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Trends

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Long-Term Investing

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Alternative Investments – Commodities Has the price of gold already risen too high?

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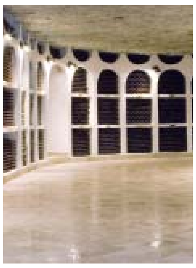

"Good things come to those who wait."
A wine basement in old quarry as an example for an alternative long-term investment.

Editorial

Arun Ratra
Chief Investment Officer

Arun Ratra is a Managing Director with Credit Suisse's Asset Management Division, based in Zurich. He is the Chief Investment Officer of Multi Asset Class Solutions (MACS).

Before joining Credit Suisse in May 2005, Mr. Ratra held various positions in the Dutch pension fund industry. He was Chief Operations Officer & Executive Director Asset Management at Pension Factory NV, a Dutch subsidiary of Swiss Re. Prior to that, Mr. Ratra worked at Blue Sky Group NV, the fiduciary manager for the pension funds of KLM Royal Dutch Airlines as Chief Investment Officer and was a member of the executive board.

Mr. Ratra holds a Master in Business Economics from the Free University Amsterdam with a specialisation in finance and accounting.

Dear Reader,

Because we believe that nothing is so good that it cannot be improved upon, we set ourselves the objective of relaunching **Trends** in 2008 with a new concept and an updated look.

In doing so, we are continuing to follow the principle of positioning **Trends** as "the publication" from Credit Suisse Asset Management for all professional investors.

The first edition of the new **Trends** looks at the topic of long-term investing with a series of editorial articles dealing with this term, including the dossier at the center of the issue and a column. The existing asset class-oriented structure of Trends, which according to our survey results you very much appreciate, will of course remain unchanged.

In keeping with the spirit of the main topic, **Trends** promises a forward-looking, exciting and stimulating read - and with this in mind, we hope you enjoy it.

Yours sincerely

Arun Ratra
Chief Investment Officer

Asset Allocation

Central banks hold the key

Patrick Bucher, Investment Strategy

Unsettled by the growing signs of weakness in the US economy and a continuous stream of bad tidings from the financial sector, the markets are not counting out the possibility of a recession in the US. To date, the markets we favoured have fared better. However, these markets may not be able to avoid a further deterioration in sentiment. The actions of the central banks over the next few weeks are of key importance.

In the last issue, we mentioned how strongly selective the market is between various risks. This development has continued. The slide in financials does not seem close to ending. Current valuations of government bonds anticipate a recession in the US. In contrast, emerging market and commodities stocks that are actually very cyclical have been holding up amazingly well.

These diverging market movements are well justified by the differing growth dynamic, as we have mentioned here before. This decoupling will only continue if the weakness in the US remains within certain bounds. The US Federal Reserve plays a key role in this regard. The market currently has great expectations for cuts in key rates, under the assumption that the risk of inflation has been eliminated by the slowdown in the economy. In our opinion, this makes market disappointment in an overly hesitant Fed the most significant risk for the first six months of the year. Related expectations of a sharper weakening with a global impact contain the risk of a general reduction in the appetite for risk. Even markets that have been only marginally affected so far would suffer the effects of such a sell-off.

Think about increasing equities

As long as uncertainty continues with regard to the central banks and a possible recession, volatility should remain high. However, this also offers opportunities. Based on our scenario that the overall global economy is indeed weakening but is nowhere near the end of the growth cycle, we intend to take advantage of further price drops to increase our equity position after reducing it in the last issue. Of course, the uncertainties regarding further corporate profit developments call for caution. On the other hand, the current valuation levels have already factored in quite a lot of profit pessimism. Our sentiment indicators also point to a sell-off mood, which means that prices will soon recover.

By region, the structure of our portfolio remains unchanged for now. With overweight exclusively in emerging markets and commodities, our allocation reflects the asymmetrical growth of the global economy.

Pound is the weakest currency

The most striking change in comparison with the last issue concerns our currency allocation: After sharp losses, the US dollar could be set for a certain amount of recovery. For this reason, we have closed our US dollar underweight. We are financing this with the British pound, whose sharp drop looks set to continue.

Sample portfolio: Multi-Asset-Class Solution for pension funds

	EUR	GBP	USD	JPY	CAD/AUD & commodities	Emerging markets	Total
Money Market	**11.5%** ▼	**0.0%**	**0.0%**	**0.5%**			**12.0%** ▼
	10.0%	0.0%	0.0%	0.0%			10.0%
Bonds	**53.5%** ▲	**0.0%**	**0.3%**	**1.4%**			**55.2%** ▲
	55.0%	1.0%	2.0%	2.0%			60.0%
Equities	**10.3%**	**2.9%** ▼	**11.7%**	**3.0%**	**3.9%** ▲	**1.0%**	**32.8%**
	10.0%	3.0%	12.0%	3.0%	2.0%	0.0%	30.0%
Total	**75.2%**	**2.9%** ▼	**12.0%**	**4.9%**	**3.9%** ▲	**1.0%**	**100.0%**
	75.0%	4.0%	14.0%	5.0%	2.0%	0.0%	100.0%

Bold: tactical positioning, normal type: long-term strategy/benchmark. Arrows show change compared to last issue of Trends. Source: Credit Suisse

Asset Allocation
Outlook

Equity Market	17.01.08	12 Months	Return (local)	in EUR
USA (S&P 500)	1333	1570	17.8	15.5
Germany (DAX)	7414	8500	14.7	14.7
Netherlands (AEX)	460	550	19.5	19.5
U.K. (FTSE 100)	5902	7000	18.6	17.7
France (CAC 40)	5215	6300	20.8	20.8
Italy (MIBTEL)	36442	44000	20.7	20.7
Spain (IBEX 35)	13776	16700	21.2	21.2
Switzerland (SMI)	7788	9400	20.7	24.7
Japan (TOPIX)	1330	1620	21.8	24.8
Capital Market (10 Years)				
USD	3.66	4.10	0.4	1.4
CAD	3.81	4.40	-0.5	3.4
AUD	6.04	6.30	4.3	8.1
JPY	1.41	1.80	-1.8	0.6
EUR	3.99	4.20	2.4	2.4
GBP	4.47	4.70	2.8	2.0
CHF	2.85	3.10	0.9	4.3
Money Market				
USD	3.93	3.10	3.6	4.6
CAD	4.16	3.90	4.1	8.2
AUD	7.14	6.90	7.0	11.0
JPY	0.90	1.00	0.9	3.4
EUR	4.44	3.60	4.1	4.1
GBP	5.60	4.90	5.3	4.5
CHF	2.67	2.80	2.7	6.2
Currencies			**in EUR**	
USD	1.46	1.45	1.0	
CAD	1.51	1.45	3.9	
AUD	1.67	1.61	3.7	
JPY	156.00	152.25	2.5	
CHF	1.61	1.56	3.3	
GBP	0.74	0.75	-0.8	
Gold			**Return (local)**	**in EUR**
USD/oz	884	950	7.5	8.6

Historical performance indications and financial market scenarios are not a guarantee of current or future performance.

Source: Credit Suisse Division Asset Management

Macro Global

Downside risks for US growth persist, emerging markets should overcome much of the negative impact

Thomas Herrmann, Global Economics & Forex Research

! Interesting to know

The UN believes the urban population in the developing world will grow by nearly 1million people every week over the next 25 years.

