For investment professionals only

December 18, 2012

CIO Office

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Emerging Markets (EM) Monthly

Table of contents

Market Environment

2013 – Bring it on!

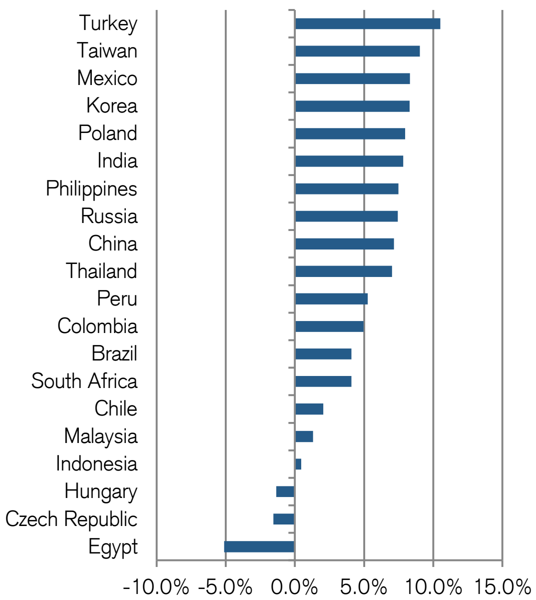
Overview

- We enter 2013 with marginally less event risk than a year ago.
- The "fiscal cliff" debate gets full attention and will most likely lead the way in the coming weeks.
- We believe that a major shift out of low-yielding assets and into riskier areas is building up.

Risk-on is back, but uncertainties remain

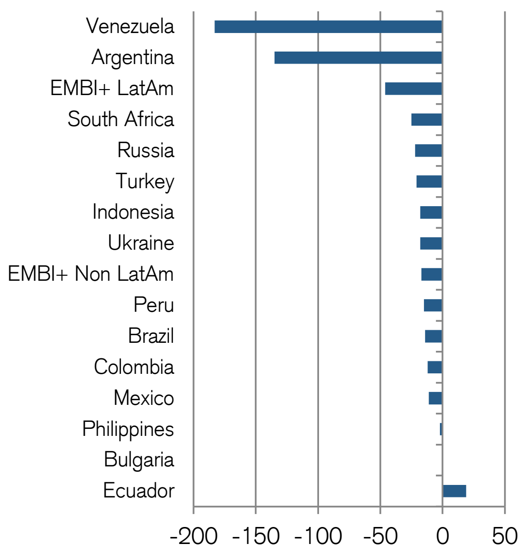
EM assets are back in demand. Equity and fixed-income prices have recovered all their losses from the post-election selloff. Investors felt more confident thanks to the recent easing in some tail risks, particularly in Europe, together with a good set of economic figures from China. In the USA, an agreement between Democrats and Republicans on the fiscal cliff is still pending, but constructive dialogue between the Obama administration and Republican House Speaker Boehner suggests that one might be in the offing. Moreover, investors are generally more constructive about 2013 and have started to reposition some of their assets into riskier areas.

Figure 1: Equity performance since last EM Monthly



Source: Bloomberg, Credit Suisse AG
Last data point: December 12, 2012

Figure 2: Hard-currency spreads in basis points since last EM Monthly



Source: Bloomberg, Credit Suisse AG
Last data point: December 12, 2012

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Setting sail into a brave new world

As we approach the end of the year, we would like to focus on the broader picture in terms of our market outlook and strategy for 2013 and to highlight areas where we see opportunities and others where we see risks. The strategy for 2013 should really be viewed in the sense of how we want to be positioned going into the new year and how to tactically adjust this strategy to changing conditions since surprises to the downside or upside are sure to occur.

We would argue that we enter 2013 with marginally less event risk than a year ago. China's economy didn't crash, but has landed softly and is already rebounding gently. No country has exited the euro zone, and we believe that none will do so in the year ahead. In this context, the ECB has succeeded in stabilizing the euro-zone sovereign debt market even though the region remains mired in a recession. US consumer spending remains supported by a recovering housing and job market. However, the US fiscal cliff remains an outlier because both sides of the aisle are still fairly far apart on the issue. Unless one side softens its stance in the next few days, the chances of temporarily going off the cliff are rather high. That sounds like some short-term volatility ahead of us, where sentiment will switch between risk-on and risk-off moods depending on the news flow. Nevertheless, the last move should be upward because we believe that a compromise will be reached eventually since neither the Republicans nor the Democrats want to send the US economy into a recession.

We expect that 2013 will be another year of modest global economic growth, with sizeable divergences between regions and countries. Our Investment Banking (IB) colleagues forecast global GDP growth of +3.4% in PPP terms for 2013, close to the 20-year average. Eighty percent of the growth is expected to come from the EM world. The sell-side consensus view is around the same level. Having said that, we, the buy side, have to be aware that these expectations have a wider margin of uncertainty than usual given the looming fiscal-cliff impact. Revisions to global GDP (up or down) are the most likely outcome once we have clarity on what will happen to the US budget in 2013.

