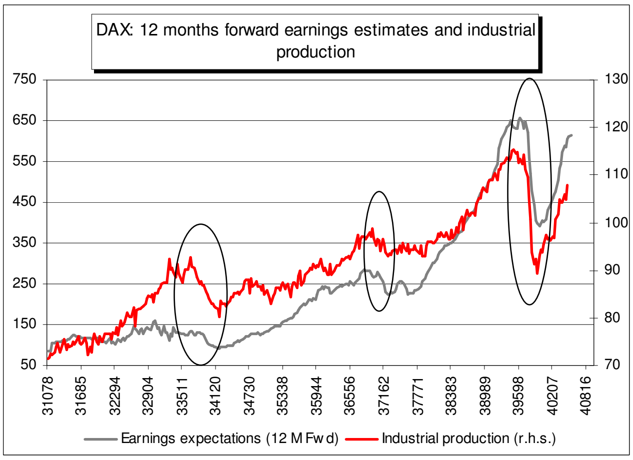
ECONOMIC SITUATION AND STRATEGY

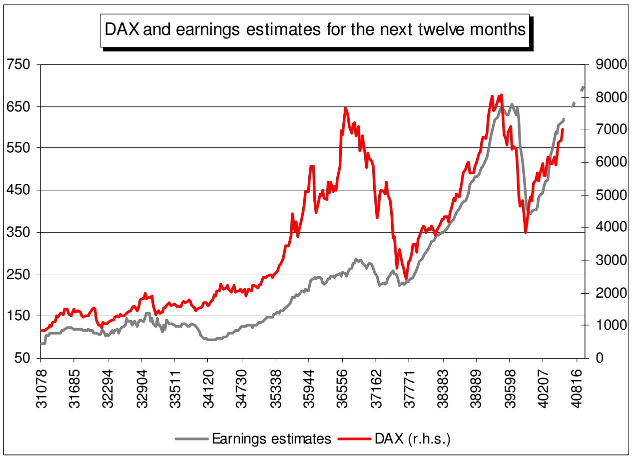
Capital market outlook for 2011: DAX at 8,000 not wildly unrealistic

To judge opportunities and risks on the stock markets, one must first answer the very important question: whether a recession or considerable economic downturn looms in the months ahead. If the answer is affirmative, then one need not give much further thought to which stocks to choose because, as an investor, one normally does not need stocks in such an economic environment. For, earnings expectations are almost always far too optimistic in such cases, thus creating huge potential for disappointment. On the other hand, if earnings forecasts have already been revised downward, stocks are then usually valued high and are thus too expensive. The years 2000-2002 and 2008-2009 have impressively shown that generally one cannot earn money with stocks during recessions. The DAX lost more than 70% in value between March 2000 and March 2003, and stock prices plummeted from just over 8,000 points to 2,200. And a similar development occurred in the period from summer 2007 to spring 2009. That time, the DAX tumbled from 8,100 to just over 3,600 points, which represents a value loss of more than 50%. The situation was different with regard to government bonds, whose prices advanced continuously in the same period because central banks were shifting to very expansionary monetary policy.



On the other hand, when the economic environment is judged positively and it may be assumed that the economy is in an upswing, another question must also be asked: whether the positive expectations are already anticipated in stock prices or earning expectations are too far ahead of (putative) reality. In that case, disappointments could still arise despite a positive fundamental environment for stocks. If it were necessary to revise earnings forecasts downward, it might be that stocks are overvalued and would thus have to be judged more cautiously despite basically positive conditions, because price potential would be lower or even negative.

