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Bank Sarasin's Global View: Economic cycle has reached its peak

In the second half of 2009 and the first quarter of 2010 the global economy recovered well from the preceding financial crisis. While the developed economies managed to successfully kick-start production and investment again, China had to take steps to stop its economy from overheating. According to the latest economic outlook "Global View", published by Bank Sarasin's Research team, sentiment indicators for Q2 2010 such as the purchasing managers' indices show that the economic cycle has already reached its peak. The Bank does not expect growth to pick up again until 2011 at the earliest. One particular cause for concern at the moment is the potentially deflationary environment in the peripheral European economies, which could act as a brake on the long-term growth of the global economy going forwards. When it comes to asset allocation, investors are advised to significantly scale back their investment risks. In view of this, Bank Sarasin is underweight in equities and has put the focus on defensive sectors. The default rate for corporate bonds is likely to ease in the second quarter.

The global economy continued to recover in the first quarter of 2010. In the USA and in the emerging markets of Asia, gross domestic product (GDP) in Q4 2009 was already higher than a year ago, and Europe and Japan are now expected to follow suit. One clear sign of this is the fall in the jobless rate and short-time working in response to increased investment activity. The recovery is being led by China, which is showing very few traces of the global economic crisis. Bold intervention by the Chinese government has helped to shore up domestic demand, boosting consumption and investment activity in the process. One problem could be the constant rise in property prices as a result of more lax lending standards, creating a bubble which state regulation has so far failed to keep in check. We can therefore expect the Chinese authorities to keep economic growth under control by maintaining a policy of very direct intervention in the economy.

Jan Amrit Poser, Head of Research and Chief Economist at Bank Sarasin

"The worst economic crisis in 80 years has given way to a spectacular recovery. Following the powerful upturn in production in Q3 2009, investment activity also started to pick up in Q4. Consumption will ultimately determine whether or not the recovery will become sustainable. There is some doubt whether final demand, which is being curtailed by negative wealth effects and stricter lending standards, really will pick up. The need to repair public finances will also act as a drag on economic growth. The cycle should become self-sustaining only at the beginning of 2011, when the majority of imbalances have been corrected."

Philipp E. Baertschi, Chief Strategist at Bank Sarasin

"The peak of the cycle has been reached, as expected, following the strong first quarter and there will soon be fewer positive surprises. The risk of a significant setback in equity markets will therefore increase significantly. The time has come to take profits and significantly reduce risk positions. We are therefore switching from an overweight to an underweight position in equities. The impending slowdown in economic growth in the second quarter should stimulate bonds. Basically we favour high-quality corporate bonds over government bonds."



Sentiment indicators signal slower growth

The inventory cycle made a sizeable contribution to growth in Q4 2009, but the purchasing manager indices show that the cyclical inventory upswing has now more or less reached or even passed its peak. This is particularly true for the USA, China and Japan, while the European economy will peak with the usual time lag in Q2 2010. Based on an analysis of economic cycles for the last 50 years, it is therefore likely that the current dynamic pace of growth will tail off during the course of the second quarter and will not pick up again until the start of 2011 at the earliest. Consumption will ultimately determine whether or not the recovery will become sustainable, and this is in turn affected by the labour market and income growth. There are a number of reasons to suggest that final demand will not recover enough to prevent the cyclical recovery from fizzling out: following the structural adjustment necessitated by the global financial crisis, employees from the bloated sectors (US construction and retail trade) cannot find any jobs at present. Second, the fiscal stimulus measures brought some of the final demand from 2010 forward to 2009. Third, the latest indicators show that the US real estate market has not yet fully stabilised. A sharp drop in house prices would put pressure on the net assets of households and, as a result, throttle any recovery trend in consumption. Another problem is that lending to households and business is still decreasing as well.

Weak public finances threaten to upset the balance of the global economy

The cocktail of weaker lending, households' lower net assets and increased unemployment (despite a slightly improved labour market) has a deflationary impact. Especially if the pace of growth is slow up to the end of the year, governments will therefore be compelled to resort to further financial stimuli in order to prevent negative multiplier effects. But states in Europe's periphery such as Greece, Ireland, Portugal and Spain need to consolidate their public finances as quickly as possible and cannot tolerate additional fiscal burdens. More financially strong countries would need to step in to support global growth. As well as sorting out their public finances, governments also need to tackle their structural budget and current account deficits by strengthening their export sector. They will only succeed in this by making painful cuts to prices and wages, boosting productivity or devaluing their currency. Experience shows, however, that most countries are capable of adapting their public finances to meet the challenges. Once the process of correcting the global imbalances has been successfully completed, the cycle should become self-sustaining again in 2011.

Headwind for equities – defensive sectors favoured

As the current cycle ends and growth starts to slow as expected, risk premiums for equity investments are likely to rise. The biggest cause for concern is financial markets in the eurozone, due to weaker growth and earnings forecasts. Within Europe, Bank Sarasin thus favours the defensive markets of Switzerland and the UK. The UK equity market should continue to profit from the weakness of pound sterling and put in a relatively good performance. Outside Europe, caution should be exercised particularly in Asia's emerging markets and Japan, as they will suffer most from the impending economic slowdown. Sarasin favours defensive stocks in its sector allocation. The defensive sectors include many shares with stable growth prospects and high dividend yields which could produce a positive performance even if growth eases slightly. These include the sectors Healthcare, Technology, Telecoms and Consumer Goods.

Bonds: No interest rate hikes expected

Given the muted outlook for the global economy, Bank Sarasin expects the central banks to hold off from raising interest rates until 2011. The combined effect of weaker growth and low interest rates will exert downward pressure on bond yields up to Q1 2011. In 2Q 2010 the focus will be on high-quality corporate bonds which should benefit from falling credit spreads. With alternative investments, commodities offer more upside potential than real estate in Q2 2010, as real estate could come under pressure if there is a setback in equity markets. Thanks to persistently strong

demand for commodities in emerging markets, with prices remaining buoyant, industrial metals should be favoured over precious metals and energy commodities.

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