Faced with this mediocre growth outlook, major central banks are forced to continue to rely on synchronized monetary expansion, with tightening not until 2015 in the USA and most likely even later in Europe and Japan. Our belief in more monetary stimulus rests simply on the view that central banks have taken a pledge to keep the economy above stall speed because they are aware that once growth hits that level, you are pushing on a string. By and large this means that more money will be injected if needed and monetary policy will become more open-ended and more unconventional over time – and hopefully will become more effective. Such a monetary landscape leaves us with a Japanese-style interest-rate environment for years to come accompanied by higher prices, because we do not want to challenge Milton Friedman's theory that inflation is a monetary phenomenon. In summary, negative real interest rates will likely define our investment landscape for years.

The world described above leaves us with a low-growth environment, some cyclical reacceleration in 2013, ultra-low interest rates, higher liquidity, higher inflation and less tail risks. So that is why we think 2013 could mark a transitional year for the capital markets that will see a structural shift take place along the risk curve away from safe-haven assets and into riskier assets. Our core asset allocation is therefore bullish on equities, credit and emerging-market exposure, and bearish on core-market bonds and cash. One thing is for sure: higher returns will not come without volatility, but investors should start to ask whether they are getting properly compensated for bearing these market swings. We think they will. In fact, that was already the case in 2012, as Figure 3 on the next page shows. Investors have reached out along the risk curve, and higher volatility has paid out accordingly. Once these feedback loops start to gain momentum, we should see more investors shift their assets into the riskier space. To conclude, we expect a good year for markets, but one still with long risk-off moments. Trading these large potential swings will be one of the key challenges.

What are the larger 2013 risk/reward scenarios for our expected world of low growth, low rates and higher asset prices next year? We think there are four major things to keep in mind:

1) The lesson of the previous three years is that market pressure has the power to overcome potential political gridlock. Whether intentional or not, it appears that policymakers have made a habit of creating deadlines to force themselves to act. This has often resulted in severe market volatility around those decision dates. Hence, one lesson from that is that market pressure has been an important mechanism for reaching compromise. Unfortunately, these past events also show that risky assets have to sell off sharply before policymakers can justify the need to take action to the public. It is therefore crucial to be active in terms of risk management and to buy protection when it is cheap while selling it when everybody wants to own it.

2) Capital spending by corporates will be a more important economic variable to watch next year. The cause behind this year's weakness is not straightforward. It was most likely caused by fiscal uncertainty, though the evidence is not so clear. We should keep a close eye on that and see if this weakness is reversing or whether soft capital expenditures are more fundamental and will not go away for some time. If that happens, economic growth could be at greater risk than broadly believed.

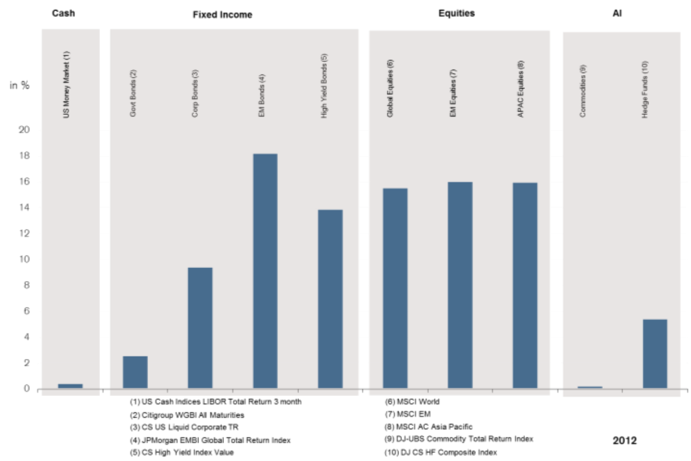
3) Economic growth could come in higher than expected. From the current standpoint, this might be a positive development, but it could have a huge impact on the financial markets. If economic performance validates central banks' success in their battle against deflation, our base-case scenario outlined above, which foresees ultra-loose monetary policy for at least another two years, would be at risk. In such a scenario, we would most likely see an accelerated flight out of fixed-income investments – not just core-market bonds – and into real assets such as equities.

4) China has become a real swing factor for economic growth. Over the last five years, global growth has been heavily China-dependent and China's growth has been strongly investment-dependent. In all, China's GDP growth will account for almost forty percent of global growth in 2013 and even more including China's economic expansion spillovers to other countries. Since China's economy is transitioning to a slower growth path due to a lower share of investment spending, we have to expect bigger-than-usual cyclical swings, particularly to the downside, which will have larger ripple effects for the global economy. So China's economic performance is a key factor to watch. For now, we think – as highlighted many times in the last few months – that the current mini-cycle is pointing upward and not down. GDP growth for 2013 should be slightly higher than in Q3 2012 even though the sell-side consensus forecast of 8%-plus growth might be a bit too optimistic. However, if our assumptions are wrong and growth comes in lower than expected, it will have a large impact on global growth and financial markets.

