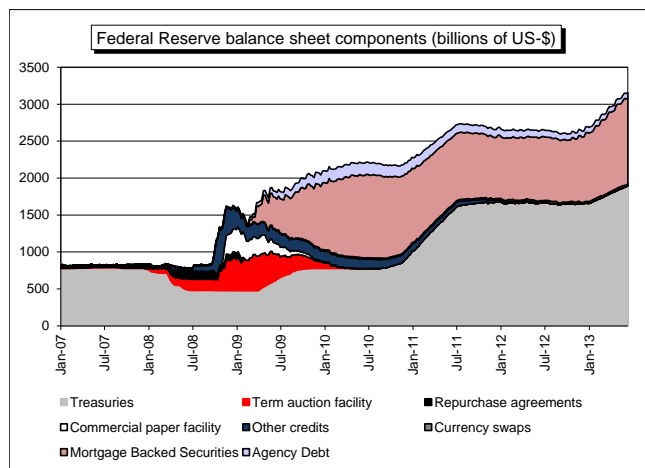


## ECONOMIC SITUATION AND STRATEGY

### Stock markets: No fear of rising interest rates (yet)

The long expected and overdue consolidation on the stock markets has begun in the past few weeks. It was triggered by statements from Fed Chairman Ben Bernanke that the US central bank might soon start reducing its bond purchasing program (QE3) in view of better economic and labor market data. After the bankruptcy of investment bank Lehman Brothers in September 2008 and the resulting financial and economic crisis, the Fed has not only lowered its policy interest rate to nearly zero, but also has hugely increased its balance sheet total by means of “unconventional” monetary policy.

The purpose of this program, also known as quantitative easing (QE), has been to reduce the general level of market interest rates further, after the possibilities of normal monetary policy (lowering policy interest rates) were exhausted. The first purchasing program (QE1) was presented by the Fed in December 2008 and made concrete in March 2009. The second (QE2) then followed in November 2010. When that expired, the Fed next sought to support the economy with “Operation Twist”, which involved selling short government securities (3 years or less) and simultaneously buying long US Treasuries (6 to 30 years). Finally, the QE3 followed in September 2012. At first, it only involved buying USD 40 billion in mortgage-backed securities per month, before the Fed decided in December 2012 (after the expiration of “Operation Twist”) to add monthly purchases of USD 45 billion in long government bonds.



More and more central banks have joined in this kind of experimental monetary policy over the last few years. The idea behind it is obvious. On the one hand, the economy is directly supported by way of lower interest rates. On the other, the central banks are hoping for positive influence of the wealth effect. Investors are expected in view of unattractive government bond yields to reallocate into higher-yielding asset classes such as corporate bonds, stocks, and even real estate and thereby drive up their prices. The perception of wealth created by rising asset values is supposed to prompt households to save less and consume more, which would lead to increased economic growth. Converse-

ly, businesses benefit from low interest rates and cheaper financing conditions, which prompts them to invest more. That is also expected to impact economic growth positively. At least that is the theory.

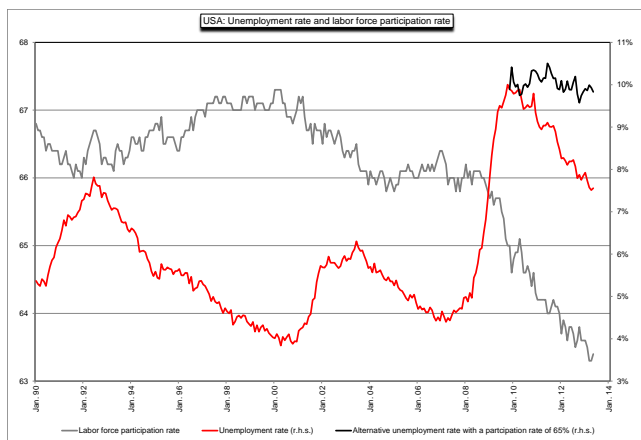
Experience with this unconventional monetary policy is quite divided, however. On the positive side, a more severe economic, even systemic crisis has been averted thanks to its use. However, the expected positive effects on economic growth have been rather disappointing. In the United States, for example, where the Fed was the first central bank to introduce this new kind of monetary policy and has implemented it vigorously, growth rates after the financial and economic crisis have lagged significantly behind those of the preceding 30 years. Real US gross domestic product grew at a rate of just over 3% between 1980 and 2006, while growth in the years 2010 to 2012 slowed to about 2% on average. And growth rates in other industrialized countries have also not returned to their levels before the outbreak of the crisis. In our opinion, this suggests that expansionary monetary policy worldwide will continue longer than many now expect.

