



FALCON PRIVATE BANK

SWISS PRIVATE BANKING

INVESTMENT COMPASS

June 2010

FALCON PERSPECTIVES

INVESTMENT OVERVIEW AND OUTLOOK

After they did extraordinary well in 2009, international equity markets have consolidated so far in 2010. Equity prices fell sharply in May, but managed to stabilize once again at the beginning of June. China's announcement to let its currency fluctuate should have a positive impact on the global economy in the longer term. On the other hand, latest data are indicating decelerating economic dynamics. The very high debt levels in many countries are worrying.

The battle between bulls and bears is likely to continue. Overall, we expect little price change in the next few months, but volatility should stay high. Other risky asset classes such as commodities or corporate bonds may take their cue from the development on the equity markets. Government bonds seem to be expensive given their historically low yields. In light of the ongoing global economic recovery, we continue to rule out a double-dip recession.

Volatile equity market performance

International equity markets have been very volatile this year. The good start into the new year was followed by a three-week consolidation that started in the middle of January. The S&P 500 Index, the global bellwether, fell by 12% in that period. The setback was triggered by President Obama's initiative for a comprehensive reform of the financial sector. Then equities rallied until the end of April, appreciating 16%. On April 26, 2010, they reached a new high for the year. A renewed correction, which sent the S&P 500 Index down 14% and to a new low for the year, followed. It is interesting to note that the high and the low for 2010 so far were achieved within only six weeks. This time, the sharp setback was triggered by the debt crisis in some euro zone countries, the austerity programs and the weakness of the euro. Equity markets only began to stabilize at the beginning of June.

Stress test

On June 17, 2010, the European Union (EU) surprisingly announced the publication of the results of stress tests for European banks until the middle of July at the latest. The stress tests began in the middle of March, and 25 large commercial banks, which account for about 60% of the total balance sheet of the euro zone banking sector, are being controlled. A stress test checks the ability of a bank to weather an unfavorable economic environment and if the financial institution has enough shareholders' equity in such a case. Besides the resilience to external shocks, the current stress test also checks the dependence of certain banks

from government aid. The results of the stress tests will be made available for each bank separately in order to strengthen investors' confidence.

Shares of European banks have lost considerable ground in the last few weeks as a result of their exposure to sovereign debt in problematic euro zone countries, a possible need for write-offs on these papers as well as rumors of financing problems. The EU hopes to soothe the market and investors with the publication of the stress tests. About one year ago, the results of the stress tests for US banks have had a very positive impact on the general market, particularly on the banking sector.

Transition to a more flexible Chinese currency regime

The announcement of the Bank of China to let its currency float more freely should be good news for the markets in the medium term, too. As China's answer to the global financial crisis, there was a tight peg between the yuan, its currency, and the US dollar once again since July of 2008. US President Obama and other western politicians have criticized the Chinese leadership to keep its currency artificially low. That seems to bear fruit already. China is expected to resume its policy of a slow, but steady appreciation of its currency, which it started in the middle of 2005. Thanks to its transition to a more flexible currency regime, China makes an important contribution to the reduction of the large global imbalances. Also, the danger of a trade war may recede substantially and the growth of the global economy should become more balanced and more stable.

The Chinese domestic economy, especially the consumer sector, should strengthen as consumer's purchasing power will increase thanks to cheaper imports to China. On the other hand, the American consumer is paying more for Chinese imports. We do not expect growth of the global economy to increase faster thanks to the revaluation of the yuan; but the composition of growth and the drivers of the expansion will change. On aggregate, global growth should become more stable in the longer term. The risk of a hard landing in China is decreasing and the stronger currency helps to combat inflation. On the other hand, the impact of the debt-plagued US consumer on the world economy is likely to abate further. Last but not least, the currency appreciation of the world's most populated country sends an important message, as China believes that the global economic recovery is still intact.