None of the above scenarios are our base case, but are nonetheless legitimated.

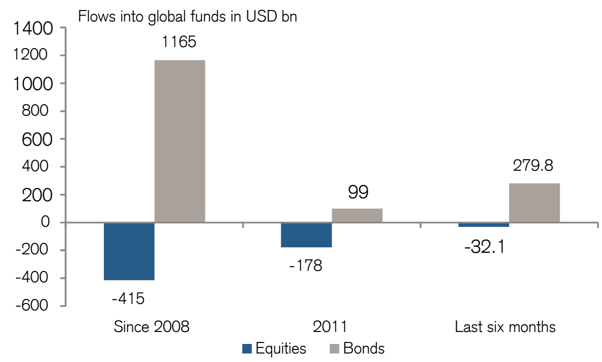
Where does that leave us with our current positioning? We want to be long risk going into 2013. With the quality/risk trade having gone on for so long and having become so extreme, the relative pricing of safety and risk have also become extreme. Risk attributes have become cheap and safety attributes very expensive. And this is reflected in the positioning of the big investor crowd (Figure 4), which is long liquidity and safety, but still short of confidence. Since central bankers have increasingly eliminated tail risks around the globe, we think that valuations are starting to matter again. Less risk coupled with a huge valuation gap is quite a powerful mix for risky assets and emerging markets, in our view. We still expect the "risk-on/risk-off" environment to linger, but believe that the traditional safety of bonds now offers even less upside and more downside and higher-beta investments more upside thanks to central banker puts regarding asset markets. In light of the near-term uncertainties due to the fiscal-cliff debate, we are not extremely long risk, but have added some beta via our EM country allocation.

Figure 3: Risky assets outperformed



Source: Bloomberg, Credit Suisse AG
Last data point: December 12, 2012

Figure 4: Out of equities and into bonds



Source: EPFR, Credit Suisse AG
Last data point: December 1, 2012

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Equities

Growth finally matters again

Overview

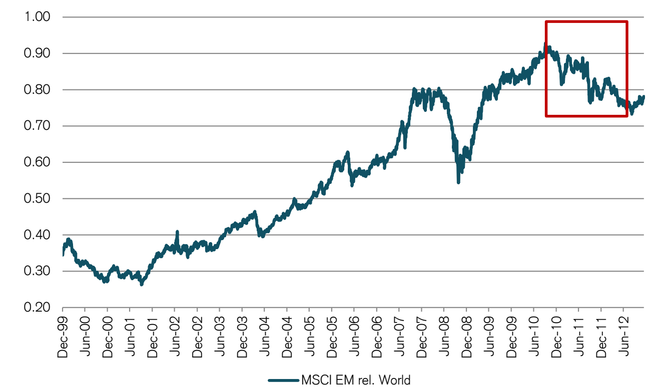
- Further confirmation that economic activity in Asia is bottoming out and exhibiting reacceleration tendencies.
- The regional performance differences underpin our strategy of continuing to overweight Asia and especially China.
- Continued positive outlook for emerging-market stocks – weighting of China particularly increased in view of upside prospects.

Less risk, more risk appetite

EM equities have underperformed the MSCI World over the past two years (Figure 5). We would argue that this stems on one hand from the deteriorating growth/inflation mix that started in 2011 and on the other hand from a very fragile global environment with heightened systemic risks in the developed world. Investors therefore preferred to stay in the core markets where they "only" had to deal with the issue of systemic risk. We expect 2013 to prove more positive on this front. The recent developments in China are a game changer, in our view. Three consecutive months of positive readings from a broad range of leading indicators should separate the objective observers from the China perma-bears. Retail sales, industrial output, the money supply, investment spending, housing prices and the official purchasing managers' index have all climbed higher (Figure 6). Furthermore, the HSBC flash purchasing managers' index has now also ascended above the expansionary threshold of 50 for the first time since November 2011. Meanwhile, inflation has stayed low and bank lending volume has surprised on the upside. From a sentiment perspective, we also note a marked difference compared to 12 months ago because many issues in the EU and USA are now much clearer. Most of the credit for this decline in risk goes to the core central banks, which have removed tail risks from equities by rolling out various easing policies. On the bottom line, we consider the fundamental drivers of EM equities to be supportive and see further potential for an outperformance, particularly at the beginning of 2013. Liquidity is ample and valuations are attractive.

