

Summer 2011

# Trends



BANQUE PRIVÉE  
EDMOND DE ROTHSCHILD



Close-up view of a table designed by Philippe Druillet, BPER Geneva - ©Tobias Regell

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# The counterfeiters

PATRICK SÉGAL

Speculators and financiers worldwide have their gaze riveted on the five Greek parliamentarians who form Prime Minister George Papandreou's majority. Stockmarkets and financial issues, in particular, have retreated 10%, waiting for the veil of uncertainty to be lifted. What would happen if some leading European banks were to suspend their payments? Or if other dominoes were to fall? The answer is that we would have a nightmare. Everyone has forgotten that Greece owes about €350 billion, i.e. a bit more than America's quarterly deficit. Solidarity among Europeans is a must, whatever the cost, to head off a second banking crisis that would be irreparable this time. Angela Merkel must have realised this, albeit a bit late. 2012 is an electoral year in a number of large countries, and none of the leaders concerned wants to bring on a crisis before facing his or her voters. Most importantly it will be a presidential election year in the US, which has a budget deficit of \$1.4 trillion and a national debt exceeding \$14 trillion. Despite this US politicians learned nothing from the 2008 credit crunch: the Democrats continue blindly to advocate social spending and the Republicans continue blindly to advocate tax cuts and smaller government. Two wars and social security with no revenues to back them have combined to create a staggering, unsustainable shortfall. Mainly Republican lobbies, lubricated by millions of dollars, shoot down any initiative designed to do away with tax niches. These lobbies are so effective that they have enabled Wall Street to stop paying taxes on the pretext that its billions in capital gains and bonuses are fair compensation for the tough work the beneficiaries have to put up with. Tough work indeed. So with any rise in taxes ruled out, the Federal Reserve continues to print money that is worth less and less. By 2013 America's public debt will reach more than 85% of GDP in a context of sluggish growth. Another sword of Damocles (and not a Greek one) is that any increase in short-term interest rates, being kept at 0% by the Fed, would become a raging financial tidal wave.

After QE2 should we expect a QE2½ to continue distorting long-term rates? With no real way to collect on big multinational companies (which keep their profits abroad) and no way to abolish the tax breaks and niches accumulated by the Bush

Junior administration, the US deficit is not going to shrink any time soon. Cutting it would not slow the economic recovery, which is jobless and quite moderate for the moment.

*There can be  
no brave bipartisan  
bid to break out of  
the crisis*

With unemployment still soaring and consumer sentiment at an all-time low, a 2% rise in GDP cannot generate enough new jobs to boost confidence and trim the deficit. If the leading ratings agencies were not American, the US would have already lost its triple-A status and the downgrade would have cost it another \$100 billion in debt-servicing charges. With professional politicians engrossed in getting re-elected, there can be no brave bipartisan bid to break out of the crisis. With no reforms before next year and no drastic measures forced on them, governments and central banks will go on printing money to dilute the value of their currency and take the sting out of the crisis. Thus, the purchasing power of currencies is collapsing under the reign of the counterfeiters. Euroland, whose politicians have cheered the stability and efficiency of their

currency for the past ten years, has experienced broad-based inflation in commodities, services, healthcare, real estate and energy. A loaf of bread in France has gone up from one franc to one euro! Stagnation and dwindling purchasing power are grinding away at the economy.

The emerging countries in contrast continue to grow rapidly, and their currencies are appreciating. This is helping export industries in Europe and the US, with Japan benefiting less owing to its tsunami-induced slowdown. But rising inflation and initial pressure on China's banks





could start slowing their growth. Moreover developing local industry will not help global sectors that have been protected by their exclusivity. Embraer has already entered the fray in aerospace, and the day of Chinese airliners is not that far away. Boeing, Airbus and their subcontractors can take notice.

The Swiss franc is dizzying high, flying above the whirlwind of counterfeit currencies. It is a commodity that speculators have bid up far beyond its normal realm of circulation. Too bad for the Swiss National Bank, which lost CHF 42 billion trying to hold it down. Speculation has driven our franc up 20% to the great dismay of exporters and hotelkeepers. The mini-Deutsche mark has become a tool for bidding against the euro, since there is no drachma left... The SNB was bitten and is twice shy of the forex market. The deflationary impact will be felt in the second half, unless a miracle on the Acropolis brings some relief.

What investment policy can one imagine amid such poor visibility? Is that gleam in the fog a sunray or

the headlight of an express train barrelling towards us? Given the counterfeiters' exclusive right of seigniorage, we recommend keeping positions in hard assets for safety's sake. Gold is still the best bet. With bonds the least lucrative and riskiest of asset classes, only corporate issues offer yields worth considering. Here, in fact, there are still some good opportunities in fixed- and floating-rate paper. Another «hedge» is to buy shares in solid industrial blue chips. These suggestions may not be very original, but they are a way of avoiding volatility with equities these days wont to dive on a single press release. On the other hand there is surprisingly little talk about Zynga's and Facebook's IPOs after LinkedIn's, at astronomical capitalisations that reflect the glut of liquidity.