In US dollar terms, China's economy could overtake Japan by 2015 and the US by 2039.

India's GDP is expected to grow at 5.5% per annum over the next 25 years.

Over almost 160 years of the US stock market, the average total real return (over and above inflation, and including dividends) has been a healthy 6.2% per annum.

US consumers stay under pressure as high energy prices reduce purchasing power, they face tighter credit conditions and now even the labour market shows increasing signs of a deterioration. Major central banks' efforts since December to provide some relief to tight money market conditions were successful but credit conditions are still likely to remain tight in months to come. The reduced willingness and ability of banks to lend is still likely to have a negative impact on growth in the US and other economies affected. The key question remains how resilient the rest of the world can be when US growth slows down. We think especially for emerging markets where the initial shock the US and other economies were facing was often much less pronounced, some buffers are in place, which could help to mitigate negative impacts from a US slowdown. The Fed seems to be commited to act decisively to reduce the downside risks for the economy, other central banks might follow even if the magnitude of easing should in most cases be lower. Inflation rates are currently at high levels but should fall back as global growth slows and oil prices retreat somewhat from recent levels.

The major negative factors that were at the root of our more cautious forecast for US growth in the coming months remain in place as we head into 2008. After oil prices have briefly breached the threshold of 100 USD/barrel higher energy costs continue to weigh on consumers purchasing power. A deterioration of labor market conditions, reflected in the latest data for December (with private employment declining for the first time since July 2003) also highlights the downside risks to growth in this regard. Major central banks started a concerted effort in December to provide some relief to tight money market conditions, which was successful in ensuring banks' access to liquidity. As survey data from central banks indicates tighter credit conditions are nevertheless likely to persist and have a negative impact on growth in the affected economies in coming months. While the data shows that the risk of a US recession is real, it is still not our central expectation. The bigger risk than a brief (and even sharp) slow-down, which would qualify as a technical recession, would be subdued US growth for an extended period of time, in our view. We continue to believe that Asian economies and other emerging markets that have grown strongly should be facing tougher times ahead and will slow down as well but the negative impact should be limited for reasons we explain in more detail below. Inflation concerns remain high as headline inflation rates reached multi-year highs in many countries as the year drew to a close. Global growth was very strong in much of 2007 and as it slows below trend this should at least limit significant increases of inflation rates from current levels or even lead to lower inflation after a possible peak in the first quarter. Especially since we believe that oil prices are likely to retreat somewhat from current levels. Past price increases might still feed through to wages and other prices and have a more lasting impact. This will stay at the back of central bankers' minds and could limit the leeway to act when growth slows.

Fed likely to ease further

Interest rates that were at very low levels (possibly for too long) strongly contributed to loose lending standards and were thus at the root of the mortgage crises the US and the global economy have been facing. The still solid growth in the emerging market world is creating demand for US exports and paired with slower import growth we expect a solid growth contribution of net exports this year. Moreover, thanks to the strength of the financial system the US economy has shown great resilience in past episodes of financial market turbulence. Clearly, the financial system has been hit hard and the capitalization of banks has deteriorated. Such a situation leaves significant downside risks for the economy, or aggregate demand. The Fed has acted decisively by lowering the funds rate by 125 basis points in a bit more than one week.

Credit crunch an issue for European economies, BoE to ease further, ECB likely to follow in the second half of the year

The latest survey data from the Bank of England shows further tightening of credit conditions. Lower readings of business confidence measures in both the euro area and the UK suggest more moderate growth; the central banks' actions to provide banks with term funding have however lowered interbank interest rates significantly in recent weeks and reduced the potential growth risks in this regard by loosening monetary conditions. Following the unexpected rate cut in December, further easing by the BoE is likely in coming months; we expect at least two more interest rate cuts. Against the background of inflation at above 3% in November, we expect the ECB to stress inflationary risks and to refrain from cutting interest rates for the time being. As growth slows and inflation is likely to retreat from current readings, we think however that the ECB is likely to start to lower rates in the second half of the year.

Emerging markets still likely to weather the storm

The credit shock over the last few months was less pronounced in emerging markets than in the US or Europe. This partly also applies to the shock from the renewed surge of energy costs, which was in some countries mitigated by subsidies, regulated prices or even less oil dependence (Brazil). Strong growth in domestic demand including not only investment spending but also increasingly private consumption (Chinese retail sales growth stood at almost 19% in November in nominal terms) is helpful to reduce the negative impact from slower growth elsewhere. Intra-regional trade in Asia and increasing interdependence of decisive growth markets (e.g. China, Russia and Brazil) are also helping to mitigate the negative impact from the US, in our view. Chinese non-US exports are growing strongly and China has become a major destination of Asian exports. This shows how the share of exports of Asian economies to China has increased and how much China has thus gained importance in this regard. Pessimists argue that China has simply become the middle-man in a specialized Asian production chain, in which inputs from the rest of the region get assembled and then shipped to the final destinations including the US. We suspect however that an increasing part of this is final demand in China itself, which would leave the region less exposed and less vulnerable to slower US growth. Another positive are fiscal positions in many emerging economies, which are in a solid state and would allow for a policy stimulus if growth really weakens more than expected.

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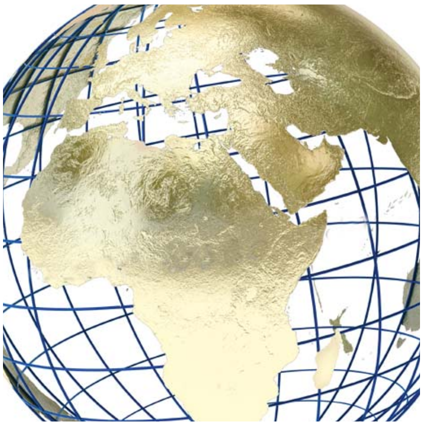
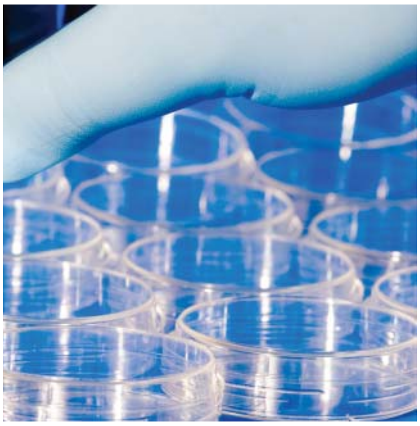
In a decisive speech on January 10 Fed chairman Bernanke has however stressed downside risks to growth and noted that the Fed stands "ready to take substantive additional action".



Equity Global

(Molecular) Diagnostics on the upswing?

Anne Marieke Ezendam, Dr. Patrick Kolb, Aude Scheuer and Igor Socchi, Global Equity Portfolio Management



Rising levels of health awareness, medical advances, demographic changes and cost pressures, are changing society's health requirements. Diagnostics play a key role in this process by improving the quality of treatment while lowering costs.

Diagnostics supports the changing health needs of society. On one hand, it includes the screening for diseases and on the other the monitoring of the status of diseases as well as therapies.

