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North America edition

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Editorial

Michael Strobaek
Global Chief Investment Officer

Giles Keating
Head of Research and Deputy Global CIO

Financial markets had a bumpy start to the new year. This was also our expectation. After steep increases in developed equity markets last year, combined with overextended optimism among investors due to the rally, it was only reasonable to expect markets at some point to correct. The triggers of the mini-correction we have seen came principally from softer leading indicators in the US and China, combined with a "scare" of a new emerging market crisis following the currency devaluation of Argentina and Venezuela. While the topic of adjustment in emerging markets will now stay with markets for quite a while, the softness in economic indicators is, in our view, not signaling that the growth trajectory has changed. Since late January, developed equity markets have rebounded fast from their lows this year. Is that now the end of the correction? For us, it is too early to tell. Interestingly, gold has rallied this year, and the combination of equity markets rebounding with gold rallying has in the recent past often meant that markets are expecting more monetary stimulus. This seems most unlikely to come from more quantitative easing by the Fed, given that Ms. Yellen has clearly stated that the tapering program will proceed as set out by her predecessor. However, she has also subtly signaled that short-term interest rates may stay low for longer than previously expected. She has done this by noting that there is probably more slack in labor markets than some investors believed, keeping inflationary pressures subdued for a long time. In short, this means to us that the Fed is still on a very dovish path, and that the backstop to growth, and also risky asset markets, is still very much alive, despite tapering. This gives us a high degree of comfort that, even if we see softer economic data, any correction is likely to be short-lived and probably not very deep – and if it were, then we would be buyers into it.

In this issue

Editorial deadline: 26 February 2014

Economics

Moderating momentum within a continued expansion

- Recent data show a reduction in global growth momentum, but the overall expansion does not appear to be at risk.
- Moderate growth and low inflation suggest continued monetary accommodation in advanced economies, while higher inflation implies a tightening bias in many emerging markets.

Oliver Adler
Head of Economic Research

Recent data show that the global economy lost some momentum over the past months. In the United States, a key reason for reduced activity has been unusually cold weather and some excess inventory. In the Eurozone, momentum remains strong in Germany and Spain, but questionable in Italy and especially France, which are both suffering from a structural lack of competitiveness and weak business confidence. In Japan, domestic demand remains robust, but the export recovery is sluggish due to slower growth in China and the fact that Japanese manufacturers have, to a large extent, offshored production. Meanwhile, the strong reliance on imported energy since the Fukushima disaster continues to worsen the external balance. In most emerging markets, growth momentum remains subdued. Many of their central banks have had to tighten policy in the face of excessive domestic credit growth, above-target inflation, external deficits and pressure on their currencies. On top of that, demand for commodities remains subdued, in part due to still moderating growth in China.

Global expansion remains supported by fiscal and financial conditions

Despite slower momentum, we do not see the global recovery fundamentally at risk. The USA and the Eurozone have shifted from a restrictive to a neutral fiscal stance, and financial conditions remain supportive. With better weather, the US housing market as well as hiring are likely to pick up speed again. Within the Eurozone, financial conditions have eased markedly, as bond yields in the periphery continued to decline. Meanwhile, the Bank of Japan has engaged in additional credit easing measures. In China and other emerging markets, policy is clearly far less supportive, however. While recent credit data in China have, on the surface, been strong, the authorities are, on balance, still trying to slow the debt and credit boom. And, as noted earlier, market pressures are forcing central banks to maintain a fairly restrictive stance in many other emerging markets.

Forward guidance in question, but low inflation suggests continued monetary ease in advanced economies

A key determinant of financial market developments over the coming months will be the trajectory of Fed policy, and to a lesser extent, that of other central banks. Regarding the Fed, our core scenario remains that "tapering" of asset purchases will continue at a steady pace, with an end-date around September, but that the Fed Funds rate will remain at zero well into next year or even beyond. The credibility of the Fed's, and more so, the Bank of England's (BoE) so-called forward guidance, has recently been undermined, however, because the unemployment rate has fallen rapidly toward levels, which both central banks had earlier declared as potential triggers for rate hikes. In response, the BoE has already "reneged" on its unemployment threshold, and we believe the Fed may do the same shortly, if less explicitly. Instead, the Fed is likely to justify continued monetary ease with the combination of very low inflation and continued economic slack. In the case of the ECB, inflation is so far below target and unemployment so high, that this credibility issue does not arise; here, economic fundamentals far more clearly justify an easing bias, though concrete measures may be delayed further. Meanwhile, the BoJ will anyway continue to pursue quantitative easing, and could even raise its balance sheet target if the coming tax hike results in a significant growth setback. (24/02/2014)

Global and North America investment strategy

Region, sector and stock selection to drive performance

- Equity strategy favors Europe and Japan; financials and IT.
- Attractive spreads support financial, European peripheral and EM hard currency credits.

Joe Prendergast
Head of Financial Markets Analysis

After a marked rise and fall in early 2014, major equity indices have recovered back to the levels around which they opened the year. From here, prospects for the equity market look broadly neutral. Better-than-expected Q4 US earnings, and more impressively, revenues, provide some fundamental underpinning to help counterbalance worries about softer economic data and Fed tapering. But risks of volatility remain. The unrest in Ukraine remains a concern. Given Ukraine's strategic geographic position between Western Europe and Russia, the local risk may have wider repercussions, although the cross-border financial exposures appear to be small.

