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Investment solutions for troubled times

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This month

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Editor's letter

This edition of Thinking Ahead will focus on investment solutions for troubled times. With a spreading European debt crisis, troubling inflation data from China, enormous public debt in the US and the soaring price of gold, the world economy is threatening to slip back into recession: investors question the future of the global economy and are looking for higher levels of diversification.

There are now a few more factors to consider before deciding where to put money and even to think whether capital protection or return should be the main priority. In times of uncertainty, successful investment requires discipline. Now more than ever it is important to take the bad with the good as volatile times are still filled with opportunities. Innovative trading approaches can offer an optimal allocation based on a risk-return profile and efficiently manage the risk of portfolios.

Yours,

Jaime Uribe
Co-Head of Financial Institutions Marketing,
Equity Markets & Commodities

The future is not what it used to be

PETER DIXON
GLOBAL EQUITIES ECONOMIST

The physicist Niels Bohr once remarked that '*prediction is very difficult, especially if it's about the future*'. This is all the more true when the environment in which we are operating has become unstable. Indeed, many of the assumptions upon which investors' views of the world are based have been called into question by the events of the past two years. Bearing Bohr's caveat in mind, we nonetheless sketch out some of the issues which investors will have to be aware of in the coming years.

THE PARADOX OF THRIFT ...

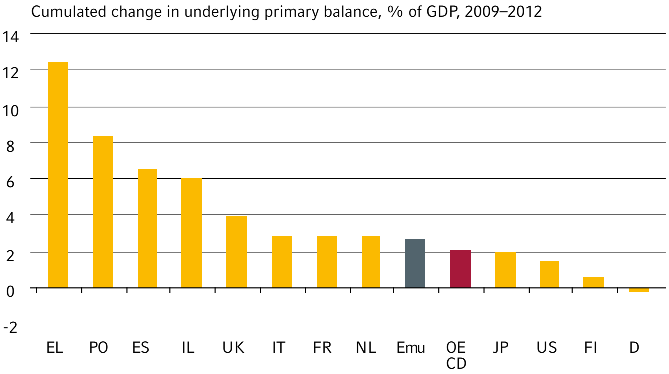
In many respects, the risks associated with the global macro environment today are greater than at any time since the 1930s. At the heart of the uncertainty is the deflation of a 20-year debt boom which in many ways is reminiscent of trends in Japan during the 1990s. We have long been persuaded of the case that the Anglo Saxon economies have experienced – and are perhaps still in the throes of – a balance sheet recession. Of course, it is not just the Anglo Saxon world which is experiencing this problem. Eurozone governments and financial institutions are also engaged in a bout of deleveraging. One of the key features of such a recession is the emphasis on debt minimisation with the result that monetary policy becomes ineffective, and the economy will only begin to recover when balance sheets have been sufficiently repaired.

The conventional view is that Japan experienced precisely this kind of environment during the 1990s, which produced a lost decade of economic stagnation and deflation. More worrying is that this is the fate which awaits the industrialised world. This would be to over-simplify the debate. As noted, there are a number of parallels with Japan in the current conjuncture across the industrialised world, although there are also many differences. The key lesson from Japan, however, is that in a world of private sector deleveraging, the government has a key role to play in keeping credit flowing.

One expert on recent Japanese economic history is Adam Posen, currently serving on the BoE's Monetary Policy Committee. He has consistently highlighted that Japan's lost decade was the product of policy mistakes and that '*we should think of Japan's Great Recession as largely demonstrating the validity of much textbook, even old fashioned Keynesian, macroeconomics*'. Richard Koo, chief economist at the Nomura Research Institute and a respected analyst of Japanese problems over the past two decades, argues that Keynesian policy prescriptions are required and '*the government must borrow and spend the savings generated by the deleveraging in the private sector in order to keep the economy from entering a deflationary spiral*'.

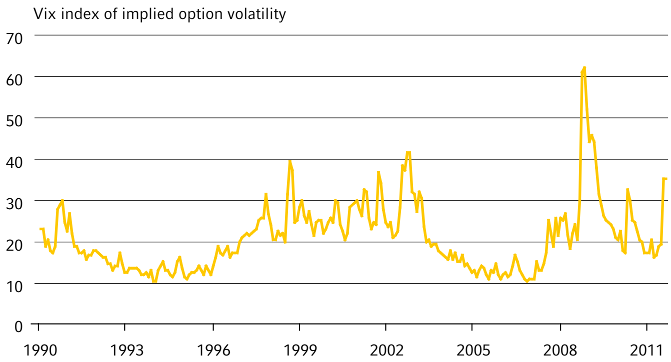
One of the problems which the global economy faces is an uncoordinated tightening of fiscal policy, as individual countries attempt to implement policies which are believed to be in their own national interest. Unfortunately, the cumulated effect of such efforts results in a degree of global tightening which has adverse consequences for growth – a phenomenon described by Keynes as '*the paradox of thrift*'. As Chart 1 shows, the degree of fiscal austerity being implemented across a range of OECD countries is significant. Between 2009 and 2012, the OECD estimates that the Eurozone will implement fiscal tightening equivalent to 2.6% points of GDP (based on the underlying primary balance which excludes the impact of cyclical effects or interest payments). This implies around EUR250bn of activity being taken out of the economy over a three year period and, other things being equal, will subtract around 0.3% points per year from Eurozone real GDP growth.

Chart 1: How much is too much?



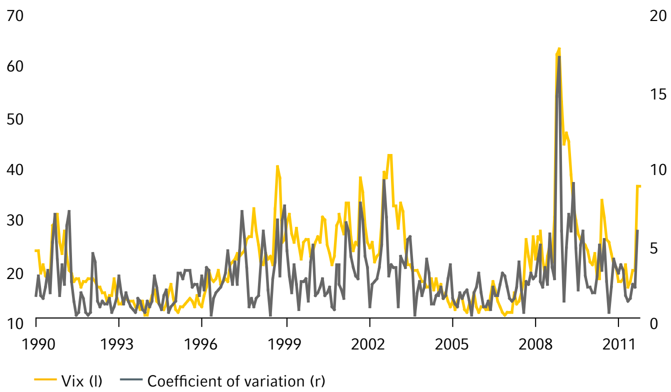
Source: OECD

Chart 2: Equity vol is high but well off post-Lehman levels



Source: Bloomberg

Chart 3: A proxy for the Vix



Source: Bloomberg, Commerzbank Research

PD
Ordinary Least Squares
Monthly data for 260 periods from Jan 1990 – August 2011
Date: 14 September 2011

Vix

= 2.62456 * 100*cv + 14.1485
(13.5626) (22.2215)

Sum Sq	10390.7	Std Err	6.3462	LHS Mean	20.9365
R Sq	0.4162	R Bar Sq	0.414	F 1,258	183.944
D.W.(1)	0.6137	D.W.(12)	1.4402		

… ALLIED TO LACK OF CLARITY ON THE EUROZONE

The problems associated with fiscal tightening lie very much at the heart of the concerns surrounding the Eurozone. There is a widening rift between the more fiscally profligate members of Emu and the more prudent core members, who are being asked to stump up an increasing amount of liquidity to secure the financing needs of the periphery. Not surprisingly, this has considerably raised the political temperature within the Eurozone. The basic problem is that creditors are demanding that debtors make sacrifices before the funds are made available, but such is the magnitude of the problem that fiscal sacrifices will make little impact upon the extent of the black hole in public finances. In these circumstances, the Eurozone is highly dependent upon the support provided by the ECB, in the form of liquidity injections to the banking system and via the direct purchase of bonds of key peripheral nations.