While the first diagnostic tests were in use by the year 400 B.C. (e.g. the use of insects to recognize abnormalities in urine samples), this relatively young industry emerged in the 1950s. The diagnostics industry produces reagents, calibrating and monitoring tools, the respective analytical apparatus and accessories, software and sample recipients. In this context, the term In-vitro diagnostics is used (IVD), i.e. the search for diseases "in glass" (such as on the basis of bodily fluids and tissues). These products are used by laboratories as well as by patients themselves (e.g. pregnancy tests).
Diagnostics are often used in healthcare as a primary decision-making criterion. A study by the Lewin Group (2005) that primarily examined practices in the US, demonstrated that diagnostics makes up less than 5% of hospital costs and about 1.6% of all healthcare costs, but their results influence between 60 and 70% of the decisions made in the treatment process.

The market for IVDs has seen considerable growth to date, with total sales of USD 30 billion in 2005.

In our opinion, within the diagnostics segment, molecular diagnostics has the most interesting growth profile. This subsegment includes viral/bacterial as well as genetic Tests and tests for resistance to medication. The advantages of these tests over conventional tests lie in their speed, accuracy and sensitivity. Further technological development and increasing knowledge about the genome result in better tests and new areas of development, which support the above average growth. One attraction for investors is that companies in this area can increase their profiles through patents and FDA approvals (neither required nor customary for diagnostics), which raises barriers to entry and can result in higher margins.

The future opportunities in molecular diagnostics are not lost on "Big Pharma". Roche, for example, took over Corange (incl. Boehringer Mannheim) in 1997. Since 2006, M&A activity has been especially strong: Siemens acquired Dade Behring, Qiagen took over Digene and Quidel recently announced a longterm alliance with bioMérieux. As economies of scale and a broad range of products can represent a big advantage to a diagnostics company, the consolidation may continue in our opinion.

Equity EU

Up 20% or down 20%? That is the question

Holger Schulz and Markus Zipperer, Portfolio Management Equities

The equity markets are at a crossroads. Will a US recession drag the markets down? Can the central banks revive the party on the equity markets? While the outcome is uncertain, one thing is clear – 2008 will not be a "normal" year.

It is difficult to say right now whether the US will enter a recession in 2008 and drag Europe into it as well. What is certain is that the US Federal Reserve, regardless of the level of inflation, will lower interest rates enough to ensure that the capital markets have sufficient liquidity. The European Central Bank does not have this monetary instrument at its disposal, as it feels a duty to ensure price stability and opposes inflation of more than 2%. As a result, all eyes are on the largest economy in the world, hoping that the old market adage – "don't fight the Fed" – will work again this year.

European equities have been in a bull market since the beginning of 2003. However, the crisis on the international credit markets and the resulting economic weakness in the US represent the greatest challenge to this upward trend in the past five years.

The historically attractive valuations – a P/E ratio for European equities of 11.9 in 2008 – will not provide support in this regard as long as a great deal of uncertainty remains concerning revised profit estimates. The consensus view continues to assume earnings growth of +5-6% for European equities in 2008, while corporate profits in the US are already in recession (Q3: -5.7%/ Q4: -10%).

Must we conclude that equities will crash? One thing is quite clear from the data in the last 50 years: after corporate profits exceed their cyclical highs, the following year never has average returns. Prices would then either rise significantly or fall significantly. As long as the outlook remains so uncertain, we recommend staying on the safe side in sector allocation, which is why we favor the defensive sectors: pharmaceuticals, telecommunications and foodstuffs. In contrast, we would be cautious about consumer cyclicals (automobiles, retail) and industrial and financial stocks.

European Central Bank
Frankfurt, Germany

Fixed Income Global

A US recession may be avoided but we expect lower (real) yields – favor inflation-linked bonds

Philipp Büchler, Global Fixed Income Portfolio Management

For the first half of 2008 we expect a slowdown in US economic growth with a simultaneous rise in inflation. This combination should be particularly supportive for inflation-linked bonds as it is likely to result in lower real interest rates and rising breakeven inflation.

Interest rate outlook

The key drivers for the Federal Reserve remain clearly the need to improve liquidity conditions and credit spreads, to avoid any systemic risk in the event of bank credit ratings being downgraded and to prevent an outright recession. We expect that the combination of a lower Fed Funds rate, liquidity injections, easier collateral conditions and term lending will prevent a US recession. We further believe that the Fed will largely ignore the headline inflation numbers for the next six months and take comfort from core numbers remaining low. In Europe, we also expect falling real yields as the strong euro will weigh on European exports and therefore growth, thereby fuelling future rate cut expectations. ECB policy is clearly focused on firstly improving liquidity in the interbank market, secondly encouraging a weaker euro and thirdly recognising the slowdown in demand and activity. Although there is concern that inflation is accelerating, until improved conditions re-emerge in the money markets, inflation will not be a priority. In the UK, we expect the Bank of England to continue to cut interest rates.

Credit markets

The liquidity crunch is still underway and uncertainty will remain for some time. Although banks have announced write-downs, investors question whether there is still more bad news to come. Moreover, with a slowdown in the US there may be a new wave of sub-prime (or even prime) losses coming from the housing market. Non-financial entities continue to run solid balance sheets, but the bulk of outstanding international securities have been issued by financial institutions (78.85% at the end of September 07, according to BIS statistics). Therefore, investors base their credit views on the state of financials. Some relief is expected in February, when previous quarter balance sheets are published. However, the malaise may continue until the first wave of economic data for 2008 is released.

Strategy

After having been neutral for the whole of the fourth quarter of last year, we decided to go short duration in the US at the beginning of January. We felt that a lot of bad news had already been discounted and from a risk/reward perspective, the trade looked very attractive. Our stop-loss level was quite rapidly triggered and we moved back to a neutral duration, as the market grew more pessimistic on the US outlook and market participants started to anticipate a recession.

We made no change in the other dimensions, although we spent a lot of time discussing our market positioning, which has so far been our best dimension. The US market has been the top performer in 2007 and could still go on in the new year, but our next move will be to look at alternatives, potentially Europe or Japan. It is nevertheless too early to reverse the trade and we would like to see a turnaround before executing the trade, as changes in market allocation are very expensive in terms of trading costs.

