Executive Summary

Over the past year, the debt crisis in Europe has dominated headlines and investor sentiment, stoking high levels of volatility and “risk-on/risk-off” market patterns. Consequently, 2011 marked a year where riskier assets sold off, while perceived “safe haven” investments—such as US Treasuries, German Bonds and precious metals—delivered strong returns.

As we settle into the New Year, one question on many investors’ minds is: Will global markets stabilize or will risk aversion once again drive market trends?

Our answer: While concerns around fiscal issues in the Eurozone still remain, recent economic data suggest signs of a modest recovery. We are further encouraged by the European Central Bank’s (ECB) recent actions, which provided much needed liquidity and refinancing to Eurozone banks.1 These points, in combination with fiscal progress among peripheral Eurozone countries such as Spain and Italy, should diminish the severity of the global crisis, in our view.

In this context, this paper discusses why investors should look to cautiously re-risk their portfolios, given what we believe are encouraging macroeconomic trends and an improved situation in Europe. We also provide our views on different asset classes, and which risk strategies may be well positioned—such as equities, emerging markets, corporate credit and commodities—to likely benefit from the current economic environment.

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1 The ECB has recently adopted a program named Long-Term Refinancing Operation (LTRO), which offers Eurozone banks three-year loans at the prevailing benchmark rate of 1%.
Global Economy Appears Poised for a Modest Recovery

Notwithstanding the issues in Europe, the global economy appears to be pulling back from a widespread slowdown. Global growth, as measured by the global manufacturing purchasing managers’ index (PMI), reversed from its recent lows in the spring of 2011, and picked up above 50 at the beginning of this year (Display 1). As such, the index appears to be forming a base pattern, and global recessionary pressures, which were more apparent six months ago, seem to be easing.

When we drill down and look at regional PMIs, we see, for the most part, encouraging trends (Display 2). The US PMI Index, as of the beginning of 2012, was above 50, pointing to the likelihood that the US will avoid a recession this year. Furthermore, our estimates indicate US growth in the first half of this year to be around 2.5% annualized, based on falling unemployment, increasing industrial output (production rose by 4.6% annualized in December 2011 compared with June 2011) and what we view as a base forming in the housing market.

Similarly, China’s PMI surveys are recovering, with the index at 50.3 (as of January 1, 2012), supported by robust domestic consumption (i.e., retail sales) and strong export growth. With inflation easing, the People’s Bank of China (PBC) has more flexibility with monetary policy, which bodes well for a soft landing and growth moderating to around 8% this year. Concurrently, non-performing loans have decreased to their lowest levels in six years, which should ease investor concerns over the country’s banking system. We discuss these risks in more detail later in the paper.

Japan’s PMI—at 50.7 (as of January 1, 2012)—is consistent with positive, but moderate, growth. The country continues to face a number of long-standing challenges including weak domestic consumption, declining industrial production and persistent deflation.

In Europe, we believe a likely scenario is that most of the region will suffer from a recession at least until the end of the year, although Germany is a relatively bright spot with growth of just under 1%. As such, while the Eurozone PMI appears to be forming a base as well, we believe growth will struggle to be positive. However, should the region’s debt problems be resolved, with restructuring programs remaining intact in Italy and Spain, then the growth outlook could improve towards year end.

Display 1: Global GDP suggests a modest recovery...

Display 2: ...Supported by regional PMI data

(2) Source: CEIC and IMF. A non-performing loan is a loan that is in default or close to being in default.

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Europe: Continued Uncertainty and Diverging Debt Dynamics

Over the past year, the Eurozone sovereign debt crisis has been marked by heightened concerns over increasing government debt levels and solvency concerns. Display 3 shows the gross debt-to-GDP and the deficit-to-GDP ratios of different countries in the region. Based on our analysis, the large divergence in the Eurozone’s debt dynamics can be broken down into four broad categories:

1. In the lower left corner, we have the “no problem” areas: Germany, Finland, Luxembourg, Estonia, the Netherlands and Austria. Based on their current fiscal situation (i.e., relatively low debt and deficit levels as a percentage of GDP), they appear to be economically stable, with little-to-no debt issues.

2. In the top middle, despite having a large deficit relative to GDP, Ireland has made progress in restructuring its economy. These measures include successfully negotiating an 85 billion euro rescue package, implementing a four-year austerity plan, and strengthening and shrinking the banking system. Assuming a successful resolution to the Eurozone issues, we believe Ireland may be well positioned to emerge as one of the first nations out of the debt crisis.

3. On the far right, Greece continues to be a concern. Despite the country’s recent financing program and debt-restructuring agreement with Euro finance ministers, doubts still remain whether Greece can repay its long-term debts and whether more rescue money will eventually be needed. It also remains to be seen whether the Greek government will be able to successfully implement austerity measures. Any result short of this could represent a risk to the progress being made in other Eurozone countries.

4. The last category, primarily in the center, includes countries that have seen modest fiscal improvements. Investors have been encouraged by recent fiscal actions taken in Italy, Spain and Portugal. Assuming that the debt problems are resolved, we believe Italy is on track to achieve a balanced budget by 2014, and Spain’s budget deficit is expected to be down to 4% in the same year.

