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S&P 500 and gold: the relationship is highly unstable, with the correlation swinging between positive and negative
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2¼% Most recent estimate of US GDP growth in Q1 2012
Page 4

1,000bn euros made available to commercial banks by the ECB, enabling them to refinance almost 80% of their debt up to 2014
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60% of European companies have reported 2011 results – a sizeable proportion of their net profits fell short of expectations
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1.40 The euro looks likely to advance to an exchange rate of USD1.40 in 6 months' time
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717,000 Annualised number of house building permits granted in the US in February
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45bn dollars earmarked by Apple to be paid out in dividends
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1.6m Total of 'shadow' inventories of housing units in January 2012, slightly down y-o-y (1.8m in January 2011)
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Deleveraging forces at work in the background

April 2012

Perspectives

EDITORIAL OUTLOOK

Gold and the S&P 500: heading for a shift in regime?

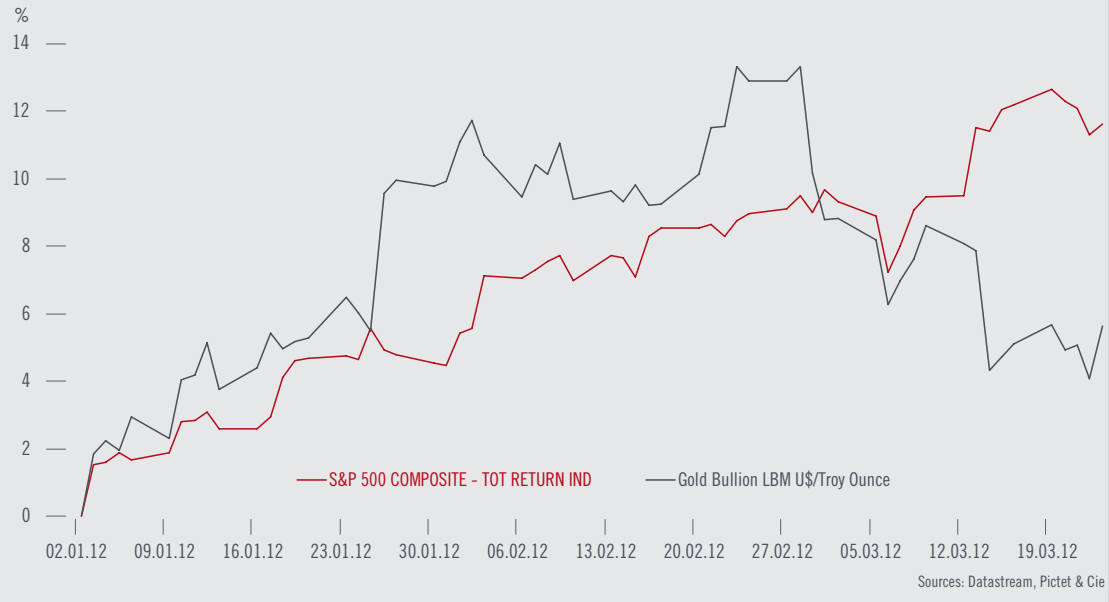
Yves Bonzon
Chief Investment Officer

The first quarter of 2012 ended on a uniformly positive note for risk assets. They were given a boost, initially, by the European Central Bank's 180-degree shift to an activist approach to monetary policy, and then by persistent and carefully stage-managed rumours of a third round of quantitative easing by the US Federal Reserve. By no stretch of the imagination have the deep-seated problems plaguing the eurozone been solved, but the ECB's 3-year long-term refinancing operations (LTROs) for Europe's banks have bought some much-needed breathing-space.

The economy remains a major headache, though. Unless economic growth regains some impetus, a key factor for the eurozone's future well-being, it will only be a matter of time before tensions bubble to the surface again. The US economy looks in much more robust shape, but, paradoxically, the economic runes are much harder for market operators to decipher. For quite some time now, we have been staunch defenders of the Fed's activist monetary stance, emphasising particularly the fact that the whole credit mechanism had seized up in the US private sector – as long as demand for lending, even offered at rates of interest close to zero, was non-existent, expansion in the Fed's balance sheet would not have any inflationary fallout and would, in effect, be working to nullify underlying deflationary pressures.

One knock-on effect of this recession in private-sector balance sheets (in this instance, US households') has been that equities on Wall Street could not, structurally, advance without help from the dollar being debased. In layman's terms, the S&P 500 would not be capable of returning within touching distance of all-time highs above around 1,300 points without the assistance of a weak dollar. The painful symptoms of this are clearly discernible in the correlation between gold and US shares. Since 2003, the S&P 500 had only been able to make lasting progress in step with a rising gold price. When US equities have been on the slide, the bullion price has either risen in anticipation of the Fed responding in order to counteract deflationary pressures or dropped on market perceptions the monetary stimulus would not be powerful enough to neutralise these deflationary surges. Ultimately, this has meant the interplay between US equities and gold has been prone to great instability, punctuated by abrupt, violent and repeated swings from positive to negative correlations. The highly volatile and unstable nature of the correlation has also rendered the situation virtually unfathomable and unpredictable. Numbers released in recent weeks suggesting the US housing market has been stabilising have been proliferating. We had not realistically expected it to swing upwards again before the latter half

of next year, but evidence is beginning to mount that the crucial turning-point might well already materialise later this year (Bernard Lambert has been looking into this in greater detail in this month's issue of *Perspectives* – see pages 12-14). In light of this, it is more than a little disconcerting to note that the latest progress made by the S&P 500 in early March appears to have been matched by a steep fall in the price of gold. Climbing equity prices on Wall Street unaccompanied by expectations of a weakening US dollar is a state of affairs we have not seen for over eight years.



Perhaps we should heed the wisdom imparted in the age-old proverb that "one swallow does not a summer make", but this turn of events, if subsequently confirmed in reality, would appear to indicate US households have at long last recovered from the wealth shock delivered to them six years ago when the value of their homes began sliding steeply.

