

Interest rates/Bond markets

Central banks behind latest bond market rally

USA

- Fed's remarks that pace of the recovery would be more modest than previously anticipated caused a sharp decline in yields
- Most important result of latest Fed move is that 30-year mortgage rates fell below trough levels of late 2008, allowing a renewed refinancing wave
- Corporate bond yields have fallen to levels which investors increasingly consider as unattractive

Euro Area

- Solvency requirements have triggered long-dated government bonds purchases by insurance companies
- Financial conditions for booming Germany have loosened further since our last investment process
- Poor economic data for Ireland and Greece caused a renewed widening of peripheral spreads

Japan

- Japanese ten year government yields fell below 1% for the first time since August 2003
- Back then, one single remark by the Bank of Japan triggered a huge sell-off in bonds

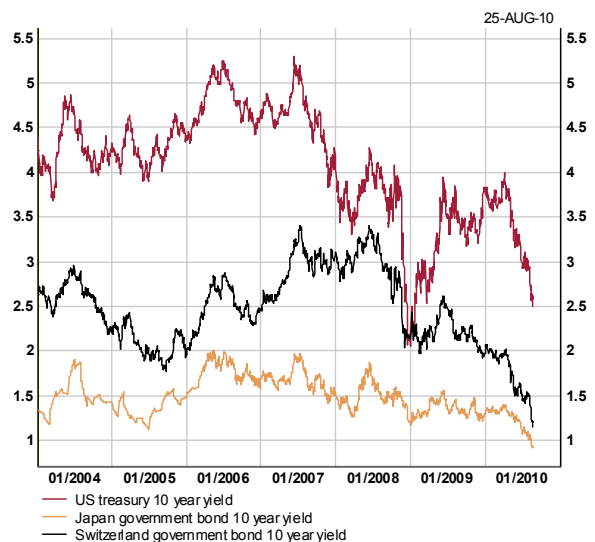
United Kingdom

- Bank of England signals no early return to normal interest rate levels as they want to observe impact of austerity measures on economic activity
- As net new public borrowing falls short of earlier projections, less supply in Gilts is coming to the market than was feared at the start of the year

Switzerland

- SNB communication is increasingly unclear: Are they afraid of deflation or not?
- At the same time, the SNB tells homeowners that rates are not going to remain new zero for ever
- Once global investors return to riskier asset classes, we expect them to exit Swiss government bonds

Zero bound?



Bond yields apparently suggest that investors are now preparing for 2% or less trend growth in the United States for a prolonged period. This is not our view: Our GDP growth forecast for the United States of 2.5% in 2011 is unchanged since November 2009. Central banks have added to such fears: In its comments after the meeting on August 10, the US central bank stated that "...the pace of economic recovery is likely to be more modest in the near term than had been anticipated." Until then the Fed's own central growth projection for 2010 was 3.9%. Financial markets reacted heavily to the new caution. To a certain degree, the fast decline in yields on long-dated government bond papers were caused by regulatory requirements for insurance companies to match duration for solvency purposes. Under these circumstances, it is difficult to find arguments why rates should move markedly higher over the next month which is the normal time horizon for this comment. Further out, we need to discuss whether recent trends in the government bond markets of the US, Japan, Germany or Switzerland have the characteristics of a bubble or not. Prudent investors should study the experience of Japan in 2003 and of the US in spring 1994, when a change in tone by the central banks triggered huge sell-offs in bond markets.

Stock markets

How sustainable is the recovery?

USA

- Market sentiment is extremely bearish, AAII investors sentiment index reached levels which we consider to be buying signals
- Earnings estimates for next year were revised higher since last month and yet equity markets are struggling
- Consequently, we consider forward looking valuations as very supportive for markets

Euro Area

- Valuations are favourable, especially versus fixed income assets
- Equity risk premium holds currently 1.8 standard deviations above its 15-year average
- Financial conditions provide strong support for European economies as is reflected in business surveys

Japan

- Japan's stock market is clearly underperforming other major regions since mid-year
- Yen appreciation and political stalemate after upper house election weigh on corporate sentiment

United Kingdom

- Positive growth momentum and an improving outlook for the banking industry are supportive for the British stock market
- We prefer an overweight of UK equities in a global model portfolio

Switzerland

- Valuation measures remain favourable as most such indicators are clearly below their historic averages
- Cooling global growth momentum and strong currency are important risk factors for Swiss firms
- Our quantitative allocation model proposes a shift from overweight to neutral in Swiss equities

Meaningful support from valuations



As bond yields fell sharply during the past few weeks, a debate emerged whether equity prices are too optimistic compared with what bond investors seem to fear. In our view, current stock market valuations are sufficiently conservative even in case that US economic growth slips below its long-term trend rate. Once investors' focus goes beyond poor US labour market data, they will realize that the corporate sector does well. Final consumer demand is contributing strongly to economic growth. Combined with low financing costs for businesses this means decent profit growth. The increase in M&A activity is a positive sign, as bidding firms apparently see value in current stock prices. Buybacks of their own shares apparently are another attractive option for firms supporting stock markets. Although central bank statements sound increasingly cautious on the economic outlook, we think that one of the goals of their current activities and their commitment to keep yields low is to force investors shifting liquid positions back into riskier asset classes. Ultimately, this asset allocation rotation triggered the recent equity market rally back in March 2009. In our view, the most powerful arguments to remain invested in equities are valuation measures: If expected earnings over the next 12 months are realised, current prices are attractive in historical comparison.

Currencies

General increase of risk aversion

USA

- The risk of renewed talks of a trade war increases ahead of the US election
- Main threat to our positive call for riskier assets and related currencies is the need to reassess US GDP growth in H2/2010 and beyond

Euro Area

- Central bank policy speaks in favour of the Euro versus Dollar and Sterling
- Renewed Euro weakness has been paralleled by widening in CDS spreads on European peripheral sovereign debt
- As we expect positive economic news out of Europe to be confirmed, we continue to see upside versus USD, Yen and Swiss Franc until the end of the year

Japan

- Yen rises as a function of US treasury yields moving lower and lower
- On a trade weighted base, Yen reaches highest level since second quarter 1995

United Kingdom

- Sterling is torn between fairly robust UK economic data and the comparably dovish Bank of England
- As we expect further good news from the economy, we expect the Sterling to recover in months ahead

Switzerland

- As Japan's central bank hinted at the possibility to fight further Yen appreciation, the Swiss Franc regained attractiveness as a safe haven
- EUR/CHF is back at levels where SNB intervened
- Given our global growth outlook for the third quarter, we expect safe haven flows to abate

As US yields fall, the Yen appreciates



Currency markets responded heavily to the comments made by the US central bank on the deteriorating economic outlook. Surprisingly, strong economic data out of Europe did not help the Euro as the Fed's decision to reinvest mortgage proceeds into US treasuries brought worries about European sovereign debt back to the surface. As Japanese firms and the government urged the Bank of Japan to act against a further Yen appreciation, central bank representatives started to hint at a potential intervention. This was the trigger for renewed strong inflows into the Swiss Franc which now appreciates not only versus the Euro, but also against Sterling and US Dollar. On a trade weighted base the Swiss Franc reached new highs in the second half of August. In other words, the Swiss Franc is back at levels where the Swiss National Bank stopped intervening a few weeks ago. Improving US job market data are a prerequisite for our call of a strengthening Euro. In our base case, we continue to expect the Euro to recover to around 1.40 versus the Swiss Franc until year end.

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