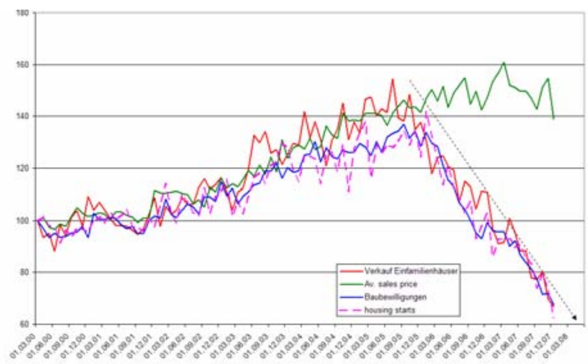
# Quarterly report 30 June 2008

## Economic environment

The economy in Europe is cooling more quickly than many expected. Confidence in the eurozone receded further in June. The trend has been downwards for a year. The key Ifo Business Climate Index also shows a similar development. European retail sales and the purchase managers' index declined sharply in June.

***Alarming decline in the US housing market***




***Depressed consumer sentiment***


The ongoing crisis in the credit and real estate markets coupled with falling consumer confidence are sharply increasing the risk of stagflation in the USA. The Consumer Sentiment Index compiled by the University of Michigan fell to its lowest point in June for more than 28 years. The sub-index of consumer expectations sank to its lowest level since it was first published in 1952. According to the Beige Book of the Fed, economic activity remains weak and is unlikely to recover significantly before the end of this year. The unemployment rate rose sharply from 5.0% to 5.5% in May, thereby exceeding expectations. The property market remains in precarious. Sales of new houses declined once again in May and were some 40% lower than the previous year. In view of the increasing price of commodities, the downturn appears to be accelerating. The greatest concern at the moment is that high inflation rates could establish inflationary expectations and lead to knock-on effects when determining prices and salaries. The danger of stagflation is now more present than ever.

***Interest rates***

| % | 3M | 6M | 12M |
|---|---|---|---|
| CHF | 2.79 | 2.967 | 3.26 |
| USD | 2.78 | 3.11 | 3.31 |
| EUR | 4.95 | 5.13 | 5.39 |
| GBP | 5.95 | 6.16 | 6.45 |

***Total return 1st half 08 for government bonds***

| % | Euroland | USA | CHF |
|---|---|---|---|
| 3 -5 J | -0.23 | 2.28 | 0.58 |
| 7-10 J | 0.81 | 2.82 | -0.18 |

## Performance

The bond markets for government bonds recorded a strongly negative performance in Q2 due to the increasing fears of inflation. As a result, the overall performance over the first half of the year was moderate to negative. In view of the inflationary environment, the fixed-income asset category remains unattractive.

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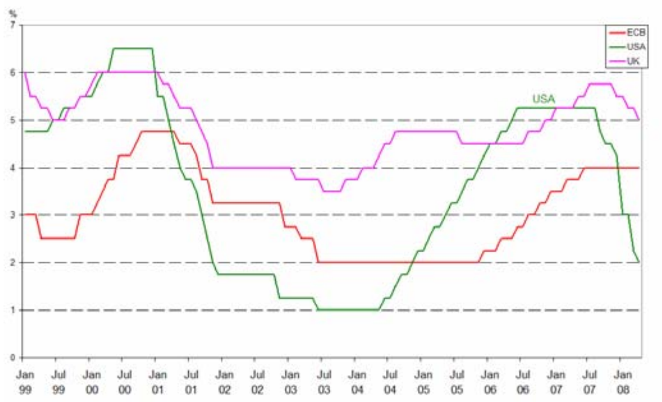
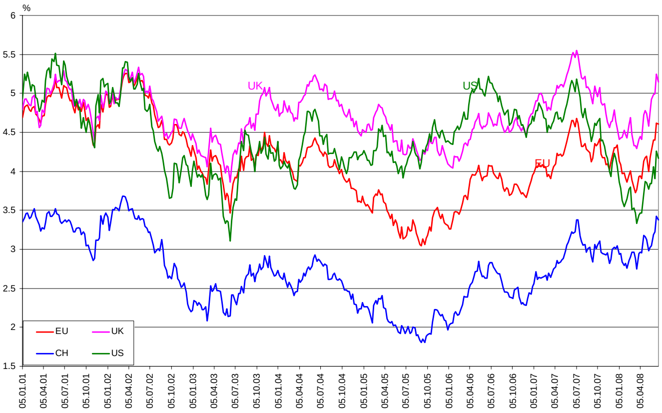
*Comparison of central bank interest rates*




