World Economy and Financial Markets shifting up a gear

3 months ago, we wrote at this point about green shoots. A look at the table below with the major exchanges reveals our prognosis as correct so far. In spite of a minor correction in January and February, by the end of March all major indices were noted higher than three months ago. Leading the pack were Japan, Switzerland and the USA. Last year's winners, i.e. the Asian markets, excluding Japan, were patently fighting increasingly for breath and had to slow down. Comparing the exchanges in the table below to the expected gross domestic product (GDP) on page 2 reveals a remarkable parallel: there too, it is Japan, Switzerland and the USA whose expected growth for the current year has been upgraded by economists.

Development of **stock markets since beginning of the year:**

		Dec 2009	March 2010	Change[1]
Asia ex Japan	DJ STOXX A/P	436.7	443.8	**1.6%**
Germany	DAX	5'957.4	6153.5	**3.3%**
Europe	DJ STOXX 600	253.9	263.6	**3.8%**
Japan	TOPIX	907.6	978.8	**7.8%**
Switzerland	SPI	5'626.4	6007.8	**6.8%**
USA	S & P 500	1'115.1	1169.4	**4.9%**
World	MSCI World index	299.4	307.4	**2.7%**

Interest rates remain low for the time being

There were hardly any noteworthy movements in the major bond markets. Yields on government bonds in the industrialised nations hardly changed compared to the year-end. Though there are signs that the Central Banks will tighten the reins (key rate increases in Australia, comments by individual Fed members), theses signals have not yet shaken market participants. Overall, the view, also shared by us, that the global economy continues to be dependent on cheap Central Bank funds appears to prevail. A premature tightening of interest rates is likely to strangle the delicate economic green shoot, which is why nobody dares to take this critical step. Singularly conspicuous; yield curves in all major currencies are very steep. Which is to say, the difference between short and long-term interest rates is remarkably high. We do not interpret this as a warning sign of a major inflationary push, but rather as a consequence of the above-described Central Bank policy of cheap (not to say free) money. In nominal terms, yields on 10-year government bonds continue to be close to their historical lows.

Yields on 10-year government bonds hardly changed since the beginning of the year:

	Dec 2009	March 2010
USA	3.8%	3.8%
Europe	3.4%	3.1%
Switzerland	1.9%	1.9%
United Kingdom	4.0%	3.9%
Japan	1.3%	1.4%

During the first quarter, the good form enjoyed by the fixed interest instrument markets was equally actively utilised by issuers of lower quality. During March, according to Bloomberg, so-called "junk bonds" (bonds by issuers with a rating below Baa3 or BBB- respectively) to the tune of 38 billion dollars were issued, beating the previous record in November 2006 of 36 billion Dollars.

Light ….

So, all the lights are set on green for go? By no means! Admittedly, there is indeed plenty of good news. The aviation industry, for example, literally took off recently. According to the International Air Transport Association (IATA), numbers of passengers carried increased in February by 9.5% compared to a year ago. Freight loads even managed an increase of 26.5% on the year. Appetite for air travel became particularly manifested in the Near East (+26%) and Asia (+13.5%). In Europe and the USA, the urge to fly developed at a rather more sedate 4%.

Matching the green shoots well were also the increase in consumer confidence and the creation of 162,000 new jobs in the USA during March. The latter represents the largest monthly increase for about three years. The sales in existing housing stock (in February up 8.2% on January) delivered the long-awaited first sign of life in the housing market. Purchasing manager's reports in the USA, the U.K. and the Eurozone also

[1] Development of index in local currency. Exceptions DJ STOXX Asia/Pacific ex Japan and World in USD.

provide good news, painting a picture of reviving economic activity. Both the American ISM Manufacturing Index and the Manufacturing Purchasing Management Index of Europe are currently above pre-crisis level. Leading indicators on both sides of the Atlantic are indicating upwards. No wonder then that with a backdrop like this, the Zürcher Kantonalbank comments that they consider the likelihood of a downright "mini-boom" as strong.