Investment strategy for a neutral equity market

For investors, the set of near-zero short-term deposit rates, low bond yields, and near fair-value major equity markets, offers an unappealing choice. We retain an overall neutral view on equities, awaiting either a better entry point to offer more convincing value, a clear re-acceleration of growth or a renewed stimulus, to support a further leg of price appreciation. Instead, we focus on aspects of relative value within the equity and fixed income markets. In particular, on regional equity allocation, we favor the combination of still-cheap valuation, growth momentum, earnings prospects and policy outlook presented by European and Japanese markets, against which we expect the US to underperform. Among equity sectors, we favor financials and IT. In fixed income, still-attractive spreads in financial, European peripheral and emerging market (EM) hard currency credit offer an offset to the likely drift higher in government bond yields.

Sensitivity to economic risks

The focus on relative and regional opportunities should help to reduce risks from the currently uncertain macro trend. If the economy turns out weaker than we expect, any negative effect on our recommendations should be relatively short-lived as a result of a likely policy reaction from the Fed, just as Ms. Yellen's recent speech helped stock markets to rebound from the recent sell-off. If, conversely, the economy is better than expected, our cyclically-sensitive credit and equity recommendations should help performance.

Regionally, Europe is among the clearest multi-asset class investment cases

Europe's recovery remains one of our Top Investment Ideas for 2014. Macroeconomic fundamentals in the region continue to gather pace and, in our view, equity valuations do not yet fully reflect earnings momentum or potential. In fixed income, peripheral European bonds can also benefit from further narrowing of yield spreads.

Asymmetric yen risks, value and earnings underpin Nikkei

Currency also plays an important role in the case of Japan, where our favored outperform view on equity would be vulnerable to any reversal in the weak yen trend. Further corrections to the weak yen trend cannot be ruled out, but the key here is that the central bank stands ready to act in the event of any resurgence of deflation risk, including yen strength. The outlook for the currency thus stays asymmetrically biased toward weakness, and the stock market toward strength.

(24/02/2014)

Bad weather or a slowdown?

- High frequency US economic data has been disappointing due to weather effects and payback from a solid end to last year.
- US Treasuries and municipal bonds have responded strongly with yields declining; senior loans look attractive.

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An accumulation of disappointing high-frequency economic data since the start of the year has led investors to question their view that the US economy will accelerate in 2014. The question is can the lackluster January job gains, manufacturing surveys, and retail sales all truly be blamed on the unusually cold weather – or is there indeed a slowdown in activity? The unusually cold temperatures and heavy snow in major parts of the country have had an effect on consumer activity. Even the minutes of the FOMC's January meeting revealed that the weakness of December's job numbers was weather-related.

Moderation in momentum but reasons to be cheerful

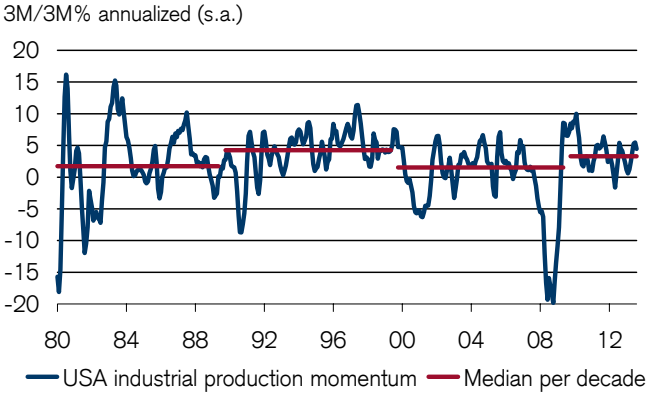
We believe that the severe weather has accentuated some of the decline in the underlying pace of economic growth, as measured by industrial production – but from a high level (see chart). However, we believe this is merely a moderation of momentum after a solid finish at the end of 2013. Two data points that confirm our thesis are consumer sentiment, and small business hiring. US consumer sentiment has remained resilient despite the recent wobble in equity prices. A similar trend is visible in small business hiring, currently registering its best readings in six years. We expect the US re-acceleration to be part of a better global landscape. Historically, when we have seen stronger global GDP growth, US equities tend to lag behind other developed market regions, specifically Europe and Japan. Thus we are favoring those two regions over the US.

How to position fixed income portfolios

Given this outlook, how should investors position their fixed income holdings? Fixed income yields have responded strongly to the relative softness in economic data and we recommend an underweight position to US Treasuries, and are proceeding with caution in the municipal bond segment. US Treasuries have gained 1.2% this year – far exceeding our full-year return expectations. Municipal bonds have gained 2.5%, with a lot of demand in 3–7 year maturities as investors are trying to limit interest rate risk. Lack of new issuance supply – January issuance was 33% lower YoY – has also given a very strong start to the municipal bond market. As such, we are recommending waiting for supply to return or demand to reverse course to find better value in municipal bonds in the near term. We favor senior loans, even though default rates, which are concentrated in a few companies, may creep up this year to 3%–4%. We think their low sensitivity to rates or anticipation of tightening central bank policies may help buttress the more volatile segments of fixed income over the course of this year.