Unfortunately, these solutions have met with considerable criticism, particularly in Germany where the received wisdom is that the central bank's role is only to ensure price stability. Tensions have been heightened by the resignation of two senior German officials from their ECB posts. The situation can thus be summarised as a clash between economic orthodoxy and pragmatism, with the former being characterised by policies of sound money and balanced budgets, and the latter by doing everything necessary to preserve the integrity of the Eurozone. Economic history tells us that adherence to orthodoxy can be potentially ruinous. In the 1920s and 1930s, governments made many fiscal and monetary policy errors which culminated in the Great Depression. Japan's lost decade in the 1990s was also in part the result of policy errors. In fact, almost all episodes of economic crisis are made worse by inappropriate policy responses. We wait to see whether Eurozone politicians and central bankers are able to devise a set of policies which steers us away from the edge of the cliff.

… WILL PRODUCE ONGOING MARKET UNCERTAINTY

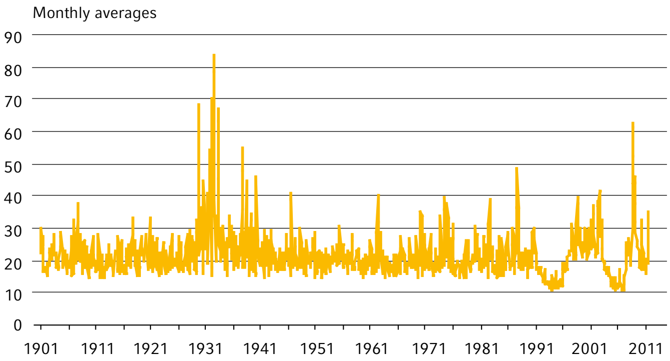
The prospect of a default by one of the Eurozone peripherals, or in the worst case, some form of breakup, is the scenario which causes investors to remain nervous. One way to measure market uncertainty is to look at measures of market volatility such as the Vix which tracks implied volatility in the US equity market. We only have data on this measure back to 1990 but the extent of spike in volatility in the wake of the Lehman's bankruptcy was unprecedented in recent history (see Chart 2).

In order to assess trends in volatility on a longer term horizon, we have constructed a volatility index which measures the coefficient of variation on the S&P500 back to the beginning of the twentieth century. We are encouraged that this is a good proxy for the VIX by the fact that there is a high degree of correlation between the two series over the past 20 years (see Chart 3). On the basis of this we have estimated a simple regression model to backcast how equity volatility traded throughout the twentieth century (see Chart 4). There is obviously a considerable amount of 'noise' in the series but in the wake of the 1929 Wall Street Crash, our index suggests that had an index of option volatility existed at the time, the Vix would have traded somewhere around 68, compared with levels in the vicinity of 62 in October and November 2008.

However, the real peaks in the series were registered in the spring and summer of 1932 when our implied Vix estimate spiked above 80. According to the BIS Annual Report for 1932 '*The year under review (April 1931 to March 1932) has been one of dramatic occurrences in the whole field of international finance, credit, monetary stability and capital movements*,' encompassing the collapse of CreditAnstalt in Austria and a sharp decline in sterling (then a major reserve currency). The impact of these events lingered throughout 1932, and it was the events of that year which prompted Franklin D. Roosevelt's famous inaugural address of 1933 when he reminded Americans that 'we have nothing to fear but fear itself'. A glance at our volatility estimate certainly confirms that there was a lot of fear around.

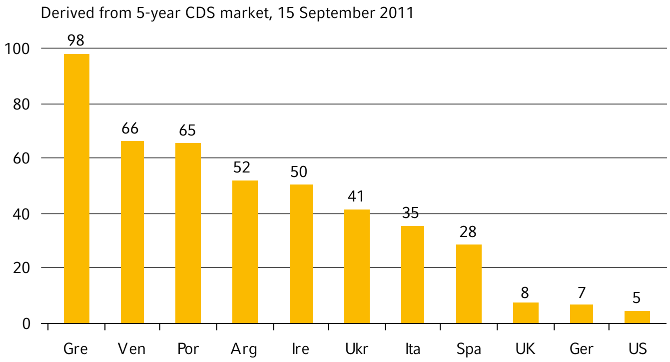
If history is any guide (and we would caution against extrapolating too much from past events) it is entirely likely that the after-shocks resulting from an initial event will continue to ripple through markets, which might produce a further sharp increase in volatility. Thus, in the same way that the after-effects of the 1929 crash unleashed a wave of market tension which broke in 1931–32, so the Lehman's default of 2008 may yet produce a major credit event in 2011–12.

Chart 4: Implied historical values for the Vix



Source: Commerzbank Research

Chart 5: Selected default probabilities (%)



Source: Bloomberg

WHAT MIGHT THAT EVENT BE?

The most obvious possibility at this time is some form of problem in the Eurozone. This might come about if politicians in the core Eurozone countries decide to cut aid to Greece[1]. This in turn would force Greece to default on its sovereign debt – an event which is already priced in the market (see Chart 5). In such an event, the government will be forced to nationalise the banks – as happened in Ireland – and the implications will ripple throughout the global financial system. Whilst the European banking system could probably cope with the immediate financial fallout of a 50% haircut on Greek debt, only reducing the core capital ratio from an estimated 9.4% to 8.6%, the bigger issue is whether there would be contagion risk.

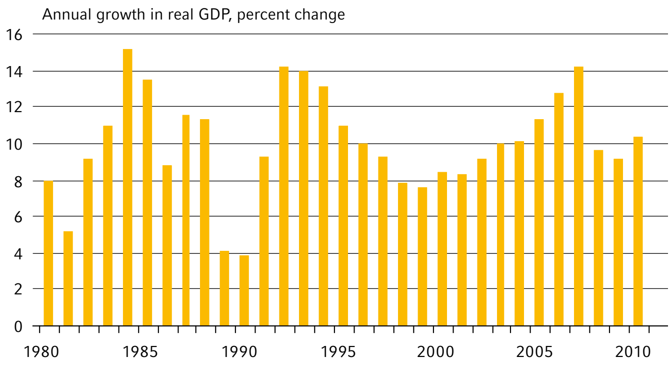
Portugal and Ireland could cope with a Greek default in the short-term since their funding requirements are being met by existing support arrangements until 2013. However, the market would doubtless be concerned about the prospect of a default by one or both of them on a longer horizon. Then there is the prospect that default risks could spread to Spain or Italy, both of whom remain reliant on the markets for funding. In the event that the markets continued to demand a higher premium to compensate for increased default risk (a self-fulfilling prophecy if ever there was one, since this would raise debt servicing costs and make it increasingly difficult to stabilise the debt-to-GDP ratio), this would require effective action to stem the problem. For example, the ECB may be required to step in to buy an increased volume of Spanish and Italian debt. Alternatively, the Eurozone may have to move towards a system of pooling risks, perhaps by issuing common euro bonds. As noted above, neither of these policies have found favour with the adherents to economic orthodoxy. In an environment where continued speculation about the future of the Eurozone remains in place, this will serve only to drive market risk measures ever higher.