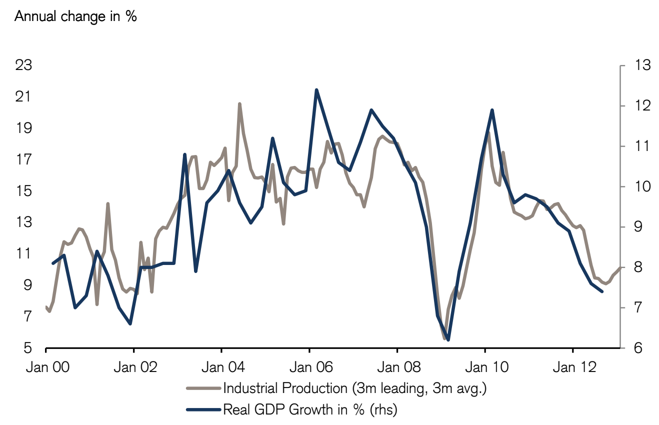
In fact, EM equities, as expected, have outperformed since our last EM Monthly. We are now talking about three consecutive months of outperformance relative to the MSCI World. Market sentiment appears to have changed to the effect that investors now seem to prefer to take on exposure to emerging economies in light of the political uncertainties in the USA ("fiscal cliff") and Europe (Greece and Spain).

Figure 5: EM equities have started to outperform



Source: Bloomberg, Credit Suisse AG
Last data point: December 12, 2012

Figure 6: Chinese manufacturing has clearly bottomed



Source: Bloomberg, Credit Suisse AG
Last data point: November 30, 2012

At the regional level, we are sticking with our Asian bias. Asia has been exhibiting a distinct outperformance versus the EMEA and LatAm regions ever since China started reporting strong economic data. China's high growth is a very powerful growth pole for the rest of Asia, so much so that the rest of Asia's aggregate exports to China are now bigger than to the USA and EU combined. And the market is obviously willing to pay for growth, and we think that the growth gap between Asia and the other EM regions will first widen and only start to narrow in mid-2013 once the LatAm and EMEA regions start to rebound as well. Moreover, valuations in Asia remain undemanding and the market is currently expecting implied earnings growth of around 5%, which we would argue is too low. Earnings momentum has turned positive for Asia while we still see negative momentum elsewhere in the EM space (Figure 7).

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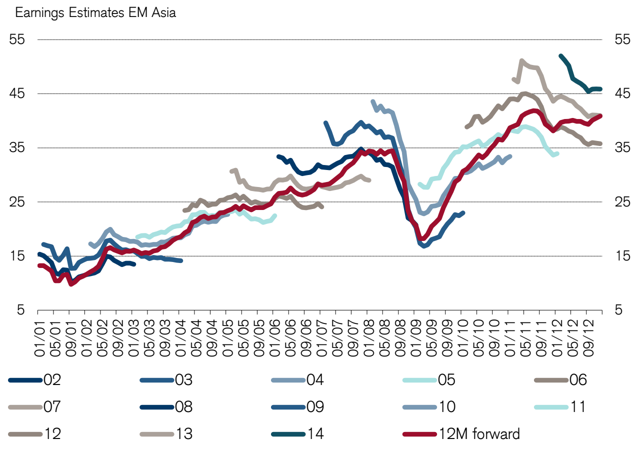
Figure 7: Earnings forecasts in Asia have bottomed



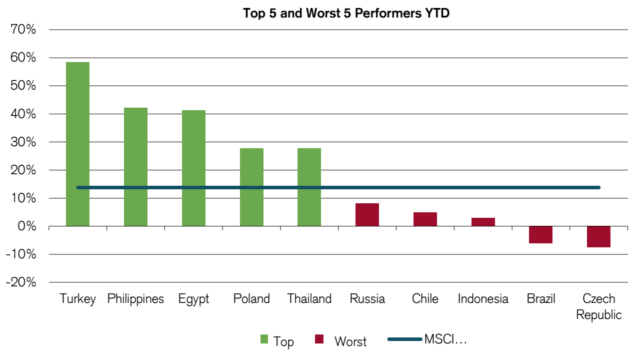
Source: Datastream, IBES, Credit Suisse AG
Last data point: December 7, 2012

Figure 8: Country and regional allocation

	Overweight	Neutral	Underweight
Asia	China India South Korea Philippines Thailand	Malaysia Taiwan	Indonesia
EMEA	Turkey	Russia Czech Republic Poland Egypt	South Africa
LatAm		Brazil Chile Colombia Mexico Peru	

Views as of December 14, 2012
Source: Credit Suisse AG

Figure 9: Wide performance gaps in 2012



Source: Bloomberg, Credit Suisse AG
Last data point: December 13, 2012

As for our country allocation, we believe that the current market phase is a good time to add to risk and to rotate further out of quality for stronger equity-market gains in 2013.