(24/02/2014)

US industrial production momentum
30 years rolling



Source: Datastream, Credit Suisse / IDC

Forecast summary

More information on the forecasts and estimates is available on request. Past performance is not an indicator of future performance. Performance can be affected by commissions, fees or other charges as well as exchange rate fluctuations.

(26/02/2014)

Short interest rates 3M Libor / 10-year government bonds

	3M Libor			10Y		
in %	Spot	3M	12M	Spot	3M	12M
CHF	0.02	0.0-0.2	0.0-0.2	1.01	1.0-1.2	1.3-1.5
EUR *	0.29	0.1-0.3	0.1-0.3	1.65	1.6-1.8	2.0-2.2
USD	0.23	0.2-0.4	0.2-0.4	2.70	2.8-3.0	3.1-3.3
GBP	0.52	0.5-0.7	0.5-0.7	2.74	2.9-3.1	3.2-3.4
AUD **	2.63	2.5-2.7	2.5-2.7	4.17	4.1-4.3	4.3-4.5
JPY	0.14	0.1-0.3	0.1-0.3	0.59	0.6-0.8	0.8-1.0

Spot rates are closing prices as of 25/02/2014. Forecast date: 20/02/2014. * 3M Euribor, ** 3M Bank Bill rates.

Source: Bloomberg, Credit Suisse

Equities

Index	Spot	P/E	Div. y. (%)	3M*	12M*
MSCI AC World	408	14.1	2.5	410	440
US S&P500	1,845	15.2	1.9	1,840	1,950
Eurostoxx 50	3,157	12.9	3.4	3,200	3,510
UK FTSE 100	6,831	13.6	4.0	6,580	7,300
Japan Topix	1,234	13.6	1.7	1,350	1,520
Australia S&P/ASX 200	5,434	14.5	4.3	5,330	5,780
Canada S&P/TSX comp	14,189	15.2	2.8	13,940	14,540
Switzerland SMI	8,506	15.4	2.9	8,110	8,800
MSCI Emerging markets	956	10.1	2.8	980	1,190

Prices as of 25/02/2014; *forecast.

Source: Bloomberg, Credit Suisse

Commodities

	Spot	3M*	12M*
Gold (USD/oz)	1341	1180	1100
Silver (USD/oz)	21.87	19	17
Platinum (USD/oz)	1438	1400	1500
Palladium (USD/oz)	735	740	780
Copper (USD/oz)	7065	7200	7300
WTI Crude Oil (USD/bbl)	102.43	101	101
Credit Suisse Commodity Benchmark	6008	5950	6000

Spot prices: New York close 25/02/2014; *forecast.

Source: Bloomberg, Credit Suisse

Credit: Selected Indices

	Yield (%)	Spread (bp)	Duration (years)	3M forecast	12M forecast
BC IG Corporate EUR	1.8	113	4.5	0.5%	1.7%
BC IG Corporate USD	3.0	110	6.9	0.6%	1.8%
BC IG Financials USD	2.6	104	5.5	0.9%	2.2%
CS LSI ex govt CHF	0.8	50	5.1	0.1%	0.5%
BC High Yield Corp USD	5.2	370	4.0	1.4%	4.0%
BC High Yield Pan EUR	4.7	311	3.8	1.2%	3.5%
JPM EM hard curr USD	6.2	361	7.3	1.5%	4.3%
JPM EM local curr hedg. USD	7.0	n.a.	4.6	1.3%	3.3%

BC = Barclays Capital, IG= Investment Grade, CS = Credit Suisse, JPM = JP Morgan (EMBI+ and GBI GI. Div). Index data as of 25/02/2014.

Source: Bloomberg, Credit Suisse

Foreign exchange

	Spot	3M	12M
EUR/USD	1.38	1.27-1.31	1.27-1.31
USD/CHF	0.89	0.93-0.97	0.95-0.99
EUR/CHF	1.22	1.21-1.25	1.23-1.27
USD/JPY	102	106-110	108-112
EUR/JPY	140	137-141	140-144
EUR/GBP	0.82	0.76-0.80	0.77-0.81
GBP/USD	1.67	1.64-1.68	1.62-1.66
AUD/USD	0.90	0.88-0.92	0.88-0.92
USD/CAD	1.11	1.08-1.12	1.08-1.12
EUR/SEK	8.93	8.88-8.92	8.68-8.72
EUR/NOK	8.29	8.38-8.42	8.08-8.12
EUR/PLN	4.15	4.08-4.12	4.03-4.07
USD/CNY	6.12	5.98-6.02	5.93-5.97
USD/SGD	1.26	1.27-1.31	1.30-1.34
USD/KRW	1073	1040-1060	1040-1060
USD/INR	62.0	62-64	64-66
USD/BRL	2.34	2.40-2.50	2.45-2.55
USD/MXN	13.2	13.0-13.1	12.4-12.5

Spot rates: London close 25/02/2014.