According to the statement released by the Federal Open Market Committee (FOMC) in December 2012, the Fed will maintain its highly accommodative monetary stance for some time after the asset purchase program ends and even in case of economic recovery. Interest rates will not be raised at least as long as the unemployment rate is above 6.5% and at the same time the inflation rate does not exceed 2.5%. Based on these statements, market participants have kept a close eye on US labor market development. Although an explicit interest rate hike probably still lies in the relatively distant future, it is quite possible that the Fed will reduce its bond purchasing program from the current USD 85 billion per month in the foreseeable future. After all, the unemployment rate has fallen from 10% in October 2009 to 7.6%. If that trend continues, the unemployment rate will drop to 6.5% by the end of 2014. The Fed is thus likely to consider a first interest rate increase sometime in 2015 at the earliest.

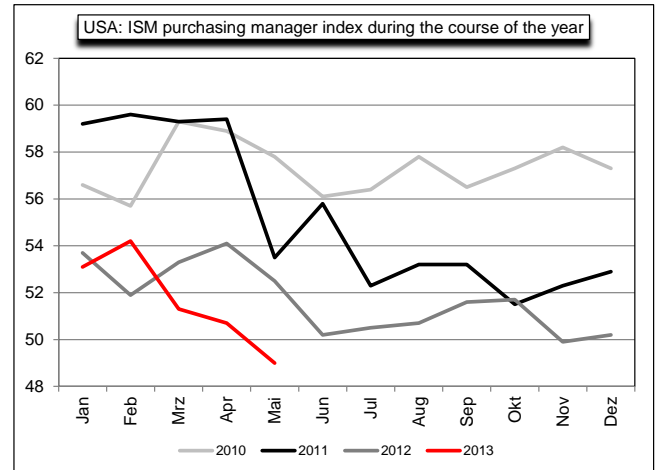
Nevertheless, the stock markets have reacted very sensitively and with price declines in the last three weeks to any “too positive” economic data from the United States and any statement by a Fed member advocating a reduction of asset purchases soon. Not without justification, since not only the economy but also the capital markets are dependent on the cheap money. The crucial question on the stock markets now is therefore when and to what extent the Fed will cut back its QE3 program. The first opportunity for announcing a change would be the FOMC meeting next week (June 18 and 19). But how much has the labor market really improved? And is an acceleration of economic growth in the United States actually a foregone conclusion, as some data suggest?

The official unemployment rate’s decline certainly seems to indicate significant progress. However, a somewhat different picture emerges if one considers that many job seekers