Chart 1: Markets

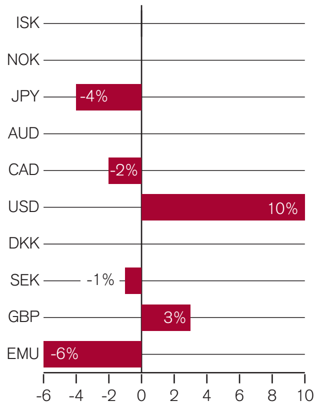


Chart 2: Currencies

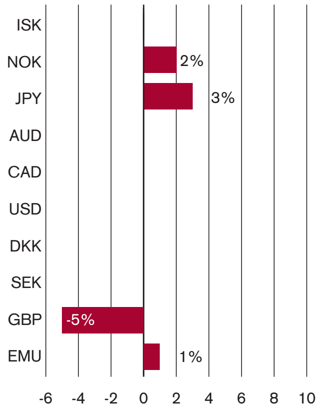
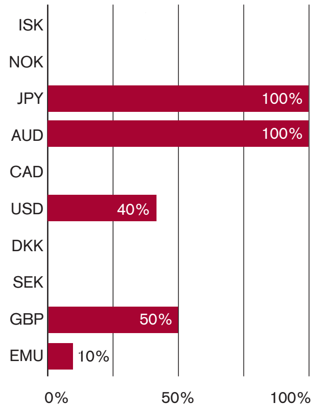


Chart 3: Swap exposure



Source: Credit Suisse

Boom, Bust and Recovery

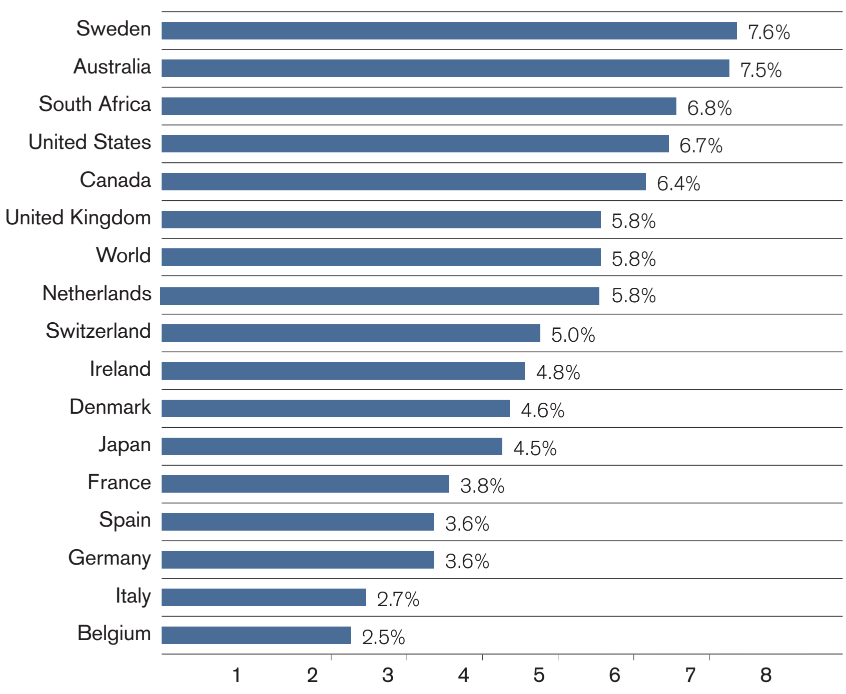
Long-Term Investing

Giles Keating, Head of Research for Private Banking and Asset Management

Weighing the balance between long secular trends and short- to medium-term cycles is a key input to investment decisions. The underlying influences from economics, politics, technology, demographics and finance are always evolving, but even so we believe there are many lessons to be learned from a long, historical perspective.

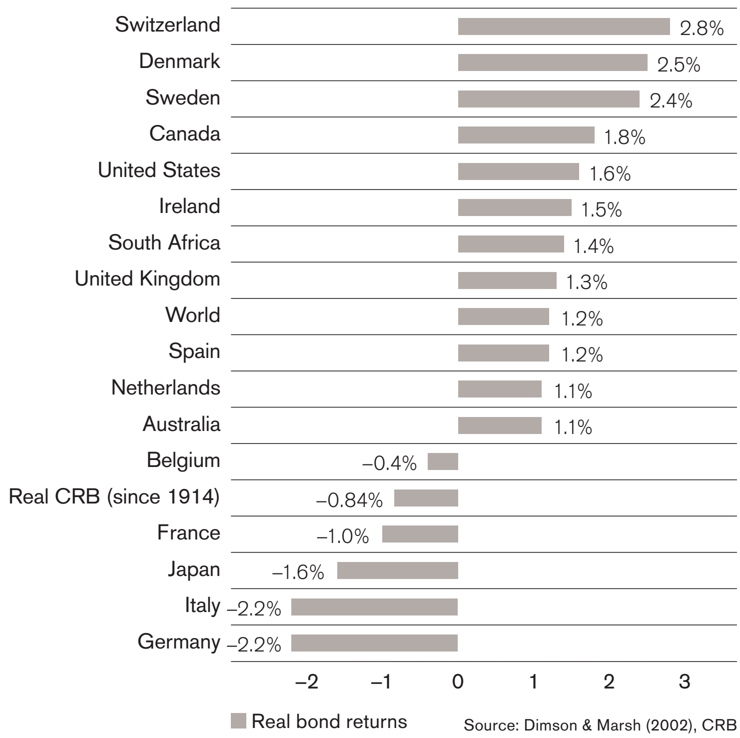
Looking back over almost 160 years of the stock market, we find that the average total real return (over and above inflation, and including dividends) has been a healthy 6.2% per annum. US equities benefited from political continuity throughout this entire period, as did those in some other countries, such as the UK and Switzerland, while stocks in some other nations including Germany and Russia saw price collapses or total losses, reflecting political trauma. A study by Professors Elroy Dimson and Paul Marsh at London Business School suggests that a sufficiently diversified portfolio, held for a long enough period, will tend to average out even events of this magnitude. Their work showed that a portfolio of stocks diversified across 16 major countries purchased in 1900 would have delivered about 5.8% per annum average real return since then, as shown in Chart 1. This is significantly ahead of the real returns achieved on bonds during the same time period of about 2.8% in Switzerland, 1.6% in the US and just 1.3% in the UK. It also beats the negative real return recorded since 1910 for commodities, as measured by the CRB index (see Chart 1 & 2). Holding assets for a long period makes it more likely that returns will be close to these averages. Investors who bought a diversified stock portfolio and held it for 25 years would have achieved a real return very close to the long-term average (see Chart 3). This applies to any entry point, even when the purchase was made right at the top of the market, just before a crash. However, few investors are willing or able to hold their investments for such a long period. For shorter holding periods, returns can differ from the average by a large margin in either direction, depending on market

Chart 1: Average real equity returns since 1900



Source: Dimson & Marsh (2002), CRB

Chart 2: Average real bond returns since 1900



Source: Dimson & Marsh (2002), CRB

conditions. Looking back in history, we think it is helpful to divide those conditions into two broad types: long secular bull markets, of which there seem to have been three in the last 160 years, and the turbulent periods in between bubbles, crashes and slow recoveries.

The secular bull markets

The first secular bull market lasted about three decades, from the US Civil War until the start of the 20th century. It reflected major economic expansion in the US and elsewhere, as well as massive migration to the Americas, technologies such as railroads and electricity, and monetary stability or even deflation under the gold standard, which underpinned a powerful bull market in bonds.

The second secular bull phase for equities came after World War II and lasted for just over two decades until the end of the 1960s. Drivers included cheap oil, the baby boom, the spread of US suburbia, post war reconstruction in Europe, tariff cuts for manufacturers, and military and civilian use of technologies like aerospace. An expansionary monetary and fiscal bias gradually became embedded in chronic inflation, initially stimulative but finally destructive, with bonds unsurprisingly in a long bear market.