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Coincident, but not concerted action by the world's central banks

Central banks in the world's major developed nations have been pressing ahead with accommodating monetary policies. Their measures have been coincident, but not concerted. They are aiming to counter deflationary risks stemming from ongoing deleveraging by households, banks and governments.

Christophe Donay, Bernard Lambert and Jean-Pierre Durante*

** with Wilhelm Sissener*

Central banks throughout much of the developed world have, one by one, become determined to commit themselves wholesale down the route of quantitative easing to limit systemic risks that might arise as a result of all the deleveraging taking place. If we compare the size of central banks' balance sheets to the GDP of their respective economies, the ECB comes out on top of the league table for quantitative easing.

The global macroeconomic backdrop: deleveraging

After initially shifting to a policy of zero interest rates in December 2008, the US Federal Reserve went on to push through two rounds of quantitative easing, familiarly referred to as QE1 and QE2, covering the repurchase of US Treasury bonds and securities totalling USD2,300bn. These were followed up by Operation Twist, launched in October 2011 and scheduled to terminate in June this year. This has involved redeploying proceeds from maturing securities in a drive to flatten out the long-term yield curve further by purchasing long-dated US Treasuries. Although there has been much heated debate over what knock-on effects all these measures would have on the economy, there is no denying that, without them, the US economy would have sunk into a far more serious depression during which lending and employment would have been even more grievously damaged.

Following in the Fed's quantitative-easing footsteps, the European Central Bank (ECB) finally grasped the bull by the horns in December 2011, pushing through its version of quantitative easing in a resolute bid to ease tensions stoked up by the eurozone debt crisis. The crisis was threatening to unleash a systemic tsunami that would engulf Europe's banking sector and the world's banks via a classic domino effect. After its initial long-term refinancing operation (LTRO) offering banks loans at 1% for three years, the second LTRO right at the end of February took total liquidity made available by the ECB through these two operations to over EUR1,000bn.

Both the Bank of England (BoE) and the Bank of Japan (BoJ) seem equally determined to press ahead with buying back financial assets should this prove necessary. Authorities in the emerging world have been striving to lend support to economic growth as well. Central banks have, for instance, continued to lower statutory reserving requirements for banks, as the People's Bank of China or the Reserve Bank of India have been doing recently.

In order to put the world's leading central banks' quantitative-easing programmes into some perspective, it is worth noting that the ECB tops the league table: its balance sheet now stands at the equivalent of 32% of the eurozone's nominal GDP, closely followed by the BoJ at 31%; by comparison, the BoE is some way further back at 21% and the Fed even lower as its balance sheet 'only' amounts to 19% of US GDP.

If we now turn to the state of macroeconomic play in Q1 2012, economies are ostensibly beginning to swing upwards, most notably in the US. It is still unclear whether a third round of quantitative easing will be needed in the US even though upswings in both lending and consumer spending are still too sluggish to confirm the likelihood of a sustainable economic recovery taking root in the US. The assumption that the recession in the eurozone will be less severe than feared may also be challenged by contradictory statistics released towards the end of the opening quarter. The most recent economic numbers for the emerging world also tend to point towards growth decelerating gently. All in all, the global upturn remains a rather fragile creature, with the backdrop to economies in the developed world being heavily dominated by the phenomenon of across-the-board deleveraging.

US: encouraging economic outlook

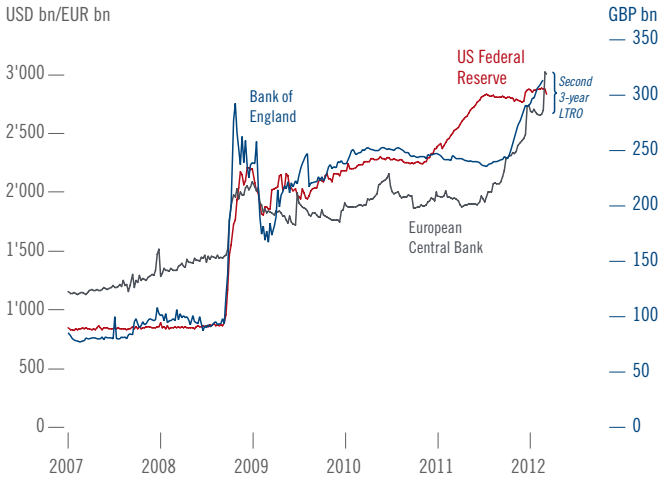
Economic statistics reported recently have continued to point towards US GDP growth slowing from 3.0% in Q4 2011 to around just 2¼% in Q1 2012. Nevertheless, this likely dip does not paint a realistic portrayal of what is happening in the economy. The tempo of job creation has been gathering momentum, the rate of increase in production by manufacturing industries has unmistakably quickened and retail sales figures suggest that consumer spending will have been much more robust in the first quarter this year than had previously been feared.

If the recent spike in oil prices were to continue, it could act as a serious drag on US consumer spending

In addition, underlying fundamentals have continued to improve. Lending has rebounded further, with the net flow of new loans to households just edging into positive territory in Q4 2011. The virtuous circle of jobs-income-consumer spending-jobs would at long last seem to be taking shape. Moreover, signs of the housing sector picking up have also been confirmed even though they remain fairly tentative for now.

Some risks have not gone away though. If the recent spike in oil prices were to continue, it could apply a serious brake to US consumer spending. Moreover, some of the upturn in

SIZE OF LEADING CENTRAL BANKS' BALANCE SHEETS HAS EXPANDED THREE-FOLD IN JUST 3 YEARS



Sources: Pictet & Cie, ECB, Fed, BoE

the economy can probably be put down to the exceptionally mild winter this year, which means some sort of temporary backlash might occur. Nonetheless, overall, we are confident economic growth in the US will be solid enough, at least until late this year.