In Asia, we haven't materially changed our country allocation. Our **China** overweight remains a key call and is working. In sum, we think that Chinese equities are likely to continue to rerate as incremental policy loosening and an increase in global risk appetite exert their impact despite structural imbalances. The leadership transition offers new hope for incremental reforms to sustain economic growth and could thus spark a possible market rerating. We see a good chance that the MSCI China index can break out to a new high. We are staying mildly overweight in **Korea**. Economic indicators have started inching upward in Korea. November exports showed a consecutive better-than-expected bounce, which seems a welcome sign given Korea's diversity of export markets. In particular, trade and manufacturing conditions are improving, further supporting our view that conditions will stabilize going into 2013. Korean equities should be further supported by aggressive domestic pump-priming and easing measures in the wake of the election. Valuation-wise, the MSCI Korea index is trading at a 12-month forward P/E of 8.5 times, 1.3 standard deviations below its five-year average. Its relative valuation versus the Asian region is also 1 standard deviation below the average. We are adding to our overweight in **India**. Indian policymakers announced market-friendly reforms back in September. Though widely anticipated, they are a welcome achievement. The steps announced thus far are moderate – opening the retail sector to foreign investors, mild reform of energy subsidies. But new reforms are now on the agenda, and there is hope that some of the structural bottlenecks impeding growth can be removed. At the same time, we think that valuations work in favor of the country and that the announced reforms should spur capital inflows. This should support the rupee and ease the RBI's inflation/growth/currency "trilemma".

Within the ASEAN region, we remain neutral on Malaysia, which we downgraded last month. The market's low beta does not appear to jibe with our outlook for 2013. Moreover, we would discourage investors from seeking protection in the Malaysian market because high valuation is a risk in and of itself. But the key market risk for Malaysia is the upcoming elections there. Malaysia will head for the polls in 2013, with April 28 being the deadline for dissolving parliament. We believe that investors will prefer to wait for the political uncertainties to clear before committing fresh money. We are staying overweight in the **Philippines**. We are impressed with the country's economic performance, and we think that unlike in Malaysia, the runup to mid-term elections will be favorable.

Accelerated government spending and stable domestic demand will lead to further GDP upgrades in the months to come. In **Thailand**, we are holding on to our overweight. We remain concerned that the strong fiscal spending there could translate into domestic inflation and could affect monetary policy, but we think it is too early to neutralize our country call. We upgraded **Taiwan** to neutral due to its cyclical exposure and the bottoming in earnings revisions. **Indonesia** remains underweighted. The political environment will probably heat up next year ahead of the 2014 elections, and we see a growing risk of a policy impasse that could further restrict investment. This is likely to add pressure to Indonesia's already weakening external position and thus puts a question mark behind the country's quest for an investment-grade rating.

Within the EMEA region, we are sticking with our key overweight, **Turkey**. Who would have believed at the beginning of 2012 that a country from the EMEA region would be the best-performing market in the EM space? We did not, but we nonetheless were overweight in the Turkish market for most of the year, and we continue to see outperformance potential. The market rallied strongly after Fitch upgraded Turkish long-term foreign-currency debt to investment-grade status for the first time since 1994. The move by Fitch is by no means central to our constructive view on Turkish equities, but it does reinforce our positive view. In sum, we think that Turkey is in the right stage of the cycle to allow monetary policy to support growth, and the distance to Europe is reflected in the earnings upgrades. In addition to the cyclical outlook, there is also a strong secular element here. Turkey is the most classical EM story in the EMEA region in terms of demographics and the rising middle class. **Russia** stays at neutral, but an upgrade is looming. Given Russia's solid macro environment, the high Brent oil price and depressed valuations, we believe that the Russian market should start to outperform in the foreseeable future. Furthermore, Russia is one of the most underowned markets in the EM space and has underperformed of late.

In Latin America, we are sticking to a neutral country allocation. The region has continued to show distinct weakness caused by the country heavyweight **Brazil** – the worst EM market in 2012. Brazil's bad performance is mainly related to the poor economic growth there. Brazilian economic growth has been unimpressive. Brazil was the slowest-growing BRIC country in both 2011 and 2012. Although our IB colleagues forecast a recovery in growth to +4.0% in 2013 as interest-rate cuts should stimulate investment, we would first like to see some evidence in terms of leading indicators. Having been underweight in Brazil for most of the year and lately with a neutral position, we feel comfortably positioned. However, with China in a recovery mode, we are monitoring relative performance closely and stand ready to act.

Fixed Income
Lingering demand for positive real yields

Overview

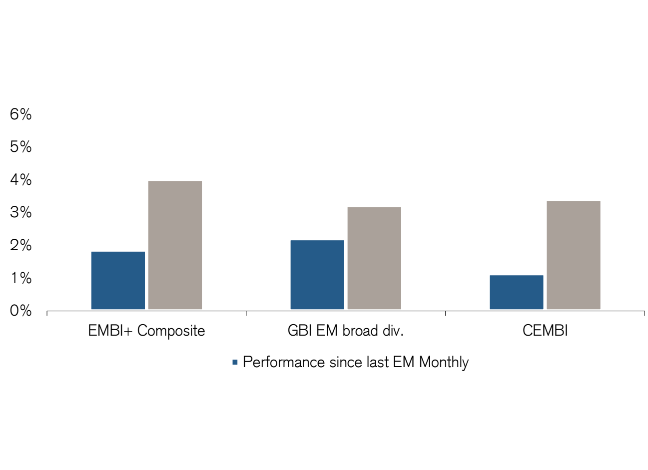
- The dearth of investment opportunities make a case for investing in EM local-currency bonds.
- EM FX will most likely be the key performance driver for EM local-currency bonds in 2013.
- We prefer those EM bond markets where monetary policy has the most flexibility.