Average **growth and inflationary forecasts** from „The Economist"'s April poll of economists:

	Real GDP Growth		Inflation	
	2010	2011	2010	2011
Germany	1.6	1.6	0.9	1.3
Euroland	1.2	1.4	1.3	1.4
United Kingdom	1.3	2.1	2.7	1.9
Japan	1.9	1.6	-1.0	-0.2
Switzerland	1.7	1.8	0.9	1.0
USA	3.1	2.9	2.0	1.6

.... and shade

On the other hand, caution remains dominant and widespread in many quarters with warning fingers raised frequently. Obviously, one would not like to see the mini-boom followed by a maxi-crash. No lesser figure than the head of the International Monetary Fund, Dominique Strauss-Kahn, recently felt obliged to warn against exaggerated economic optimism. The Chinese Central Bank put its finger on it when, in view of the high government debt in the USA, it warned of potential threats to the global economy.

Indeed, government indebtedness - and not only that of the USA – is a matter for concern and a potential drag on growth. Equally, the private indebtedness of many consumers is far from resolved. On the one hand, this is acting as a brake on consumption and on the other is weighing on banks still digesting the losses from mortgage, credit card and other consumer lending. Small to medium-sized US banks are, in spite of the harbingers of spring, faced with yet another harsh year. During the first quarter of 2010, about 40 banks in America folded, a number only reached by the middle of 2009. In this respect, 2010 could well provide a new sad record.

Commodities - inflation digested well so far

Creeping up stealthily, oil prices reached an 18-month high by Easter. Copper rose once again to pre-crisis levels. Today, in dollar terms, oil is noted 76% higher than in early 2008. Stated in Euros, the increase amounts to 84%. On the one hand, the significantly higher prices are a sign of the recovering global economy. On the other, the swift and rapid development is already casting a shadow once again in that such a marked increase in such a pivotal commodity, which touches all aspects of the economy, poses a serious threat.

The **equity funds employed by us** achieved the following returns since the beginning of the year and all closed in positive territory[2]:

Aberdeen Asia Pacific (USD)	**2.9%**
Invesco Asia Infrastructure (USD)	**0.6%**
Nomura ETF Toppix (Yen)	**9.0%**
Performa Fund - Asian Equities (USD)	**1.0%**
CIIM European Stock Portfolio (EUR)	**9.6%**
Performa Fund - European Equities (EUR)	**2.6%**
Neuberger Berman US Equity Value (USD)	**3.4%**
Performa Fund - US Equities (USD)	**7.3%**

Other funds employed by us developed as follows:

BlueBay High Yield Bond Fund (EUR)	**6.1%**

Equities climb the wall of worries

With this background, it is well justified to pose the question as to how stocks can deliver such a brilliant performance when faced with all these dark clouds overshadowing the sky. As with many other questions of this nature, Wall Street is as always never at a loss for a reply in the form of a "bon mot": "Bull markets like to climb the wall of worries" is the fitting reply. This is to express the well-known fact that equities always like to rise when their potential is still in doubt. Once the doubt is removed,

[2] Performance in currency of fund. Source: Bloomberg.

however, it is time to return to caution, as the entire world would now have stocked up on equities sufficiently and monies for further purchases would be lacking.

Another dictum equally fits the current situation on the exchanges perfectly: "The trend is your friend". Indeed, almost all the important indices globally are currently on the rise. All the major markets followed by us are currently trading above their 30, 90 and 200-day moving averages, which according to technical models indicate that the prevailing trend is intact.

Measured on the **price/earnings ratio**[3] using the latest 12 months' profit figures, all equity markets have become cheaper (green):

	Dec 2009	March 2010	Change
MSCI World Index	32.1	21.0	**-35%**
DAX Index/DE	60.2	21.6	**-64%**
DJ STOXX 600 Index/EU	58.2	19.2	**-67%**
S & P 500 Index/USA	24.3	18.7	**-23%**
SPI Index/CH	37.8	19.1	**-49%**
TOPIX Index/JPN	n.a.	n.a.	n.a.

Price / Book and **Dividend Yield** of major equity markets:

	Price / Book	Div. Yield
MSCI World Index	1.9	2.3%
DAX Index/DE	1.6	3.4%
DJ STOXX 600 Index/EU	1.7	3.2%
S & P 500 Index/USA	2.2	1.9%
SPI Index/CH	2.1	2.2%
TOPIX Index/JPN	1.2	1.6%

Commentary on Asset Allocation / Investment Outlook

At its meetings, the investment committee decided upon the following changes to the asset allocation for medium-risk balanced portfolios, not subject to client's restrictions:

Liquidity: As a consequence of the decisions mentioned below, the money market share has decreased. Target allocation for liquidity is now about 8% compared to 15% previously. Unchanged, we view money market investments only as a parking position or rather a tactical reserve as yields remain negligible.