But it is not only in Europe where there are major economic risks. There are not inconsiderable concerns that the Chinese economy may experience a harder landing than is currently anticipated. Our own view is that China is likely to experience a relatively soft landing[2]. But a number of factors such as monetary tightening, rising non-performing loans and power shortages all suggest that the risks to the outlook are non-negligible. Of course, a Chinese hard landing would likely be very different to a similar occurrence in the US or western Europe. The nearest we

[1] For a more detailed discussion see 'What would happen if the EU were to pull the plug on Greece?' *Week in Focus*, 16 September 2011

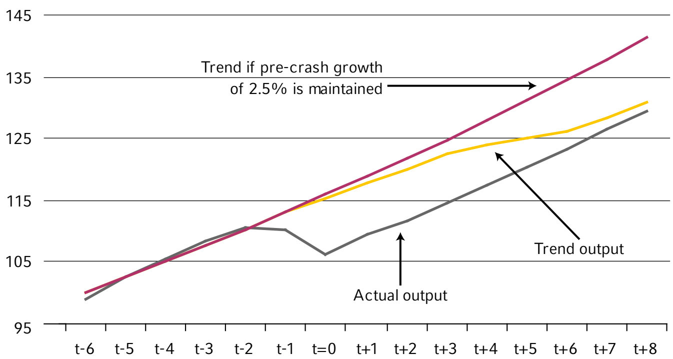
[2] See 'Is China facing a hard landing?' *Thinking Ahead*, July 2011

Chart 6: Hard landings are different in China



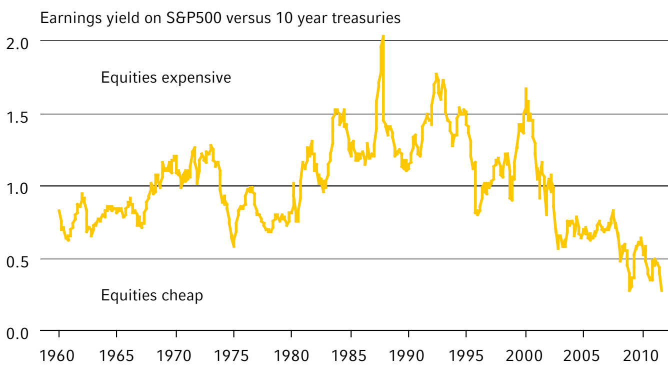
Source: IMF

Chart 7: Stylised representation showing how potential growth corrects following recession



Source: Commerzbank Research

Chart 8: Comparison of earnings yields shows equities undervalued versus bonds



Source: Commerzbank Research

have come to such an event in the last 30 years was the collapse in growth in 1989–90 to a rate of 4% (see Chart 6) and a growth rate of less than 5% would probably constitute a hard landing. Nonetheless, what appear to be elevated growth rates by western standards could still have a considerable impact on markets such as commodities, where the super-cycle is predicated on growth of at least 8% per year.

One other issue to consider are prospects for inflation. In a world in which growth is likely to be fairly sluggish in the years to come, are we likely to experience a low-inflation environment or should we reckon with a faster rate than we have recently become used to? Although slow growth might suggest that the overhang of spare capacity will bear down on inflation, this is far from certain. For one thing, if excess capacity is left unused for too long, it tends to be scrapped with the result that the rate of potential growth slows (see Chart 7). Consequently, the output gap tends to narrow in the medium-term even without an apparent pickup in growth.

Moreover, the forces acting on inflation are generally global rather than local. Throughout much of the last 20 years, global inflation has been held down as a result of the rise of Asia as a centre of production, notably China whose rise led to a massive increase in global productive capacity. But with Chinese inflation now relatively high, there is a strong possibility that this will be translated into faster rates of inflation in the industrialised world. In addition, strong emerging market demand for commodities has also made its presence felt in recent years. Even in the course of this year, approximately one percentage point of inflation in the industrialised world can be attributed to higher oil prices despite sluggish domestic demand. It is also likely that central banks in many highly-indebted economies would not be overly concerned about above-target inflation since this is an easy way to reduce the debt burden. Indeed, US and UK efforts to create liquidity in the past couple of years may yet feed into higher inflation in future.

SO WHAT SHOULD WE BE POSITIONED FOR?

Investor positioning is the product of a number of factors, such as risk tolerance, the investment horizon in question and limits on the instruments in which they can trade. Thus it is almost impossible to devise a generic strategy which will please all investors all the time. Nonetheless, we sketch out a few themes which may be worth considering on the basis of the ideas outlined above.

It seems almost inevitable that we should be positioned for a slow-growth world in the near future. On the surface, this might suggest a strategy of overweighting fixed income *vis-à-vis* equities. But much depends on the inflation outlook. After all, it is prices as well as quantities which are important in determining equity performance. Although the world growth outlook is likely to be very sluggish in the course of the coming years, we do not see this triggering a deflation scenario. On the contrary, in many parts of the world we see inflation being higher than anticipated due to a combination of global factors and benign neglect on the part of central banks. With fixed income markets highly overvalued, both in absolute and relative terms, a medium-term strategy of overweighting equities may well pay off. Indeed, as Chart 8 suggests, the yield on US Treasuries is well below the earnings yield on US equities – a relationship which over the long-term has tended to unity on average. Even allowing for the safe haven effect in the bond market at present, equities have not been this cheap relative to bonds for many a decade.

But supposing investors were to overweight equities. How should they play it? In the short-term, buying cyclical stocks may not be the best way forward, and instead there is a strong case for sectors which deliver decent dividend payments as a safety play. Further ahead, the low cost of capital opens the possibility for equity investors to look for cash rich companies hoping to embark upon M&A led growth. There are also geographical considerations to take into account. Investors will likely obtain better medium-term returns in markets such as the US and China due to better growth prospects, although relatively safe haven markets such as core Europe (notably Germany) also offer attractive valuations – particularly if one believes that the China bubble is about to burst.