The battle between bulls and bears continues

We do however not believe that the positive effects from the announcement of the stress tests and the appreciation of the yuan will be sustainable. Instead, we expect that the well-known problems such as high global debt levels, especially in some euro zone countries, will take center stage once again soon. We remain cautious as the latest equity rally was accompanied by low volume. In other words, not many investors participated in the uptrend. In addition, some market participants are afraid of a so-called double-dip recession that means that the global economy would fall back into recession. Since many European countries introduced serious austerity measures, this possibility is

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now being discussed even more intensively.

After a series of relatively strong US economic data, the picture has darkened a bit as of late. May labor market data were surprisingly weak and the housing sector seems to stagnate. It is no surprise that some US economists may ask the Fed to make its monetary policy more expansive once again, reintroducing some programs to improve liquidity in selected markets. For the first time since May 2009, the growth rate of the index of leading indicators, compiled by the US Economic Cycle Research Institute, has become negative. We however keep the opinion that the current dynamics in the global economy, especially in the emerging markets, are strong enough to prevent the world from falling back into a renewed recession.

Hence we expect the battle between bulls and bears to continue for some time: The bulls see enough growth both from the economy and from the corporate earnings. The bears are focusing on the high debt levels, the danger of a renewed fall into recession (double dip) and increasing regulatory activities, especially in the US (financial market reform).

Commodities and fixed-income investments

Other risky asset classes such as commodities and corporate bonds corrected in May, too. If the global economy slows, so the general opinion, fewer commodities would be needed. The prices of oil and industrial metals came under severe selling pressure, whereas precious metals, above all gold, proved to be very resilient. The strong negative correlation between the US dollar and the gold price has loosened a bit as of late: The strengthening of the greenback could not prevent the yellow metal from rising to fresh all-time highs. Gold benefited from its reputation as a safe-haven investment. Corporate bonds suffered from the general perception that easing global growth rates could impact corporate earnings and therefore cause balance sheets to weaken. As we do however not expect a double-dip recession, we continue to prefer corporate bonds to government fixed-income paper. Interest rate differentials or credit spreads have widened again in recent weeks, making corporate paper more attractive once again. In sum, due to the low global risk appetite, commodities and corporate bonds are likely to move more or less in synch with equities

for the time being.

In our view, the perspectives on the government bond markets are not very encouraging in the medium term. Investors are painting quite a downbeat picture of the economy, which is one of the main reasons why government bond yields continued to decline in recent months to historically very low levels. The yield of the 10-year US Treasury fell from 3.83% at the beginning of this year to currently about 3%. The same picture in Germany, where long-term capital markets interest rates eased to below 2.5% from 3.39% at the end of 2009. As a result, government bond investors achieved above-average capital gains. Thanks to the elevated uncertainty on the international equity markets, the world-wide low inflation and the postponement of rate hikes well into 2011, yields could stay at low levels for some time. But the potential for further gains with government bonds is limited: The heavy supply of new paper to finance the rising public deficits and the recovery of the global economy – at an awfully slow pace however – are likely to limit a further marked drop in yields.

RECOMMENDED ASSET ALLOCATION

July 2010

FALCON PRIVATE BANK BALANCED STRATEGY USD			
ASSET CLASS	ALLOCATION	CHANGE	COMMENTARY
Cash	10%	0%	European sovereign debt crisis and euro weakness are causing elevated uncertainties; low key interest rates in the foreseeable future.
Bonds	36%	0%	Focus on corporate bonds thanks to still elevated credit spreads; government paper offers relatively poor value in the long run due to rapidly increasing public debts and the potential for higher inflation rates in 2-3 years from now.
Equities	48%	0%	Corporate earnings continue to surprise positively, but stronger evidence of a sustainable economic recovery and a stabilization of the labor market needs to be seen; despite significant improvement, the financial sector is still undercapitalized.
Alternative Investments	6%	0%	Proper selection of hedge fund strategy is key to success.

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