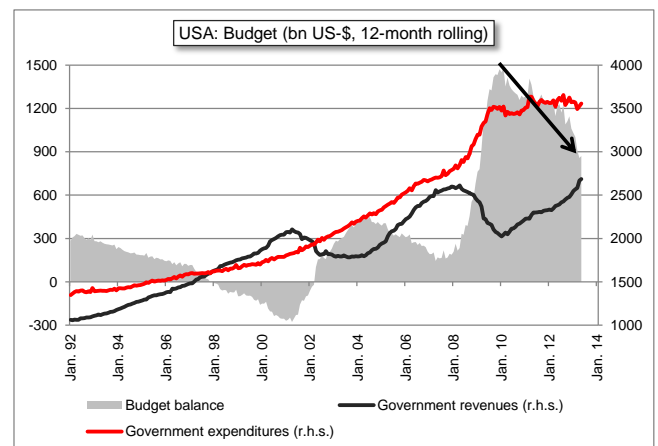
are no longer trying to find work. This is shown by the participation rate, which has fallen from just over 65% in the spring of 2010 to 63.4%. But if the participation rate were unchanged at 65%, there would be 15.7 million people unemployed in the United States instead the official figure of 11.7 million. Accordingly, the unemployment rate would still be almost 10%, and there would not be any real improvement on the labor market. It also appears that growth in the number of employed persons has slowed lately. The annual rate of change in employment growth has been relatively constant at about 1.5% in the past months, but there has been a slowdown since the beginning of 2012. The absolute numbers on employment also show that the 3-month moving average has fallen from over 200,000 additional workers at the beginning of the year to just over 150,000.



The impression recently given by other US economic data is similarly ambiguous. The recovery on the real estate market has continued, and thanks to the positive wealth effect due to rising real estate and stock prices, US consumer sentiment is more positive than at any time in the last five years. That suggests private consumption will remain the growth engine of the US economy. Nevertheless, the positive economic development in the United States will not go on indefinitely. The automatic budget cuts that took effect at the beginning of March will cause US growth to slow by about one percentage point. Real GDP is therefore likely to grow by a rate of 1.5% to at most 2% this year. Having fallen in May to 49 points, the lowest level since June 2009, the US purchasing manager index for the manufacturing sector also points to such a subdued development. There is thus no compelling justification for a change of monetary policy from an economic standpoint. It should also not be forgotten that the US central bank has a dual mandate. It is supposed to gear monetary policy to support full employment while ensuring price stability. Stable prices are usually equated with an inflation rate of 2%. The rate of price increase according to the central bank's favored definition (core rate of the PCE index) is currently only 1.1%, which is too low in the Fed's view and probably too close to the deflation threshold – this rate has never been lower since the 1960s. Judging the appropriateness of monetary policy by a simple Taylor Rule that considers both economic development (via the output gap) and price development, our calculations show no need at present to make monetary policy less expansionary.



In our opinion, the Fed will therefore decide to scale back asset purchases at its meeting on September 17-18 at the earliest, with a possible first step being a reduction from USD 85 billion to USD 50 billion. If our scenario is correct, the turbulence on the stock market and especially the bond market could soon subside. For, in the United States, in particular, yields on US Treasuries have recently risen significantly in anticipation of less expansionary monetary policy. Another argument also supports the view that the yield increase of the past few weeks should prove exaggerated and not continue. For, even if the Fed reduces its government bond purchases, one should not lose sight of the fact that new issuance of US Treasuries will decline in the months ahead. That is because of the significant decrease of the US budget deficit. Thanks to higher tax revenues, the deficit has been reduced in the past 12 months to USD 870 billion (5.4% of US GDP). In the summer of 2012, it was still at USD 1.2 trillion (8% of GDP). Moreover, a further decline of the deficit to about USD 600 billion is likely, since the budget cuts will have a dampening effect on spending in the months ahead. This halving of the deficit means that the US Treasury will issue about USD 50 billion less in bonds per month. So, even if the Fed were to decide to reduce the QE3 program by that order of magnitude (which we do not expect, at least in a first step), the supply-and-demand situation in respect to Treasuries would not change.



Overall, a fundamental change of monetary policy in the near future thus seems unlikely. It could take a long time until the uncertainty settles and investors adjust their expect-

tations to this scenario, so a rapid price recovery should not necessarily be expected. But at least the probability of further significant price declines on the stock and bond markets is low. One should especially not forget that although the Fed's monetary policy might be less expansionary in the near future, that will probably not be the case for almost all other central banks. General economic conditions are still too weak for that in large parts of the world, so inflation is also not an issue.