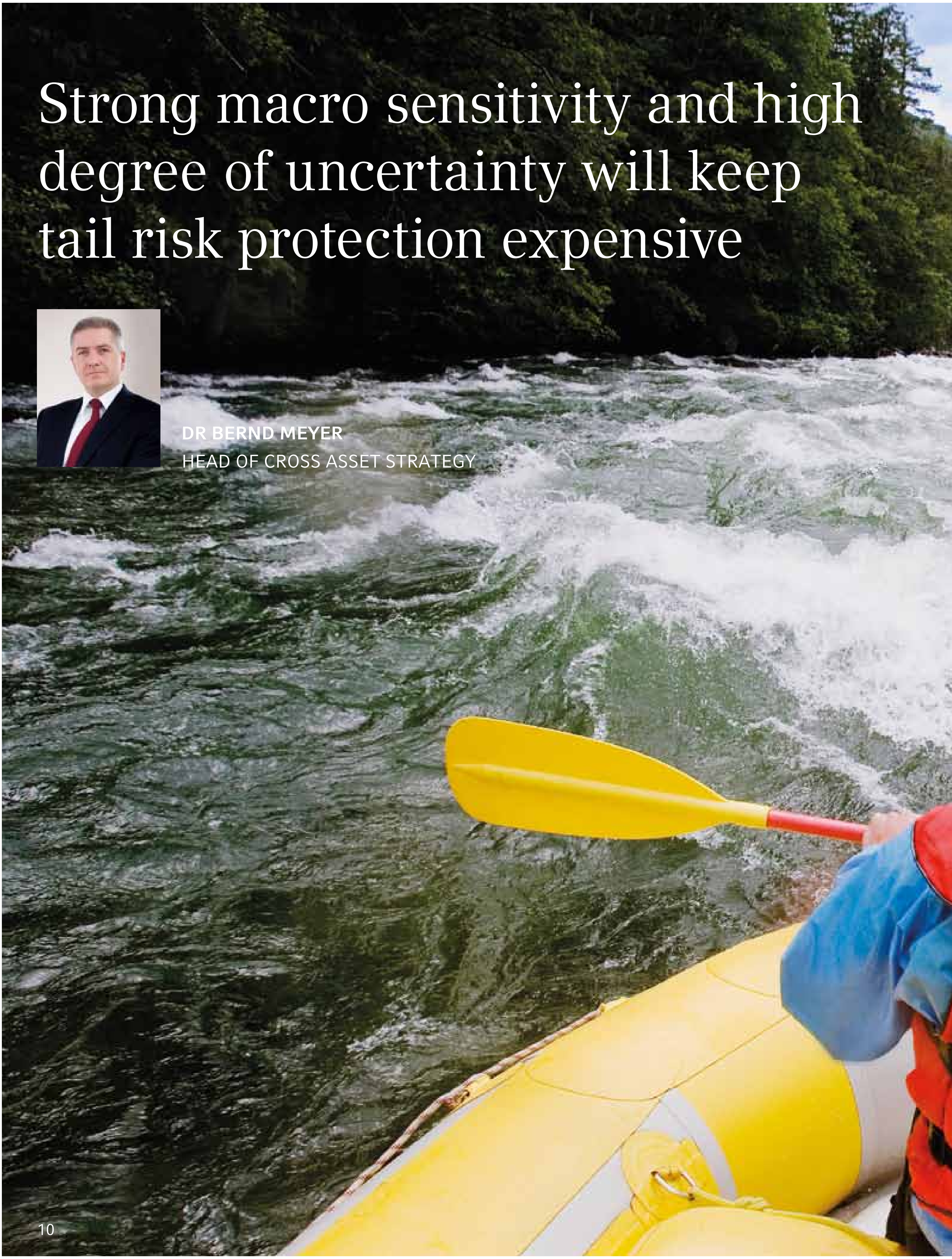
Investors also need to be aware of risks associated with spikes in market volatility in the event of a major credit event. Wise investors should think very carefully about how to hedge against the possibility of a sudden blip to unprecedented levels (refer back to Chart 4) and a whole range of option products are available to trade such positions.

There may also be a need for greater investor protection in the medium-term. Risk averse investors who do not wish to play high inflation via the equity market ought to consider looking at inflation-protected bonds which guarantee returns above the rate of inflation.

Finally, we look for the commodity space to continue generating decent long-term returns. However, depending upon prospects for China, there could be considerable volatility in industrial metals and oil in the near-term. But one commodity class which is likely to outperform is agriculturals. After all, people have to eat, and rising incomes tend to be associated with a change in diet, with rice being replaced by meat. The more meat people eat, the more cattle will have to be raised and the more grain the cattle will need. With physical space and environmental conditions to the fore, the price of these commodities is likely to continue rising in the medium-term.

In this article, we have simply tried to illustrate a few possible themes which are likely to be of relevance to investors in the years ahead. It is impossible to cover the full range of outcomes since the future has a nasty habit of surprising us. But just as we began by quoting Niels Bohr, so we end with a quote from another physicist to illustrate that however imperfect our analysis, it is better to be try and assess what might happen rather than leave the future to chance. For as Enrico Fermi put it, ‘ignorance is never better than knowledge’.

For further information, please contact:
peter.dixon@commerzbank.com



Strong macro sensitivity and high degree of uncertainty will keep tail risk protection expensive

DR BERND MEYER
HEAD OF CROSS ASSET STRATEGY

Limited ammunition for fiscal and monetary stimulus and the fact that slower growth or a recession would increase the likelihood of the western economies experiencing a fate similar to Japan should keep the market's focus on and sensitivity to macro data releases strong. With bond yields below 2% and rates close to zero at least until late 2013, is a Japanese-like fate avoidable for western economies? Our 'Roadmap to Japan' shows alarming parallels, but also several major differences that give hope for a better outcome this time around. The outcome though will remain unclear for some time to come. In addition, the uncertainty regarding the future of the Eurozone will remain considerable with the need for harsher decisions looming, even if politicians and the ECB avoid an open escalation of the crisis in the short to medium term. The high degree of uncertainty will increasingly weigh on economic activity and should keep tail risk protection expensive in all markets.

STRONG MACRO FOCUS TO PERSIST

Markets are currently more focused on and more sensitive to the macro news flow than in the past. True, you could argue that at the edge of a recession, markets are always strongly focused on macro data. However, we identify two further factors that are making markets more sensitive to macro data than has previously been the case when a transition into or out of recession appeared likely. First, ammunition available for fiscal and monetary stimulus to fight slowing growth is more limited. This could mean that a recession could be deeper and/or longer. Second, slower growth or a recession would increase the likelihood of the western economies experiencing a fate similar to that suffered by Japan over the last 20 years.

ON THE ROAD TO JAPAN?

Since the US housing market bubble burst, leading to the financial market crisis, it has repeatedly been asked whether western economies and the US in particular, are to suffer the same fate as Japan following its own asset price bubble 20 years ago. The Federal Reserve, in particular Ben Bernanke, has stressed time and again that one can learn from historical experience and avoid making the same mistakes. However, the Fed's recent pre-commitment to keep rates close to zero for two further years and Bund and Treasury yields at record lows below 2% have brought back doubts in this regard.