Display 3: Divergent debt dynamics in Europe: Spain and Italy are improving

Note: Projections for Greece do not include the private sector involvement (PSI) agreement.
Source: European Commission

(3) Greece and Eurogroup finance ministers agreed to a debt restructuring framework on February 21, 2012.
While we remain constructive on steps taken by Eurozone governments, the situation remains uncertain. The region continues to be afflicted by the uncertainty around Greece, weak domestic consumption, high unemployment and a moderation in export-led growth due to diminished demand from emerging markets.

The health of the European banking system is also a concern. Banks will continue to deleverage, due, in part, to higher capital requirements, which may weigh on economic growth. Display 4 shows the divergent banking systems of the US and the Eurozone. Eurozone banks, because of poor capital market conditions, are entrenched in the slow process of restructuring and deleveraging. As such, the credit flow in the Eurozone is lagging their American counterparts and slowing the recovery in Europe.

Display 4: Eurozone banks deleveraging; US credit conditions improving

While we believe the Eurozone in the short-term will struggle to show positive GDP growth, we reiterate our view that we are seeing improving trends. The ECB’s loan program in late 2011 should improve money market and bank liquidity, and there are renewed efforts on the part of finance ministers to resolve the debt crisis in Greece. In Germany, we believe that the manufacturing sector is forming a base, and that growth will continue to be positive. Finally, assuming that the debt problems will be resolved and that restructuring programs are intact in Italy and Spain, then the growth outlook in the Eurozone could improve towards year-end, and German growth could accelerate back above 2% in early 2013.

As of November 15, 2011
Source: Datastream and Credit Suisse
Emerging Markets: No Hard Landing for China

While equity markets in emerging economies generally underperformed developed markets in 2011, we maintain a positive long-term outlook on emerging markets, based on their continued improving economic and fiscal fundamentals.

Investor concerns in emerging markets have been largely centered on China and the potential for a “hard landing” as well as a bubble in the nation’s housing market. We believe those concerns might be overly pessimistic, as a number of trends have pointed to a soft landing in China. As previously noted, we see China’s GDP moderating to around 8% in 2012.

Among the reasons bolstering China’s economy, we believe that the US recovery and persistent Asian demand are likely to support China’s export growth (Display 5), which is likely to mitigate or offset the slowdown in Europe. Domestic consumption (as measured by retail sales) and industrial production have also held up, with year-over-year increases of 18.1% and 12.8% (as of January 2012), respectively. Inflationary pressures also appear to be abating, with the Chinese CPI slowing to an annualized rate of 4.1% (as of January 1, 2012).

Display 5: Economic growth should remain healthy in China

As of October 31, 2011
Source: Bloomberg and Credit Suisse
In our view, concerns over the housing market have been eased by the recent actions of the Chinese monetary authorities. Last year, the government implemented a tightening policy by increasing bank reserve levels to an exceptionally high level of 21.5% and pledged home buying limits, prompting a reduction in real estate lending and housing prices.

We do recognize some of the risks in China, namely the shadow banking system—large, off-balance-sheet debt—and poor-quality loans issued by local authorities (i.e., municipal bonds). However, we believe these are unlikely to represent systemic financial risks, at least in the short term, as these loans have limited direct exposure to commercial banks.

Emerging markets as an asset class are attractive on several levels, in our view. Last year’s weak performance, we believe, has made them relatively cheap to developed markets (Display 6). Since the beginning of 2012, emerging market equities have rallied (15.5% year-to-date)⁴ and earnings should be broadly in line with nominal GDP growth (i.e., 10% plus in India and China; 7% to 8% in Brazil and Russia). Lastly, many emerging economies should benefit from low debt levels, the easing trend in monetary policy and a substantial growth gap relative to developed economies.

Display 6: EM equity markets potentially offer attractive valuations to investors

![Graph showing 12-Month Forward P/E Multiple for various emerging markets as of December 30, 2011.](image)
Investment Opportunities: Is It Time to Re-risk?

The modestly improving macroeconomic scenario that we have presented supports the idea that investors may benefit from increasing their exposure to riskier assets, especially in the current low-yield environment.

According to the Credit Suisse Risk Appetite Index (Display 7), which compares risk-adjusted returns across a wide spectrum of global assets, we see that investor sentiment in recent months has rebounded from the lows in July and August of 2011. As such, investors’ risk aversion appears to be slowly dissipating—a trend which we expect to continue this year. In the remainder of the paper, we provide our views on the individual asset classes.

**Display 7: Investors’ appetite for risk appears to be improving**

**Equity Markets**

While short-term risks remain in global equity markets, we believe a sustained rally will develop in the latter half of 2012, driven by a number of factors including: 1) the unattractive level of money-market and G4-government yields will likely compel investors to look for returns elsewhere; 2) global equity markets appear, from a historical perspective, to be attractively valued, relative to bonds; and 3) downside risk for the asset class is low—particularly in the US and emerging markets—because markets have already discounted weak economies and recessionary scenarios.