In the event no problems or eyebrows are being raised in Brussels, where the EU's sprawling bureaucracy wants to vote a 5% increase in its budget. Obviously they need it to pay juicy subsidies to Greece for make-believe olive groves and farms!

# A glance at Greece

THANASSIS GONTIKAS

Having lived in Greece for many years and having witnessed its unprecedented growth—a true metamorphosis of the country in the past 40 years—I can't help but wonder what the next step will be.

Greece has been developing on a model that allowed huge budget deficits in order to sustain continuous annual growth, on the assumption that future revenues would repay the debt. In essence, a good scenario provided for government revenues that would continue growing and for expenses that at some point would level out. And that is what actually happened for many years: the country grew 4-5% annually and in 2008 reached a per-capita income of around \$34,000, among the top PCI's in the world. Greece was indeed dancing along, ranking, if I remember well, as the 17th richest country on earth.

The global financial crisis of 2008 left the Greek banking system almost unscathed as there was no exposure to subprime risk. But the credit crunch made everybody much more careful about whom they were lending money to, and this helped Greek banks. Because they were considered extremely solid at the time, they saw inflows of many billions of euros into their balance sheets. But the annual budget deficit kept piling up, topping 10% of GDP in 2009. In actual numbers it reached €25 billion, and the national debt climbed to staggering levels

close to €300 billion. Then everything came tumbling down! The markets were suddenly unwilling to lend and the country slowly but surely slipped into the hands of the IMF and its European partners.

A massive bailout plan worth €115 billion was set up, and Greece was told to implement structural reforms in its economy. To a certain extent the reforms have been carried out. But now, 18 months later, the EU is faced with another Greek request, this time for €90-125 billion to prop up the country for the next couple of years. It is absolutely certain that without this assistance Greece will not be able to meet its payment obligations and will default.

That is the tragedy, and it is Greek through and through! If the country defaults many European banks, pension funds and investment funds, the ECB, and all the European governments involved in the first round of the bailout will suffer serious losses. And if the country does not default, they will have to extend another €90-125 billion!

So it's damned if they do, damned if they don't, since no one today really believes that Greece will be able to start repaying down its debt in the years to come. To add to the confusion the political system in Greece is in limbo, and no one knows how long this or any other government can remain in power while



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applying extremely harsh and unpopular austerity measures.

The situation today is that practically the entire Greek economy is going through a demand implosion. Tax revenues are collapsing, salaries are down 20% in the public sector, the country is sliding into depression and the risk of political instability is increasing by the day. The privatisations supposedly needed to bring €50 billion into the treasury by 2015 have not started, yet plans call for €12 billion of additional revenues in 2011 and 2012.... We are quickly reaching the point where major decisions will need to be taken—and enforced—if Greece wishes to remain in the EU and honour its obligations as a hardcore member.

If not? Well, that is where the real trouble would start. If Greece for any reason opted to default unilaterally, we in Europe would be faced with such a crisis that 2008 would look like a kindergarten exercise. Here is what it would be like.

On day one Greece would need to freeze all bank deposits to defend against a massive bank run. All state and private pension funds would go bankrupt. Insurance companies, required by law to keep a certain amount of their capital in Greek sovereign bonds, would go bankrupt. Within two weeks the government would no longer be able to meet most of its payment obligations. The banks would need massive recapitalisations or would be sold for €1 to anyone willing to buy them. Business activity would come to a full stop and, in my view, the country would be prone to major social unrest that would spread like a bushfire outside the Greek borders. In Europe banks would suffer heavy

losses on Greek public debt and potentially similar losses on the country's private-sector debt since no one would be able to repay it. European pension funds and investment funds would also suffer, and private companies would take major hits on their balance sheets. The EU would have to provide many billions of euros' worth of state aid to banks or risk a cascade of failures. Liquidity would dry up in the interbank market and interest rates could go sky-high, creating greater uncertainty. Issuers of CDSs would have to honour them, creating potentially massive losses not only for EU banks but for US ones as well. In reality no one knows where such an event could lead us.

All this is unthinkable. It is something that anyone in his right mind must avoid at all cost, even if this cost is greater than the numerical exposure to Greek debt. If we allowed such a thing happen, we would open Pandora's box on Europe. "Who's next?", the markets would wonder. Speculators would zero in on those countries suffering the most in order to short them to death. "How quickly can I sell my euros?" people would think. Etc., etc., etc.

So no, that is not a viable solution. The solution is for Greece to pull its act together and take the necessary steps to reorganise its economy, curtail its notorious and huge black market (estimated to be worth 30% of GDP), downsize the public sector and make regulations transparent to allow free competition. Meanwhile the EU will have to continue supporting the Greek economy with fiscal measures and direct investments. Let's hope for our sake that they are all capable of doing this.