The third secular bull market for stocks began in the early 1980s, lasting about two decades until the dotcom bubble burst in 2001. Corporate America copied Japan's lean production and emphasized shareholder value, tax reforms boosted incentives, the digital era began, populations exploded in poorer nations, liberalization stimulated world trade, and the emerging market boom spread across Asia, Mexico and elsewhere, thus offsetting stagnation in continental Europe. Stimulus also came from falling real oil and commodity prices, following earlier over-investment. Monetary policy reversed the excesses of the 1970s, and maintained generally low inflation, triggering a new bond bull market.

Within these secular equity bull markets, there were periods of decline, many of them small to medium-sized, but occasionally larger, like the 1987 crash. The smaller events were reversed within weeks or months, the larger ones usually rebounded within a year or so, and none appear large in the longer historical perspective. Had investors held positions through them, they would have regained their losses reasonably quickly. Of more importance are the three much larger boom-bust-recovery cycles in between the secular bull markets. Two of these cycles occurred in the 1914–1945 period, in between the first and second secular bull markets.

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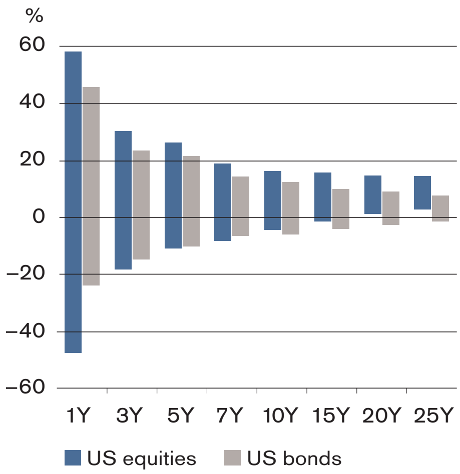
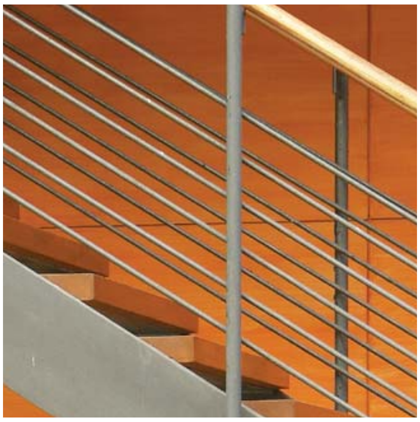
The underlying influences from economics, politics, technology, demographics and finance are always evolving, but even so we believe there are many lessons to be learned from a long, historical perspective.

Chart 3: Range of annualised real returns for different holding periods



Source: Global Financial Data



The third one occurred in the 1970s, in between the second and third long bull phases. The dotcom bubble, crash and subsequent rebound looks as though it may be a fourth such boom-bust-recovery cycle. More details about these cycles are given in the charts.

Although the details differ, a common pattern of four phases can be detected.

- In the first phase, there was a sharp rise or bubble, sometimes building up over four or five years, and sometimes happening more quickly.
- The second phase saw a very large fall of between about 40% and 80% (in real total returns), spread over some two-and-a-half to three years.
- The third phase was a recovery, lasting about four to six years. The fourth and final phase began with a short but sharp correction, of perhaps 15%–20% or more, before seeing a resumption of the recovery for another three to four years that brought the markets back to the starting point in terms of real total returns.

Will history repeat itself?

If we map the dotcom bubble, the crash and the subsequent recovery (starting in early 2003) against these historic cycles, it appears that the first three phases have been completed, and the fourth phase has now started. If the historical pattern is repeated, this would suggest that stock markets can continue their rising trend for at least another three years, but this trend would be more volatile than it was in the first five years of the upswing. The bout of high volatility that started last August certainly seems consistent with this view.

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If the historical pattern is repeated, this would suggest that stock markets can continue their rising trend for at least another three to four years, but this trend would be more volatile than it has been recently.

Special thanks to Marcel Thieliant, Alison Weingarden and Reto Meneghetti for providing the research data used in this article.

Fixed Income EUR

European credit

Rob Thomas, Credit Analyst Fixed Income

The turmoil in financial markets is far from over. But, although this negative trend is likely to continue for some time yet, it is also true to say that, at least in Europe, financial markets are not as in bad shape as they are in America. The problem, however, is that of a self-fulfilling prophecy. Fearing the worst, European markets have become so risk averse that, in all likelihood, negative sentiment will have an impact on performance.

One of the main issues is that much of the fear in markets has been driven by the outlook for the US economy, which, so far, has been much bleaker than for Europe's. In an attempt to pre-empt any future downturn, and therefore avoid the shock wave experienced in the US when the subprime crisis kicked off, those in the credit market are running ahead of themselves and taking an overcautious position regarding the downside risk of a slowing economy.

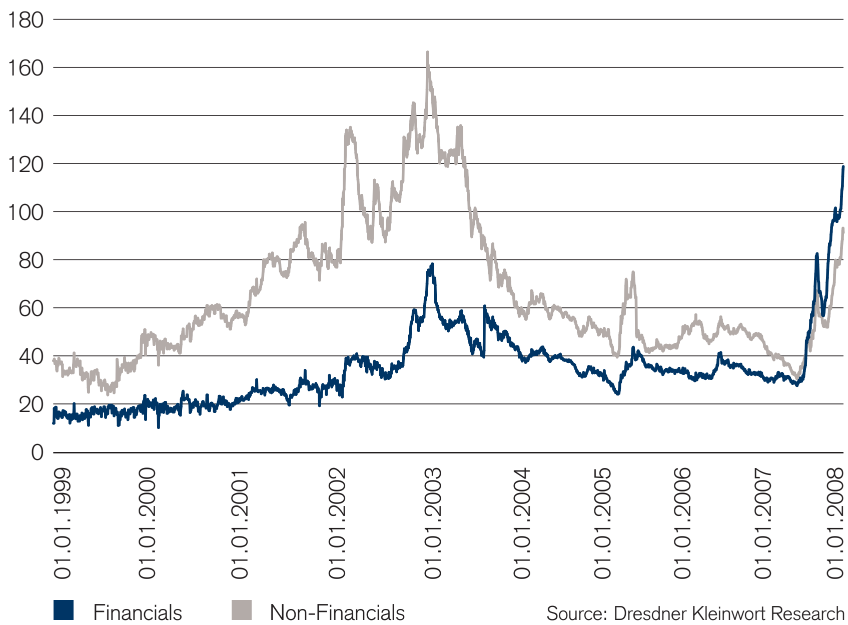
As a result, we are seeing a movement towards a downturn in credit ratings for corporates, both in Europe and in the US. Negative newsflow on the financial sector is also affecting corporates in other sectors, even though balance sheets that will corroborate market fears are yet to be seen.

The expectation is that of a reasonable earnings season from non-financial companies, though there will be disappointments from cyclical industries such as retail. However, the underperformance of financials in relation to corporates will start to correct later this year. Therefore, although corporate earnings are expected to slow, we do not expect these effects to show up in balance sheet stress until the latter half of 2008 and beginning of 2009. Such negative trend could also be exacerbated by a global economic slowdown.

Crucial is also the fact that, throughout the last credit cycle, when credit was cheap, lending criteria for borrowing corporations, were far from stringent. This means that, with further deterioration of fundaments, the true extent of defaults will filter through at a later stage, when the downturn in the market will be even more evident. For example, Moody's expects delinquency rates in corporate bonds to go up five fold this year.

