



Media release

Hong Kong, 15 March 2010

Sarasin's Strategy Outlook: Bad News Travels Faster Than Good News

Financial markets currently find themselves driven by macroeconomic and political news, of continuing budget woes in Greece, rumbles of tighter monetary policy in China, and, in the US, the largely symbolic increase in the Federal Reserve's discount rate for US banks. Evidently, Greek tragedies, Chinese constraints, and grand American gestures make for better headlines than the alternative reality, a reality which has seen record levels of corporate cash flow, consistent earnings recovery, and ambitious dividend growth from many large international blue chip companies. Setting aside the headline negatives, the positives presently available in financial markets offer excellent opportunities for investors, according to Sarasin Group's latest Strategy Outlook from Burkhard Varnholt, Chief Investment Officer, and Guy Monson, Chairman of the Investment Policy Committee.

The European Central Bank's reluctance to tighten into the unfolding budgetary crisis in peripheral states is already having a knock-on effect; the yield on German 2-year bonds, for example, has fallen significantly (by 24 basis points) in the last three months. Similarly, in Japan where deflationary fears are back, new finance minister, Naoto Kan, has urged the Bank of Japan to "conduct monetary policy appropriately". With Japanese gross domestic product falling by 3% last month (the largest decline on record), it follows that ultra-loose monetary policy, quantitative easing, and massive liquidity will be the order of the day in Japan for some time yet.

Guy Monson, Chairman of the Investment Policy Committee

"We recommend that investors use this backdrop as an opportunity to buy real income-producing, inflation-protected assets. Our vision is that these can be found in a powerful new "Nifty Fifty"* universe of international super-cap stocks, with very strong balance sheets, powerful cash flow and progressive dividend paying policies. These companies have yields similar or close to government bonds as they will continue to benefit from the return of global economic growth."

Burkhard Varnholt, Chief Investment Officer

"We anticipate a renaissance in equity valuations. Ultra-loose money will persist in the developed world, though it is important to have a defensive stance against the use of inflation as the soft way out for embattled politicians. Realistically, the risk of changes in core interest rates is only truly evident in the emerging world and other commodity-linked economies. With tighter bank reserve requirements being implemented or forecast in China, India, and several of the smaller Asian economies, it is these nations which are seeing rising headline inflation, especially where they have pegs to the US dollar."

Corporate cash flows outstrip expectations unsurprisingly

As global recovery progresses, Sarasin points out that the continual outstripping of expectations by corporate cash flows should not come as a surprise. The IMF has upgraded its growth estimates for 2010 from 3.1 to 3.9%; US GDP rose to a blistering 5.7% in the last quarter of 2009; and a raft of global manufacturing surveys have reported stronger readings than expected. The technology sector, for example, particularly stands to benefit from current trends, gaining from the handover from an inventory to a capital expenditure (capex) led recovery. In the fourth quarter of 2009, when

companies finally began to splash out on equipment upgrades, long delayed by the depleted house budgets of earlier in the year, technology sector earnings grew by 57% (against an expected 24%) and revenues by 9.3%.

Almost 29% of the European main market has reported fourth quarter earnings, with net balance of positive less negative surprises of 19%; above the historical average of +16%. This broadly parallels the US earnings season; the fourth quarter has seen 73% of companies in the S&P 500 beat expectations, second only to the rate of 78.7% for the third quarter of last year. Earnings and revenue (ex-financials) grew by 13.8% and 3.6% respectively, exceeding expectations by 9.6% and 1.9% correspondingly, which – amidst strong cost control – explains the strong cash flow seen globally.

Global Investment Strategy Implications

In a two-speed world there are undoubted positives including healthy and accelerating corporate earnings and revenues, declining volatility, attractive equity and ‘risk asset’ valuations. These are confronted by the headwinds in leading indicators starting to slow down, the gaining of momentum of monetary tightening, the risk of longer-term interest rates rising, and European sovereign risk spreading. In such circumstances Sarasin recommends a focus on a new “Nifty Fifty”* universe of global blue chip equities. These are well capitalised stocks that have been overlooked and de-rated over the last two years which show powerful return, risk, cash flow and yield characteristics. This quality focus provides a measure of defensiveness and growth and compares favourably with AAA and AA bonds which by contrast have performed strongly and now look richly valued.

With fears of monetary tightening prevailing, Sarasin is cautious in the short term about emerging market equities, particularly China, due to risks of higher inflation, though in the longer term, the attractions generally of emerging market equity and bonds remain intact. Reduction in exposure to beneficiaries of resource-intensive growth in emerging markets is recommended particularly in commodity, energy and cyclical holdings.

Though a surge in inflation is not Sarasin’s central case, it points to the attractions of strategies that hedge against this risk, and favours well-capitalised equities with progressive yields which are capable of outstripping inflation as they have done in the past. Moreover, Sarasin advocates having exposure to commodity-linked investments including general funds, targeted ETFs (e.g. platinum) and companies providing leveraged exposure (e.g. oil & gas exploration and production and gold mines). Infrastructure companies with investments in road or port revenues linked to a rise in the consumer price index (CPI) are also favoured.

In fixed interest markets Sarasin favours sovereign risk with low indebtedness at the expense of corporates. High government bond issuance raises questions, not just about investor appetite, but in the longer-term about the soundness of money itself. Sarasin still sees the attractions of gold as an independent store of wealth.

With regard to currencies, the US dollar’s rally from oversold levels is likely to gain traction as economic growth continues to surprise on the upside and expectations of an acceleration of monetary tightening increase. Both the euro and the yen, being heavily encumbered, do not appear to be a compelling “buy”, and their interest rates will likely be kept low. Finally, Sarasin is increasingly negative on sterling on grounds of levels of indebtedness and likely fiscal paralysis ahead of a general election.

The quarterly Strategy Outlook is available from media@sarasin.ch or visit www.sarasin.com

Remarks: * -"Nifty Fifty" refers to the 50 most favourite stocks by institutional investors. Companies in this group are characterized by consistent earnings growth and high P/E ratios.

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