Bonds: Unchanged, we continue to hold primarily corporate bonds of mid-to-high quality, plus an addition of high-yield-bonds. In contrast, we consider government bonds of developed industrialised nations to be unattractive. The target size for the entire bond allocation of a balanced portfolio remains unchanged from the last report at about 37%. Equally unchanged, is the maximum term at five years, where we target an approximate equal weight of maturities between one and five years.

US Equities: The correction in US equities earlier in the year was surprisingly small and of only short duration. Valuations have since come down. Markets are currently trading at fair valuation levels. The forward price-/earnings ratio currently lies at 14.7, which roughly corresponds to the historical median. A value indicator published by the American Research Institute "Bank Credit Analyst" equally indicates neutral territory. Compared to the global equity index MSCI World Index, the S&P 500 Index is currently undervalued in terms of historical P/E, estimated P/E and price/cash-flow ratio. We expect the bull market in US stocks to continue and have consequently upped the US weighting in March to just above of 13%.

European Equities: Compared to global equities, European equities are undervalued across all criteria. When compared to its own historical price/earnings ratio, the market is trading at a discount of 27%. As a consequence of its recent performance, the current weighting now amounts to just above 26%. We expect the positive development to continue.

Asian Equities: Dynamics in Asia are impressive, as the crisis there was much less pronounced than in Europe or North America. The development in China, where we may possibly see an overheating, appears almost too good to be true. Still almost unnoticed, the shaken Japanese market now appears to be finding its footing. In March, industrial production in The Land of the Rising Sun was 31% up on the previous year. Even though still far removed from pre-crisis levels, the recovery is impressive. For most investors, Japan is still off their radar screens. The attractive valuation of the market has prompted us into taking on a Japanese equity product with a 2% asset allocation for the first time for quite some time. Together with the exposure

[3] Source: Bloomberg

contained in Asian equity funds, the total allocation to Japan now amounts to nearly 4%.

Non-traditional Investments: No positions are currently held in this sector.

Summary of our current asset allocation**:**

Investment Category	
Money Market	overweight
Bonds	underweight / short duration
Equities USA	underweight
Equities Europe	overweight
Equities Switzerland	neutral
Equities Japan	neutral
Equities Asia	overweight
Non-traditional assets	underweight

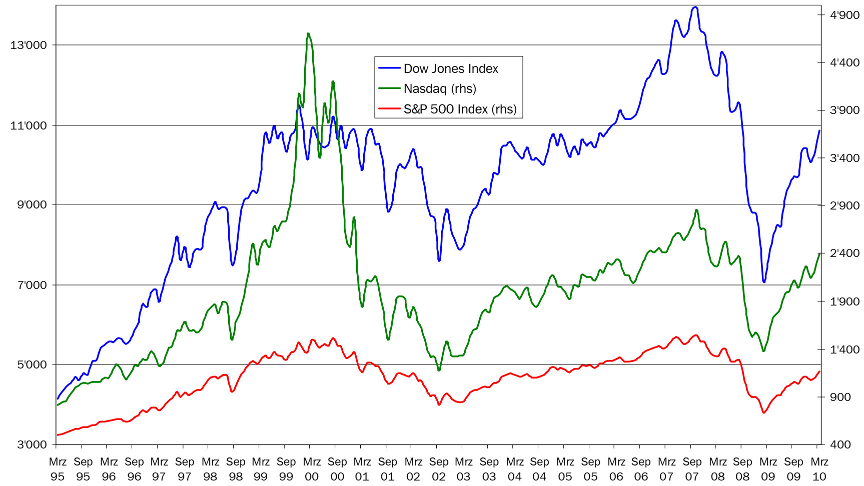
One more thing to conclude,

Within the framework of the „livestock" crisis, in which the „PIGS" (Portugal, Italy, Greece, Spain) had to endure some pain, it was once again interesting to observe how the game of passing the buck was played at all levels. Some of the major players overshooting badly is part of the game in the search for a possible culprit. The hypothesis that nasty speculators kicked Greece and the Euro over the cliff by means of dubious financial transactions met with applause in the heated atmosphere of „finance bashing". This thesis is about as plausible as the one where the white horse won the race because a lot of punters supported it with high bets, whereas the brown hack lost because a lot of backers bet against it.