# « Hope changed sides and the soul of the battle swayed »

Victor Hugo

PIERRE-YVES BRACK

The mood remains gloomy, even though fundamentals and valuations are improving in many quarters.

It should gradually become easier to find a way out of the Greek crisis, set monetary policy in emerging markets and dictate new rules to the global financial system. All the while, Japan is slowly getting back on its feet.

As such, the second half is likely to buck — rather than exacerbate — the trend witnessed in the first half of the year.

Analysing companies is still not child’s play, especially when it comes to picking those with scope for upside surprises (driven by solid market positions and a competitive edge) while avoiding others those that may fall short of market forecasts. That said, opportunities are starting to emerge.

No doubt about it: hope must indeed switch sides if we are to see a major stockmarket rally.

There is plenty of cause for concern. These are the matters that have monopolised investor attention for the past two months, and it is still hard to see a way through:

- Europe is failing to get a handle on the debt crisis that has engulfed its periphery. Remedial measures to public finances will dampen growth and job markets.
- Emerging markets are tightening the monetary tap to ward off the threat of inflation.
- The property market in the US remains in an appalling condition.
- Banks are less willing to lend money (and hence finance growth) until the exact terms of the new rules governing funding are known.
- The Fed’s second round of QE is set to grind to a halt on 30 June.

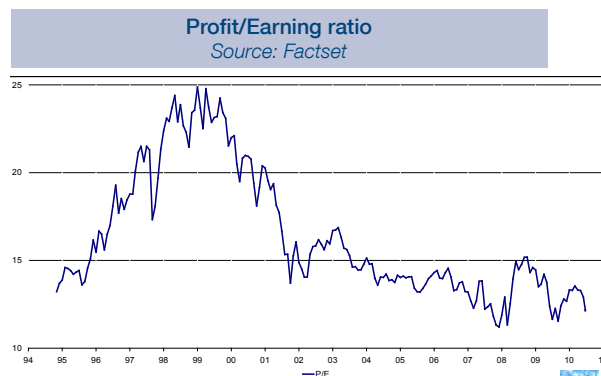
While not wanting to play down the seriousness of each of the above challenges nor deny their existence, we would suggest that risks are largely priced in, based on US stock valuations (S&P 500), which have fallen back to 25-year lows.

## The pressure may soon be off

In the coming weeks, we are hoping for news that can at last rekindle the hope that, as we project, the second half will buck — and not exacerbate — the trend witnessed in the first half of the year.

**Proper management of the sovereign debt crisis:** Following the vote of confidence by Greece’s parliament, a workable austerity budget is likely to be passed. Not only will this release the planned fifth tranche of financial support, but it will enable the EU to draw up clearer, more plausible plans for managing the debt crisis on its periphery over the long run.

**In emerging economies, a drop in inflationary pressure and less hawkish monetary policy:** The correction that has hit commodities across the board in the second quarter (including softs in recent weeks) should soon result in a drop in inflationary pressure, enabling emerging markets to steer their economies towards a soft landing and place monetary policy on a more stable footing. As



regards overall growth, we should also bear in mind that despite stagnating consumer spending in these countries, investing in infrastructure (a vital need in emerging economies) has been maintained and, in places, even sped up. Hot on the heels of the 12th five-year plan in China (the purpose of which is the rapid expansion of the country's interior and second-tier cities), Brazil is instigating temporary measures to quicken much-needed spending for the football World Cup (2014) and the summer Olympic Games (2016) to run smoothly. More than simply building or renovating the odd stadium, the blueprint plans for the development of a whole new system of roads, airports, hospitals and hotels — to name but some of the planned infrastructure.

**More relaxed financial rules than feared initially:**

In the weeks ahead, the financial industry will be informed about a sizeable chunk of the new rules that will govern its business in the future. First of all, the Basel Committee will meet to set in stone the new Basel III rules that major banks (i.e. those that would trigger a systemic risk in the event of failure) will have to abide by, in addition to the minimum capital threshold (7%) applicable to all banks. We would wager that once again the reality will not be as harsh as current expectations (which suggest a doubling of the lower capital limit); rather, we expect an increase within a fair average (+2.5-3.5%). For now, the market has focused on the downside of the extra burden, namely that banks will have less capital to allocate to business activities, which means fewer loans and a lower return on equity. But investors have completely ignored the fact that sounder balance-sheet ratios are synonymous with lower funding costs: As always, matters are not as clear cut as it seems.

**Aftermath of QE2 not like when plugged was pulled on QE1:**

The market is currently dreading the discontinuation of the Fed's second round of QE, fearing that it will be a rerun of March 2010, which is when QE1 ended. At the time, this led to a 15% slide in equities that was driven by banks (-25%). But some comparisons can be misleading...

