

## **BLOM BANK (SWITZERLAND) SA, GENEVA**

Brief market review and Recommendations, 4<sup>th</sup> October, 2006

### **ECONOMY**

The IMF in its latest economic report stated that the global economic activity has slowed down since the spring, reflecting higher oil and commodity prices as well as policy tightening. It is in the US where the slowdown has specially occurred, but Europe and Asia witnessed also some slowdown in their economies as well. Nevertheless the US global growth remains above the long-term average since 2003 and appears to remain likely above it this year. As for the eurozone, economic figures suggest that the growth will remain over 3.5 % annualized drawn by a continuous exceptional performance in Germany and France. As for the UK economic activity it has been firm so far this year. Therefore rate hike probability is on the upside. In the USA the majority of analysts believe the Fed has completed its tightening cycle, however a fall in the rates in the year 2007 could be a possibility in many analyst scenarios. In its latest meeting on September 19<sup>th</sup>, the Federal Open Market Committee kept its benchmark Fed Funds rate unchanged at 5.25 percent as expected. The statement accompanying the decision did not contain any great surprises or changes from the August meeting statement. The Fed said the moderation in economic growth appeared to be continuing, partly reflecting a cooling of the housing market. It also said that inflation pressures seemed likely to moderate over time reflecting “reduced impetus” from energy prices, contained inflation expectations, and the cumulative effects of monetary policy actions. Monetary tightening has persisted in many economies in Europe and Asia. The ECB seems to have accelerated the pace of interest rate tightening and the Swiss National Bank, SNB as well. Japan witnessed its first rate hike for nearly six years and China seems to be on the way.

### **STOCK MARKETS**

The very well followed Merrill Lynch monthly poll of fund managers showed investors cutting cash holdings and moving back into equities in September because of the positive sentiment created due to lower oil prices and to the Federal Reserve holding interest rates for the first time in two years. However the optimistic mood was tempered by doubts about the outlook for corporate earnings. Sixty eight percent of respondents expected corporate earnings to worsen during the coming year, compared with 14 percent expecting an improvement, which is considered the worst reading since early 2001. The equity market rally since the beginning of June has continued without interruption till the issuing of this note. The Dow Jones index reached level of 11720 at the end of September while S & P 500 level was 1327 which is nearly the highest level for nearly 5 ½ years. Performance in continental Europe and Emerging markets was slightly stronger than the average while the United Kingdom market was lagging behind. Equities in Europe performed very well and the Eurostoxx 50 hit its high of May with a performance of 12 % year to date. The Swiss Market index hit its all time high to the level of 8400, while the Japanese Nikkei 225 stays in a negative territory year to date. The valuation of stocks are considered reasonable in spite of the recent rally because of the correction which the market witnessed in mid May. For the time being the consensus of market analysts believe that Japanese, Asia Pacific and emerging markets have a potential performance to come in this year and the next year while they are less bullish on the US and UK equities as well as the European ones due to the long performance they had till now.

## **BONDS**

Renewed optimism that US interest rates might have peaked provided a favourable backdrop to US bonds, while European bonds came under pressure recently after a member of the governing council of the European Central Bank declared that the ECB was very “worried” that inflation was no longer expected to ease in the year 2007. Data showing that wholesale prices in Germany rose by 5.3 percent in August, well above consensus forecasts of 4.7 percent added to inflation worries. The news raised expectations that the ECB might go further than expected in tightening interest rates. Markets had been pricing in two further quarter-point hikes in the ECB’s benchmark interest rate to 3.5 percent. United Kingdom Gilts were also weaker following higher than expected UK inflation data for August. Consumer prices rose by 0.4 percent, taking the year-on-year inflation rate to 2.5 %. This was the fourth month in a row that consumer prices growth has remained above the 2 percent target adding to expectations that the Bank of England might raise its benchmark rate from 4.75 to 5 per cent by the year end.

