

Market Outlook

Investing Themes for Q3 - 2010

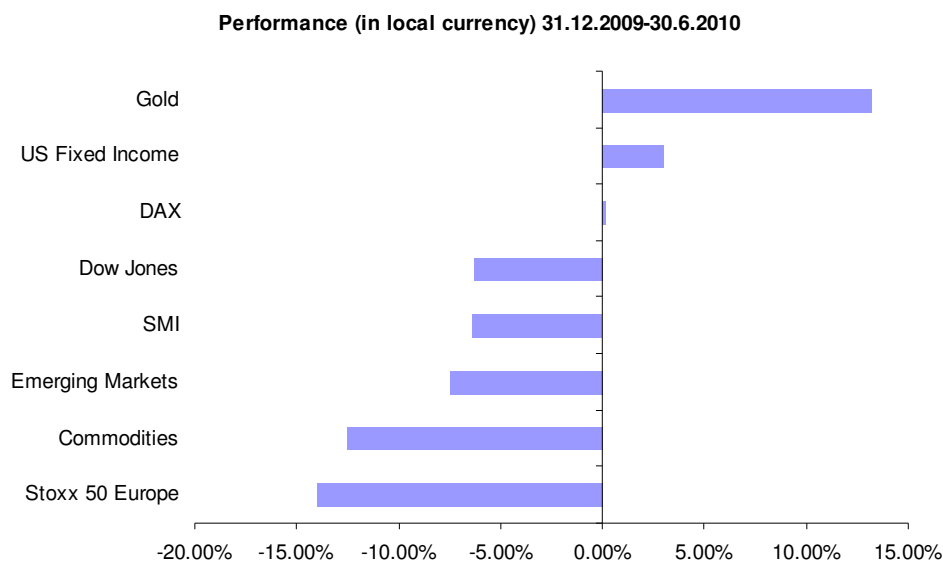


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Market outlook

It has been a poor quarter for risky assets with equity markets falling sharply whilst Gold and high quality bonds have rallied. Investors have become increasingly concerned about the crisis in the Eurozone with many now questioning whether the single currency will still exist in a few years time.



The USD has also been a beneficiary and has appreciated significantly against the Euro. Equity investors have been rattled by the problems in the Eurozone, the general rise in budget deficits and the implications for future taxes and growth. Signs that growth momentum is now fading with leading indicators beginning to roll over have added to growth concerns. Unemployment rates in the USA remain stubbornly high while European countries are now scrambling to avoid Greece's fate. Ireland, Portugal, UK, Italy and Spain embarked austerity plans. This means less investments, higher taxes and higher unemployment.

Over the next six months, our forecast for the global economy can be described as mediocre. An important feature of this recovery is that it is unsynchronised as economies emerge from recession at different rates. The emerging economies have been less affected as their banking sectors were not as heavily leveraged or dependent on wholesale markets as those in the US or Europe.

In response to this view we remain defensive in our portfolios and remain short the Euro. However, we have not abandoned risk trades completely. Furthermore, market falls mean that bad news is being priced in and our analysis suggests that equity valuations are becoming more attractive again.

Asset Allocation Views

1. Interest Rate and Fixed Income

Excluding those economies with questionable fiscal positions, government bonds in general have rallied strongly over the last three months. These bonds have benefitted from investors seeking a place of safety from sovereign debt and double-dip fears. Adding to the pot, key central banks have reiterated their intentions to keep policy rates low for an extended period. This is driven by concerns that the fiscal tightening by some of the major economies may derail the recovery. Therefore interest rate hikes have been postponed and we expect interest rates (especially short term rates) to remain low for the remaining months of the year.

How to invest: We prefer to stay invested in high grade fixed income instruments. For more risky investors we suggest to invest in selected corporate bonds, where valuation is looking more attractive. We also have an overweight position in cash in order to weather turbulences in the bond market resulting from a spreading of the Euro crisis.

2. Global growth and Equities

Our main concern is that the peripheral European countries and increasingly core EU-countries like UK, France and Germany need to undertake an even more rapid reduction in their government deficits through higher taxes and/or less spending. Meanwhile, business and consumer confidence in the Euro area falls, unemployment remains high and the banking sector may run into liquidity problems, as investors fear the outcome of a sovereign debt default.

The equity market attractiveness of the US is limited by the lacklustre job market. With more than 70% of GDP coming from private consumption US-growth rates are linked to the labour market. So far, company earnings growth came from restructuring and cost cutting measures. Sales growth was subdued and we expect earnings growth to start to wane going into Q3 2010.

Arguably, the best growth prospects remain in the emerging world, as unlike their developed peers they are not disadvantaged by their banking and government sector being as heavily leveraged.

How to invest: We are neutral on equities as growth will be subdued in the coming months. In term of sectors we prefer non-cyclical less economy sensitive companies that are able to generate high levels of free cash flows and dividends. We avoid financial stocks as the outlook for the sector looks very uncertain in terms of earnings, regulation and taxation. Emerging Market stocks performed relatively well in the first half of 2010. However in terms of valuation, they appear expensive relative to their peers.

3. Commodities and Gold

With the exception of precious metals, commodity price performance was poor during the last three months. Unsurprisingly, against a backdrop of increased risk aversion, investors sought the perceived safety of gold and trimmed their holdings of risky assets. Gold also benefitted from uncertainties surrounding the Euro devaluation and the increase of money expansion by Central Banks. Near term, a less rosy economic outlook picture will limit the attractiveness of energy and commodity stocks.

How to invest: We remain overweight in gold. Precious metals in general are an important hedge against macroeconomic risks. In addition, gold looks attractive given that real interest rates are expected to remain low for an extended period. Alternatively gold stocks also look attractive from a valuation perspective. We also remain invested in energy and commodity stocks. Long term trends, such as a growing world population, climate change, emerging market diet development and planting competition with biofuels are beneficial to the sector.

4. Currencies

Europe's common currency, the Euro, has been one of the biggest victims of Greece's debt crisis and its fallout on other struggling Southern European economies. The Euro dropped considerably against all major currencies and as long as solvency risks persist the Euro remains vulnerable. The USD, Swiss Francs, Emerging Market currencies and gold benefitted from this weakness.

How to invest:

Avoid currency risks by investing most of your assets in your reference currency. For the developed economies, the preferred currencies are those supported by macro-fundamentals and firm fiscal conditions, such as the Swiss Franc. Meanwhile, we remain moderately positive on the US dollar, which reflects the relative strength of the US economy. In comparison, we are underweight the Euro.

Established by

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