In actual fact, the current round of QE is set to linger on in an unofficial capacity. Income stemming from the redemption of paper securities held until maturity will be reinvested. As such, the Fed will keep a long position (potentially over the long term) equating to the amount already allocated (assuming that repayments are honoured in full). This reinvestment procedure was missing when QE1 was put to bed. Moreover, the finances of both banks and households are far more solid today than in the spring of 2010: bad debt has fallen over the past five quarters while coverage ratios have increased sharply. The increase in deposits (6% year to date compared with the same period last year) is strengthening banks' balance sheets because lending has not risen. Personal bankruptcies are down (-7% year

on year) and interest payments as a percentage of household disposable incomes have eased back to their 1995 level.

There is no reason, objectively speaking, that market moves should automatically resemble those of spring 2010.

**Low US rates:** Let us not forget that US interest rates have swung down by some 80bp all along the yield curve in the second quarter. This means less pressure on government finances plus a let-up for householders. Mortgage rates are mostly calculated in reference to the yield on 10-year Treasuries. A sharp rise in refinancing has also been witnessed.

**Japan gradually returning to form:** Disruptions to supply chains resulting from the disasters that hit Japan will gradually disappear (a factor that concerns not only Japanese firms). Furthermore, initial reconstruction efforts are set to quicken business trends and imports in the country in late 2011 and throughout 2012.

**Forecast-beating corporate earnings:** The slim rise in volumes along with operating leverage (with costs cut to the bone during the crisis) are having a positive effect. Warnings on Q2 earnings have so far been scarce. Further to this, the price hikes announced in H1-11 by several sectors of the economy will exert their full effect in H2-11, just as pressure on costs is subsiding.

These more immediate factors should not make us lose sight of the **supportive long-run trends**. Population growth and urbanisation, along with environmental issues and increasingly hard-to-get-at natural resources, represent genuine opportunities for several industries (e.g. agriculture, infrastructure, renewable energy and pollution clean-up equipment, etc.).

**Summing up:  
a soft patch but not a credit crunch**

From where we are standing, we expect a soft patch rather than seeing the economy rushing headlong back into recession. In practice, this means more moderate growth after an initial boom. Progress to date is being "digested", although the slowdown has been worsened by the disaster in Japan and the knock-on effect that this has had on the supply chains of several industries.

In other words, we expect the second half of the year to start reversing the trends witnessed in H1-11, rather than making matters worse. At the same time, European authorities are likely to implement proper coherent measures to halt the deterioration in sovereign debt risks (although these measures will come with a price tag and will only have an effect over the long run).

Some investment options for today's conditions

Even though the recent correction was slightly harsher than we had expected (in terms of duration and size), we are not shifting our stance.

But note two recent occurrences:

**Some industrial stocks** have experienced a sharp correction even though fundamentals have not soured, e.g. building site equipment and mining equipment.

**Some segments of the property sector** are attractive. According to communication experts, a picture is worth a thousand words. The following chart gives us a far more poignant illustration than words would of the potential of this sector, which is in recovery phase (although asset portfolios should be carefully chosen).

**For the rest**, there is no reason to make huge changes to our recent recommendations:

To seize the opportunities coming to the fore in these troubled times, our preference lies with companies with **gold-plated finances** — we are not enticed by those gearing up. Strong finances often means higher shareholder returns. More than ever, **dividends** have become pivotal to overall returns.

All else being equal, Japan's reconstruction will boost

demand inside the country for **natural resources** (including coal and gas, to compensate for nuclear generation). At the same time, investment and residential construction are picking up pace in China. Copper, coal and iron ore remain our favourites.

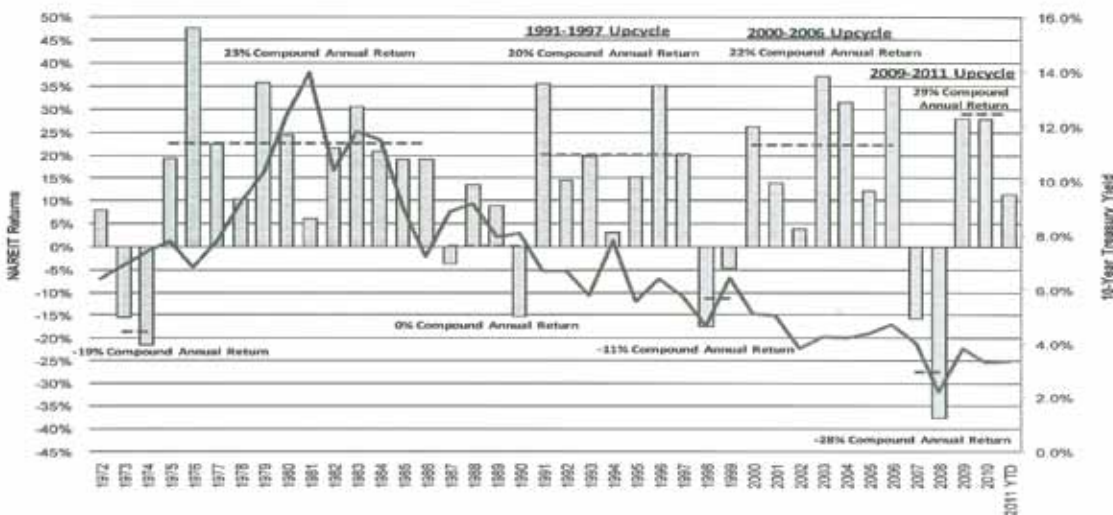
**Platinum and palladium** have priced in a sharp slowdown in automotive output worldwide. To our mind, the decline is overdone for these metals (which have base and precious usages) given the production shortages and the introduction of tighter environmental standards around the globe. **But gold remains the ultimate safe haven.**