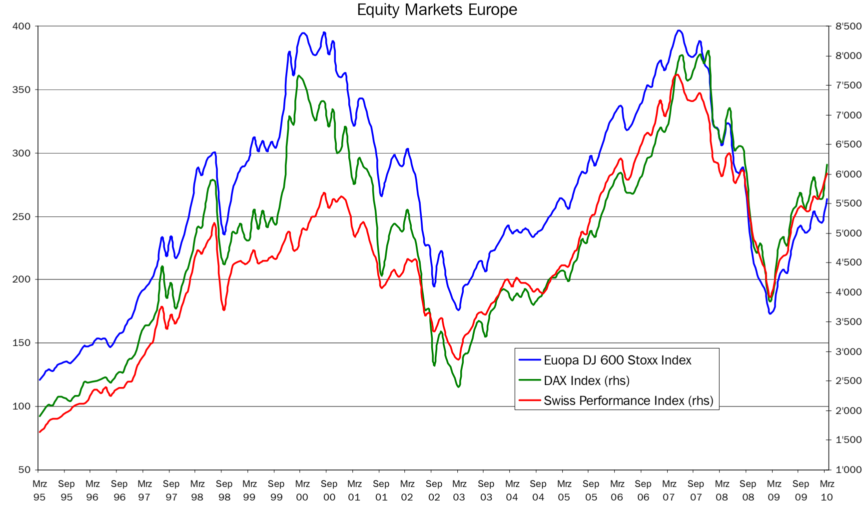
Alfred Ernst
Vaduz/Zurich, 31st March 2010