→

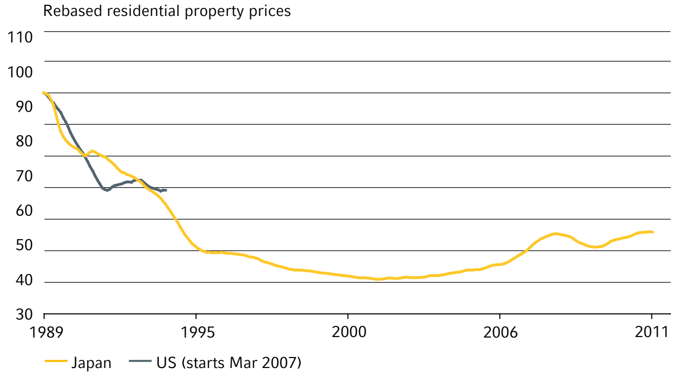
Four years into the respective crises, the real estate prices in both regions had fallen to levels 30% below the bubble peak (see Chart 1). In Japan, real estate prices continued to decline during the following 10 years, dropping to a level roughly 60% below the peak. In the US the fall in real estate prices initially stopped roughly 18 months into the crisis, given the massive stimulus provided to markets by then. The development in the last 12 months, however, raises doubts as to whether the decline in real estate prices has indeed come to an end.

Developments in US financial markets in recent years show alarming parallels with developments in Japan in the early nineties. The development of US equity and bond markets, for example, resembles the experience in Japan following the collapse of the Japanese real estate market, as illustrated in Chart 2.

The 'Roadmap to Japan' in Chart 3 compares the development of various markets and macro indicators in the US and Japan since the onset of the respective crises. While it shows many similarities, there is also clear evidence of major differences, providing reasons to hope for a better outcome this time around:

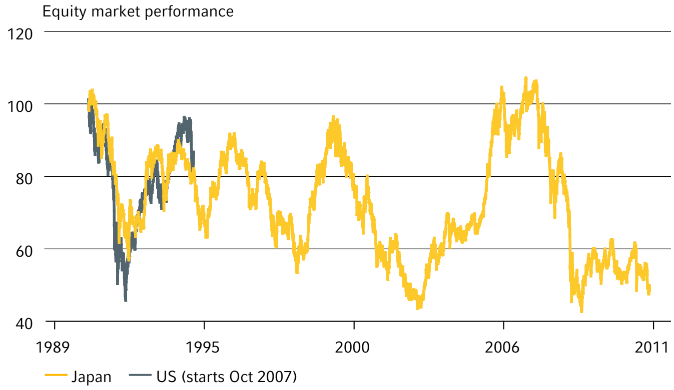
- Central bank rates were undoubtedly lowered more quickly by the Fed than by the Bank of Japan
- Lower rates and quantitative easing have led to a stronger rise in the M2 measure of money supply in the US. In contrast, the BoJ was more timid in introducing unconventional measures once interest rates hit the lower bound. While this might signal that the US is on the right track, the relationship between M2 and GDP growth seems to have broken down post financial service deregulation when credit growth became the important driver. We will see whether the increase in M2 translates into an increase in credit in due course – in times in which the private sector reduces debt, monetary policy becomes ineffective
- The total volume of outstanding consumer credit in the US seems to have stabilised recently and the trend looks more favourable than was the case for Japan in the early 1990s. This is consistent with our economists' view that the savings rate of the US consumer has already risen to a level that is likely to be sustained rather than increased
- The demographic developments are more favourable in the US as the (working age) population continues to rise due to immigration despite the weaker domestic demographic development, in particular the baby boomers retiring. The net migration rate remains close to 3% while it has been fluctuating around zero in Japan in the last 20 years as shown in Chart 4
- While the trade-weighted JPY appreciated by 80% in the first five years of the Japanese crisis, the trade-weighted USD has depreciated by roughly 5% so far. This has two major benefits. First, it provides support for exports and second, inflation rather than deflation is imported, helping to keep up inflation and inflation expectations

Chart 1: Development of metropolitan residential housing prices since the peak in the US and Japan



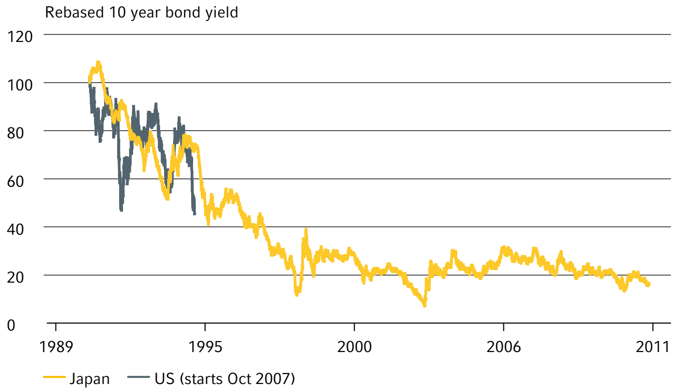
Source: Bloomberg, Commerzbank Corporates & Markets

Chart 2: Equity market and government bond yield developments in the US since October 2007 resemble developments in Japan since February 1991 (series rebased)