**Rare earths** are extremely attractive (though very volatile). Chinese export quotas have been slashed due to a surge in demand, without mentioning likely strategic stockpiling in the US for defence applications (missile guidance systems, night sights, etc.) or "green" applications (catalytic converters, electric car batteries, and wind/solar power). The huge correction of 35% in the space of a few weeks (which is nonetheless representative of the sector in terms of size and duration) represents an attractive opportunity for investors hungry for gains.

Lastly, some specific stocks that have in the past been inoculated against inflation are today worthy of consideration: **industrial gas** and some **healthcare stocks**.

Historical Total Returns : NAREIT Equity REIT Index:

Source : Bloomberg, Raymond James



## « Of all torments uncertainty is the most difficult to endure. »

Alfred de Musset

PHILIPPE LEDERREY

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Soft patch or part of the healing process? In either case, a transition period.

Economic growth is decelerating. That is the only certainty in the current economic and financial environment. And it is a trend that leading indicators suggest could continue in the coming weeks. The finance industry still faces an uphill battle: the central banks' exceptional measures will soon come to an end, interest rates are set to rise, sovereign risk is widespread and could still be contagious (will Europe be able to push off its problems until 2013 through new deficit-reduction measures?), and speculative assets are reaching bubble status (social networking, Bordeaux wines, Paris property up by over 20% this year, etc.).

### Cash injections have not resolved fundamental imbalances within various economies

A number of scenarios can be built on this stark backdrop. We could, like most strategists, say this is part of the normalisation process following an initial period of recovery. Or we could take the opposite tack and say that this synchronised slowdown is not simply a passing phase but rather the inevitable outcome of the gradual elimination of adjustment mechanisms put in place in the wake of the financial crisis. The massive cash injections and the expanded role of governments and central banks were a key factor in avoiding a prolonged recession, but the measures enacted did not correct the fundamental imbalances plaguing the global economy (and that helped spark the crisis in the first place). These imbalances will still have to be dealt with in the future. In addition, the economy and the financial industry will have to break their addiction to the liquidities that have been provided cheaply and copiously by the stimulus measures – this is an unprecedented situation that further complicates forecasting stockmarket trends. Under the first scenario, a soft economic landing could send European stockmarkets 10-15% above current levels. Under the second scenario, cutting off the flow of monetary stimulus could drive the markets down to the same degree, if not more.

### Companies in good shape, but rising commodity prices on the horizon

Unlike government finances and debt levels, companies are now in an excellent position. They are currently benefiting from sound balance sheets, manageable debt, record margins and profitability, strict cost control, and a bright outlook in emerging-

market countries (which continue to show strong growth). Companies in the western world are among the big winners in globalisation and enjoy considerable managerial leeway and exceptionally low financing costs. Their solid earnings performances could, however, be disrupted by the rising costs of commodities, especially energy. These costs act like a tax on both consumers (who lose purchasing power) and manufacturers (which cannot fully pass rising prices along to customers). The impact so far has been limited: European companies are healthy and their earnings have been resilient.

### Inflationary pressure from emerging markets

We would again mention our fears of foreseeable downward pressure on margins. With central banks' exceptional measures on the way out and commodities prices on the way up, we are probably nearing the gradual end of a deflationary period that has lasted for around 25 years. Yet the financial community has not yet recognised that a slightly more inflationary environment would have a significant impact on earnings. So far, only the virtuous effects of the rise of emerging-market countries on earnings growth has been considered. Yet the end of deflation in this region will also translate into greater pressure on costs. This is a harbinger of a lower return on future investments. Many managers have already observed significant upward pressure on salaries and property rents in a number of emerging markets. At the same time, companies are not yet in a position to offset these major cost rises through higher selling prices on mature markets. As a result, it will become increasingly difficult to keep margins on an upward track.