UK ---USA ---ECB

*Interest on ten-year government bonds*




Since September 07 the Fed has opted for an aggressive relaxation in monetary policy and by May reduced the key interest rate from 5.25% to 2%. The impaired situation of the financial sector means that this reduction in key rates has scarcely impacted on the real economy. The scarcity of shareholder capital hinders an increase in lending activity and clients must continue to take on board large risk surcharges for credits.

For the first time the FOMC recently stressed the dangers of inflation more forcefully than those of an economic downturn. Both in the USA and in Europe the market is anticipating an increase in interest rates by central banks in order to fight high inflation. The possibility of increased interest rates was emphasised by the President of the European Central Bank (ECB), since the ECB ascribes more importance to the risk of inflation than to that of an economic downturn. In the futures markets an interest rate increase of 25 basis points by the ECB has been priced in.

**Fears of inflation further accentuated**

Driven by the sustained increase in energy and food costs, the inflation rate in both the USA and also in Europe is massively above the central banks' inflation target. A further increase in inflation in the USA will lead to substantially higher long-term interest rates, which is likely to have negative repercussions on the economy as a whole and in particular on the real-estate market. In May the annual inflation rate in the eurozone was 3.7% and in the USA 4.2%. In some emerging markets inflation already poses a serious problem related to a slowing of the economy. A rise in interest rates coupled with high inflation is bad news for the bond market. In view of these inflationary trends, we recommend mixing so-called inflation booster notes in the fixed income area, as they provide a high coupon payment together with inflation protection.

## Currencies

***Exchange rate trends***

| | YTD | 2007 | 2006 |
|---|---|---|---|
| GBP/USD | 0.37% | 1.33% | 13.69% |
| EUR/USD | 7.98% | 10.54% | 11.39% |
| USD/CHF | -9.92% | -7.01% | -7.19% |
| USD/JPY | -4.92% | -6.18% | 1.12% |

The dollar weakened against all other major currencies in the first half of the year. Exchange rate trends remain highly volatile. Although the dollar recovered after the end of the cycle of interest rate cuts announced by the Fed, the greenback lost ground once again in the second half of June.

The market anticipates an appreciation in the USD against the EUR of approx. 5% by the end of 2008. In accordance with purchasing power parity, the dollar is undervalued by 30% against the EUR. For this reason we expect to see a reversal in trends over the next few months and a substantial appreciation in the USD in the coming years. The Bush administration and the US Federal Reserve have already announced that they will prop up the dollar in order to keep a grip on the inflation risk. The main problem of a weak dollar is that the price of commodities continues to rise, thereby increasing inflation in the USA. In the case of USD reference currency mandates we recommend a reduction in currency risks, ergo a shift in focus to the domestic currency. In the case of non-USD reference currency mandates we recommend a slight increase in the dollar positions in order to gain from this appreciation in the medium term.