Source: Bloomberg, Credit Suisse

Real GDP growth and inflation

	GDP growth			Inflation		
in %	2013	2014E	2015E	2013	2014E	2015E
CH	1.8e*	2.0	1.8	-0.2	0.2	1.0
EMU	-0.4	1.2	1.6	1.3	0.9	1.3
USA	1.9	3.0	3.0	1.5	1.5	2.0
UK	1.9	3.0	2.4	2.6	1.9	2.0
Japan	1.6	1.5	1.4	0.4	1.9	1.2
China	7.7	7.5	7.2	2.6	3.0	3.5

Forecast date: 25/02/2014. *e = estimated

Source: Credit Suisse

Top investment ideas

Top investment ideas 2014

■ The 7 Top investment ideas were introduced in December 2013. Overall performance has been robust, while "Emerging markets reloaded" and "China reform re-accelerates" have faced headwinds.

■ We adjust "Seeking equity alpha" and maintain the status of "Emerging markets reloaded" on yellow.

Dan Scott
Capital Goods Research

Seeking equity alpha

At the time of writing, the idea has an absolute performance of 2.1%, outperforming global equities by 0.6%. To reflect the latest views of our equity strategists, we now adjust the components of the idea, removing industrials from our top picks and adding exposure to financials.

Emerging markets reloaded

At the time of writing, the performance of the idea is down just over 2%. We maintain the status of this idea on yellow, as we believe political uncertainties and exposure to China's investment growth slowdown leaves certain emerging markets, particularly in Latin America and EEMEA, vulnerable.

China reform re-accelerates

Slowing economic momentum and concerns over increased default risks have rattled investor confidence, but we believe the risk of a full-scale financial crisis is rather low. Government debt levels are manageable, savings rates are high, foreign debt is limited and good progress is being made on structural reforms. We believe current valuations do not reflect the benefits of the upcoming structural reforms, and maintain the idea's status on green.

Forex as the Fed tapers

Despite recent strength, we maintain our outlook for a weaker EUR/USD. EUR/USD is richly valued and we expect policy divergence between the Fed and the ECB to weaken the EUR, despite currently strong technical support. Selection will remain key within emerging markets. Despite some policy actions (such as tightening in Turkey) we still prefer currencies of surplus and reform countries, such as CNH, KRW, MXN and PLN, to those with external deficits like TRY, ZAR, BRL, INR and IDR. (24/02/2014)

Top investment ideas 2014- Overview

Top idea	Status	Comment
Europe's recovery	■	Buy (or overweight) European stocks. We currently favor Germany, given its operating leverage toward a recovery, and Italy due to low equity valuations.
Seeking equity alpha	■	Choose sectors, styles, countries and individual stocks based on prevailing market dynamics; current favorites include financials and IT stocks.
Emerging markets reloaded	▲	Gain exposure to export-led, growth-sensitive countries, e.g. Taiwan, and also look for those where the potential for successful structural reforms is not yet fully discounted.
Fixed income in a world of rising yields	■	Focus on short-duration assets in areas where value still exists, like corporate senior loans, bank subordinated debt, bank contingent convertible bonds and corporate hybrids.
Forex as the Fed tapers	■	Buy USD/JPY, spot or forward. Opportunistically sell EUR/USD near the top of its range. In emerging markets, we believe investors should sell currencies of deficit countries against those of surplus countries and of reformers.
Cash-rich companies	■	Large corporate cash piles will be put to use. We recommend gaining exposure to increasing M&A and share buybacks.
China reform re-accelerates	■	Stock selection is key. Gain exposure to global, regional and domestic firms that can benefit from China's structural reforms with a focus on the private companies, services sectors and winners from economic rebalancing toward consumption.

Key to status symbols: green = attractive investment opportunities – continue to invest in theme; yellow = keep holdings but do not add to existing positions; red = reduce /exit existing positions.

Source: Credit Suisse

Special topic

Value approach works for emerging markets

- Higher dividend yield and weak currencies are useful signals for EM equities, and underpin our outperform on Russia.
- EM consumer optimism tempered, though Chinese consumer story still positive.

Michael O'Sullivan
CIO – UK & EEMEA

Emerging markets (EM) have been to the fore since the start of the new year, with currency weakness in countries like Turkey and Russia contributing to a more cautious investment climate. In this context, we highlight the benefits of two longer, broader perspectives on emerging markets with the publication of the Research Institute's Investment Returns Yearbook and the EM Consumer Report, both of which are based on unique, proprietary datasets.