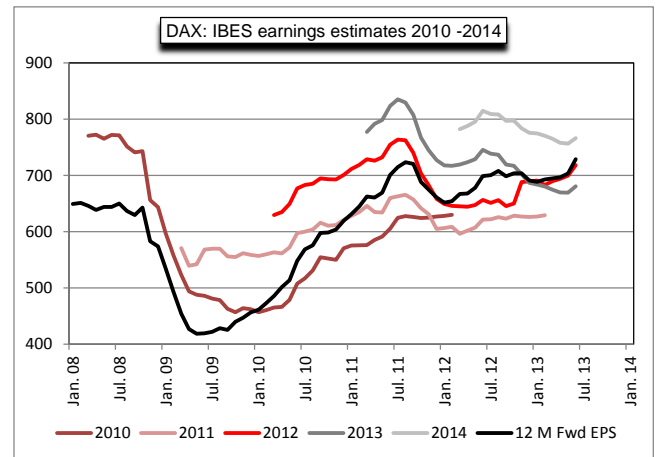
We therefore expect that central banks worldwide will not so quickly put at risk their successes achieved with expansionary monetary policy, which have only been modest in any case compared with past developments. A further yield increase would cause the small economic bright spots now emerging to disappear again quickly. Moreover, it should be pointed out again that a lasting low-interest-rate environment must be ensured for the purpose of financing government debt. Otherwise solvency would very quickly become an issue for many countries (in Europe, but also Japan).

What does this mean for investors? After the sharp rise of yields on the bond markets in the past few weeks and resulting price losses on government bonds with 10-year residual maturity (-4.5% for US Treasuries, -3.8% in Japan, -3.2% for Bunds, -3.9% in Spain, and -3.8% in Italy), the situation should calm down relatively fast. However, if the Fed announces a reduction of its asset purchases next week, contrary to our expectations, yields will presumably continue to rise for a while longer. Nevertheless, we regard the yields on US Treasuries and German Bunds as not yet attractive enough that one should enter those markets. That would only change if yields were to rise back to near 3%. One must especially watch the development of interest rates in the European periphery countries. At 4.6% and 4.3%, respectively, yields on 10-year bonds from Spain and Italy are still far from their highs of last summer. But a further and especially continuing rise would make financing government budgets significantly more difficult. That could prompt the ECB to take action and possibly necessitate activation of the OMT program in the coming months – provided the German Constitutional Court does not rule adversely in the case now before it. If it does, considerable market dislocations might result.

We are maintaining our basically positive stock market assessment despite the latest price declines. Stocks are no longer cheap, but based on the average price-earnings ratio of the past 10 years, they are at least fairly valued. By comparison, there is less reward for risk in almost all bond segments, since yields are still near all-time lows even after their latest countermovement. Moreover, the stock markets should benefit from the expectation of somewhat better economic development in the second half of the year. The IMF, OECD, and now the World Bank have revised their global growth forecasts downward for this year, but in evaluating our economic models, we conclude that the economic situation is recovering after the “spring dip.”

We are leaving our DAX forecast of 8,550 points at year's end unchanged for the time being, but we now see a chance of revising the price target upward in the coming weeks and

months. For, one can observe for the first time since last summer that corporate analysts have raised their earnings estimates for DAX companies. If this trend should prove stable, the DAX price target could be increased to near 9,000 points. In addition to the German stock market, US stocks should also be overweighted in a portfolio. The US dollar's current weakness does not make much sense to us. If monetary policy does become less expansionary, that will happen in the United States, but not in Europe. In view of the still weak economic situation, the ECB could even lower interest rates again, which should move the interest rate differential in the dollar's favor. The US stock market should additionally benefit from the relatively good economic situation, which will probably likewise entail better earnings estimates. At the sector level, we regard banks and financial stocks in the United States as interesting after the latest interest rate rise; they are benefiting from the steeper yield curve.