**Note:** The CS Global Risk Appetite Index, formally launched in July 1998, compares risk-adjusted returns across a wide spectrum of global assets. We believe the global risk appetite index can be used as an allocation tool because: 1) It has well defined extreme zones, which we call euphoria and panic. When risk appetite moves into these zones, the probability of mean reversion becomes very high; and 2) once the risk appetite index starts to mean revert, it tends to move from the one extreme to the other.

As of December 29, 2011

Source: Credit Suisse
In terms of global sectors, we continue to favor more defensive areas such as consumer staples, energy and healthcare, as these companies typically exhibit strong free cash flows, low leverage, high surplus liquidity and high dividend payouts. We also favor energy, which we view as a partial hedge against the ongoing political turmoil in the Middle East.

**Fixed Income**

G4 government bonds will likely remain low this year, in our view, given the continuation of quantitative easing programs, investors continuing to seek "safe haven" assets and low economic growth. Should investors move back into equities and higher-risk assets, we could see yields start to increase later this year and into 2013. Current yield levels are especially problematic for pension funds and insurance companies trying to meet actuarial liabilities.

Corporate credit spreads remain tight due to improved corporate earnings and low yields on G4 government bonds. We believe factors further supporting tightening credit spreads include high levels of corporate liquidity, low leverage, low default rates and the limited downside risk in equity markets. US corporate liquidity, for example, is at an all-time high, close to $2 trillion. Increased cash reserves may likely foster higher dividends, share buybacks and increased M&A activity.

Lastly, we favor high yield bonds and senior loans, which currently offer higher yields, below-average default rates and attractive valuations. We prefer US over European issues, reflecting our views on the dichotomous growth prospects between the two regions.

**Commodities**

The political situation in the Middle East has clearly escalated in 2012, with rising tensions in Syria, Saudi Arabia and Iran. We believe that even if there is no further increase in tension, oil prices may carry a risk premium of around $10/barrel. Disruptions in supply may cause prices to spike, but given the recessionary impact, we believe any spike would be short lived. Nevertheless, assuming that the US recovery is intact and China experiences a soft landing, we believe oil prices will remain elevated this year.

We believe the upside for precious metals remains limited in 2012, due to the ongoing uncertainty in the Eurozone, the continuation of easy monetary policy and low levels of speculative activity. However, any increase in inflation risk, which may not occur until 2013, could support an increase in precious metals prices.

**Currencies**

We favor emerging market currencies, many of which are undervalued, in our view (Display 8). We are cautious on the euro given the prospect of further liquidity injections by the ECB, continued concerns over Greece and continued funding pressure on the Eurozone banks.

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**Display 8: Many EM currencies appear undervalued, especially in Asia**

![Graph showing percent deviation from fair value in real effective exchange rate terms (REER)](image)

- **Overvaluation vs. USD**: Overvaluation for some currencies compared to USD.
- **Undervaluation vs. USD**: Undervaluation for others.

As of February 23, 2012
Source: MSCI Emerging Market Index

(5) Source: US Federal Reserve; as of June 30, 2011

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Conclusion

We see several positive macroeconomic trends supporting riskier assets, such as equities, emerging markets, corporate credit and commodities. Many of the risks that concerned investors last year—namely a global recession and a hard landing in China—have diminished, in our view. Debt concerns in the Eurozone continue, but we see measured progress on the back of the recent actions taken by the ECB to provide liquidity to banks and government plans to bring their deficit levels to more manageable levels.

We do recognize there are a number of risks that require close monitoring going forward, and that investor sentiment could remain depressed in the short term. However, we believe that risk appetite will gradually increase, with a sustained rally in the latter half of 2012. As such, investors should look to re-risk their portfolios in light of the modestly improving economic environment.
Credit Suisse Asset Management Publications

Insurance Linked Strategies: Defining the Opportunity in Run-off Portfolios
February 2012—Our experts dissect the characteristics of Insurance Linked Strategies and discuss how investors can unlock the hidden value in property and casualty and run-off portfolios.

Asset Management’s Q1 2012 Alternatives Quarterly
January 2012—Our Global CIO, Stefan Keitel, outlines key investment themes he believes will drive financial markets this year, specifically issues surrounding Europe, US and emerging markets. Additionally, our leading alternatives portfolio managers outline areas of opportunity in their respective strategies in the wake of ongoing market uncertainty.

Robert Parker, Credit Suisse Senior Advisor, January 2012 Market Update
January 2012—Robert Parker, senior advisor - Credit Suisse, outlines the market conditions going into 2012, the factors that could support riskier assets this year, as well as the potential risks.

Fixed Income Outlook: The Search for Yield
November 2011—In this white paper, John Popp, Global Head of the Credit Investment Group, reviews options for investors seeking returns in a low-yield environment.

Hedge Fund Investing: How to Optimize Your Portfolio
October 2011—In a post financial-crisis environment, how can investors address potential risks associated with hedge fund investing? The paper discusses how hedge fund replication can help address these challenges while potentially providing alternative-like returns.

The Way Forward: Measuring the Impact of Short-Term and Structural Growth Drivers on Emerging Market Investing
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Real Assets: Inflation Hedge Solution Under a Modified Risk Framework
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