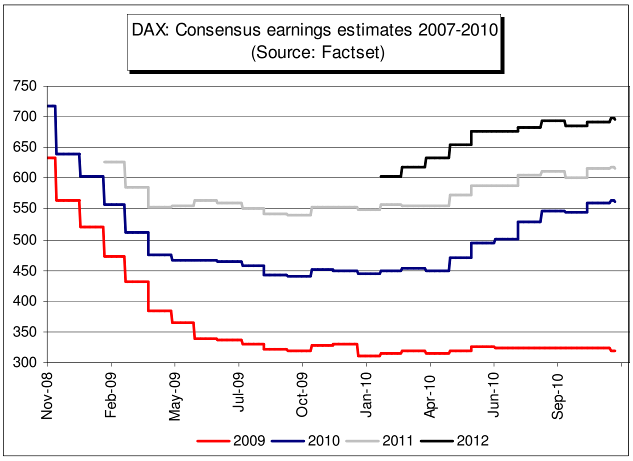
Our current economic assessment for the year 2011 remains positive (see our Flash Report of 2 December 2010 entitled “World economy in robust shape”), and we do not regard the stock market as overvalued at all. In the case of the DAX, one can see that stock prices have been developing in line with corporate earnings since 2003, as was the case from the middle of the 1980s to the beginning of the 1990s. But then, in the course of the 1990s, stock prices advanced much faster than corporate earnings, so the stock market became valued higher and thus more expensive from year to year. At the end of the decade, such a stock market bubble had formed that its bursting led to considerable price losses over the next three years, and that although the economic slowdown in 2001-2002 turned out to be much less severe than what happened during the “Great Recession” of 2008 and 2009.



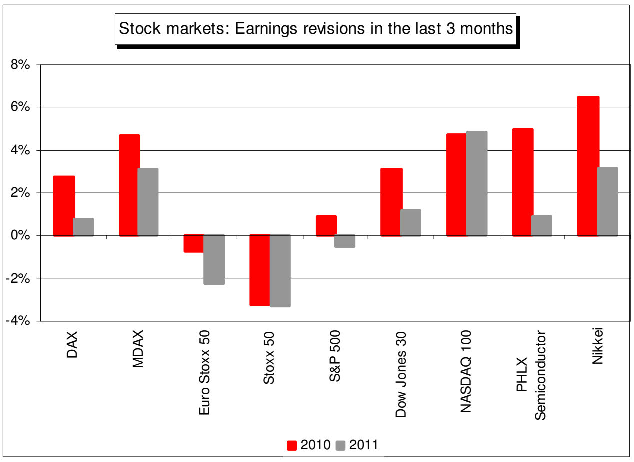
The DAX shows a price-earnings ratio of 11.4 at present, based on corporate earnings expected for the coming 12 months. After companies represented in the DAX managed to raise their earnings by a good 75% this year, analysts believe they are capable of further increases of almost 10% in 2011 and 13% in 2012. While the percentage improvement this year benefited from base effects, 2011 and 2012 should be under the influence of the global economic upswing. In our opinion, one can compare the current phase to the period of 2004-2006. Companies managed to raise earnings by 71% in 2004, and earnings increased by further by 25% and 30% in 2005 and 2006, when the world economy was also prospering. Those were surely unusually high growth rates for a 3-year period, but they show what is possible in a positive environment. We therefore do not believe that analysts’ expectations for 2011 and 2012 are too optimistic, since they are by comparison far less ambitious.

To forecast the level of the DAX at the end of 2011, one has to determine how high corporate earnings will be in 2012. From today’s perspective, it appears that DAX earnings will increase from about 565 index points in 2010 to 700 index points. Since we want to be cautious, we discount the earnings forecasts slightly and expect 680 index points. Multiplying this value by the current P/E ratio, one arrives at a DAX price target of 7,750 points. This optimistic-sounding target is based, in our opinion, on rather conservative assumptions regarding earnings forecasts and the valuation multiple. The latter of those is the greater unknown factor. The long-term average for the

P/E ratio (from 1985 to 2010) amounts to 15, which would open up additional price potential of 30% if the P/E ratio were to rise to that level in the next 12 months. On the other hand, if one excludes from the analysis the stock market bubble from 1994 to 2002, the average P/E ratio comes to 12.2. Even then, our price target still has enough of a buffer from the valuation side in case the economy and earnings develop somewhat worse than expected. However, if the economic recovery remains intact, the DAX could even exceed 8,000 points in 2011 and attain a new record. We had been expecting that to happen in 2012, since that is when analysts suppose DAX earnings will surpass their old record level from 2007. But the chances are not bad that it will already happen in 2011. We therefore believe that the upside outweighs the downside risks for German stocks now, and this expectation does not even include the often-cited argument from the huge amount of liquidity that is driving the markets.



