sheet, such an exit scenario has shed some of its former scare. Once again, however, contagion and the erection of fire walls are at the forefront of discussions. The plan to recapitalize Spanish banks is still lacking details and the market fears that Spain will soon need to get a full bailout which would likely prove very challenging due to the size of the Spanish economy compared to the funds available in the EFSF and ESM. Furthermore, the French budget consolidation plan is not impressive and with the current measures taken by the Hollande administration, even the 2012 deficit goal of 4.5% seems ambitious. Yield developments around the globe continue to reflect the well known safe haven flows and persisting uncertainties over the past month. Given all the uncertainties and fears mentioned above, we do not see a change of environment over the next four weeks. Corporate bonds remain the bright spot on the fixed income landscape, increasingly assuming the status of safe haven investments.

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Stock markets

Too many hurdles around still

USA

- Earnings momentum has decreased and forward looking adjustments to earnings are slightly to the negative side
- Lower yields and gasoline prices and recovery of the housing market should support sectors with high exposure to domestic economy
- Valuations remain extremely favourable and loose monetary conditons granted until at least 2014

Euro Area

- Credit growth in Europe has declined notably as companies' credit demand has weakened and banks are stricter as regards collateral requirements
- Comments by ECB Council Member Nowotny, who favors granting the European Stability Mechanism (ESM) a banking license to increase its firepower boosted markets at least temporarily
- ECB President Draghi commented that the central bank is prepared to do whatever needed within its mandate to preserve the single currency

Japan

- Japan's economy is currently reflating, which should be beneficiary for domestic sectors
- The Japanese economy shows fewer signs of economic slowdown than other economies

United Kingdom

- GDP growth in the second quarter again largely disappointed to the downside
- We observe a big shift in economic activity from the public to the private sector, in employment and value added, which will support potential growth going forward

Switzerland

- With economic growth persistently beating market expectations, we continue to expect a turnaround in earnings expectations by analysts to the upside

Attractive dividend yield still

As other financial market segments, global equity markets were driven by news out of Europe for yet another month. The correlation between global equities, the German government bond and Spanish spreads, which used to be fairly pronounced over the past months, however, broke down: Equities rallied while both the price of a German Bund and risk premia on Spanish government paper all climbed close to new all-time highs. The setback in the last few days brought equity markets down to levels of a month ago, and thus the usual correlation was re-established. Nevertheless, compared to the soft patch in economic activity of last year, the market reaction this year to the observed slowdown of macroeconomic momentum is benign. Yet, besides political imponderability, macro- as well as microeconomic uncertainty remains fairly high: negative earnings momentum increased heavily over the past month as forward looking adjustments to earnings came in more on the negative side. As a consequence, we maintain our negative outlook for the coming month. Loan growth to companies in Europe is heading towards the zero line as banks err on the cautious side but may be critical for those companies which cannot access the financial market. However, the already depressed sentiment and very low risk appetite should not be left unmentioned as contra-indicators. Valuations are very attractive and although we position ourselves cautiously over the next month, we remain constructive for the potential of equities in the medium to long term.

Currencies

US Dollar as the safe haven currency

USA

- The USD extended its status as a safe haven currency and appreciated against most of the main currencies except for the Japanese Yen
- Uncertainties surrounding the fate of the single currency and rate differentials in favour of the USD caused the Greenback to reach the highest level against EUR since November 2010

Euro Area

- Over the past month, a substantial flight of investors out of the EUR was taking place
- Driven by renewed worries about the future of the single currency, safe haven flows into other currencies led to a sharp depreciation of EUR
- The ECB president Draghi promised that they would do everything within its mandate to preserve the euro – this calmed markets notably

Japan

- The Japanese Yen, being a safe haven currency, reached the highest level vs. EUR in eleven years

United Kingdom

- Sterling depreciated slightly versus the Dollar, but appreciated substantially versus CHF over the past month
- Fundamentally, we think that continued household consolidation should support the Pound Sterling in the medium to long term

Switzerland

- Because eof the SNB floor of CHF versus the EUR, the CHF depreciated against all other currencies at about the same extent as the single currency
- The SNB probably had to buy again substantial amounts of EUR last month to keep the floor

Structural decline of the Euro

The avowal of an ECB council member towards equipping the European Stability Mechanism with a banking license and the latest statement of the ECB president on their determination to do anything to support the EUR ended a phase of substantial depreciation of the single currency against almost all other major currencies. The EUR served as the favourite funding currency for carry trades over the past month, implying that many investors shortened the EUR. Due to the SNB's strong commitment to keep the floor of 1.20 versus the EUR, the Swiss Franc equally depreciated against most other major currencies. It is almost certain therefore that the pressure on the CHF was again very strong, causing the SNB to intervene heavily in currency markets to be able to keep that floor. Political tensions may be rising over the next months as the Swiss central bank has undoubtedly added a lot of EUR exposure onto its balance sheet over the past months. Should the confidence crisis surrounding the European debt issue finally calm down in the near future, the counter-movement of the EUR has the potential to be equally pronounced. This is, however, rather a risk to our basic call that uncertainties will persist for the time being causing further downward pressure on the EUR and consequently also on the Swiss Franc.