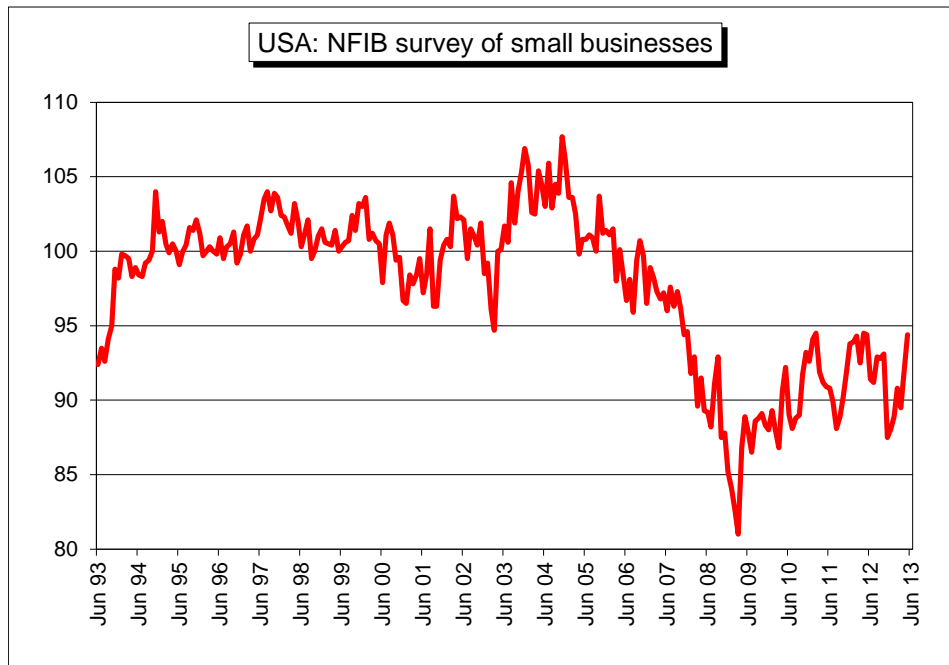


**Weekly outlook for June 17-21, 2013**

	Jan.	Feb.	Mar.	Apr.	May	June	Release
DE: ZEW economic expectations	31.5	48.2	48.5	36.3	36.4	38.1	June 18
DE: Producer prices, m/m	0.8%	-0.1%	-0.2%	-0.2%	-0.1%		June 20
DE: Producer prices, y/y	1.7%	1.2%	0.4%	0.1%	0.3%		June 20
DE: PMI, manufacturing	49.8	50.3	49.0	48.1	49.4	50.6	June 20
DE: PMI, services	55.7	54.7	50.9	49.6	49.7	51.1	June 20
EU17: PMI, manufacturing	47.9	47.9	46.8	46.7	48.3	49.0	June 20
EU17: PMI, services	48.6	47.9	46.4	47.0	47.2	47.6	June 20
EU17: Consumer confidence	-24	-24	-24	-22	-22	-22	June 20

MMWB estimates in red

**Chart of the week: Is optimism returning to US small businesses?**



Sentiment has recently brightened among small businesses in the United States. The small business optimism index of the National Federation of Independent Business (NFIB) climbed in May to its highest level since a year ago. Two subindexes of the NFIB survey show that the better sentiment is also likely to positively affect the labor market. Nineteen per cent of small businesses reporting having at least one job opening that they could not fill. That is still below the 20-year average (21%), but the trend has been pointed moderately upward for months. Five per cent of respondents also indicated that they intend to increase total employment in the coming months. A

moderate uptrend is also emerging here, in our opinion. We interpret this as a clear sign, particularly because small businesses employ about two-thirds of all workers in the United States. However, our chart of the week also shows that small business sentiment has not substantially improved since mid-2010, and the optimism index has rather fluctuated in a range of 87 to 94 points. In view of the recently better data from the United States, however, we believe small businesses might generate somewhat more confidence and soon surpass the 95-point mark.