Source: Bloomberg, Commerzbank Corporates & Markets

Chart 2a

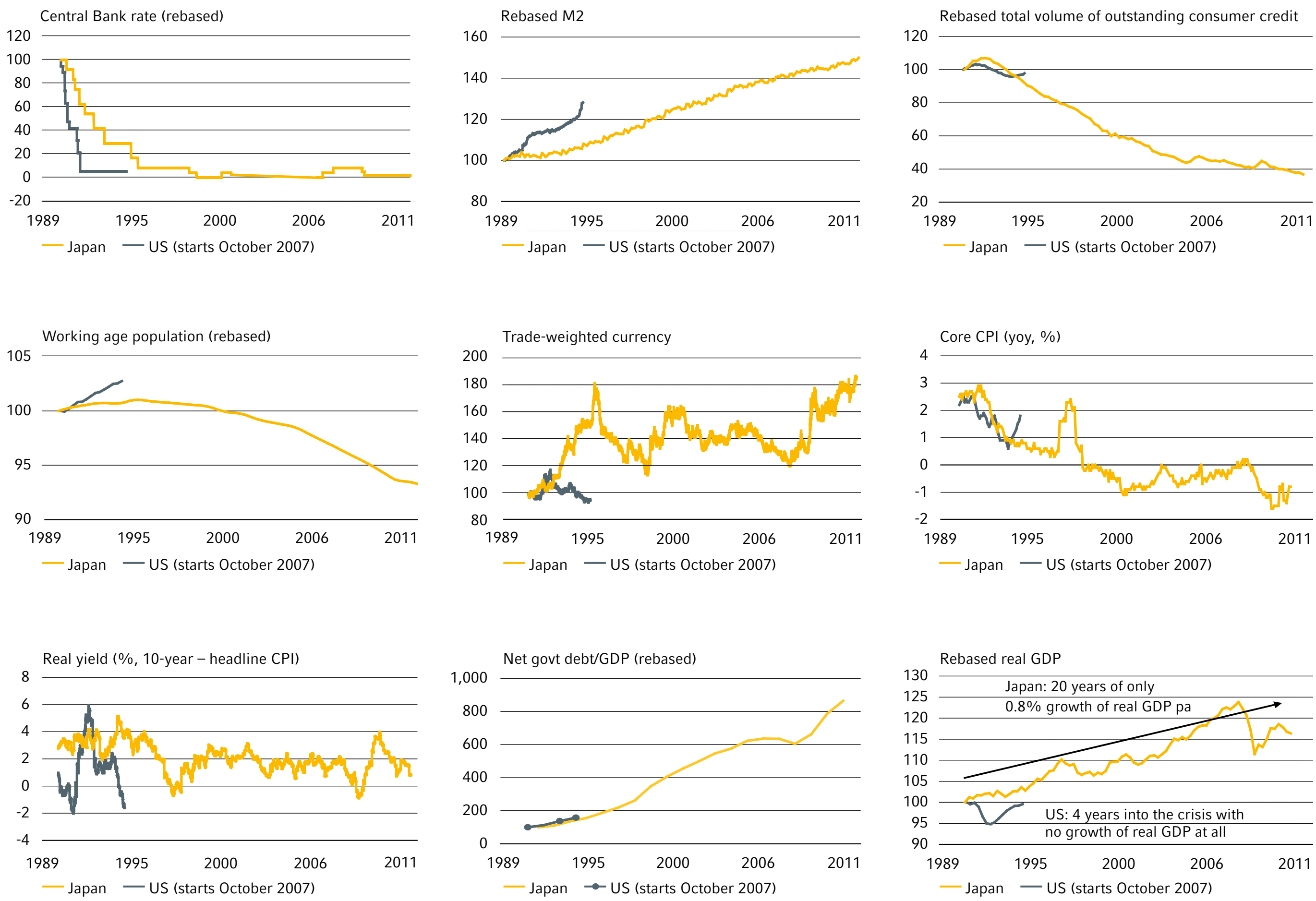


Source: Bloomberg, Commerzbank Corporates & Markets

- Against this backdrop, deflationary trends have not yet been firmly established in the US. Core inflation has recently started to rise again. It should be noted, though, that it took until 1998 for deflation to bite in Japan
- Real bond yields have been and are lower in the US. This may be of benefit to the US if real growth and real asset prices are boosted as a consequence, helping keep inflation up
- The US government debt to GDP ratio has so far risen in line with the trend observed in Japan in the early 1990s, suggesting a similar amount of fiscal stimulus in both regions. However, the absolute US debt to GDP ratio already stands at a level that was not reached in Japan until 2001, 10 years into the Japanese crisis. Moreover, given the debt ceiling and the agreed austerity measures, the future development of debt/GDP in the US should remain below the trend observed for Japan in the nineties as the public sector tries to consolidate its balance sheet
- Looking at the cumulative development of real GDP, the development in the US so far is inferior despite the more favourable trends discussed above. This is mainly due to the strong global recession in 2009. However, the anaemic growth experienced since the limited rebound of growth in 2010 shows some parallels with the meagre 0.8% real GDP growth pa experienced in Japan over the last 20 years.

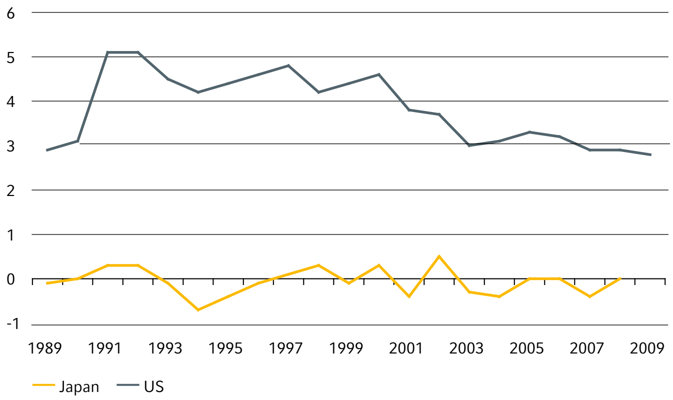
In short, all of the things that the central bank can control appear to have taken a more favourable path for the US. Moreover, the demographic situation seems to be more favourable thanks to a healthy net migration rate. On the other hand, fiscal stimulus is likely to become less supportive than it was in Japan – western governments do not seem to be willing or able to increase debt levels to the same extent that Japan did. Still, this suggests that the worst scenario ought to be avoided. However, one cannot escape the fact that (government) debt levels will have to be eroded over a long period and ongoing deleveraging will continue to weigh on growth, so the outcome may not be clear in the near future. Markets, in the meantime will likely remain vigilant and unwilling to fully price out the Japanese scenario.

Chart 3: Roadmap to Japan – Comparison of development from the outbreak of the crises, ie the real estate bubble burst (Japan in February 1991 and US in October 2007)



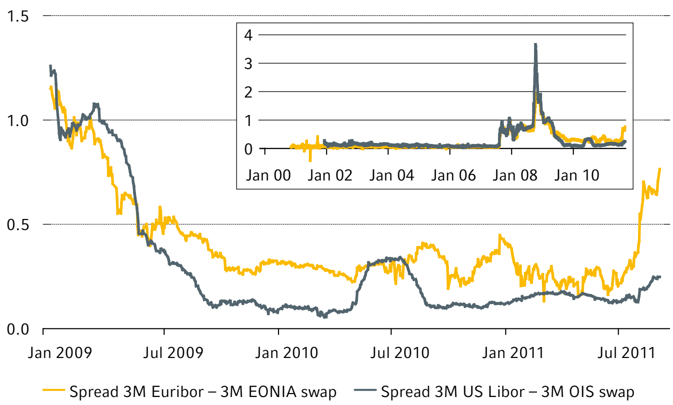
Source: IMF, Bloomberg, Commerzbank Corporates & Markets

Chart 4: Net migration remains strongly supportive in the US, keeping the population growing (% of population)



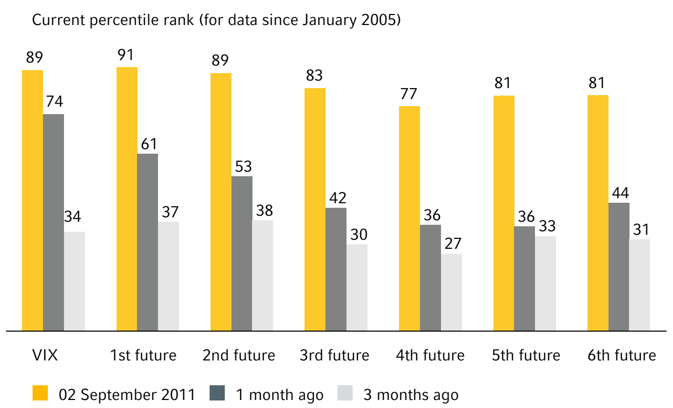
Source: IMF, Bloomberg, Commerzbank Corporates & Markets

Chart 5: The 3M Euribor to 3M EONIA swap rate spread has risen to the highest level since early 2009



Source: Bloomberg, Commerzbank Corporates & Markets

Chart 6: VIX term structure with limited room to steepen



Source: Bloomberg, Commerzbank Corporates & Markets

FUTURE OF THE EUROZONE TO REMAIN UNCERTAIN; UNCERTAINTY TO WEIGH ON GROWTH

While time will tell whether Fed policy can keep the US off 'the road to Japan', policy decisions in the Eurozone appear to be of a far more pressing nature. The market will increasingly recognise that there is no easy solution to the sovereign debt crisis. In our view, the Eurozone will have to decide at some point whether it wants more centralisation and integration, or whether it needs to take a decision to no longer exist in its current form. More centralisation and integration could mean a central fiscal policy, with a common European bond being one of the final steps.

