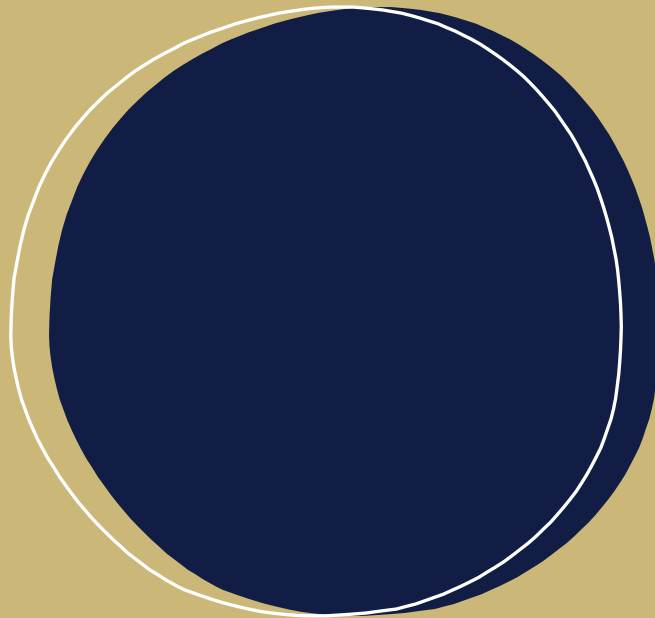


News from the financial markets

Gradual recovery in the equity markets

July 14, 2009





Gradual recovery in the equity markets

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After rallying sharply in March and April, the equity markets have been taking a breather since May. At present there is a lack of any particular impulse. We nevertheless expect to see new impetus for a gradual recovery that is likely to arise in the third quarter and be driven by the industrial sector.

A turbulent first half lies behind us

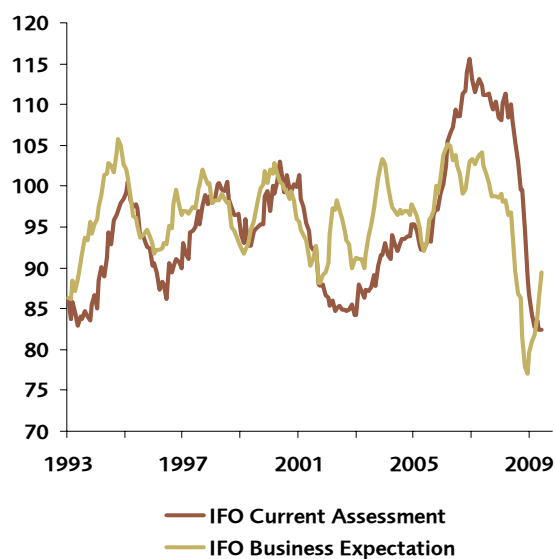
A glance at the performance of the key equity market indices reveals little net change for the first half of 2009, but the impression that the period was uneventful is indeed misleading. The fact is that an extreme degree of turbulence marked those initial six months of the year. During the first quarter, fears about the economy took center stage and drove share prices down another 25%. However, the data published in the second quarter showed that the general shared angst among stock jockeys was somewhat overdone and equities ultimately managed to recoup their earlier losses. Now, the markets are searching for direction.

Inventory cycle: the potential trigger

Ever since the beginning of the year, purchasing managers have been offering a progressively more upbeat view of their future order flow. Even economists, for example, are expressing a greater degree of optimism in the latest Center for European Economic Research (ZEW) monthly surveys. Nonetheless, their assessment of the *current* situation has improved only modestly in recent months and therefore still remains at a very low level. Such a lead in the expectations component of the survey is by no means atypical. And those brighter expectations should ultimately result in an improvement in the current situation as autumn comes around. At that point, the concurrent economic indicators (i.e. the "hard

numbers") such as new factors orders should start to reflect the previously announced sentiment indicators.

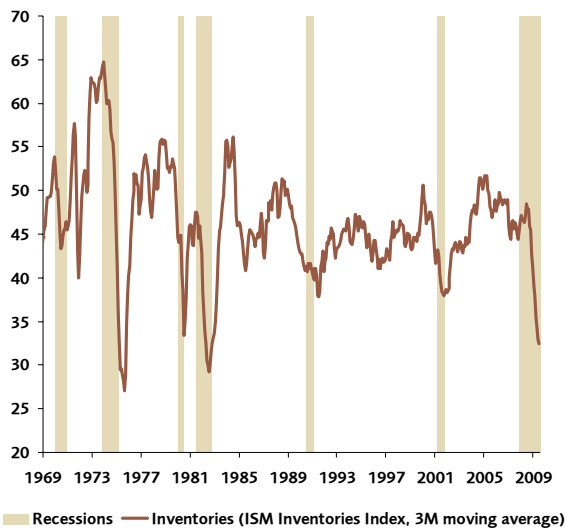
The current situation should ultimately reflect earlier expectations



Sources: VP Bank, Bloomberg

In the months gone by, industrial production experienced a dramatic breakdown and only recently has it started to stabilize at a low level. In response to the Q4 2008 collapse in new factory orders, companies were initially forced to build up inventories because they were unable to cut production at a pace that matched the drop in demand. As the months progressed, those inventories were built down at the expense of production. This phase of inventory reduction is already far advanced and the increase in new orders that is currently underway (coupled with other backlog) can no longer be filled by merely drawing down inventories. That situation should kick-start production once again.