It is clear, however, that the negative news is coming mainly from the US and banks involved in Europe are those with global exposure. Therefore the key question for the market right now is confidence. Although the turmoil is not over yet, European markets are not going through the same crisis as their American counterparts. However, if the markets continue to behave as if they were, then they are likely to respond accordingly.

Financials vs. non-financials spreads



Source: Dresdner Kleinwort Research

Emerging Markets

Outlook for emerging market equities – a more testing 2008?

Annabel Betz, Emerging Markets Equities Strategist

After stellar returns of just over 37% in the MSCI EM Index in 2007 and a net gain of over 350% since the index bottomed in 2003, what can we expect for emerging markets in 2008? As we have seen in the sharp sell-off in the first part of the year, markets remain vulnerable to changes in global risk appetite and shifting expectations of global growth. However, the fundamentals for the asset class remain strong, the long-term structural drivers for growth are in place and new opportunities for investing in emerging market growth are likely to increase. While 2008 could be a more testing year than 2007, we continue to believe that the investment case for emerging markets remains intact.

The positives: strong domestic growth and ongoing structural change

Going into 2008, emerging market equities face a more uncertain growth environment than in previous years. The stress in credit markets emanating from the fallout from the sub-prime crisis has placed greater uncertainty on the US growth outlook for 2008 and hence global growth as a whole and has resulted in a sharp rise in risk aversion which has hit emerging market stocks disproportionately. While we do not expect the US economy to slide into outright recession, growth risks are increasingly on the downside, which is already feeding into commodity prices and export growth within certain emerging markets.

Having said that, slowdown in the US economy does not necessarily translate into significant slowdown globally as it did in the past. Europe and Japan are on a stronger macroeconomic footing while domestically driven growth within the emerging markets remains strong and more durable than in previous cycles. Over the past decade, the adoption of market-based policies, trade and capital account liberalization, and strong capital expenditure have created longer-term sources of growth for much of the emerging world and, by extension, the global economy as a whole. As a result, emerging markets themselves are becoming growth leaders and now account for about 30% of the global economy compared to 23% a decade ago. In 2007, they are estimated to have contributed 47% of the world's growth. Moreover, most of this has been led by domestic growth, as investment spending has accelerated across many markets (China, Russia, India, Brazil, Indonesia, Central Europe, Middle East) while consumption growth has entered a take-off phase as per capita GDPs have risen.

Meanwhile, macro and micro fundamentals within emerging markets remain supportive

Emerging markets were chained to the global events over the course of the 1990s due to weak external fundamentals and fixed exchange rates, which meant that any deterioration in global growth and liquidity had direct negative transmission effects on the real economy. The sharp improvement in external surpluses, fiscal, monetary and exchange rate management and greater policy continuity have put emerging markets on a stronger footing than in previous cycles. As a result, while developed economies enter 2008 on shaky ground, emerging market countries – almost across the board – come into the current turbulence with multi-year positive growth momentum, record levels of investment and portfolio flows and lower debt levels. On the micro level, emerging market corporates are underleveraged compared to the past, while banks in general have limited exposure to the type of financial engineering structures that have resulted in the liquidity crunch and capital losses among developed market financial institutions.

One area of concern has been the rising levels of inflation in much of the emerging world

Much of this is related to the global rise in food and energy prices which command a larger share of CPI baskets in the developing world (27% on average versus 15% in developed world CPI baskets). In addition, the complications of managing external liquidity and a build-up in reserves have resulted in higher monetary growth in much of the emerging world which could potentially threaten domestic price levels. In 2007, we saw several cases where monetary authorities unexpectedly hiked rates to deal with incipient inflation problems – South Africa, Chile, Taiwan, Mexico and of course China. While we do not see inflation as a serious issue for emerging markets generally as yet, there could continue to be monetary policy surprises that could affect individual market sentiment.

Themes for 2008 – the search for uncorrelated growth

Given the more uncertain outlook for US growth, growth visibility and uncorrelated growth are likely to be strong investment themes for 2008, which could take a variety of forms. The first of these is a focus on domestic demand, i.e. consumption and investment. On the consumption side, the reduction in real interest rates, growing disposable incomes and deepening financial intermediation have significantly increased the potential for domestic spending in a number of markets. Longer-term demographics favour consumption in the developing world, given the projected structure of working age population and growth in labour force. As countries progress up the development ladder, we expect developing market consumers to close the gap with peers in other markets, be it in the form of rising car ownership, greater overseas travel or enhanced demand for financial services products.

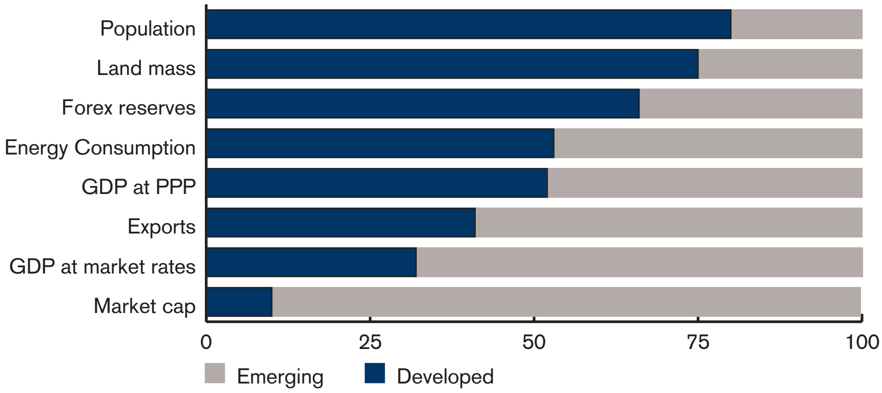
Infrastructure is also likely to remain an important theme

The improvement in fiscal balances over the past decade and greater macro stability have allowed governments in emerging markets to embark on longer-term infrastructure spending after severe neglect over the 1990s – a theme that did not go unnoticed by investors in 2007, as infrastructure-related sub-segments (construction and engineering, transport) posted very strong returns. We believe that the search for earnings visibility will continue to support the investment case for infrastructure-related stocks. Expansion in ports, airports, highways, rail systems and power generation capacity is a multi-year phenomenon that will continue to support overall growth, regardless of the global cycle - and could even be stepped up as a countercyclical policy tool should global growth falter more than expected.

Smaller markets and smaller caps have also shown themselves to be less correlated to the global cycle

Positive demographic and growth trends and economic liberalization make for a compelling investment case across many "frontier" markets in Africa, the former Soviet Union, Asia and the Gulf region. In the past, regulatory and liquidity constraints have limited foreign participation in these markets but over the past few years, we have seen greater liberalization in market access. Similarly, smaller cap stocks which tend to be more domestic in focus have also attracted greater investor attention. While global flows to emerging markets could continue to prove volatile in the short term, we still believe that global asset allocation will continue to favour a shift toward emerging markets. With emerging markets now accounting for close to 50% of the world economy and continuing to increase as a proportion of global market cap (now 11%), they are simply becoming too important to ignore by global asset allocators and the current sell-off is creating attractive entry points into what we believe to be a longer-term structural growth story.