While the DAX has shown a value increase of a good 17% since the beginning of the year, the Stoxx 50 is almost unchanged and the Euro Stoxx 50 is even negative. That is partly because the DAX reflects performance including dividends paid. However, the primary influence on European indexes is the poor performance of Spanish, Italian and Greek stocks and the negative price development of European bank stocks, which are heavily weighted in both indexes. Moreover, the earnings revision trend is an important influence for stock prices, and it has recently been negative for both indexes. To calculate price targets for the Stoxx 50 and Euro Stoxx 50, we proceed analogously to the case of the DAX. We check the earnings forecasts against the macroeconomic scenario and use the current valuation multiple. Analysts' estimates for 2011 are somewhat more optimistic for European stocks than for the DAX, and somewhat more subdued for 2012. We also apply a slight discount here to be on the safe side and thus arrive at price targets of 2,780 points for the Stoxx 50 and 3,060 points for the Euro Stoxx 50. Using the same approach, we obtain price targets of 1,350 points for the S&P 500 and 10,800 for the Nikkei.



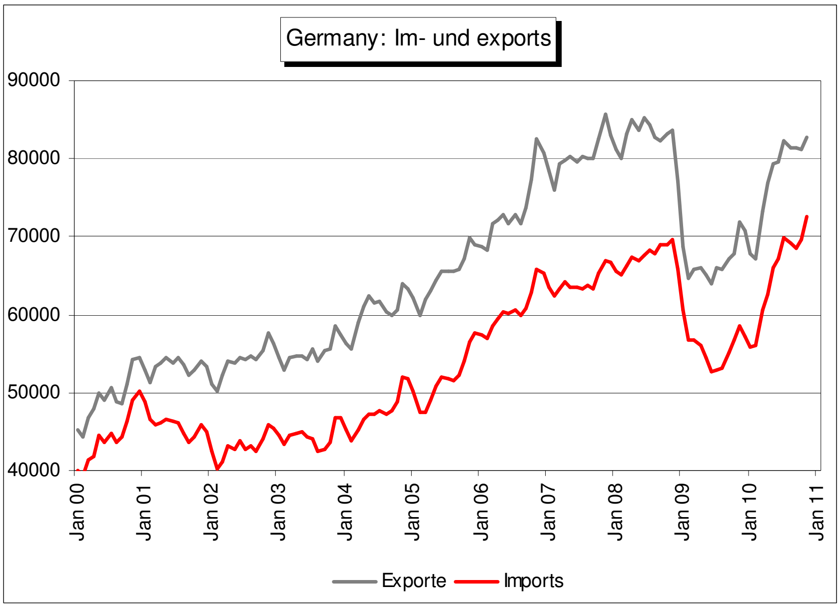
In view of the economic scenario, stocks thus continue to be our favorite asset class. We do not believe it will be possible to earn much money with bonds next year. Corporate and emerging market bonds as well as convertible bonds should show positive performance based on macroeconomic conditions, since they should benefit from further upgrades by the rating agencies. However, spreads have already narrowed significantly, so the remaining room is limited. Short-dated bonds from EU periphery countries whose term to maturity falls within the official duration of the European rescue package might yield significant price gains if the political establishment manages to regain the confidence of the capital markets. But institutional investors are still avoiding these securities at present. On the other hand, we expect price losses from Bunds and US Treasuries in the months ahead. After the already significant rise of yields in recent days, the short-term potential for price setbacks is limited. We nevertheless expect yields on 10-years Bunds to rise to 3.6% in the next 12 months, and those of 10-year US Treasuries to 3.5%. For investors, that means that the entire coupon would be consumed and negative performance of about 2% would be registered at year's end.

Weekly outlook for the period of December 13-17, 2010

	July	Aug.	Sept.	Oct.	Nov.	Dec.	Release
DE: ZEW economic expectations	21.2	14.0	-4.3	-7.2	1.8	0	December 14
DE: PMI, manufacturing	61.2	58.2	55.1	56.6	58.9	58.0	December 16
DE: PMI, services	56.5	57.2	54.9	56.0	58.6	57.5	December 16
DE: Ifo business sentiment	106.2	106.7	106.8	107.7	109.3	109.0	December 17
EUR16: Industrial production, m/m	0.1%	1.1%	-0.7%	1.5%			December 14
EUR16: Industrial production, y/y	7.3%	8.0%	5.6%	7.2%			December 14
EUR16: PMI, manufacturing	56.7	55.1	53.7	54.6	55.5	55.1	December 16
EUR16: PMI, services	55.8	55.9	54.1	53.3	55.2	54.5	December 16
EUR16: Consumer prices, m/m	-0.3%	0.2%	0.2%	0.4%	0.1%		December 16
EUR16: Consumer prices, y/y	1.7%	1.6%	1.8%	1.9%	1.9%		December 16
EUR16: Core inflation, m/m	-0.4%	0.3%	0.2%	0.4%	0.1%		December 16
EUR16: Core inflation, y/y	1.0%	1.0%	1.0%	1.1%	1.2%		December 16

MMWB estimates in red.