European stockmarkets are not overpriced, but the averages obscure wide differences

Whether or not they can truly be considered cheap, European equities are much less expensive than other asset classes (and than equities on other continents) and offer very attractive and safe dividend yields. Still, the situation from segment to segment varies widely. For example, around one third of overall European earnings growth in 2011 stems from segments that are already quite expensive (growth sectors, cyclicals, etc.), while another third is associated with financials (where limited short-term visibility on future regulations has led to erratic forecasts).

Even with cautious scenarios, it's hard to argue that European markets are too expensive.



Investors are unable to gauge the real value of theoretically risk-free assets (such as sovereign debt) in the current environment, and currencies and commodity prices have been rising and falling abruptly. As a result, the only investment approach likely to pay off without straying from the basic prudential rules is one with a long-term horizon (5-10 years) and based on solid fundamentals.

Liquidity is plentiful but not channelled into equities

Abundant liquidity is supposed to boost the stockmarkets. This widely shared view is based in part on the idea that the largest investors will exit other asset classes (especially those linked to interest rates) and that at least part of these vast sums will necessarily be used to buy stocks on European markets. The truth is a bit more complex than that at this point. The fact is that additional investments in equities have been very limited recently despite nearly cost-free financing and enormous sums of money made available to the financial markets in the past two and a half years. Traditional equity market investors (pension funds, insurers, banks, traditional funds, etc.) are still experiencing strong regulatory pressures, and this situation does not lend itself to investing in risky segments.

The danger of handing over control to unregulated institutions

Unregulated financial institutions in the shadow banking system account for up to three fourths of daily trading volumes. Their type of investing is usually driven by an arbitrage or a trading mentality rather than by medium-term investment needs. Rather than injecting net new cash onto the stockmarkets, they tend to generate yo-yo style movements. Their financing terms are so much better than elsewhere in the finance industry (and their risk control so much laxer) that some of them will be tempted sooner or later to resume risky behaviour (with a cost of credit

Unless counting on an unlikely raise in leading indicators, defensive segments must be favoured.



Source: Datastream, MSCI

over five years at around 3.5%, they can make money on stocks with multiples of 25x, which is around twice as high as those on European stockmarkets).

Synthetic structured products could become predominant

The investment culture in equities has been so weak over the past decade that most positions take the form of structured products (or ETFs) rather than direct holdings. The only catch is that a growing proportion of these derivative products (30-40% of those created in 2010) are constructed synthetically (e.g. swaps on futures contracts), i.e. products that are no longer covered at all by their underlyings. The risk is not limited to the counterparty but is also affected by the quality of the underlying collateral. If the markets were to fall more sharply than expected at this point, a devastating snowball effect could magnify the damage.

Adapting to the aftermath of the financial crisis: abrupt, uneven movements

Following the recent market correction, we still feel that the next few months are likely to be a transition period characterised by abrupt, uneven movements.



That said, we do not have the conviction that the European markets are headed for a major and prolonged market decline. A typical mid-cycle correction would amount to 5-10%. Adding in other exceptional factors stemming from the financial crisis, we are probably looking at downside of 15-20% (two thirds of which are fortunately behind us). With so many uncertainties hanging over the financial environment, it will probably take some time before stockmarket growth can resume a more linear trend.

### European stockmarkets: next few weeks are crucial

The global finance industry has improved and can now be taken off life support. The surrounding jitters are legitimate, but if things go well, without any major relapse, we can hope for more sustained earnings growth. The next few weeks will therefore be crucial for the medium-term outlook of European stockmarkets. Keep in mind that the best investments take place when anxieties are highest – as long as the fears are groundless. More bullish investors should not wait for the end of summer to act: sentiment indicators are already extremely low and bad newsflow is high. A rebound could happen now. That said, we feel that upside is limited, and a rally would probably not surpass 5-7%. Any investments made should therefore not be overly risky.

### Defensive strategy still appropriate both in sector terms...

In this uncharted territory, we therefore still advise overweighting defensive sectors. This includes

healthcare, where companies – despite being hit by the rise in generics and cuts in public spending – still have significant room to cut costs and reorganise their manufacturing processes for increased efficiency. In this particular phase of the cycle, some segments are attractive simply for the sector they are in (such as banking, utilities, non-cyclical consumer spending, energy), while a stock-picking approach needs to be taken for most of the rest (technology, cyclical consumer goods, industrials, etc.).

### ...and regional terms

We would still steer clear of countries facing sovereign-risk or private-debt problems (Greece, Ireland, Portugal and Spain, for domestic companies in particular). The confidence vote by the Greek parliament is a relief, but the devil is in the details. This show of support does not guarantee approval of new austerity measures (without which help from the IMF and the Greek government's support plan will not take place), especially since the Greek prime minister slipped by with a small majority of five votes. Even if the refinancing situation resolves itself favourably, as it should, the austerity measures put into place by creditor countries and the lack of competitiveness of wage earners (who are over-indebted in Spain and Portugal) will weigh on corporate growth and prevent earnings growth cycles from getting back on track. At this stage, we prefer core European countries (France, Germany and Italy), which are experiencing higher growth and are relatively cheap. Northern European countries (and Switzerland) are now a bit expensive and their currencies are overvalued. We are not avoiding them, but are simply not focusing all our investments there.