Growing importance of emerging markets in the global economy



Source: Bloomberg, Morgan Stanley, Credit Suisse Asset Management, LLC

Column

Market Outlook – 2008

Giles Keating, Head of Research for Private Banking and Asset Management

Giles Keating

Market volatility has led to a re-assessment of asset classes. In this article, Giles Keating, Head of Research for Private Banking and Asset Management, takes the opportunity to consider the current market environment and outline some expectations for the year ahead.

The world economy grew well above trend for most of 2007 and inflation rose. Toward the end of the year a slowdown began, which so far has been mild. In 2008, the challenge for policymakers is to ensure that this slowdown deepens enough to tame inflation, but not so much that major economies move into recession. Some of the necessary policy measures are now in place, with central bank liquidity injections helping to reduce disruption in the interbank money markets, and the Fed funds rate cut. However, these measures can succeed only if accompanied by more action from the banks worst-hit by the credit crisis, which need to make yet further write-downs, raise more capital and start disposing of non-core businesses.

If successful, these measures should help to free up the flow of credit, and this in turn should allow a re-acceleration of world economic growth in the second half of 2008. The fundamental underpinnings for growth remain firmly in place, given strong non-financial corporate balance sheets, generally sound emerging market finances, and structural drivers like demographic expansion and urbanisation. So if the financial blockages can be mitigated, the world economy should be set for a robust end to 2008 and a similar start to 2009.

Equities: Value in many markets

This economic outlook suggests that profits can continue growing, albeit at a slightly slower rate than in recent years, and this in turn suggests that equity valuations are not expensive. As a result, we would recommend investors to overweight equities, while noting that volatility is likely to remain high.

Within equities, we would recommend investors maintain exposure to the core markets of Europe, the US and Japan at neutral levels. Overall, these markets are fair to good value. Japan's domestic economy remains muted but Japanese companies provide good exposure to Asian growth, while foreign investment flows are also expected to provide support.

S&P 500 forward P/E ratio

We favour emerging markets, although we note that in India, earnings multiples have risen to well above developed economy levels, with the same being true to a lesser extent in Hong Kong. While such high valuations may ultimately prove justified by rapid profits growth, we see better value elsewhere, including parts of South East Asia, Russia and the new markets in the Gulf. Frontier markets, ranging from Vietnam to parts of Africa, also offer opportunities for those investors able to accept their idiosyncratic risks. Developed market companies exposed to emerging markets, including many capital goods and luxury goods producers, can also benefit from the whole globalisation theme. Resource companies may however underperform in the early part of the year, reflecting the cyclical slowdown, with the longer-term trend of rising resource prices dominating again later.

For the banks, we think a turning point can come once the bulk of the write-downs are perceived to have happened and once banks start to focus their balance sheet reconstruction more on disposing of non-core businesses rather than capital-raising. However, this may not happen for several months and, until then, the sector is likely to stay volatile and subdued.

Fixed Income: Government bond yields appear unsustainably low

In fixed income markets, government bonds benefited in late 2007 as investors sought quality and liquidity, driving yields to low levels by historical standards. We believe these effects are likely to subside as financial stresses unwind, which is why we recommend an underweight in government bonds.

Within credit, we see three key issues.

- One is the search for value in the financial sector, where, of course, the implications for bondholders of re-capitalisations are clearly positive in contrast to the effect on stockholders.
- The second is within investment grade non-financials, where we recommend a focus on identifying issuers most vulnerable to event risk. With leverage close to historic lows for many companies, earnings should generally be ample to support debt, but M&A among companies is likely to accelerate (just as LBOs have fallen), and this may lead to new capital structures that do not always favour bondholders.
- Third, in the high yield and leveraged loan area, we think investors should be alert to the risks posed by the "cov-lite" structures issued before the credit crisis. These tend to increase borrowers' ability to delay debt restructuring when they run into trouble, and perversely, this may have adverse effects in the longer term.

Other markets

In commercial real estate, we believe that prime office space in parts of Japan and some of the smaller Asian locations still offer value. Investors can also look to more volatile plays in the dollar-linked centres (Hong Kong and the Gulf), where resistance of upward currency pressure implies high domestic liquidity, that for a period, can help drive local property markets to high valuations. Opportunities may also emerge later in 2008 in markets such as the UK where prices are currently easing from over-valued peaks.

In commodity markets we could see some further weakness in the short term. However, if the global economy picks up as expected in the second half of 2008, there will be renewed demand and we could see prices move higher in line with what we still believe is a long-term structural uptrend.

The big story in the currency markets in 2008 is likely to be the strength of the Asian currencies, as they tend to move up in sympathy with the Chinese renminbi, which we think is set to speed up somewhat its appreciation. We think the dollar is unlikely to repeat the major weakness against European currencies seen in 2007, and expect it to gradually establish a broad trading range against the euro and the Swiss franc, as the US external deficit continues to decline and the interest rate differentials do not repeat the large swings seen in 2007.

Alternative Investments — Real Estate

Construction boom in India

Ulrich Braun, Real Estate Strategies & Advisory

Massive economic and population growth will continue to drive demand for Indian real estate in all segments in the years to come. However, it is far from easy to enter into the real estate market with its bright prospects.

Significant population growth, a qualified labour force and rising investments from both domestic and foreign sources will provide India with an economic growth rate of about 6% over the next 10 to 15 years. More IT services are outsourced to India than to any other country in the world, which is why in the high-value office segment alone about 55 million square meters of additional office space will be completed in the next five years.

India's growing middle class will push retail sales up 10% p.a. by the year 2010. At the same time, retail chains are gaining in importance. While this segment amounts to only 3% today, it will be at 10% in 2010.

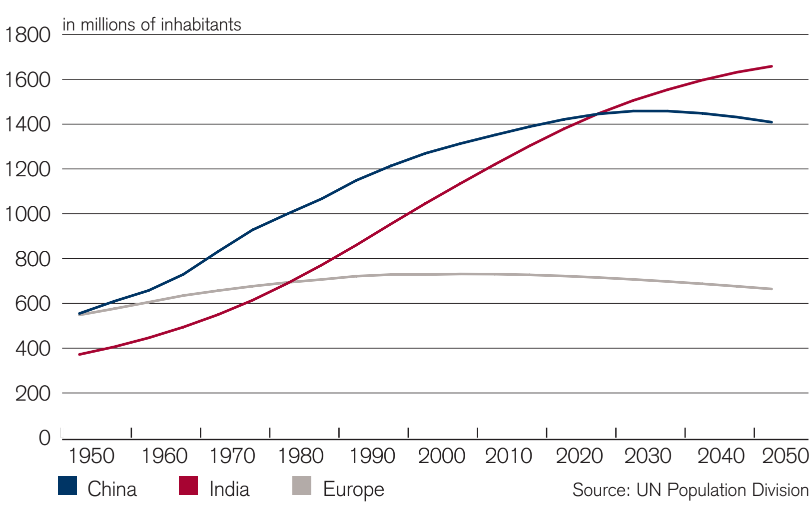
Significant population growth, rising income, falling household sizes and a 20 million unit housing shortage are driving substantial investments in new home construction. There is tremendous market potential in the financing of private housing.

However, investing in Indian real estate is not without risk. The market is not as transparent there as in Europe or the US. It is absolutely essential to have a professional local partner. In addition, there is minimal liquidity, and prices in the real estate markets have recently risen sharply in many areas. Finally, infrastructure expansion is not keeping pace with urban growth.