Chart of the week: German imports at record level



Although Germany lost the title of world's champion exporter last year to China and even dropped to third place just behind the United States in the first nine months of this year, there is still good news to report from foreign trade. Exports have almost made up the slump undergone during the 2008-2009 crisis. The best export month in Germany's modern history was April 2008, with total exports of EUR 88.8 billion. That level was only 2% away in October 2010, and in view of the huge volume of foreign orders placed with German companies, it is very likely that it will be reached or even surpassed before the end of this year. On the other hand, imports have already risen to a new record level. In October, Germany's imports amounted to EUR 72 billion and came mainly from China, the Netherlands (because of its seaports), and France. Thanks to strong domestic demand, the German economy's positive development is thus radiating to other countries. Nevertheless, exports remain the most important key to the German economy's success. And the criticism from abroad about Germany's focus on exports will not die down very quickly. For, the current account surplus will increase this year from EUR 120 billion to EUR 130 billion.

Financial markets at a glance

Stock markets	As of 09.12.2010	Change versus 03.12.2010 -1 week	09.11.2010 -1 month	09.09.2010 -3 months	31.12.2009 YTD
Dow Jones	11.370	-0,1%	0,2%	9,2%	9,0%
S&P 500	1.233	0,7%	1,6%	11,7%	10,6%
Nasdaq	2.617	1,0%	2,1%	17,0%	15,3%
Wilshire 5000	13.019	0,7%	2,2%	13,2%	13,2%
DAX	6.964	0,2%	2,6%	11,9%	16,9%
MDAX	9.806	0,2%	3,1%	13,2%	30,6%
TecDAX	824	2,5%	-0,2%	7,5%	0,7%
EuroStoxx 50	2.841	2,1%	-1,7%	2,1%	-4,2%
Stoxx 50	2.614	2,3%	-0,1%	1,2%	1,1%
Nikkei 225	10.286	1,1%	6,1%	13,1%	-2,5%
Topix	892	1,4%	6,1%	7,8%	-1,8%
Bond markets					
3 months Euribor	1,03	0	-2	15	33
3 months Treasury Bill	0,14	0	1	0	8
10 year US Treasuries	3,23	22	57	47	-61
10 year Bunds	2,90	9	49	57	-49
10 year JGB	1,25	8	29	14	-3
US mortgage rate	4,46	0	22	14	-59
IBOXX AAA, €	3,62	11	54	65	-2
IBOXX BBB, €	4,98	10	65	71	-14
ML US High Yield	7,93	-7	38	-49	-126
JPM EMBI+, Index	558	-0,7%	-2,9%	1,3%	13,2%
Convertible Bonds, Exane 25	4.998	0,4%	-0,5%	2,4%	4,4%
Commodities					
CRB Index	594,10	0,2%	-1,4%	15,5%	22,6%
MG Base Metal Index	411,01	2,5%	-1,7%	14,1%	13,8%
Crude oil Brent	90,92	1,5%	3,5%	17,3%	16,8%
Gold	1385,43	-1,5%	-2,2%	10,7%	26,4%
Freight rates Baltic Dry Index	2.111	-2,6%	-14,4%	-29,4%	-29,8%
Currencies					
EUR/ USD	1,3214	-0,2%	-5,2%	3,9%	-8,3%
EUR/ GBP	0,8379	-1,6%	-2,9%	1,8%	-5,7%
EUR/ JPY	111,02	0,1%	-1,3%	4,3%	-16,6%
EUR/ CHF	1,3060	-0,6%	-2,7%	1,6%	-12,0%
USD/JPY	83,69	1,3%	2,3%	-0,2%	-9,9%

Source: Thomson Financial

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