India and South Africa look expensive compared to Russia

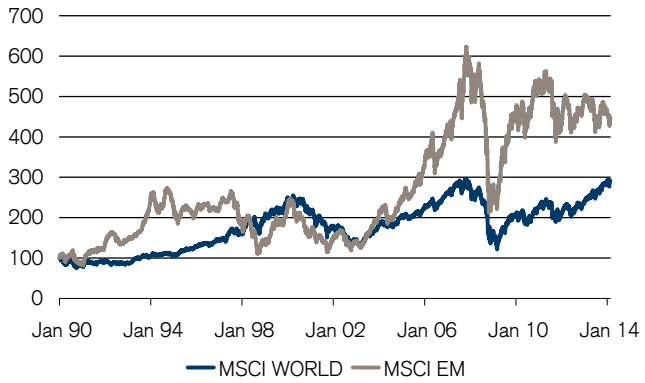
The CS Investment Returns Yearbook brings stock and bond return data for the past 114 years across 26 countries to bear on current market developments. With emerging markets in mind, we construct an EM index going back to 1900. We find that between 2000 and 2010, EMs returned an annual average of 10.9% compared to just 1.3% for developed markets (DM). But, stepping further back, since 1900 EMs have underperformed DMs by 1% per annum though from 1950 onward EMs have outperformed by 1.7% per annum.

In recent years, a couple of structural trends have manifested themselves. EMs have become much less volatile relative to DMs, and increasingly correlated with them, and we estimate that in the long term, EMs deserve a small (1%+) premium to DMs. With recent volatility in mind, the key insight from the Yearbook is that buying EMs with high dividend yields and that have recently experienced currency weakness (usually post a crisis) appears to produce higher subsequent returns. From this point of view, our outperform on Russia makes sense. South Africa and India, which we expect to underperform, have a lower dividend yield compared to Russia and look expensive. Of course, more developed and financially strong emerging markets, such as Korea and Taiwan, stand upon their own positive fundamental merits.

EM consumer optimism less pronounced, but demand still healthy for smartphones and sports goods

Continuing the EM focus, in our EM Consumer Survey we worked with AT Nielsen to interview 16,000 people in the 9 main EM economies. For the first year, we see a drop off in consumer optimism. Expectations of personal finances are lower, especially in Turkey, Russia, Saudi Arabia and India. In most countries, household income expectations have fallen compared to last year. Adding up all the results in our EM Consumer scorecard, China comes tops, with Turkey and South Africa unsurprisingly last. However, we witnessed several interesting sub-trends – young people have higher income than old ones in many EMs and rural income expectations are rising steadily in India. (24/02/2014)

Performance – MSCI Emerging Markets vs. MSCI World
Long-term perspective



Source: Bloomberg, Credit Suisse / IDC

Special topic

Europe's recovery

- The European economic recovery is gathering pace.
- Bank Asset Quality Review and the ECB stress test should restore trust.

Javier José Lodeiro
Financials Research

Reto Hess
Capital Goods Research

Demand in Europe continues to pick up

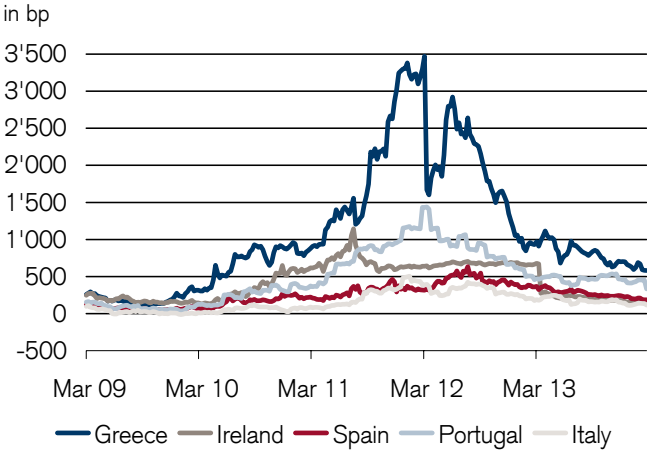
With the European economic recovery gathering pace and sentiment indicators improving, we are gaining confidence that European companies will likely benefit from growing demand for consumer goods or industrial equipment. For example, car registrations in Europe have increased for the fifth month in a row. However, we expect a rather gradual increase, in line with generally cautious company outlooks. This is understandable, however, as it is still early in the year and risks remain.

The economic slowdown in a few emerging markets is one of the bigger risks, as they have become important markets for many European companies. The negative impact of the strong EUR is also weighing on profits and might increase the competitive pressure on European companies. In addition, political risk (e.g., new Italian prime minister, crisis in Ukraine) could also increase volatility.

Trust in European financials could improve in 2014

2014 will remain a year of regulatory uncertainty for EU banks in particular, while the rules are more advanced in the US and Switzerland. If done properly, the Asset Quality Review and the ECB stress test should serve to restore trust and could spark potential M&A activity. All in all, uncertainties remain, but the ECB is fully aware of the importance of the stress test, and we therefore think it will do everything it can to rebuild investor trust by conducting a harsh test. Further ECB action to either lower interest rates or imply negative deposit rates is still the main risk. (26/02/2014)

EMU periphery bond spreads relative to German Bund
Tighter peripheral European bond spreads as an indicator of lower market stress



Source: Bloomberg, Datastream, Credit Suisse / IDC

Fixed income

Favor financials, peripheral and solid emerging market sovereigns

- Temporary weakening in economic data caps yields, but they are now low in range and exhibit little value.
- We stay negative on fixed income overall, but financials, European peripherals and solid emerging markets hard currency bonds are still attractive.