The Fed has duly noted evidence of the economy perking up and, with inflation pitched pretty close to its target, the likelihood of a need for a third round of quantitative easing has undoubtedly diminished. The bond markets reacted smartly to the shifting expectations. Even though interest-rate movements almost certainly overshot, particularly judging by the shift in expectations reflected in futures contracts linked to the Fed funds rate, the rebound by long-bond yields would appear to have been an understandable response to brightening growth prospects. That said, even though we do believe US T-bond yields are likely to close 2012 above current levels, we should not lose sight of the fact that the Fed's finger is still hovering on the QE trigger. If there were to be the slightest hiccup in the economy and/or a resurgence in tension in the financial system, the Fed would probably not flinch from pushing through further measures to stimulate the economy.

Eurozone: hovering between temporary respite and a definitive solution

It is reasonable to conclude that the ECB's two LTROs in December 2011 and February 2012, coupled with the broadening of the range of securities accepted as collateral, the halving of the reserve ratio for banks and the concerted increase in the supply of dollars, helped to avoid a disaster. By pumping over 1,000 billion euros into commercial banks, the ECB made it feasible for almost 80% of banking debt maturing between now and 2014 to be refinanced at low cost. This windfall for the banks enabled the eurozone to avoid the plight of a headlong and frenetic rush into deleveraging. Distressed sales and a credit crunch have also undoubtedly been averted. Almost automatically, economic prospects have been improved and governments (and, crucially, their finances) have been relieved of the need to recapitalise banking systems further. As a result, investors' enthusiasm for shares, especially those of the banks, has been mounting. Peripheral eurozone sovereign debt also benefited from a wave of buying, with Italian and Spanish banks prominent among the purchasers.

As the worst now seems to have been avoided, the question is how long the positive impact of these measures is going to last. The answer hinges largely on the recovery capabilities of Europe's economies, especially those hardest hit by the crisis. As the deleveraging phase in both public and private sectors is far from over, this will continue to act as a drag on domestic demand. Hopes of an economic rebound lie primarily in external demand at a time when most peripheral member states are lacking much of a competitive edge. As a result, they are genuinely bereft of any real growth driver. These fears have been reflected in the recent deterioration in leading economic indicators, such as the slide in the Purchasing Managers' Index (PMI) for the second month in a row. If the danger of a relapse into recession is going to be permanently warded off, financial markets will need to be cheered by a regular influx of good news. One of the most eagerly awaited announcements would be news that the bailout funds available have been increased. Combining the firepower of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) would go some way to fulfilling these expectations. The expected increase in IMF funds in April would reassure investors about prospects for the rest of the year. Nevertheless, the risk of things escalating for the worse cannot be dismissed out of hand. A general election in Greece (early May) could well see a government being formed that is incapable of pushing ahead with reforms instigated by the current stopgap administration. Presidential elections in France and the Irish referendum to ratify the Fiscal Compact also have the potential to wreak some damage. There is no doubt a catastrophe was averted earlier this year, but the scale of the challenge still ahead to drag the eurozone well clear of the danger zone is still huge.

Financial markets in a quandary

On the one side, central banks in the developed world have continued to be highly accommodating, fuelling hopes of an economic recovery in the making and, by extension, encouraging greater risk-taking on financial markets. On the other side, the widespread deleveraging, which is deflationary by nature, is ongoing in both the US and Europe.

Christophe Donay, Jacques Henry and Yves Longchamp*

** with Wilhelm Sissener*

FINANCIAL MARKETS

Local-currency returns in % from financial markets. Data as of 28.03.2012

		Index	Since 30.12.2011	Previous month
US equities*	USD	S&P 500	12.3%	3.1%
European equities	EUR	STOXX Europe 600	8.0%	-0.1%
Emerging-market equities*	USD	MSCI Emerging Markets	14.4%	-3.1%
US government bonds*	USD	ML Treasury Master	-1.2%	-0.9%
US investment grade*	USD	ML Corp Master	2.6%	-0.4%
US high yield*	USD	ML US High Yield Master II	5.2%	0.0%
Hedge funds	USD	Credit Suisse Tremont Index Global**	4.0%	1.6%
Commodities	USD	Reuters Commodities Index	2.0%	-3.4%
Gold	USD	Gold Troy Ounce	6.3%	-3.5%

* Dividends reinvested ** End-February

Financial markets have revealed themselves to be increasingly hesitant over the last few weeks, undecided about which scenario to place their trust in: a scenario envisaging an economic upswing, nurtured by central banks' accommodating monetary stance, or a scenario marked by deflationary risks stemming from all the deleveraging and a possible renewed flare-up in the eurozone debt crisis.

Financial markets: tug of war between reflation and deflation

After a strong showing in the opening months of this year and in spite of the non-stop decline in volatility since November, returns from equity markets have displayed some very mixed readings. The STOXX Europe 600 has fallen by 1.5% since 3 February. Emerging markets have also been struggling a little: Brazil's Bovespa index is down 0.5% and China's benchmark CSI 300 has dropped 2.2%. In contrast, Wall Street has advanced over the same period, with the S&P 500 up 4.3%. For the near term, our core scenario, which is influencing our tactical allocation choices, remains geared to the prospect of equity markets going through a gentle consolidation phase. All the good news about developments in the US economy and central banks' repeated interventions to stave off systemic risks already look to have been amply priced in. Unless there is some exogenous shock, stock markets should experience a fairly limited spell of consolidation of 5% to 7%. This lull looks amply warranted. Equities could not realistically be expected to extend their rallies until such time as US economic growth has clearly locked on to a virtuous circle. Even though things have been picking up on the jobs front for three months now, consumer spending and lending have still not provided the necessary impetus to confirm the economic cycle is moving on to the self-sustaining stage. As a result, our investment allocation remains reasonably circumspect.