# Consumer stocks: standing out through quality at a time of tough competition

LINDA ABDELLI

We recently attended a conference that covered most global consumer stocks. Although the recession has had an impact, companies have emerged stronger and more capable of meeting the new challenges posed by the more competitive environment.

Macroeconomic conditions remain tough for consumer companies in Europe. However, encouraging signs are appearing in the USA, while emerging markets are continuing to drive growth. This is shown by stockmarket performances, and by the renewed interest in IPOs within the sector.

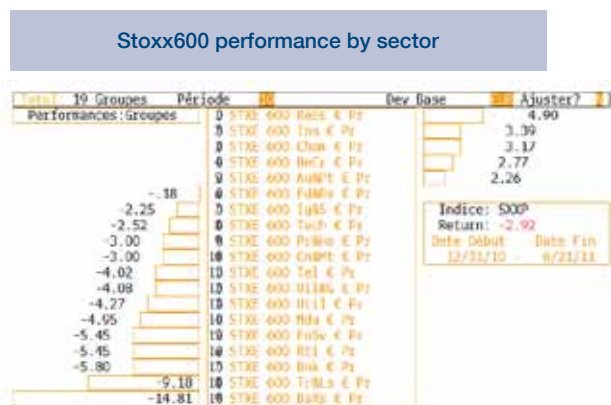
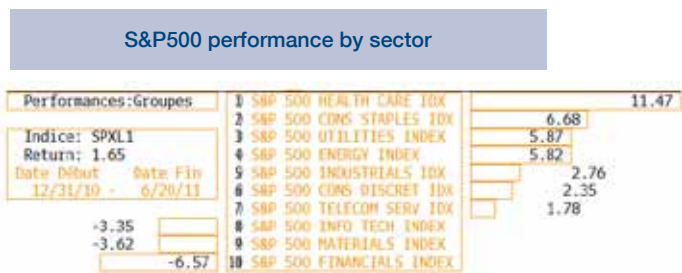
At the start of 2011, we predicted an ongoing recovery in US consumer spending and a stabilisation in Europe. We expected growth to continue, driven mainly by emerging markets but with a gradual improvement in developed countries. We reckoned without the turbulence created by the Greek crisis and the disasters that occurred in New Zealand and Japan in early 2011.

US and European companies exposed to US consumer spending have performed well. However, other distinguishing features have enabled certain companies to outperform their peers.

## Current operating environment and market challenges

Uncertainties clearly remain, despite the improvement in global macroeconomic conditions.

- The global economy is recovering slowly, particularly in Europe. Unemployment remains high and growth remains weak. Exchange rates are also a problem.
- Consumers remain cautious in developed countries.
- Emerging-market consumer spending is being driven by aspirational factors. Buying certain products gives consumers a kind of social status.
- Margins are under pressure because of rising commodity prices and wage costs in emerging markets. This is not a new phenomenon, and it is likely to continue.



- Competition is tough, with numerous promotions and aggressive pricing. Companies can distinguish themselves by their ability to deal with surging commodity prices through reduced packaging, new recipes and price rises.



### Common sector themes

After the first day of the conference, we noticed that the presentations shared certain common themes. Some of the themes seemed surprising given their context.

For example, the day's first presentation featured the following key phrases:

- Ownership of brands, but not just any brands
- Affordable luxury
- Fashionable, high-growth categories

One might imagine that these words were used by a luxury-goods company, but in fact they come from a presentation by a giant US food producer. Many consumer goods producers selling staple products are trying to stand out by offering something unique to customers who want to feel unique, even when eating their breakfast.

In our view, the common ingredients of success are as follows:

- Companies need to focus most of their resources on leading, high-impact brands. Sometimes, a brand needs to be backed up by a history or heritage, particularly in the luxury goods sector.
- They need a good pipeline, but consisting of fewer innovations with greater impact. Innovation justifies price increases and enables products to stand out from retailer own brands.
- Premium quality, which provides pricing power, and productivity are crucial in ensuring consumer confidence and therefore loyalty. This is particularly the case given recent food scares involving melamine and deadly bacteria of unknown origin found in food products. Providing customers with an upmarket service is also crucial. For example, some brands invite their best customers to individual appointments in upmarket apartments above their stores.
- Global reach is required. In 20 years' time, demographic changes will mean that 70% of spending by the middle classes will be in

emerging-market countries. In China alone, the number of people with disposable income of more than \$6,000 per year is likely to more than double in the next 20 years. Geographical positions are vital. A major agri-food company has developed the concept of the MICRUB countries, i.e. Mexico, Indonesia, China, Russia, USA and Brazil.