Sylvie Golay Markovich
Head Fixed Income Analysis

Government bond yields to resume upward trend; favor European periphery

Major government bond yields have been on a downward trend since the start of the year, despite the improved risk sentiment observed in equity markets in recent weeks. At the same time, negative economic surprises have had a smaller impact on rates, partly explained by the weather effect that may have influenced recent US releases. Moreover, the continued Fed tapering course and prospects of interest rate normalization highlighted in the FOMC minutes should ultimately underpin the upward trend in US Treasury yields. A similar trajectory is expected for UK Gilts following the change in forward guidance by the BoE. We thus keep a negative view on these two government bond markets. In contrast, we remain positive on European peripheral sovereign bonds. Political noise has not led to higher volatility, as highlighted by the positive performance of Italian bonds ahead of the change in prime minister. In addition, the European rating trend remains positive, supported by the general improvement in economic backdrop and improved capital market access.

Credits: Preference for financials and emerging market investment grade sovereigns in hard currency

Along with receding emerging market crisis concerns, credit spreads have tightened again in the past month despite continued weakness in economic data. Due to stronger investor risk appetite, lower quality issuers were also able to tap the capital market, with firm issuance activity recorded in Europe and emerging markets. In corporate credit, we continue to favor financial over industrial issuers from a fundamental standpoint, with the recent earnings season confirming the better positioning of financials. Furthermore, valuations also remain more attractive than for non-financials. After the recent spread tightening, we view high yield spread valuations as rather tight. This and the recent weakening in economic indicators explain our neutral stance on high yield corporate bonds. In emerging markets, spreads have also come down from their recent extremes, but they remain attractively wide, in our view, especially in comparison with high yield. We reiterate our negative stance on Argentina, Venezuela and Ukraine, as local risk remains skewed to the downside. In contrast, we keep our positive view on investment grade countries and favor Mexico, Philippines, Russia, Poland, Hungary, Columbia and Peru.

(25/02/2014)

USD credit spreads of high yield (HY) and emerging markets (EM) bonds

After their strong underperformance last year, EM offer more value than HY, in our view.

Source: Bloomberg, Credit Suisse / IDC

Equities

Japan and Europe to outperform

- US equity sentiment has normalized, but the market is near fair value and immediate risks remain.
- Among regions, we favor Europe and Japan. In terms of sectors, we prefer financials and IT.

Gérald Moser
Head of Equity Analysis

Equities recover after spike in risk aversion

Tactical indicators reflecting sentiment and flow registered highly elevated levels in major equity markets going into the new year, before witnessing a healthy pullback in January. The market now appears to be on a more neutral footing from a sentiment and flow perspective, with the upside surprises to US earnings and revenues in Q4 adding some underpinning from fundamentals. Risks remain, however, as economic growth goes through a soft patch, deepened by bad weather, and the Fed continues to taper its asset purchases. We stay neutral on equities overall, and negative on the fairly valued US market, favoring instead the combination of still-cheap valuation, growth momentum, earnings prospects and policy outlook presented by European and Japanese equity markets.

Japan better positioned than emerging markets

Emerging markets (EM) and Japan have both underperformed the broader equity market YTD. But we view the outlook for Japan more positively than for emerging markets. Japan's valuation (in terms of a ten-year low P/E ratio relative to the world) is reinforced by a strong trend of upward earnings revisions. Moreover, monetary policy is supportive, while many emerging markets, in contrast, have had to tighten their monetary conditions. EM shows comparably relative value readings, but suffers from a clear trend of downward earnings revisions. As highlighted in our Top Idea, "EM reloaded," we therefore prefer to focus on differentiation within EM, not on EM more broadly.

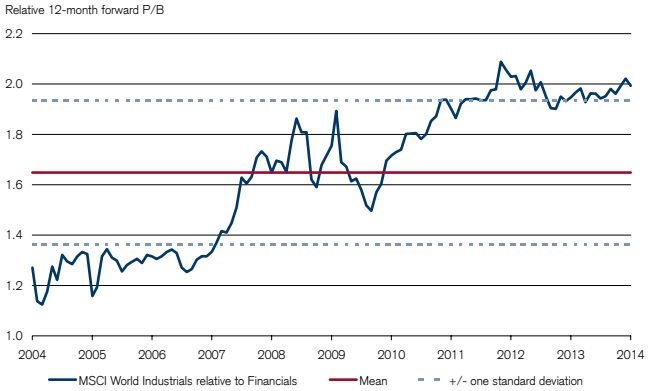
Changes to our sector allocation

We upgrade utilities to neutral. Regulatory headwinds are fading, and we think the sector has fully discounted the negative news. Positioning continues to be low and sentiment is cautious toward the sector, but the earnings outlook has actually improved.

We upgrade financials from neutral to outperform. We were already positive on insurance within the sector and now raise banks and diversified financials to outperform, too. Financials had a solid earnings season on both sides of the Atlantic, and valuation still looks attractive. While harsher regulation will likely have a negative impact on profitability, we believe that improved confidence in the sector's soundness will more than offset these headwinds.