We are monitoring risks associated with this core scenario very watchfully. If fresh tension related to the eurozone crisis were to resurface or the price of crude oil were to climb beyond the USD125 threshold or China's growth were to slow much more noticeably, the spell of consolidation on equity markets could degenerate into steeper falls ranging from 10% to 15%.

Against a fundamental background marked by ongoing deleveraging throughout developed nations and central bankers' repeated reflationary measures, long-bond yields should stay well below rates of nominal GDP growth. Yields on long-dated US Treasury bonds, pitched at around the 2%-mark, are considerably below the country's nominal rate of GDP growth projected at 4.5% to 5%.

Profit margins being squeezed in Europe

The Q4/full-year 2011 reporting season has continued in Europe. Just over 60% of companies have now released results, and we have begun to piece together a much more reliable picture of just how fragile corporate profits have become. Very dishearteningly, reported net profits have, on average, come in around one third lower than expected. This shortfall can be blamed chiefly on poor results published by banks and insurance companies. No country in Europe has been spared the pain here although setbacks were much less disconcerting in the UK. However, even if we put financials to one side, very few sectors managed to deliver profits in line with expectations, let alone surpassing them. In contrast, turnover figures were not all that disappointing. Revenues even produced some pleasant surprises for insurance, property, telecom operators, utilities and most cyclical industries (construction, vehicle manufacturing and chemicals). The gap between trends for turnover and profits highlights the serious squeeze on profitability. This contrasts quite starkly with results reported by US companies. It is further borne out by forecasts for 2012 and 2013 where profit margins are expected to prove more resilient in the US.

At the same time, the downgrading of earnings growth forecasts has noticeably eased. The trend has been showing a distinct improvement since October 2011. If we are going to witness a more robust rebound in profits in Europe, margins will need to level out. This has not yet proved the case. The latest reappraisals of earnings growth expectations have offered a little more encouragement though: estimates for earnings growth for European companies in 2012 had been consistently revised downwards from end-November, whereas, on 22 March, forecasts for 2012 were upgraded for the first time, raised by around 1 percentage point to +6.4%. Around half of this can be put down to a beneficial base effect, with 2011 profits being revised down and forecasts for 2012 being kept unchanged. The other half can be explained by upgraded forecasts for growth in cyclical sectors. We will be keeping a close eye on growth expectations, especially in this area, over the next few weeks.

Consolidation of carry trade

Carry trade, which involves borrowing funds in currencies with low interest rates and reinvesting proceeds in those on higher interest rates, has delivered a return of 3.5% since the start of this year according to our model portfolio. The latest turn of events in the sovereign debt crisis in Europe and recent US economic numbers have been more encouraging, which has been confirmed in lower volatility as measured by the VIX Index. This generally more clement climate has, however, turned a little gloomier again in recent weeks owing to worries about a steeper slowdown in China.

Carry trade provides exposure to the rising trend on commodity currencies which are sensitive to demand for raw materials, of which China is a gluttonous consumer. As long as doubts persist over the outlook for the Chinese economy, carry trade as a strategy will struggle. As a result, we have scaled back our exposures to carry trade until we see more tangible signs of things picking up again.

Euro rising in value

Although the euro and the US dollar are the two dominant currencies on the world's forex markets, they exhibit quite different patterns of behaviour. The euro tends to be more cyclical whereas the dollar is undoubtedly defensive. The gradually improving US economy and diminishing systemic risks in Europe have provided conditions conducive to the euro. In addition, several technical indicators are also signalling the onset of a rally phase for the single European currency. We believe the euro looks likely to reach an exchange rate of USD1.40 over the coming six months.

Switzerland's economy has shown itself to be quite resilient to the franc's strength. Even though the franc looks blatantly overvalued, the Swiss National Bank recently upgraded its forecasts for GDP growth. As a result, we expect the Swiss franc to stay close to the threshold exchange rate of CHF1.20 to the euro set by the SNB last September. Over the coming 12 months, the franc might well drift down a little against the euro to reach CHF1.25.

Following the Bank of Japan's surprise announcement to continue targeting an inflation rate of 1% and to embark on a cycle of quantitative easing, the yen has fallen quite steeply since the start of this year, dropping by over 6% against the dollar. In spite of this depreciation, we remain upbeat about the yen. Effective implementation of policy by the BoJ has, in reality, betrayed its hesitancy about going through wholeheartedly with its new policy line. Moreover, there has always been a significant seasonal impact around the turn of the tax year between March and April, which suggests the yen may well regain some ground over the coming month.

Inflation slowing in Brazil and China

Inflation rates have been coming down in several emerging nations, allowing monetary and political authorities to implement further measures geared towards supporting economic growth. India has proved the exception to the rule, with inflationary pressures on the rise again.

-0.2%

After an encouraging upturn phase earlier in 2011 (+0.7%), **the Irish economy shrank by 0.2% in Q4 2011,** plunging the country back into recession.

717,000

Annualised **number of building permits granted in the US in February, a rise of 5.1%** on January levels and a 14.7% increase over 6 months. Unlike other statistics for the housing sector, building permits do not tend to be influenced by the weather (unusually mild winter this year in the US), **making this recent upturn that much more encouraging.**

5.8%

Brazil's rate of inflation slowed from 6.2% y-o-y in January to 5.8% in February. The Banco Central do Brasil is sticking with its inflation target of 4.5% for 2012.

9.9 million

Saudi Arabia's current output of crude oil is running at around 9.9 million barrels a day. The authorities estimate production capacity at 12.5m barrels a day and have stated that output could quickly be ramped up to 15 million if needed. **Libya looks set to export almost 1.4 million barrels a day in April.**

3.4%

Inflation fell in the UK from 3.6% y-o-y in January to 3.4% in February, its lowest rate since November 2010. Inflation dropped on the back of falling prices in the housing, electricity and cultural sectors.