Just a pause in the rally

Since our last EM Monthly, EM bonds have risen once more, with returns of +1.9% for hard-currency debt and +2.2% for local-currency debt (see Figure 10). With financial markets globally moving slowly into a risk-on mode, EM bonds have significantly outperformed their core-market peers. On a year-to-date basis, EM hard-currency bonds have by far been the best-performing asset class with a return above +18% (EMBI+ index). The local-currency segment in USD is also near the top of the league table with a performance above +15% (GBI EM index) These impressive numbers are a perfect example of what is going on in the financial world. Investors are getting repressed by central banks and are forced to move farther out along the risk curve. With the US Fed, the ECB and the BoJ adding liquidity to the global economy to reduce prevailing tail risks, EM bonds have popped up on the radar screens of investors searching for yield combined with a modicum of safety. Since yield-sensitive investors have been priced out of core government bond markets given their negative real yields, the price of reasonable close substitutes has been bid up dramatically. Nominal yields on investment-grade corporate bonds in the USA have reached record lows, and the collapse in real yields is even more dramatic (Figure 11). In other words, the search for yield has driven value out of assets that are reasonably close substitutes for safe-haven investments (Figure 12). The EM hard-currency space is one of them given the improvements in local fundamentals and the central-bank put for the underlying yield curve. We certainly do not see an end to this shift and expect EM sovereign and EM hard-currency corporate bond yields to reach new record lows as investors move out along the risk curve. In other words, we are staying overweight in EM external bonds versus core markets.

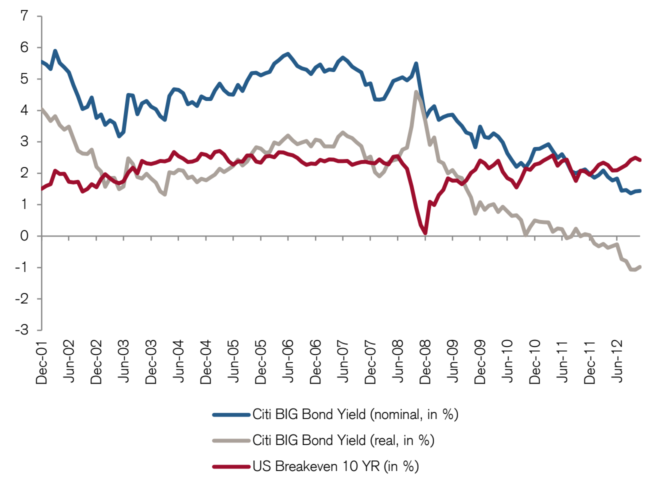
However, we would like to add a word of caution. We have recently heard many comments from sell-side analysts that EM sovereigns look set to become the new flight-to-quality trade due to EM countries' strong balance sheets and net external creditor positions. Of course, we acknowledge the accomplishments that those countries have achieved over the last 20 years. After having been plagued by some painful defaults in the 1990s, emerging-market countries did their homework over the last decade and have significantly cleaned up their act. Many emerging-market countries have implemented sound fiscal and monetary policies. This has resulted in a structural improvement in creditworthiness and has served to considerably reduce the historically high volatility of emerging-market asset values. Sovereign debt has been systematically reduced, and the debt ratios of most EM countries are now well below the European guidelines outlined in the Maastricht Treaty (Figure 13). However, EM sovereign bonds should still be considered risky assets. The dearth of investment opportunities in the core bond space is the reason why they are trading today at record-low yields and super-tight spreads. In other words, EM sovereign bonds are less a flight-to-quality trade and more a flight to positive real interest rates, and this consequently brings higher volatility – for which you should get compensated over time.