Inventory build-down is far advanced



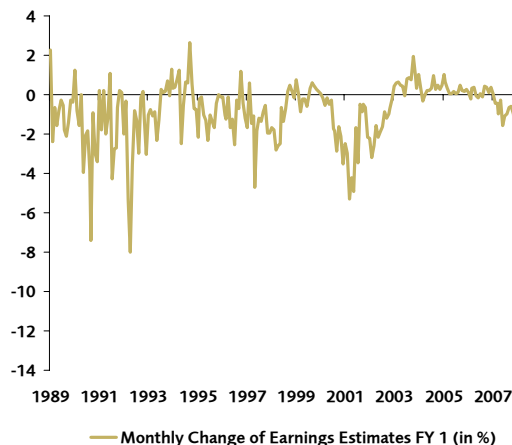
Sources: VP Bank, Datastream

Bose-building in analysts' expectations

Following their earlier sharp revisions to the downside, analysts are now no longer adjusting their earnings expectations southward. The quarterly corporate figures scheduled for release in the coming days and weeks will reveal whether a renewed round of revisions is called for.

Analysts' expectations have come to rest at a low level, but uncertainties remain high in anticipation of the impending semiannual reporting season. In the USA, the "earnings recession" is the farthest advanced. Forecasts are being based on the assumption that Q2 corporate profits in the USA plummeted yet again during the period, this time by 34%. In total, operating earnings of US companies will have dropped by 57% from the highs registered in Q3 2007 if one is to believe the consensus expectation. But apart from the raw numbers, it will mainly interest us to see whether the captains of industry are willing to provide guidance on what lies ahead.

Earnings revisions have run their course



Sources: VP Bank, Datastream

We are going on the assumption that US corporate profits will improve in the second half. In terms of European corporate earnings, we expect to see a similar trend reversal only at a somewhat later date. Favorable surprises could be in store mainly on the part of US companies. They have initiated dramatic cost-reduction measures that should already start to show up on the expense side of their income statements.

In past years, a base-building phase in analysts' expectations was a prerequisite for a trend reversal in the equity markets. A number of other requirements have also been fulfilled in this regard, e.g. a nadir in commodity prices, the proactive monetary policy being conducted by central banks, the steep yield curve and declining credit spreads.

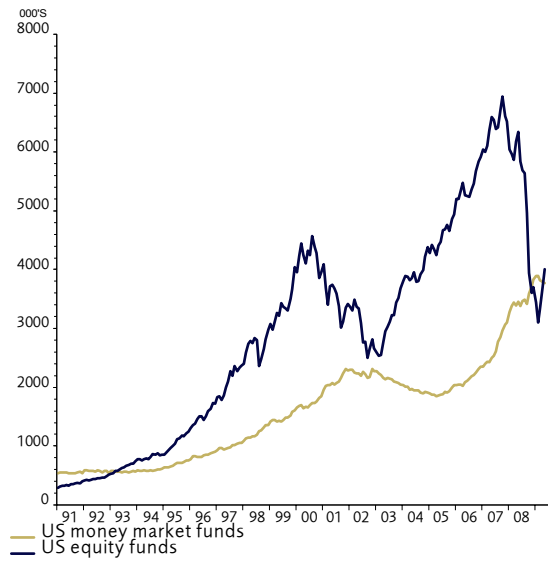
Which risks remain?

Despite these significant improvements, numerous risks still exist. The magnitude of the upside potential for stocks is in direct proportion to the level of uncertainty in the marketplace. Volatility – a stress indicator – is currently at a level last seen prior to the collapse of Lehman Brothers, even though the financial system today remains on the ropes. Banks' hesitancy to lend has negative implications for the real economy. And despite the fact that the decline in US housing prices has decelerated of late, the cost of an average home is still on the decline. Over the short term, the greatest risk in terms of equities is the possibility that the improvements we expect to see could in fact be postponed, with investor disappointment then being expressed through share prices.

Many investors are underexposed to equities

Although the outlook for the equity markets has improved, many investors are either avoiding stocks entirely or are heavily underweighted in that asset class. They are sitting on record-high levels of cash that could ultimately find its way back into equities. Obviously, if share prices advance, the pressure to get on the bandwagon will increase. Recently, tentative withdrawals from money market funds have been observed. But the amount of liquidity parked in those funds continues to equal the total market capitalization of all US equity funds combined, or more than 40% of the collective market capitalization of all US stocks.

Net assets of money market and equity funds



Sources: VP Bank, Datastream

The bottom line

We are looking for an improvement in the economic data and expect that the equity markets will respond in kind. Given the aforementioned uncertainties, however, we are not tactically increasing the currently neutral equity exposure of our discretionary asset management mandates. If visibility were to improve in the coming weeks, we would re-examine the weightings within the framework of our risk-controlled investment process. Our regional favorites remain unchanged: Pacific, Emerging Asia and North America.

The VP Bank Group

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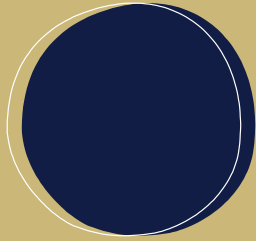
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