3.2%

China's rate of inflation fell to 3.2% y-o-y in February, down from 4.5% in January. Growth in the M2 measure of the money supply quickened from 12.4% y-o-y to 13%.

6.95%

The annual rate of inflation in India picked up speed again in February, advancing from 6.55% in January to 6.95%. The Reserve Bank of India has lifted key interest rates thirteen times since March 2010 so this latest surge in inflation has quashed any hopes of a rate cut to come.

Financial markets cannot decide

Reflation or deflation? Virtuous economic recovery or downward spiral? Perceptions of prospects have swung back and forth over the past month. Judging by shifts in regime as regards correlations between asset classes, financial markets clearly cannot come to any hard and fast conclusions.

Equities

Less euphoria around

So far, stock markets have not corrected all that noticeably, but the rally has been losing steam in the past month, especially in Europe.

Equity markets in the US and Europe made further progress over the past month, but the rate of advance has been slower, most noticeably so in Europe.

The main surprise in March was the plunge in risk indicators, with implied volatility as measured by the VIX Index sinking swiftly below 15%, which marks the top end of the low-volatility regime. Only some exogenous shock looks likely to force equities much more steeply downwards. Dealing volumes have been quite subdued since the start of the year, implying most probably that a good many investors are preferring to bide their time before venturing back into shares. The pattern of revisions to earnings forecasts for 2012 and 2013 has improved quite considerably since October 2011. Even though we have not yet seen a spate of earnings upgrades, this improving trend does put some disappointing Q4 2011 results from European companies into perspective.

Stock markets have been rallying since December, causing multiples gradually to expand. In March, valuations of mainly financials and defensives turned a little more demanding whereas levels for cyclicals were more or less stable. With markets trading at 12.8X projected earnings in the US and 10.7X those forecast for Europe, P/E ratios are currently roughly one point below average historical multiples. That leaves some upside potential for equities over the next few weeks even without any rebound in expected profits.

Bonds

Risks of a correction phase confirmed

Sovereign bond yields finally succumbed to the stream of positive economic news, especially from the US. From 9 March when encouraging payroll numbers were followed by better than expected retail sales data and survey findings, a severe correction kicked in on US Treasury bonds.

Following the stream of good economic news, yields on benchmark 10-year US T-bonds jumped from a touch below 2% to almost 2.4% in the space of just a few days. The subsequent slight cooling of investors' mood saw yields drift back down to 2.2%. Despite this mini-rebound, government bonds as an asset class struggled in March, recording a negative return of -0.9%. Its return for the year date is even deeper into the red (-1.2%).

German Bunds tracked a similar path, though not quite as dramatic, with the spike in yields being damped down by decidedly less heartening economic news in Europe. Nevertheless, yields on 10-year Bunds still progressed from 1.8% to a peak of 2% before closing the month at 1.9%.

The recent return to a less upbeat mood gave rise to renewed tension in the eurozone, with yields on 10-year Italian and Spanish bonds climbing back above the 5%-threshold.

The more promising economic outlook for the US and still unresolved issues in the eurozone are creating conditions that are putting US Treasuries more at risk than Bunds.

Corporate bonds

Suffering from shifts in investor sentiment

Corporates were penalised by the spike in sovereign bond yields even though credit spreads did narrow. This asset class still deserves its key place in portfolios during this delicate phase of the crisis.

Mood swings among investors during the month tended to penalise credit-risk instruments. Investment-grade corporate bonds were down 0.4%, but high-yield corporates held steady. Both still managed to outperform US Treasuries (-0.9%), but underperformed the S&P 500 (+1.6%).

The league table of year-to-date performances reflects asset classes' sensitivity to risk: sovereign debt has been the most affected (-1.2%), followed by investment-grade corporates (+2.6%) and high-yield corporates (+5.2%), with equities (+11.3%) coming out on top. This pattern is reflected in sector showings too. Financials – brokers (5.5%) and banks (+5.3%) – have retained their leadership, whereas defensive groups like consumer non-cyclicals and utilities have been bottom of the pile.

This asset class continues to offer considerable appeal to investors during this unsettled phase hovering between hopes of an end to deleveraging and the threat of a plunge back into recession. Corporate bonds offer some protection should the overall climate degenerate, but would also deliver gains if the early-year optimism were to hold good for longer.

Hedge funds

A stock-picker's market

Lower volatility and lower asset correlations see a resurgence of fundamentals-based stock-picking.

Hedge fund performances were again positive in February with the rally in risk assets adding to strategy returns. The HFRI Fund Weighted Composite Index climbed 2.2%, helped by strong US data and further monetary injections by central banks. Despite a constructive backdrop, gains by long/short equity managers had more to do with a manager's ability to pick the right stocks than with drastic changes in their gross and net exposures. As correlation and volatility levels fell, stock-picking based on fundamentals resumed. To express their convictions, managers mainly sought companies flush with cash or large-cap technology brands.

Mid-March estimates for hedge fund returns suggest more dispersion. On the one hand, equity-sensitive strategies, such as event-driven, were spoilt by a flurry of hard catalysts hitting the headlines. One of the most significant being Apple's decision to issue the first dividend in 17 years, buy back USD 10bn worth of shares and reinvest USD 45bn of its cash reserves. In contrast, trend-following CTAs were faced with sharp reversals in fixed-income markets, notably in US and German 10-year notes.

Precious metals

Perceptions shifting around

Investors' wavering over which macroeconomic scenario to trust in – deflationary or inflationary – has been mirrored in movements in the price of precious metals. After bouncing back and forth over the month, the gold price ended March down by just over 3%.