Figure 10: EM bond performance



Source: Bloomberg, Credit Suisse AG
Last data point: December 12, 2012

Figure 11: Negative real yields on investment-grade corporates



Source: Bloomberg, Credit Suisse AG
Last data point: November 30, 2012

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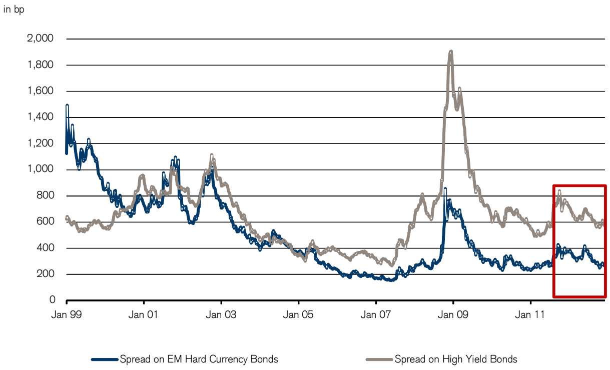
Given the basic scenario described in the first part of this publication, we see no major obstacles getting in the way of this aggressive search for yield in the months ahead. We therefore continue to overweight the EMBIG and CEMBI going into the new year. As long as the tail risks discussed above remain under control, we expect to see strong capital inflows into emerging markets. Liquidity at the global level remains abundant, and there is a great sense among the EM investor community that more assets need to be put to work. In other words, the flow backdrop is quite supportive. Looking ahead, double-digit returns are unlikely to recur in 2013 for the hard-currency segment given the more limited room for spread tightening and no further interest contraction in the US Treasury segment.

From a near-term perspective, EM hard-currency debt appears to be the least sensitive of all EM asset classes in the context of the potential temporary uncertainties that loom from a "fiscal cliffhanger". Hard-currency debt could therefore even do well in the context of heightened uncertainty about the direction of policy in the USA. We recommend an overweight stance on Russia and Turkey, and underweights in Hungary and South Africa. Nevertheless, we think that the more interesting, albeit also the more volatile, way is to add domestic EM debt.

Going into 2013, we strongly believe that the EM local-currency segment will outperform the hard-currency segment throughout the year – of course accompanied by higher volatility. We expect spot FX to replace duration as the key driver of local debt performance because EM yields overall are down to their lowest level since 2003. It's worth adding that they still pay a 4.5-percentage-point premium over US Treasurys (Figure 14). But from the perspective of central-bank action, we do not expect major support for the local-currency space. In contrast, the outlook for EM FX overall is more constructive as growth expectations for emerging economies increase, and we expect EM spot FX to contribute positive returns next year as opposed to this year, which saw a flat contribution. As depressed global trade and capital flows are lifted by the better growth prospects that we expect, the combination of spot gains and carry should push total returns toward low-double-digit territory. Local currencies could also benefit from a likely rebalancing of the global flow of funds, which in 2012 was largely skewed toward fixed-income funds.

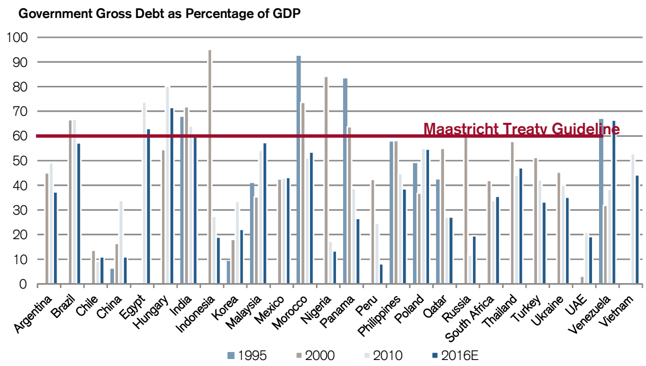
Regionally, we believe that LatAm has the most to benefit from the recovery in China and the USA. Within the LatAm region, Mexico is our preferred market given its close links to the USA. The MXN has now corrected slightly, and given its high correlation with risk-on/risk-off appetite swings, it would very effectively capture the changes in global market sentiment resulting from the evolution of the US "cliff" risk. Brazil continues to look attractive from a carry perspective. The pickup in economic momentum also makes a strong case for RUB bonds. The valuations of TRY and PLN bonds also look appealing. In Asia, our favorite local bond markets are CNH and PHP, where valuations remain very supportive.

Figure 12: The search for yield drives investors farther out along the risk curve



Source: Bloomberg, Credit Suisse/IDC
Last data point: December 6, 2012

Figure 13: Healthier EM sovereign debt ratios



Source: IMF, Credit Suisse AG
Note: Data for 2016 are IMF estimates

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Figure 14: Attractive yield differential between EM local-currency bonds and US Treasurys

Source: Bloomberg, Credit Suisse AG
Last data point: December 12, 2012

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Foreign Exchange (FX)

2013 – The start of more nominal appreciation?

