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Management Report

4th Quarter 2007

Economic developments in the fourth quarter of 2007

Key data on the US economy indicated that the rate of economic growth in the USA was dropping fast towards the end of the year. Shifting economic winds were most evident in the real estate sector, which had shown signs of overheating in previous years. The previous excesses in the housing market underwent a correction throughout 2007. The number of delinquent subprime mortgages rose as did the number of unsold homes (the latter decreasing only slightly as the year came to a close).

However, the US economy did not grind to a halt and, therefore, the risk of higher inflation was slow in subsiding. Core inflation actually started rising again during the second half of the year and surpassed the 2% upper limit of the central bank's comfort zone, but the Federal Reserve nevertheless lowered its overnight lending rate in the autumn by one percentage point to 4.25% to prevent an excessive slowdown in economic growth. The US central bank thus had quite a difficult balancing act to manage, with growth risks on the one hand and inflation risks on the other.

Economic growth in Euroland peaked during the course of 2006 and has generally eased somewhat since then, the main reason being the European Central Bank's (ECB) more restrictive monetary policy as it took action to keep a lid on inflation risks. Subsiding economic activity in Euroland was cushioned by the strong global economy (excluding the USA), which bolstered demand for European products.

The Japanese economy expanded only slightly in 2007 and exhibited occasional bouts of weakness. Capital expenditure suffered a particularly steep downturn while productivity growth outstripped wages. Consequently deflationary tendencies increased again, which helped to keep Japanese interest rates low and the yen weak.

Developments on financial markets

In most markets government bonds showed a positive performance in local currency for the fourth quarter. British bonds delivered the best performance, followed by Canadian and US bond markets. This good performance was fueled by expectations of a general slowdown in economic growth. The main risk was that the real estate crisis in the USA would cause credit markets to seize up because of the lack of confidence among banks. Interest spreads widened enormously in relation to the risk-free interest rates. The "Ted spread" (spread between USD 3M Libor rates and 3M US Treasury bills), which is viewed as an indicator of global liquidity, remained well above the long-term average spread during the fourth quarter. This situation led the central banks to take concerted action with huge injections of cash to make the money market liquid again.

Stock markets moved sideways at best in the fourth quarter. The Swiss and Japanese stock markets were weak. Stock prices headed south as a result of the US real estate crisis. Earnings momentum gradually declined in most sectors with the financial sector taking an especially hard hit. The repercussions of the US housing market crisis were first felt in the US banking system but later spread to a number of banks outside the US because US mortgages are often not carried in the balance sheets of the mortgage-issuing banks but instead repackaged as mortgage-backed securities (MBS) that can be traded worldwide. The increase in non-performing mortgage loans reduced the value of the MBS held by many banks. This led to liquidity problems and write-offs. The share prices of banks plunged because of the uncertainty regarding the actual extent of their write-off requirements. Other stock-market sectors with a negative performance were cyclical consumer goods and healthcare, whereas the energy, commodities, telecoms and utilities sectors delivered double-digit gains.

After having weakened considerably during the course of the year the Swiss franc strengthened against most other currencies during the fourth quarter. This appreciation was driven to some extent by investor uncertainty in connection with the international banking crisis. Pound sterling lost the most value against the Swiss franc, followed by the Australian dollar and the USD.

Commodity prices continued rise in the fourth quarter. This was particularly true for oil prices. Crude oil supplies were largely unchanged because investment in oil production projects had been restrained for a long time while global demand for oil continued to grow. Growing demand was particularly evident in the booming emerging markets of China and India. This situation was exacerbated by a high risk premium, arising from the possibility of supply problems and declining crude oil inventories further down the road.

In the 4th quarter 2007, the value of the A-share has decreased by 1.1%, from CHF 254.00 to CHF 251.24, and in the same period the B-share has increased by 0.6%, from CHF 211.60 to CHF 212.90. For the whole year 2007, the A-share has increased by 1.83% and the B-share by 1.62%.

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