## **CURRENCIES :**

In its latest assessment of the global financial system, the IMF said that the risk of disorderly decline in the US dollar could increase unless policies are put in place to address global savings and investment imbalances. The US dollar remained firm since the dip it has witnessed in the first quarter of this year. Despite the pause installed by the Fed on its series of uninterrupted rate hikes since Sep. 2004 reaching interest rate level of 5.25 % from 1.25 %. Many analysts believe that unless we get economic figures that are drastically worse, the dollar will stay in the range since many currencies like the Canadian, Australian and New Zealand dollars which are very much related to the prices of commodities are starting to fall as commodity prices witnessed a sharp drop since May of this year. The Yen for its part witnessed a carrying trade - a strategy to exploit low Japanese interest rates to earn higher returns elsewhere many financial analysts believe that this very popular trade has not come to an end for the time being.

## **GOLD**

Gold has fallen by more than USD 130.-, or almost 20 percent since May when it reached a 25 year high of USD 730.- per ounce. Weaker demand for jewelry has been one of the factors behind gold’s retreat since May. High and volatile prices particularly affected India where jewelry demand fell by half while Turkey and Saudi Arabia recorded a one-third drop in manufacturing in the first half of this year. For now, GFMS, the precious metal consultant said in its latest research publication that gold could profit again from a significant increase as US investors renewed interest in gold due to concerns about slow down in the US housing market have created a bleak outlook for the American economy and particularly the dollar. On the other hand Central bank reserve rates of gold shrunk dramatically in the first half of 2006 compared with the same period last year, declining by 60 percent. A 500 tons annual limit on gold was agreed by signatories to the Central bank Gold Agreement (CBGA) but they had sold just 337 tons by the end of August. As the quota cannot be rolled over into the next year, fears that Central banks might rush to sell gold before the dead line has damped sentiment towards gold recently but as this deadline of end of September passed, gold profited immediately and rebound over USD 600 per ounce.

## COMMODITIES

Since peaking in mid-May, the CRB index, a broad measure of the performance of commodities compiled by the US based commodity Research Bureau, has fallen about 16 % , oil is down 20 % from its high on July, while natural gas is down 59 % in 2006, copper is down 15 % since May. Oil prices continued to slide during mid September, leading a broader sell off in commodities. Analysts said prices of oil come down due to relatively calm hurricane season in the US, rising inventories of crude and petrol, reduced fears about the extent of geopolitical tensions and expectations of reduced demand as the global economy slowed.

<p style="text-align: center;"><b>UPDATE OF OUR RECOMMENDATIONS FOR 2006</b></p>
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We maintain our recommendations for the year 2006 and add to it a new one which would be :

☞☞ Using reverse convertibles (selling put options) on valuable stocks witnessing a dip to profit from the high volatility we see now on the market. The objective is to catch the high yield premium or buy stocks on a low price (please see practical ideas enclosed). Or sell call options to take profit on stocks in portfolios.

Based on the above mentioned analysis and to conclude, the recommendations of the main analysts and brokers in the market would be as follows :

- ☞☞ Making use of any setback in the stock markets to build new positions especially when there are good opportunities
- ☞☞ Prudent diversification in the portfolios is highly recommended whether in the asset classes or the geographical diversification
- ☞☞ Over weighting Asian and Japanese equities
- ☞☞ Over weighting the fixed income of emerging markets as well as the new European countries entering the European Community
- ☞☞ Under weighting the US dollar in the portfolios and over weighting the European ones
- ☞☞ Introducing the Gold and commodities or other instruments tracking them in the portfolios as these asset classes are not correlated to the stocks and bonds; this will be a good diversification strategy
- ☞☞ Introducing alternative investments which are not correlated to the traditional asset class.

☞☞ In order to boost the performance of the portfolios, we have selected the best funds registered in Switzerland based on a track record of 5 years to fill up a model of asset allocations reflecting the above mentioned recommendations.

*We can give details on this model upon request.*

Without liabilities.

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