Politicians are unlikely to take such a decision anytime soon. The first option will hardly be supported by the majority of the population, while costs and risks associated with the second are unpredictable. Thus, politicians and the ECB will continue to try to avoid an open escalation of the crisis, to buy time and to delay the necessary decision. They will likely pursue further steps towards a transfer union the long-term sustainability of which seems questionable. Markets clearly recognise that these steps though, are also not without risks and that in the end the decision of a fiscal union or a breakup will remain. Let alone the question of whether the mechanisms will bring more sustainable relief, there are many implementation risks associated with the Eurozone leaders' decision to set up a permanent EMU rescue fund for the period after 2013 (European Stability Mechanism, ESM) and the expansion of the volume and remit of the current European Financial Stability Facility (EFSF), which is due to expire in 2013.

So the Eurozone has become the wild card in the global economy with the situation regarding the sovereign debt crisis becoming less transparent each day. The ECB has bought some time by buying Italian and Spanish bonds, but over the next months, many hurdles need to be overcome just to maintain the current situation and prevent an open escalation of the crisis.

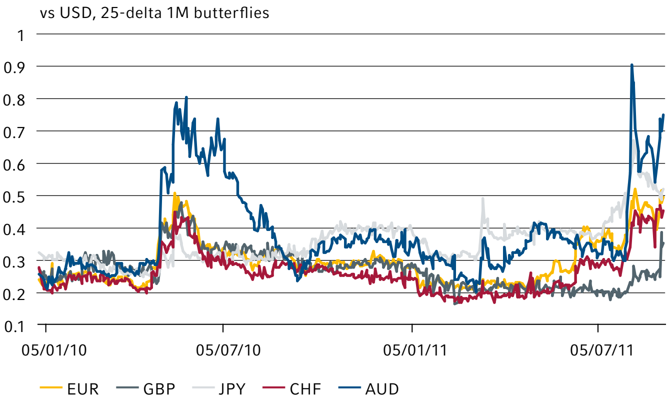
Against this backdrop uncertainty is likely to remain elevated for some time to come and spike every now and then, creating an environment that will continue to weigh on economic activity and will continue to lead investors to look for tail risk protection. Uncertainty weighs on real activity mainly through two channels: (1) Investment and consumption decisions are postponed and capital is allocated away from its most productive and growth-enhancing use, eg towards gold. (2) The transmission mechanism of central bank policy becomes less effective with confidence in the banking system vanishing and interbank liquidity getting scarcer. The spread between 3M Euribor and the 3M EONIA swap rate has risen to the highest level since early 2009 as shown in Chart 5. An uncertainty shock and/or increasing stress in the financial system as short-term funding becomes scarcer could even push the global economy towards a more severe slowdown.

EXPENSIVE TAIL RISK PROTECTION IN ALL MARKETS

With leaders and central bankers in the Eurozone needing to negotiate a treacherous path towards a sustainable situation for the single currency, and the fate of western economies in general still unclear, tail risk protection has become expensive in all markets. In the equity space, for example, the VIX futures term structure has flattened strongly from the long end, with the six-month future rising by 29% from 23.6 to 30.5 over the last month. Given the distribution of VIX future prices since 2005, this is an increase from percentile 44 one month ago to percentile 81 now, making a successful bet on a further rise of volatility actually a relatively low probability event.

The tendency of investors to strongly favour tail risk protection is also revealed by the elevated equity implied volatility skew, and by butterflies and risk reversals in the fx space. The level of butterflies of major fx crosses, which is the difference in valuation between out-of-the-money and at-the-money options, is a measure of the demand for tail risk protection in the market. As can clearly be seen, investors are currently valuing tail protection highly compared to historical levels (see Chart 7).

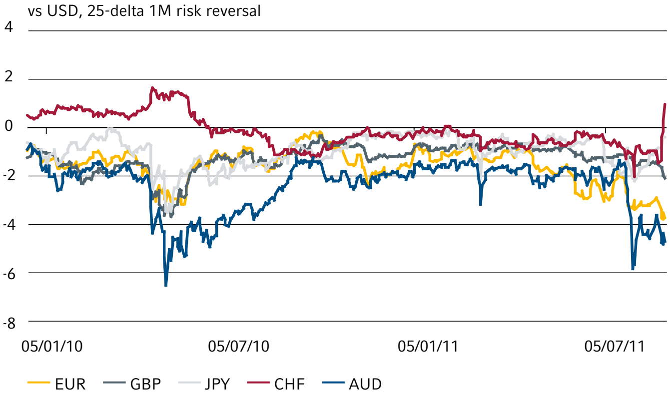
Chart 7: Butterflies for major fx crosses at high levels reflect that the market prices in a high probability of strong exchange rate moves …



Source: Bloomberg, Commerzbank Corporates & Markets

Beyond the fact that the market is pricing in a high probability of large exchange rate moves, looking at the risk reversals also reveals in which direction the large move is expected (see Chart 8). Risk reversals quantify the skew of the option implied volatility smile. Thus, if risk reversals rise, this indicates that demand for a call option has risen relative to that for a comparable put option, and vice versa. At the moment, risk reversals are well below their historical averages and clearly show that the majority of the market is seeking protection against depreciation versus the US dollar in almost all currencies. In our view this is a clear tail risk positioning, which reflects the dollar's role as 'safe haven' in case of a very severe event. We believe that tail risk protection will remain expensive for some time to come.