## Equity markets

***Yields for first half 2008 and 2007***

| | **1Q08** | 2007 |
|---|---|---|
| SMI | **-17.99%** | -3.43% |
| FTSE 100 | **-12.87%** | 3.80% |
| CAC 40 | **-21.00%** | 1.31% |
| DAX | **-20.44%** | 22.29% |
| DJ Stoxx 50 | **-21.10%** | -0.36% |
| S&P 500 | **-12.83%** | 3.53% |
| Nasdaq 100 | **-13.55%** | 18.67% |
| Russell 2000 | **-11.89%** | -2.75% |
| TSX Canada | **-9.97%** | 7.16% |
| AS30 Australia | **4.58%** | 13.76% |
| Nikkei 225 | **-16.95%** | -11.13% |
| Shanghai | **-11.93%** | 96.66% |
| Sensex | **-48.00%** | 47.15% |

The increasingly gloomy economic picture and the fears of stagflation were a heavy burden for equity markets in first half 2008. They are now almost back to their lowest level of March.
The mood of on financial markets deteriorated quickly in June and both investors' risk aversion and volatility rose. The fear of a new round of write-downs by financial institutions is all-pervasive. The coming reporting season could lead to further disappointments.

**Crisis not blown over**

It is still too early to build up an interest in the financial sector. The position remains highly precarious and write-downs are expected to continue. The increasing cost of capital, high production costs due to the high price of commodities, deteriorating economic forecasts coupled with sharply falling consumer confidence will place the momentum of corporate earnings under huge pressure and cause profit margins to melt away like snow in the sunshine.
As previously, we recommend underweighting the equity ratio and overweighting non-cyclical sectors such as health care and energy both in Europe and in the USA. In view of the threatened cooling of the economy we remain cautious and remain heavily underweighted in the equity market. Market timers with built-in put options are ideally suited to a gradual and opportunistic increase in the equity ratio in this environment.

## Commodities

***Yields of various commodity categories for first half 2008***

| | Last | 1H | Δ2007 |
|---|---|---|---|
| WTI Spot Oil | 143.90 | 45.8% | 57.2% |
| GSCI Energy | 815.28 | 51.2% | 35.6% |
| GSCI Agriculture | 96.48 | 14.1% | 22.6% |
| Wheat | 46.90 | -8.8% | 52.1% |
| Corn | 26.13 | 52.6% | -2.3% |
| Coffee | 30.59 | 9.1% | -6.4% |
| Cotton | 40.17 | -3.6% | -2.4% |
| GSCI Livestock | 299.13 | 14.1% | -12.7% |
| GSCI Prec. Metals | 146.30 | -8.0% | 22.3% |
| Gold | 933.50 | 9.1% | 31.0% |
| Silver | 18.13 | 10.5% | 14.7% |
| GSCI Ind. Metals | 319.53 | 13.0% | -9.8% |

**Price of oil reaches all-time high**
The price of oil continued its spectacular rise of recent years and closed the first half 2008 with a gain of 45%. Despite a clear cooling of the economy in both the USA and Europe, the price of oil continues to rise. Even Saudi Arabia's plans to boost oil production have not eased the situation. According to Goldman Sachs, a "super spike" of USD 200 /barrel could become a reality in the coming 6 to 24 months. A decisive driver in the rise in prices is how investors rate the long-term risk of a scarcity in supply.

**Soft commodities: inconsistent performance**
In the area of agricultural products the GSCI Agriculture Index posted a substantially positive performance of 14%. Corn posted a spectacular performance of 52% due to sustained rainfall in the US corn belt, the most important production area worldwide, and the lowest inventory level for twenty-five years. The performance of cotton, wheat and livestock was negative. The general bull market in soft commodities is both of a fundamental and a speculative nature.

### Our expectations

We anticipate a gloomy macro-environment together with a slowdown in growth momentum and a high inflation rate. The stagflation scenario is expected to gain the upper hand in the USA. In addition, we expect a continued high level of volatility on equity markets and generally disappointing results with the publication of the second set of quarterly figures. A cautious increase in the equity ratio by market timers is to be recommended during the coming weeks.
We expect to see very varied performance in the commodities categories in the current year. With base metals, the downturn in growth is likely to limit the upward potential. A substantial price correction in this area would represent a buying opportunity. Soft commodities are expected to continue a long-term trend and offer a cushioning effect in the event of an equity market correction.

Vaduz, 2nd July 2008