Overview

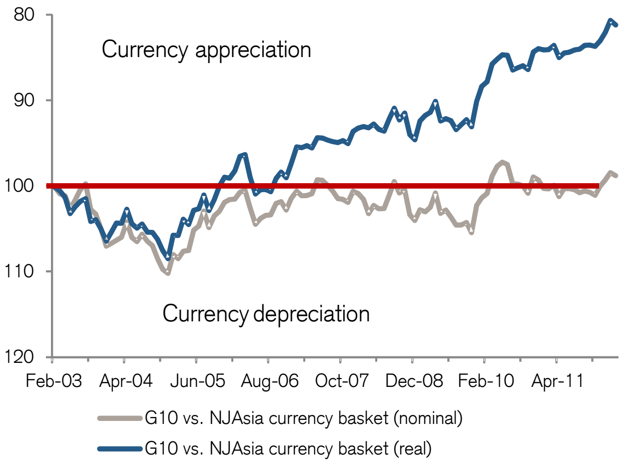
- QE will eventually have a negative impact on the USD once the "fiscal cliff" fears are behind us.
- Valuations look more appealing, particularly amid an environment of improving sentiment.
- We expect the environment going forward to be far more favorable for nominal currency appreciation.

More liquidity should be negative for the USD

The rational conclusion drawn from unlimited QE in the USA would argue for a double-whammy negative impact on the USD. First, more of the same tends to lower the price. Second, QE tends to foster a risk-on mood that eventually helps to ensure a weaker USD and stronger EM currencies. While the first effect currently holds true, the second effect has not materialized yet for obvious reasons (fiscal cliff). However, like previous rounds of QE, we believe this will eventually contribute to a weaker USD once the US cliff discussion is behind us. Increases in risk appetite are typically correlated with episodes of a weaker USD. We see no reason why this episode should be any different. An additional point worth emphasizing is the reemergence of the carry trade, which is symptomatic of periods during which risk is well supported. The combination of G3 easing and persistent growth concerns creates a favorable backdrop for USD-funded EM carry trades. But we would argue that we are likely to see a more secular appreciation of some of the stronger EM currencies in 2013 and beyond that will stem from a different approach to currency policy.

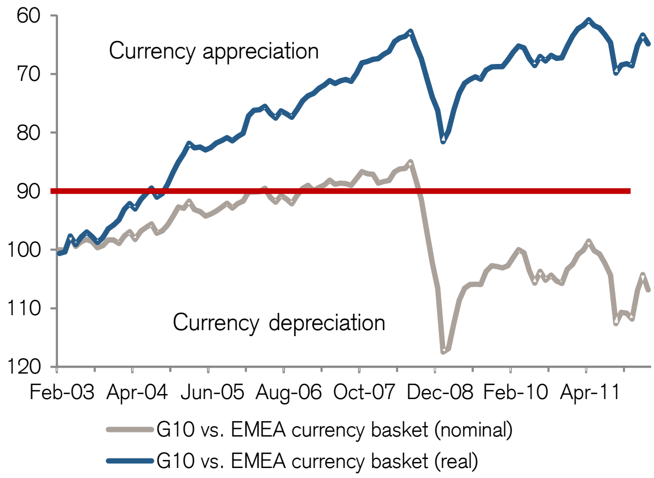
The three graphs below illustrate that the relative price appreciation in all three regions has been largely accounted for by higher rates of inflation. We do not believe that this will be sustainable as a framework for policy over the next few years. We believe that many emerging-market countries will be more willing to allow a greater degree of nominal appreciation of their currencies as an instrument for combating inflation. Our argument rests on the view that many of the larger countries are switching their growth driver from exports and investment to domestic consumption. To be sure, this process is slow and will take at least a decade, but most countries have already begun the transition process. In such an environment, managing a nominal exchange rate lower is far less critical than managing domestic inflation. Raising interest rates to control inflation will have a far more adverse impact on domestic consumption than an appreciating nominal exchange rate. In particular, we believe that non-Japan Asia will be where the change of policy will first take place.

Figure 15: Non-Japan Asia effective exchange rate



Source: Datastream, Bloomberg, IMF, Credit Suisse AG
Last data point: September 30, 2012

Figure 16 : EMEA effective exchange rate



Source: Datastream, Bloomberg, IMF, Credit Suisse AG
Last data point: September 30, 2012

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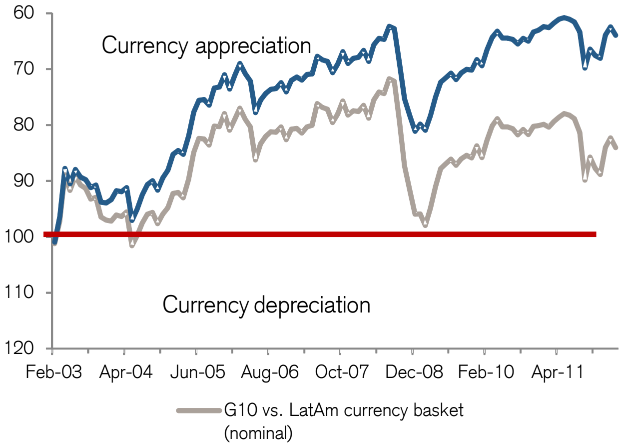
Figure 17: LatAm effective exchange rate



Source: Datastream, Bloomberg, IMF, Credit Suisse AG
Last data point: September 30, 2012

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