We downgrade industrials to neutral. We still like the sector structurally, but valuations relative to financials have become demanding (see chart) and expectations high. The sector disappointed in the earnings season. We favor a neutral stance now, but would use a significant pullback to up our recommendation again. (24/02/2014)

12-month forward P/B – MSCI World Industrials relative to financials



Source: Datastream, IBES, Credit Suisse / IDC

Alternative investments

Limited upside in commodities; hedge funds with good prospects

- Hedge funds to benefit from low volatility and falling correlation.
- Commodity rally unlikely to continue much further.

Tobias Merath
Head of Cross Asset and AI analysis

Mixed picture for alternative investments

Alternative investments had a mixed start to the year, with commodity performance up and hedge funds down. We expect the divergence in performance to continue, but think that hedge funds have better prospects than commodities. REITs should deliver positive returns for the full year.

Hedge funds: Prospects positive despite small dip in January

The turmoil in emerging markets and the dip in equities affected hedge fund performance negatively. As a result, the Credit Suisse Hedge Fund Index was down 0.3% in January. Within hedge funds, the dispersion between individual styles has increased. Unsurprisingly, EM-focused strategies underperformed, while relative value managers did better. Going forward, we would argue that the environment for hedge funds is favorable, given solid economic growth, good market liquidity, moderate volatility and falling correlation among individual securities. We prefer long/short equity strategies due to the low correlation among individual stocks. This is also part of our Top Idea, "Seeking equity alpha." We also have a preference for fixed income arbitrage, as this strategy should perform well even when rates rise.

Real estate: Positive returns expected

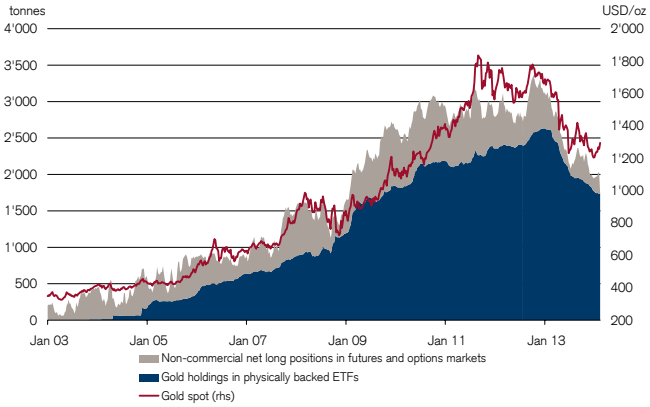
Global REITs started with a flat performance in 2014 after having returned 3.6% in 2013. In the short term, REITs show high interest rate sensitivity, while on a longer time horizon, economic growth is one of the main drivers. With global growth momentum slowing temporarily and the Fed tapering, the near-term outlook is rather cautious. However, for the full year, we expect REITs to show positive returns. Our preferred markets remain the UK due to solid growth momentum, and the US, given our positive outlook on rental growth. We are underweight on EM REITs, as earnings momentum still is negative.

Commodities unlikely to rise much further; gold with downside risks

After a correction in early January, commodity markets recovered in February, and the major commodity indices are now in positive territory year-to-date. However, this increase is unlikely to go much further. Global growth is recovering, but emerging market growth dynamics lag behind developments in the developed world. This is important because commodity prices are closely linked to growth in emerging markets. In our view, growth dynamics there are simply not strong enough to trigger broad-based commodity price increases. Within commodities, gold looks vulnerable, as it is sensitive to higher interest rates, and investment flows remain weak. After the recent rally, oil prices should also have less upside, but due to steeply discounted forward rates, the market offers a reasonable yield.

(24/02/2014)

Investment outflows from gold continue



Source: CFTC, Bloomberg, Credit Suisse / IDC

Foreign exchange

Euro resilience to prove vulnerable

- We maintain a positive view on USD vs. EUR and CHF, given Fed tapering, USD undervaluation and likely ECB reaction to euro strength.
- Currencies of surplus and reforming countries, such as CNY, PLN and MXN, expected to outperform.

Marcus Hettinger
Foreign Exchange Analysis

USD increasingly undervalued, but technicals weaker

The USD has recently weakened to new lows, helped by softer US data, stronger-than-expected growth in the EMU, and continued capital flows into the Eurozone (likely still including some EUR-supportive de-leveraging flows among European banks). The technical picture has turned more bearish as a result, but we still think that a relative monetary policy shift between the Fed and the ECB, in combination with a now richly-valued EUR, is set to strengthen the USD. Strong growth in the UK is likely to keep alive expectations for early tightening by the Bank of England. GBP/USD will thus remain supported despite rich valuation, and we remain neutral. But we still expect GBP outperformance vs. the EUR. Our expectation for rate spreads to move against the JPY and a resumption of capital outflows from Japan are key reasons for our positive USD/JPY outlook. We therefore reiterate our recommendation to sell EUR/USD and buy USD/JPY, which forms part of our Top Idea, "Forex as the Fed tapers." Within Europe, we remain neutral EUR/CHF, as we expect only modest recycling of Switzerland's current account surplus and the SNB to maintain the floor at EUR/CHF 1.20.