Accordingly, investors are compensated with attractive returns: Initial returns in Delhi, Mumbai and Bangalore are 9.5-10%, and as high as 10.5-11% in Hyderabad, Pune and Chennai.

Finally, it should be noted that foreigners may only invest in construction projects – existing properties are reserved for Indian citizens.

India's population continues to grow – population trends 1950-2050



Source: UN Population Division

Alternative Investments — Commodities

History repeats itself – or not?

Philipp Vorndran and Robert Hillmann, Investment Strategy

It is the Thursday after a car-free weekend in all of Europe in March 2009. The ECB has just raised interest rates to 6% because inflation, driven by rapidly rising energy prices, has hit levels not seen since the 1980s. Unions are demanding massive pay increases to offset the loss of purchasing power in recent months. Companies threaten layoffs because profit margins have recently come under significant pressure. Fear of stagflation is rampant on the markets, long bonds look decidedly unattractive and the price of gold has risen to USD 2,000 an ounce.

Is this the summary of a science fiction novel or is it a realistic scenario? Well, history repeats itself, but not completely. This time it is not the supply side closing off the world's oil taps; it is the strong global economy forcing up demand. If the economy cools – at least a temporary slowing should be assumed – then demand for oil would have to fall. Hopefully, the unions have learned from their earlier mistakes and know about the dangers of second-round effects. But what about the central banks? They are stuck in a dilemma: On the one hand, there is a smoldering liquidity crisis coupled with fears of a recession in the US that could drag Europe down with it, and on the other hand, there are more than just indications that inflation is on the rise. This is a classic conflict of objectives which in the past few weeks seemed to be resolving itself in favor of allowing more inflation rather than lowering production[1]. This is reason enough to continue to address the topic of protection against inflation, especially gold.

Has the price of gold already risen too high? The comparison with the record gold price of 1980 in US dollars is not quite right for two reasons: First, the US dollar has since lost value against other currencies, e.g., the euro. A large part of the most recent increases in the price of gold on the global market can, then, be traced back to the weak US dollar. And the most important reason is that gold is a real asset whose price is best considered after adjusting for inflation, in which case gold is nowhere near an all-time high. As long as uncertainty about inflation and about the global economic outlook remains at current levels, the price of gold still has substantial room to move upwards.

Those who remain skeptical about gold should consider other real investments, especially investments in agricultural and forestry properties.

Several factors that promise success come together here: There is a clear protection against inflation – if the price of foodstuffs continues to rise, then the prices of land on which the foodstuffs are grown rise due to the relative inelasticity of the supply of land that can be used for agricultural purposes. The global warming debate also highlights the significance of forests: The raw material wood, which absorbs tons of carbon dioxide, will find additional impetus from this fact.

Gold price in euro 1968 = 100

Source: Deutsche Bundesbank, own calculations

1 Difference between the growth of the actual gross domestic product and potential output

Alternative Investments — Hedge Funds

Hedge funds should offer attractive risk-adjusted returns in 2008

Cédric Spahr, Alternative Investments Research & Portfolio Analysis

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Macroeconomic and financial risks should support a high volatility environment. Our preferred hedge fund styles for 2008 are global macro, emerging markets, event-driven and equity long/short.

Performance review and outlook

Hedge funds delivered good returns in 2007. The CS Tremont Investable Index gained 7.4% while the HFRX Investable index returned a more modest 4.2%. The CS Tremont Index, which comprises high quality closed funds, delivered 12.6%, illustrating the benefits of investing with “top tier” hedge funds. Hedge fund performance compared favorably with equity markets, especially once that return volatility was considered, a phenomenon we expected to be repeated in 2008. Generally, we believe that hedge funds will be one of the asset classes of choice in 2008. Rapid swings in risk aversion and bursts of volatility will, at times, inflict large paper losses on long-only portfolios. Investors focusing on risk-adjusted returns should increase their allocation to hedge funds to reduce drawdown risks.

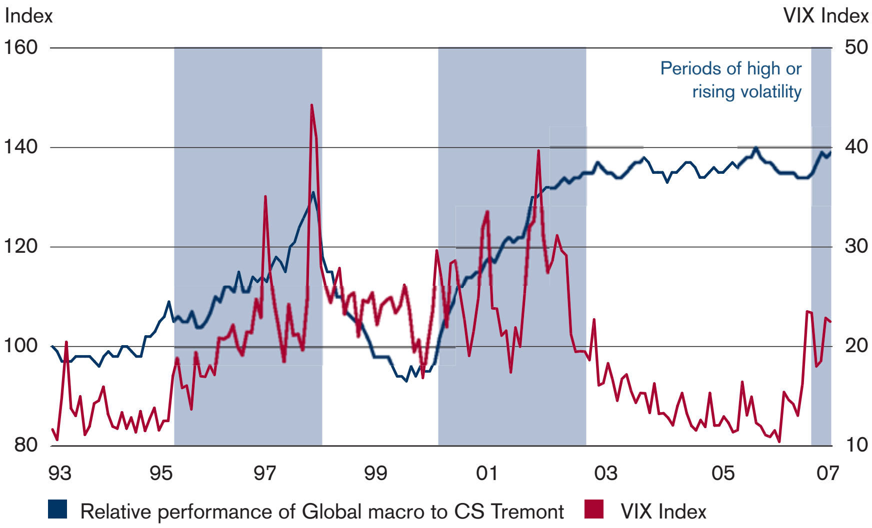
Global Macro is our favourite hedge fund style

We still have a preference for hedge fund styles with a directional bias, though we believe volatility will remain high in 2008. This is one of the reasons why we particularly favor the global macro style, which tends to outperform other hedge fund styles in this environment. Other styles which we favor are equity long/short, emerging markets and event driven. Sound macro fundamentals, an ample supply of liquidity, strong earnings growth and reasonable valuations should contribute to another solid year for emerging markets. We caution, nonetheless, against markets exhibiting expensive valuations such as China and India. After record volumes of M&A transactions in 2007, we expect the flow of strategic M&A transactions to decelerate but remain robust in 2008. This should offer some attractive opportunities for merger arbitrage / event driven funds.

New or illiquid niche markets offer attractive opportunities

We advise seeking out specialist managers investing in underexploited niche markets which still tend to be inefficient to a greater or lesser extent. Many of these markets remain fairly illiquid and offer attractive profit opportunities. The trading of power or CO^2 certificates represents one of these areas. The direct ownership of real assets especially in the commodity sector requires a substantial initial investment and is accessible only to large hedge funds, but offers the benefits of arbitraging market dislocations through the ownership of production capacity and/or commodity stockpiles. Funds involved in asset-based lending activities extend credit to parties that cannot access traditional sources of funding (bank credit, capital markets). Last but not least, insurance companies seeking to reduce the risk exposure of their balance sheet securitize insurance risks through the emission of insurance-linked bonds. Catastrophe bonds, whose performance is linked to natural disasters, constitute a segment of this small market where illiquidity still offers an attractive return potential.

Global macro hedge funds should outperform other hedge fund styles as volatility should remain high throughout 2008



Source: Datastream

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