Investment Policy Report – 31st March 2010

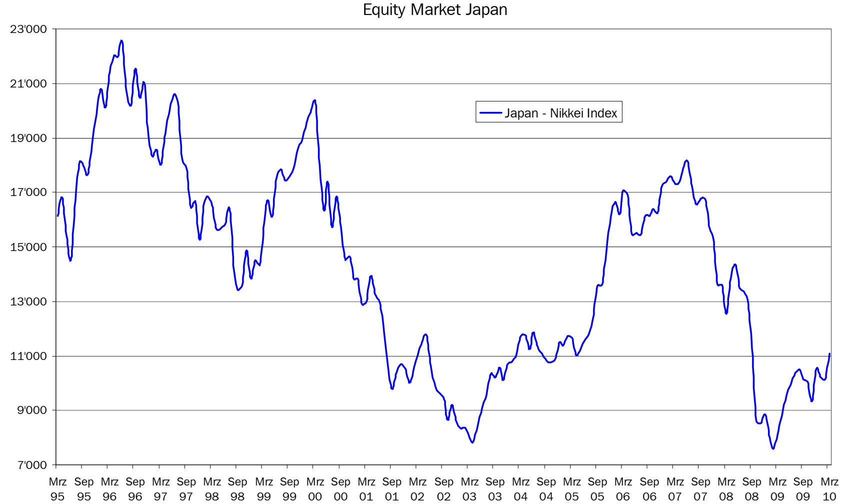
Equity Markets USA



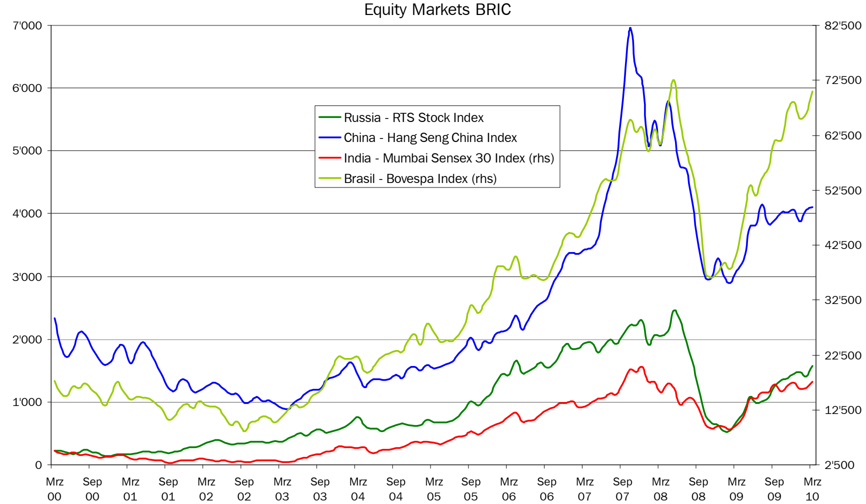
Equity Markets Europe



Equity Market Japan



Equity Markets BRIC



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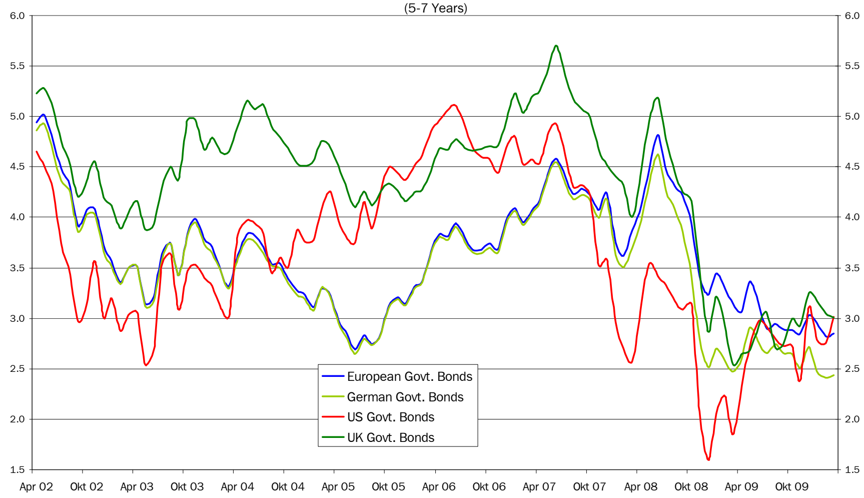
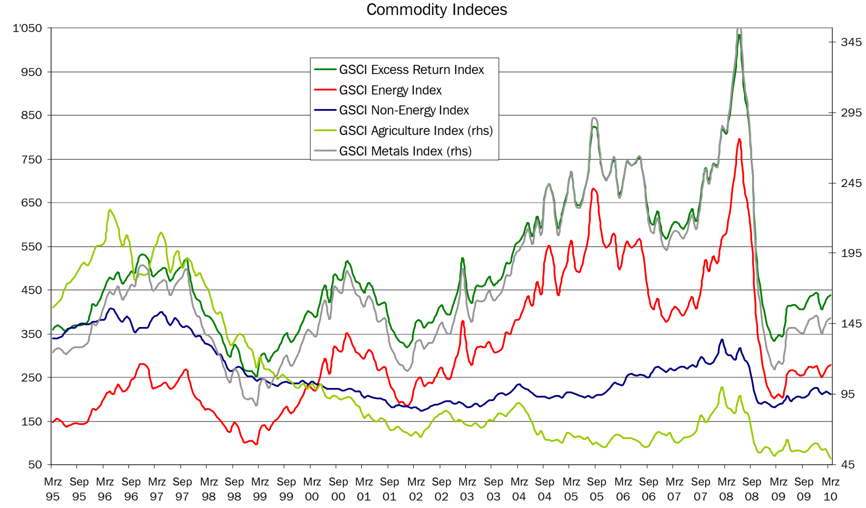
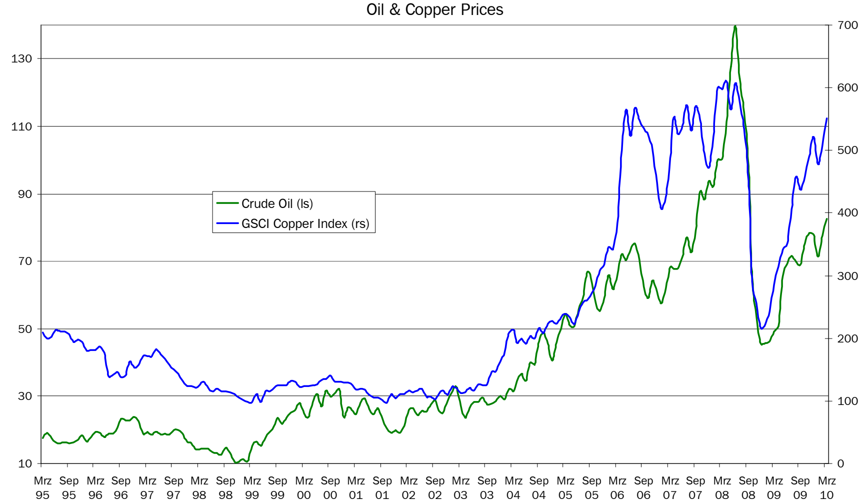
Government Bond Yields



Commodity Indeces



Oil & Copper Prices



Consumer Confidence