	As of 13.06.2013	Change versus			31.12.2012 YTD
		07.06.2013 -1 week	13.05.2013 -1 month	13.03.2013 -3 month	
<b>Stock markets</b>					
Dow Jones	15176	-0,5%	0,6%	5,0%	15,8%
S&P 500	1636	-0,4%	0,2%	5,3%	14,7%
Nasdaq	3445	-0,7%	0,2%	6,2%	14,1%
DAX	8095	-1,9%	-2,2%	1,6%	6,3%
MDAX	13834	-0,1%	-0,3%	3,2%	16,1%
TecDAX	945	-1,2%	-0,7%	2,4%	14,1%
EuroStoxx 50	2662	-2,3%	-4,2%	-1,6%	1,0%
Stoxx 50	2647	-1,7%	-5,0%	-1,7%	2,7%
SMI (Swiss Market Index)	7628	-2,0%	-6,4%	-2,0%	11,8%
Nikkei 225	12445	-3,4%	-15,8%	1,7%	19,7%
BOVESPA	50415	-2,3%	-7,4%	-12,1%	-17,3%
RTS	1262	-4,0%	-11,3%	-17,6%	-17,4%
BSE 30	18827	-3,1%	-4,4%	-2,8%	-3,1%
China Shanghai Composite	2148	-2,8%	-4,2%	-5,1%	-5,3%
MSCI Welt (in €)	1464	-0,8%	-4,7%	-0,2%	8,4%
MSCI Emerging Markets (in €)	944	-4,2%	-11,8%	-12,3%	-11,4%
<b>Bond markets</b>					
Bund-Future	143,19	-20	-170	5	-245
Bobl-Future	125,97	-1	-42	12	-185
Schatz-Future	110,44	5	-28	-21	-42
3 months Euribor	0,21	1	1	1	2
3 months \$ Libor	0,27	0	0	-1	-3
10 year US Treasuries	2,18	2	30	16	43
10 year Bunds	1,56	1	21	9	26
10 year JGB	0,85	2	7	24	6
US Treas 10Y Performance	533,00	-0,1%	-2,0%	-0,4%	-2,2%
Bund 10Y Performance	504,89	-0,1%	-1,5%	-0,2%	-0,7%
REX Performance Index	441,58	-0,3%	-0,7%	-0,1%	-0,3%
US mortgage rate	3,91	0	49	39	56
IBOXX AA, €	1,82	4	22	5	21
IBOXX BBB, €	3,02	11	43	-8	-2
ML US High Yield	6,73	19	67	28	-2
JPM EMBI+, Index	668	-0,6%	-5,3%	-3,2%	-6,0%
Convertible Bonds, Exane 25	5633	0,0%	-1,6%	1,6%	3,7%
<b>Commodities</b>					
CRB Index	527,74	-0,8%	-2,0%	-4,7%	-4,8%
MG Base Metal Index	319,07	-4,1%	-2,6%	-9,2%	-10,7%
Crude oil Brent	103,44	0,0%	0,2%	-6,1%	-6,5%
Gold	1382,90	0,1%	-3,5%	-12,9%	-16,8%
Freight rates Baltic Dry Index	873	7,5%	-0,7%	-0,2%	24,9%
<b>Currencies</b>					
EUR/ USD	1,3315	0,4%	2,6%	2,6%	0,9%
EUR/ GBP	0,8481	-0,3%	0,2%	-2,3%	4,6%
EUR/ JPY	125,36	-1,1%	-5,0%	0,6%	10,3%
EUR/ CHF	1,2290	0,1%	-0,9%	-0,2%	1,8%
USD/ JPY	95,38	-2,2%	-6,3%	-0,8%	9,9%

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