Commodity currencies: Neutral outlook, positioning still skewed to shorts

We maintain our neutral view on AUD/USD and USD/CAD as positioning is still heavily skewed to short positions in AUD and CAD. As the RBA has now shifted to a neutral stance, from previously an easing bias and recent stronger Canadian data reduce the need for stimulus from the BoC, we see this as balancing the risks for further weakness of AUD and CAD at the moment.

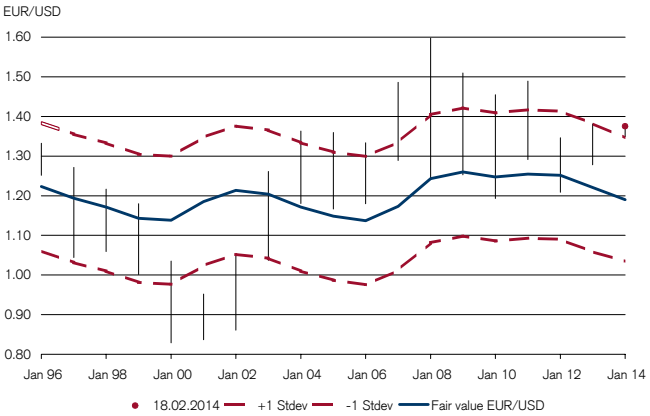
Emerging markets: Selection remains important

Central banks in some countries suffering from weak exchange rates have tightened monetary policy, such as in Turkey or South Africa. However, we think risks of further FX weakness remain, as policy credibility needs to be re-established, growth is still weak and inflation high. We thus maintain our relative preference within emerging markets for currencies with a strong external position (CNY), where reforms have been implemented (MXN) or which are less sensitive to rising US yields (PLN). Within the scope of our Top Idea, "Forex as the Fed tapers," we still favor a basket of CNY, MXN, PLN, KRW against BRL, TRY, ZAR, INR and IDR.

(24/02/2014)

Fair value (FV) EUR/USD

EUR/USD is becoming increasingly overvalued.



Source: Datastream, Credit Suisse / IDC

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Pricing	Option premiums and prices mentioned are indicative only. Option premiums and prices can be subject to very rapid changes: The prices and premiums mentioned are as of the time indicated in the text and might have changed substantially in the meantime.
Risks	Derivatives are complex instruments and are intended for sale only to investors who are capable of understanding and assuming all the risks involved. Investors must be aware that adding option positions to an existing portfolio may change the characteristics and behavior of that portfolio substantially. A portfolio's sensitivity to certain market moves can be heavily impacted by the leverage effect of options.
Buying calls	Investors who buy call options risk the loss of the entire premium paid if the underlying security trades below the strike price at expiration.
Buying puts	Investors who buy put options risk loss of the entire premium paid if the underlying security finishes above the strike price at expiration.
Selling calls	Investors who sell calls commit themselves to sell the underlying for the strike price, even if the market price of the underlying is substantially higher. Investors who sell covered calls (own the underlying security and sell a call) risk limiting their upside to the strike price plus the upfront premium received and may have their security called away if the security price exceeds the strike price of the short call. Additionally, the investor has full downside participation that is only partially offset by the premium received upfront. If investors are forced to sell the underlying they might be subject to taxing. Investors shorting naked calls (i.e. selling calls but without holding the underlying security) risk unlimited losses of security price less strike price.
Selling puts	Put sellers commit to buying the underlying security at the strike price in the event the security falls below the strike price. The maximum loss is the full strike price less the premium received for selling the put.
Buying call spreads	Investors who buy call spreads (buy a call and sell a call with a higher strike) risk the loss of the entire premium paid if the underlying trades below the lower strike price at expiration. The maximum gain from buying call spreads is the difference between the strike prices, less the upfront premium paid.
Selling naked call spreads	Selling naked call spreads (sell a call and buy a farther out-of-the-money call with no underlying security position): Investors risk a maximum loss of the difference between the long call strike and the short call strike, less the upfront premium taken in, if the underlying security finishes above the long call strike at expiration. The maximum gain is the upfront premium taken in, if the security finishes below the short call strike at expiration.
Buying put spreads	Investors who buy put spreads (buy a put and sell a put with a lower strike price) also have a maximum loss of the upfront premium paid. The maximum gain from buying put spreads is the difference between the strike prices, less the upfront premium paid.
Buying strangles	Buying strangles (buy put and buy call): The maximum loss is the entire premium paid for both options, if the underlying trades between the put strike and the call strike at expiration.
Selling strangles or straddles	Investors who are long a security and short a strangle or straddle risk capping their upside in the security to the strike price of the call that is sold plus the upfront premium received. Additionally, if the security trades below the strike price of the short put, investors risk losing the difference between the strike price and the security price (less the value of the premium received) on the short put and will also experience losses in the security position if they owns shares. The maximum potential loss is the full value of the strike price (less the value of the premium received) plus losses on the long security position. Investors who are short naked strangles or straddles have unlimited potential loss since, if the security trades above the call strike price, investors risk losing the difference between the strike price and the security price (less the value of the premium received) on the short call. In addition, they are obligated to buy the security at the put strike price (less upfront premium received) if the security finishes below the put strike price at expiration.

Source: Credit Suisse

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