Rather like other financial markets, movements on precious metals exhibited no real discernible direction in March. From the start of month to the time of writing, the flagship precious metal, gold, saw its price fall by just over 3% to USD1,662 an ounce after a spate of five alternating up- and downtrends ranging between USD1,625 and USD1,725. This pattern reflected the constant shifting between hopes about central banks' reflationary measures and fears about an upsurge in deflationary risks. Moreover, gold's diversification merits also varied quite dramatically over the month as correlations shifted from one mode to another. The bullion price and share prices tended to show a negative correlation whenever the economy began to exhibit signs of long-lasting and self-sustaining growth. In contrast, whenever investors' perceptions shifted to focus on possible interventions by central banks to counteract deflationary risks, fuelled by a renewed drive towards deleveraging, the correlation between the two assets reverted to being positive.

Exchange rates

Temporary halt for carry trade

The slowdown in China's economy has put commodity currencies under a little pressure, and these have been the drivers behind returns from carry trade since the start of 2012.

The uptrend on high-yielding currencies underway since the start of the year came to a halt in March. It had made a significant contribution to the return from carry-trade strategies built around these currencies (+3.5% in the year to date). The reason for the standstill has primarily been the slowdown in the Chinese economy, which points towards a fall in commodity prices to which most of these high-yield currencies (Australian, Canadian and New Zealand dollars) are linked. When China shows signs of regaining economic momentum, we will switch back into carry trade.

The euro lost a little ground against the US dollar during March, with its exchange rate hovering between USD1.30 and USD1.33. Looking ahead, the euro can be expected to strengthen to reach USD1.40 over the coming six months. The crisis in Europe appears to have been ring-fenced and the risk of the euro falling apart at the seams has unmistakably diminished. Moreover, improving growth prospects in the US are likely to cause the dollar to weaken as it tends to behave counter-cyclically.

When is it really going to turn upwards again?

Construction and the housing market remain conspicuous by their absence among those sectors of a US economy that has been recovering now for almost three years. Some timid signs of improvement have been detected, but that is all they are – timid. Fundamentally speaking, damaging fallout from the housing and financial market crashes is still having an influence, but the requisite rebalancing process would appear to have advanced quite some way.

Numbers of workers in construction and housing-related businesses account for a mere 6% of the total employed workforce in the US. Despite this low percentage, around one-quarter of the 8.8 million jobs lost during the 2008-2009 recession were wiped out in these sectors. The pattern of employment during the upswing has not provided much cheer either. Since employment bottomed out in February 2010, around 3.5 million jobs have been created in the US economy overall, but just a trifling 35,000 in the construction and housing sectors. Those bald figures graphically illustrate to what extent the US housing sector was at the epicentre of the 'Great Recession' and how significant its rebound is likely to be for the sustainability of the economic upturn currently underway.

Genuine upswing or just a weather-induced blip

Hearteningly, signs of things improving have begun to surface in greater profusion. Residential construction expanded at an annualised q-o-q rate of 11.5% in Q4 2011 while increases in housing starts and building permits in recent months have pointed towards the upswing extending over H1 2012. Moreover, sales of homes have picked up quite smartly over the last six months and, in parallel, the stock of homes available for sale has been diminishing fast: the total in January 2012 stood at 2.7 million properties, 20% lower than 12 months earlier.

Bernard Lambert
Economist

The figures should be taken with a healthy pinch of salt, though. The 2011/12 winter was unusually mild, which could explain some of the impetus behind the recent uptick in numbers in this sector. This means figures for the spring months will need to be monitored very closely. In any event, the black spot in the housing sector remains, without any shadow of doubt, the behaviour of housing prices. These fell steeply again last year, with the annual rate of fall working out at 4% by end-2011.

Construction: considerable upside potential

At this point, we need to analyse fundamentals underpinning housing and construction to gauge whether the upturn in progress is likely to have the stamina to last. The position as far as construction work itself is concerned looks surprisingly robust. Even after recent increases, monthly levels of housing starts are still extremely low (roughly 700,000 at an annualised rate compared to 1.8 million on average in 2006), but therein lies the sector's considerable recovery potential. The number of homes being built is still pitched very low, but it is also still running below the rate for new homes being sold. The upshot is that the stock of new homes for sale has continued to dwindle. It is running beneath its level in the early 1960s, whereas, since then, the US population has expanded by 75%. Moreover, if demolitions are taken into account (roughly 300,000 p.a.), the levels of housing being built are unmistakably lower than the increase in the numbers of new households being established. Moreover, even the latter is still very low by past standards: approximately 650,000 new households being created annually at the current pace, around half the average pre-recession number. This suggests the potential for residential construction to swing upwards is quite considerable. The upturn could prove even stronger if household formation were to speed up again, which would appear a logical development considering the ongoing improvement on the jobs front and the backlog in the creation of new households accumulated in recent years (over 2.5 million).

This set of circumstances begs the question of why the rebound in housing starts has not already been more vigorous. The problem lies with the competition in the market-place from existing homes. As there was a huge surplus in the supply of existing housing at prices significantly lower than those for new homes, demand for new housing has been lacklustre. Homebuilders are acutely aware of this so they have tended to put off new building work except in districts or regions of the country where specific circumstances prevail or in segments of the housing market where demand is particularly brisk, such as for flats on the back of strong demand for rented property.

Existing homes: waves of distressed sales

So, this brings us neatly to the state of play on the market for existing homes. Analysing this is distinctly more complex. As we mentioned earlier, some signs of an upturn have been detected here, too. Sales have been picking up gradually and, more significantly, the stock of houses up for sale has been diminishing fast. At present, the number of homes on sale, as a ratio to total housing units existing

in the US, has sunk back in the last few months a touch below rates that could be described as 'normal'.

On the minus side, housing prices appear unresponsive to this healthy shakeout in the housing market. Worse still, they have continued dropping. There are probably two main reasons for this. Firstly, distressed or enforced sales – which generally go through at prices knocked down by around 30% – account for a sizeable chunk of homes being sold (roughly a third). The proportion has even been tending to rise of late. As the legal wrangles surrounding the so-called 'robo-signing scandal' (foreclosure proceedings instituted automatically with invalid or false documentation) have recently been resolved, the percentage might well go on climbing in the near future.

