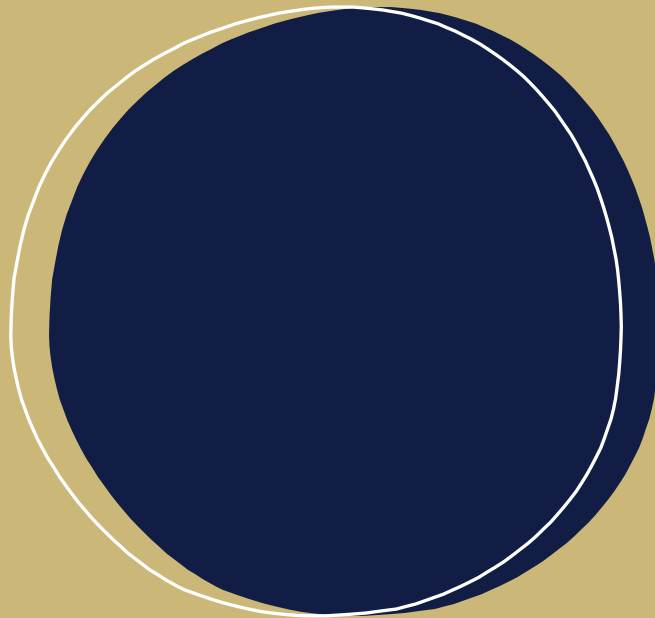


News from the financial markets

Sovereign debt worries dominate market action

February 5, 2010





Sovereign debt worries dominate market action

Bernd Hartmann, Senior Investment Strategist

Fears with regard to Greece's state finances – and now the balance sheets of Portugal and Spain as well – have led to heightened risk aversion in the markets. These credit concerns are overshadowing positive economic and corporate data.

Angst (from our point of view, exaggerated) that certain peripheral EU member states could default on their sovereign debt is driving the action in the capital markets at present. Originally, Greece was the center of focus; now come other candidates such as Portugal, Spain, Italy and Ireland. Many institutional investors are hedging their bets, as evidenced by the recent spike in premiums for credit default swaps (CDSs) and yields on government bonds of the aforementioned countries. Simultaneously, the euro is losing ground against the dollar and yen. The equity markets are suffering under investors' waning appetite for risk. Not just European stocks, but foreign shares as well, have been hit hard of late: since the beginning of the year, Wall Street has lost roughly 4%, Europe 10% and Switzerland 4%.

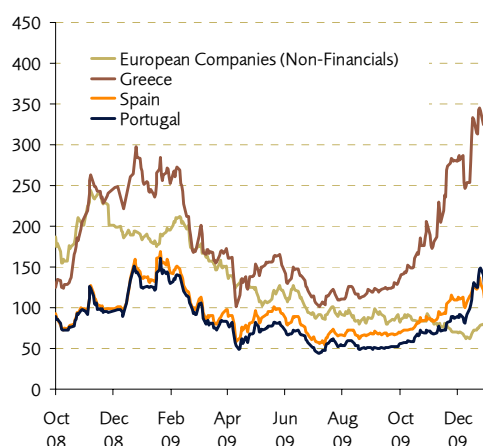
The EU Commission is forcing Greece to tighten its belt dramatically. Within a three-year time frame, new national debt is to be reduced from 13% to 2.8%. As a result, Greece will relinquish far-reaching competencies. Until now, direct assistance from other EU members was ruled out. This was mainly understood as a warning to other member states to get their financial households in order. But if the current situation deteriorates further, it can be expected that the other EU states will step in. Because Greece accounts for a mere 2.6% of Europe's GDP, Brussels will not want to risk the entire currency union. Intervention on the part of the International Monetary Fund would jeopardize the ECB's

independence. Thus we anticipate a European solution to the problem.

Currently, the markets are viewing the announced measures with a jaundiced eye. Although the most recent bond issues by Greece (€ 8 billion) and Spain (€ 4.6 billion) were oversubscribed (albeit a planned € 500 million auction of Portuguese paper came in below expectations, with takers lining up for only € 300 million of the issue), mistrust still prevails in terms of Greece, given that previous administrations in Athens have failed to stand by their commitments.

That being said, the latest developments in the bond market nevertheless tend to indicate that players are starting to differentiate between the various risks. For example, while credit risk premiums on the sovereign debt of Europe's problem children have risen sharply, CDSs on the borrowings of European companies (which have successively reduced their debt ratios over the past decade) have not.

Default risk premiums (CDSs)



Sources: VP Bank, Bloomberg

The equity markets are also demonstrating a similar kind of rotation away from cyclical countries/regions and into the defensive ones. Such a switch out of last year's winners into last year's laggards (i.e. high-quality shares) would be beneficial for the equity market because it provides the cyclical bull with a shot of taurine.

Apart from the credit worries, there was indeed some upbeat news for US stocks over the past two weeks:

- The earnings season was sunny: 78% of the US companies managed to beat analysts' expectations. Q4 revealed a turnaround both in terms of profits (+46%) and revenues (+8%).
- America's GDP came as a positive surprise by growing in the fourth quarter at an annualized rate of 5.7%.
- The ISM manufacturing PMI hit its highest level since 2004, and corporate productivity in January continued to increase markedly.

The bottom line:

We do not expect that Greece, Portugal or Spain will go belly-up. Hedging at current prices strikes us as being an expensive undertaking; rather, we are looking for modest price gains in the bonds of EU peripheral states once the market calms down, as it most probably will. At that point, investors' appetite for risk should return.

This latest correction is unlikely to be a harbinger of the cyclical bull's demise. Granted, undervaluation in the equity market has been largely neutralized. However, given a revival of the willingness to assume risk, the rapid pace of corporate earnings growth has the potential to fuel further gains in the coming months. Equally spoken – as already mentioned in our Equity Market Outlook for 2010 – the year ahead for stocks will undoubtedly be accompanied by regularly recurring interim corrections. Active, risk-tolerant investors can take advantage of those opportunities.

Over the short term, investors should keep an eye out for the following announcements.

Event	Date
EU Leader Summit	February, 11th
EcoFin Council	February, 15th

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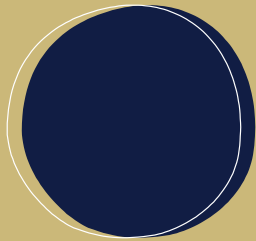
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