- Cost control is more important than ever.
- Companies need to position themselves in growth or niche areas with good prospects, and gain exposure to the categories of the future.
- Marketing is now highly dependent on social networks, the internet and phone apps. Viral marketing is the fashion, and all brands are developing apps to maximise visibility.

### Our favourite stocks

We adopted our current position on the sector in two stages:

- Initially, in early 2011 we favoured stocks exposed to emerging-market consumers, but also capable of benefiting from the US upturn. We also applied criteria relating to the themes discussed above. Our preferred stocks were companies that have delivered in terms of earnings.
- We then adopted more tactical positions, depending on market opportunities. In particular, following the Japanese crisis, we reverted to Buy ratings on luxury brands, which were unfairly marked down despite having only limited exposure to Japan. Some of those companies appear to confirm our theory that there is increased appetite for luxury goods in Japan following the disaster that hit the country earlier this year. An American jewellery company has reported record sales of engagement rings in Japan, suggesting that the disaster has made Japanese people more conscious of their own mortality: luxury is eternal, but human beings are not.

## Economic forecasts

GDP growth and contributions to global expansion (BPER estimates)

Country	GDP 2010	GDP 2011 BPER Estimates	GDP 2012 BPER Estimates	Country weights	Contribution 2011
United States	2.8%	2.5%	2.9%	19.7%	0.49%
Euro Area	1.8%	1.7%	0.8%	14.6%	0.25%
China	10.3%	9.0%	8.0%	13.6%	1.22%
Japan	3.9%	-0.2%	2.0%	5.8%	-0.01%
India	10.4%	8.2%	7.8%	5.4%	0.44%
Russia	4.0%	4.7%	4.5%	2.9%	0.14%
United Kingdom	1.3%	0.9%	0.6%	3.0%	0.03%
Brazil	7.5%	4.5%	4.5%	2.9%	0.13%
Mexico	5.5%	4.5%	4.0%	2.1%	0.09%
Canada (IMF estimates)	3.1%	2.8%	2.6%	1.8%	0.05%
Others (IMF estimates)	5.2%	4.7%	4.9%	28.2%	1.31%
<b>WORLD</b>	<b>5.0%</b>	<b>4.2%</b>	<b>4.1%</b>	<b>100%</b>	<b>4.2%</b>

### Contents

- The GDP growth rates shown above are final for 2010. Projections for 2011 and 2012.
- Each country's weighting has been translated into US dollars and is based on the principle of purchasing power parity, which takes account of differences in prices and standards of living.
- The countries are ranked by the size of their economy, in decreasing order.
- Contributions to global growth are calculated as follows: the GDP growth of each country is multiplied by its size, with the total adjusted to the aggregate weighting of the countries listed. The sum of the contributions works out to 4.2%, a good estimate of global GDP growth for the current year.
- The list is limited to the 10 countries that contribute most to world economic expansion.

# Tactical allocation (%)

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## CHF PORTFOLIO

Asset class	Switz.	Europe	UK	USA	Japan	Asia/other emerging regions	Commod.	Precious metals	Sundry or global	Total
Short-term	14									14
Fixed income	14	2								16
Equities	8	2		2	3	5				20
Directional hedge funds		7								7
Nondirectional hedge funds	23									23
Property	3								7	10
Commodities, Precious metals							3	7		10
<b>Total</b>	<b>62</b>	<b>11</b>	<b>0</b>	<b>2</b>	<b>3</b>	<b>5</b>	<b>3</b>	<b>7</b>	<b>7</b>	<b>100</b>

## EUR PORTFOLIO

Asset class	Switz.	Europe	UK	USA	Japan	Asia/other emerging regions	Commod.	Precious metals	Sundry or global	Total
Short-term		17								17
Fixed income		14							2	16
Equities	3	7		2	3	5				20
Directional hedge funds		5		2						7
Nondirectional hedge funds		23								23
Property									7	7
Commodities, Precious metals							3	7		10
<b>Total</b>	<b>3</b>	<b>66</b>	<b>0</b>	<b>4</b>	<b>3</b>	<b>5</b>	<b>3</b>	<b>7</b>	<b>9</b>	<b>100</b>

## USD PORTFOLIO

Asset class	Switz.	Europe	UK	USA	Japan	Asia/other emerging regions	Commod.	Precious metals	Sundry or global	Total
Short-term				17						17
Fixed income				16						16
Equities		4		8	3	5				20
Directional hedge funds				7						7
Nondirectional hedge funds				23						23
Property									7	7
Commodities, Precious metals							3	7		10
<b>Total</b>	<b>0</b>	<b>4</b>	<b>0</b>	<b>71</b>	<b>3</b>	<b>5</b>	<b>3</b>	<b>7</b>	<b>7</b>	<b>100</b>

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