And what about 'shadow' inventories?

Secondly, another Sword of Damocles still hangs threateningly over the housing sector: plenty of homes are not currently on the market, but might well be put up for sale soon owing to homeowners' financial woes. Much – both accurate and fanciful – has been written about these so-called 'shadow' inventories, but there is no denying the sizeable numbers involved are seriously hampering the natural rebalancing process in the housing sector.

Analysing what the situation is really like is, therefore, crucial. The widely accepted assumption is that housing whose owners are already in the foreclosure process, have defaulted on repayments or are seriously delinquent (over three months in arrears) will, in all probability, come onto the market soon, if the homes have not already been put up for sale. If we deduct those homes already up for sale (something not always done for estimation purposes), 'shadow' inventories totalled around 1.6 million in January 2012, slightly below the figure of 1.8 million 12 months earlier.

If we then add 'shadow' inventories to the stock of homes already on sale (see the chart on the left at the end of this article), we arrive at a combined total of 4.3 million, noticeably lower than the 5.2 million for January 2011. By extrapolating this downtrend forward a further 12 months, we estimate the position could revert roughly to 'normal' some time during the final quarter of 2012 (right-hand chart on page 13), making the prospect of a return more or less to equilibrium no longer quite such a remote possibility.

This excess supply could, of course, be mopped up more rapidly, especially if government measures pushed through recently to assist distressed borrowers were to be effective, but the process could also turn out to be more sluggish if the economy were to stall again and/or housing prices were to slump even further. One crucial factor will obviously be how demand for housing unfolds, most notably as evidenced by the pattern of housing sales in the coming months.

Home sales: mixed picture

The current picture on the sales front is still very mixed. On the plus side, demand for housing should be bolstered by accelerating employment growth, improving consumer confidence, brisk demand for rental property, exceptionally low mortgage rates and highly attractive property prices by past standards. On the minus side, conditions being applied to loans, although they have started to be relaxed somewhat, remain quite stringent. Many households are being refused a mortgage after their financial circumstances have been assessed or because the lender's survey of the property comes up with a valuation inferior to the price agreed by the buyers. Furthermore, as housing prices are still on a downward slope, potential home-buyers are still being tempted to wait for prices to drop even further before deciding to buy. We believe a robust and lasting upturn in the property market is only likely to take off once potential buyers, nationally, begin to expect house prices to climb.

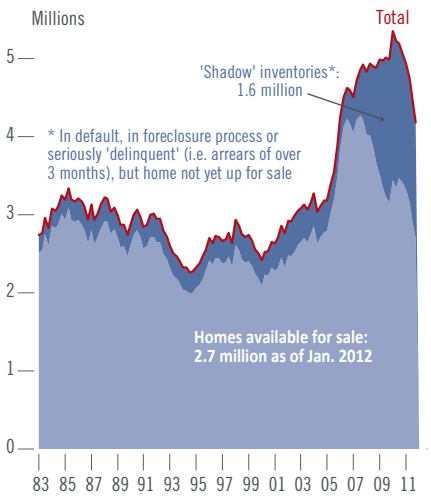
Until that happens, some of the positive factors highlighted above should, bit by bit, bring their influence to bear, and the rate of increase in housing sales should continue to pick up gradually. The trend could gather further pace if the recent strengthening upswing in jobs were to be confirmed. An improvement on the house selling front, coupled with an ongoing decline in the stock of homes for sale and 'shadow' inventories, should help to stabilise house prices over the summer and nudge them gently higher as from the autumn.

Genuine upturn no longer such a distant prospect

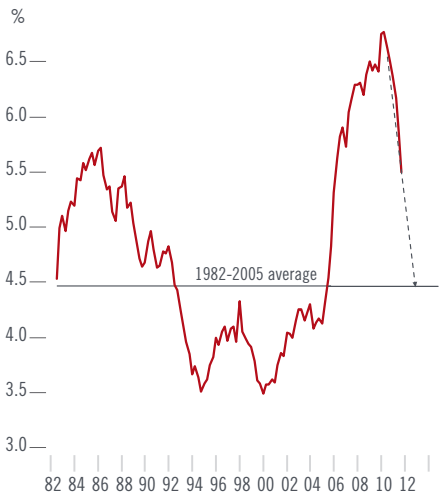
These developments should lay the foundations for a much more solid upturn in housing sales and residential construction in 2013 (matched by a gentle, but sustainable, rise in house prices). This recovery should be robust enough to deliver a noticeable lift to economic growth overall both directly (via construction work and employment in the building sector) and indirectly (via consumer confidence and a wealth effect).

The scenario sketched out above is still prone to considerable uncertainties, especially in terms of the timings. Nevertheless, the most important point to note is that the solidity of fundamentals has been significantly restored after several painful years of very anaemic demand and lacklustre construction in the housing sector, sizeable surpluses on the housing supply side and house prices sliding virtually non-stop. The process of supply and demand being rebalanced, a vital prerequisite for any genuine upswing in the US housing sector, does look to be well underway and, in a few months' time, the long-awaited upturn should start to become much more strikingly visible.

HOMES AVAILABLE FOR SALE AND 'SHADOW' INVENTORIES



HOMES FOR SALE AND 'SHADOW' INVENTORIES: AS % OF TOTAL US HOUSING UNITS



Sources: AA&MR, CoreLogic, Datastream

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Bond markets in the firing-line

10-year US Treasury bond yields spiked suddenly from just under 2% in early March to almost 2.4% by 19 March before drifting back to 2.2%. Yields are likely to remain low until confirmation materialises that a virtuous-circle upswing is indeed underway.

Data in charts and tables dated as of 28 March 2012

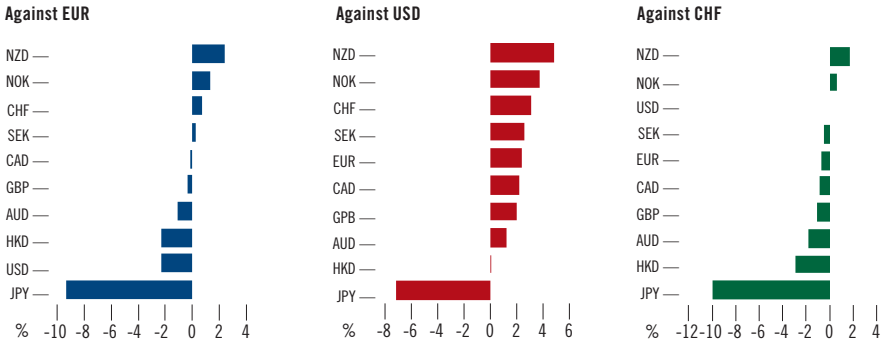
MAIN ECONOMIC INDICATORS

Pictet estimates – (consensus)

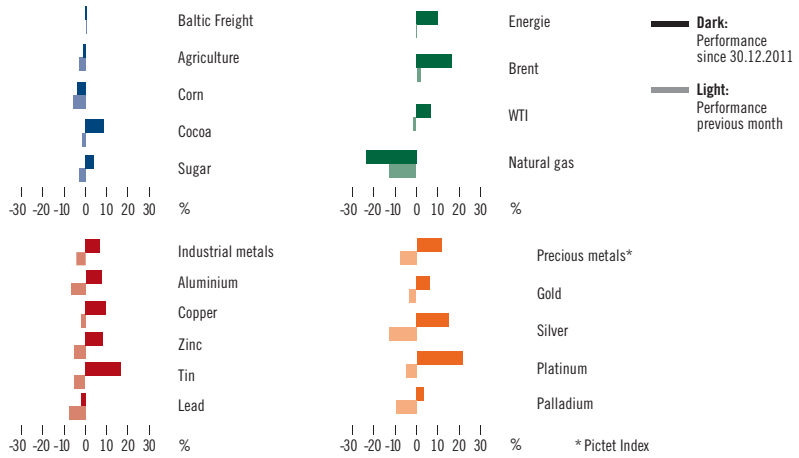
GDP growth rates	2010	2011	2012E		2013E	
US	3.0%	1.7%	2.5%	(2.3%)	2.7%	(2.6%)
Eurozone	1.8%	1.5%	-0.1%	(-0.4%)	0.7%	(0.9%)
Switzerland	2.7%	1.9%	0.7%	(0.3%)	1.5%	(1.4%)
UK	2.1%	0.8%	0.4%	(0.6%)	2.0%	(1.8%)
Japan	4.5%	-0.9%	1.5%	(1.9%)	1.7%	(1.5%)
China	10.3%	9.2%	8.8%	(8.4%)	9.0%	(8.6%)
Brazil	7.6%	2.7%	2.8%	(3.3%)	5.4%	(4.4%)
Russia	4.0%	4.3%	3.7%	(3.7%)	3.8%	(3.8%)

Inflation (CPI) Annual average, except year-end for Brazil	2010	2011	2012E		2013E	
US	1.6%	3.2%	2.5%	(2.3%)	2.3%	(2.0%)
Eurozone	1.6%	2.7%	2.3%	(2.2%)	1.4%	(1.7%)
Switzerland	0.7%	0.2%	-0.6%	(-0.4%)	0.4%	(0.7%)
UK	3.3%	4.5%	2.9%	(2.7%)	2.4%	(2.1%)
Japan	-0.7%	-0.3%	-0.2%	(-0.2%)	-0.1%	(0.0%)
China	3.3%	5.5%	4.0%	(3.3%)	4.0%	(3.7%)
Brazil	5.9%	6.5%	6.0%	(5.4%)	5.1%	(5.3%)
Russia	8.8%	6.1%	6.4%	(6.4%)	6.0%	(5.9%)

EXCHANGE-RATE MOVEMENTS (SINCE 30.12.2011)



COMMODITIES



INTEREST RATES

	Short (3-mth)	Long (10-yr)
US	0.1%	2.2%
Eurozone	1.0%	1.8%
Switzerland	0.0%	0.8%
UK	0.5%	2.1%
Japan	0.1%	1.0%
China	6.6% (1 year)	3.5%
Brazil	9.8%	11.4% (9 years)

BOND MARKETS

Returns since 30.12.2011

STOCK MARKETS

Returns since 30.12.2011

	USD	EUR	CHF	GBP
MSCI World*	11.7%	9.2%	8.4%	9.6%
S&P 500*	12.4%	9.8%	9.0%	10.2%
MSCI Europe*	10.9%	8.3%	7.6%	8.7%
Tokyo SE (Topix)*	11.3%	8.8%	8.0%	9.2%
MSCI Pacific ex. Japan*	14.4%	11.8%	11.0%	12.2%
SPI*	10.5%	7.9%	7.2%	8.3%
Nasdaq	19.2%	16.4%	15.6%	16.9%
MSCI Em. Markets*	14.4%	11.7%	11.0%	12.2%
Russell 2000	12.6%	10.0%	9.3%	10.4%

* Dividends reinvested

SECTORS

Returns since 30.12.2011	US	Europe	World
Industrials	10.5%	10.8%	11.2%
IT	21.7%	16.0%	20.4%
Materials	10.5%	8.9%	8.7%
Telecommunications	1.9%	-2.4%	0.3%
Health care	7.9%	0.9%	6.1%
Energy	2.7%	0.1%	2.8%
Utilities	-3.2%	2.3%	0.4%
Financials	21.6%	15.9%	18.5%
Consumer staples	4.5%	4.4%	5.4%
Consumer discretionary	15.8%	18.2%	17.4%

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