Chart 8: … with investors seeking protection against depreciation versus the US dollar in almost all currencies. This is a clear tail risk positioning, in our view



Source: Bloomberg, Commerzbank Corporates & Markets

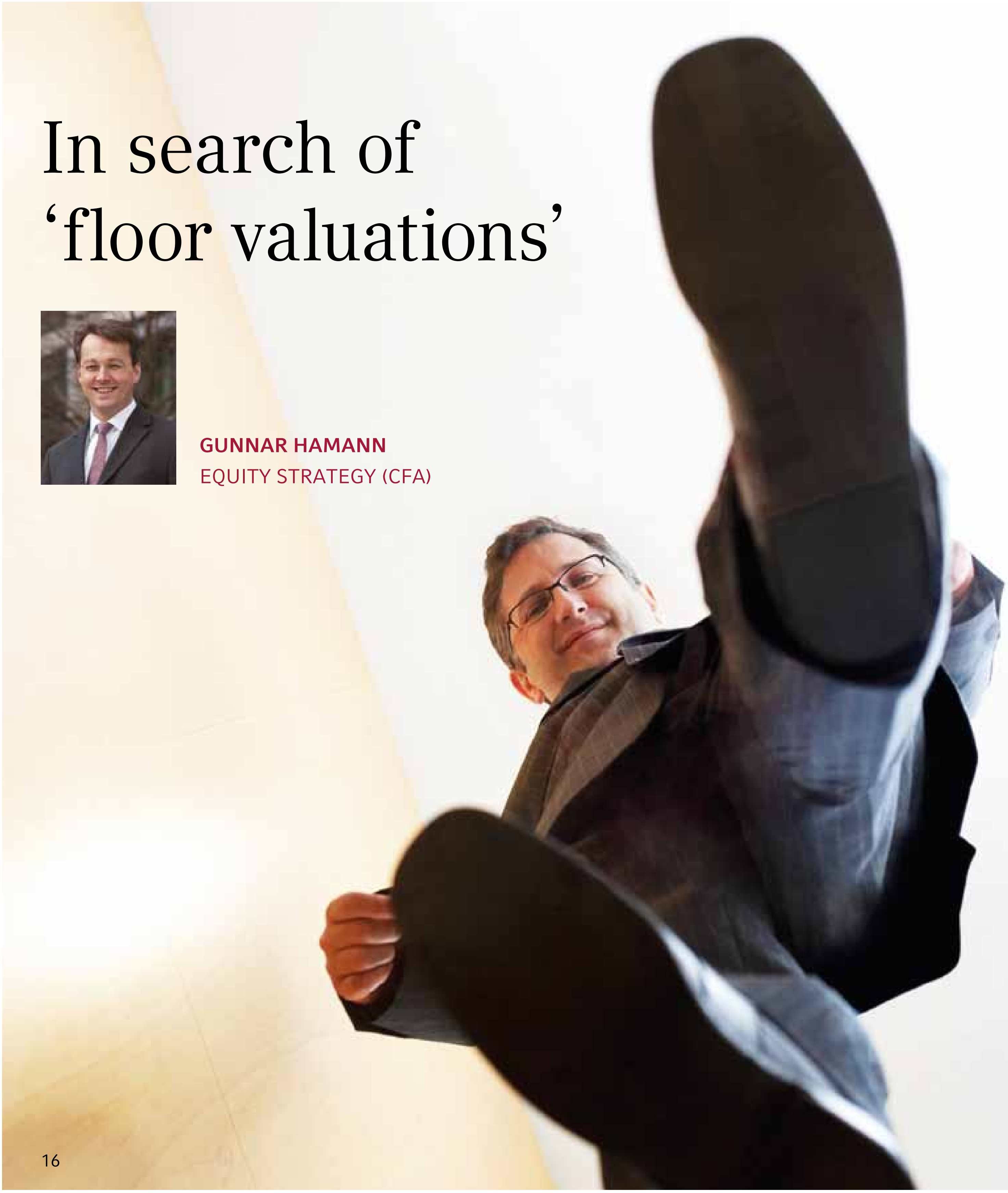
CONCLUSION

Limited ammunition for fiscal and monetary stimulus should keep the market's focus on, and sensitivity to, macro data releases highly elevated. The fact that slower growth or a recession would raise the likelihood of western economies experiencing a fate similar to Japan's during its lost decade should further reinforce this behaviour. Many developments in the US show alarming parallels with those in Japan in the nineties. However, several major differences give hope for a better outcome this time around, though the outcome will remain unclear in the short term.

Meanwhile, the future of the Eurozone remains uncertain. Even if politicians and the ECB avoid an open escalation of the crisis in the short to medium term, more robust decision-making cannot be avoided indefinitely. Against this backdrop, the degree of uncertainty is likely to remain elevated for some time to come and spike every now and then, creating an environment that will continue to weigh on economic activity and will continue to cause investors to aggressively pursue tail risk protection.

For further information, please contact:
dr.bernd.meyer@commerzbank.com

Equities



In search of ‘floor valuations’

GUNNAR HAMANN
EQUITY STRATEGY (CFA)

With plummeting share prices and elevated stress indicators in the banking system, investors increasingly question to what extent policy makers can successfully tackle the sovereign debt problem. While in the Eurozone the ECB will likely help to keep the situation from escalating, our hopes rest on turning rate cycles in emerging markets. Stronger balance sheets coupled with existing contingency plans may well prevent valuation multiples from reaching their 2008/09 trough levels again.

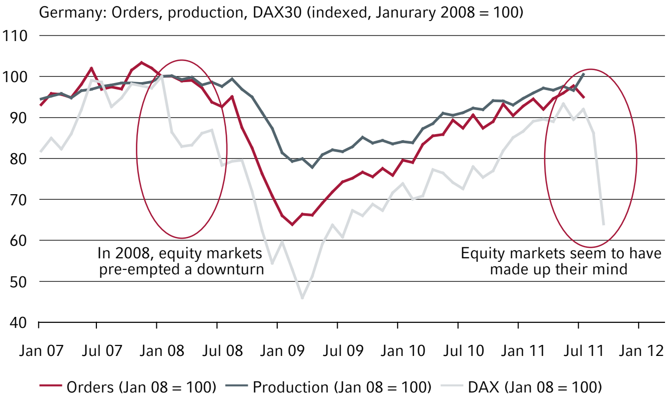
The contrast could not have been starker. On the one hand, the recent plunge in share prices is seen by many investors as evidence that worse is about to come for the global economy. However, this does not appear to be a foregone conclusion when meeting with the corporate sector. We at Commerzbank recently hosted our *Sector Conference Week* with more than 80 listed companies attending. We coined the motto of this event 'Macro caution meets micro strength' as investors met with companies that overall had not witnessed any significant deterioration in underlying trading conditions.

This, however, is not necessarily a comforting sign as, undoubtedly, we have been here before. Turn the clock back to the summer months of 2008 when there was still widespread optimism in the corporate sector on the back of order and production strength. This, however, occurred at a time when equity markets had already started to turn down decisively on the back of tensions in credit markets. While the jury is still out as to whether and to what extent there will be a downturn, equity markets seem to have made up their minds – at least judging by the brutal sell-off that has hit stock markets since the end of July (see Chart 1).

Clearly, what currently worries investors are persistent indications of tension that can be observed in financial markets at the time of writing this article. Elevated stress indicators such as iTraxx Financials indices reflect the continuing unresolved problems in the sovereign debt markets, which act as a sword of Damocles, hanging over European financials in particular (see Chart 2).

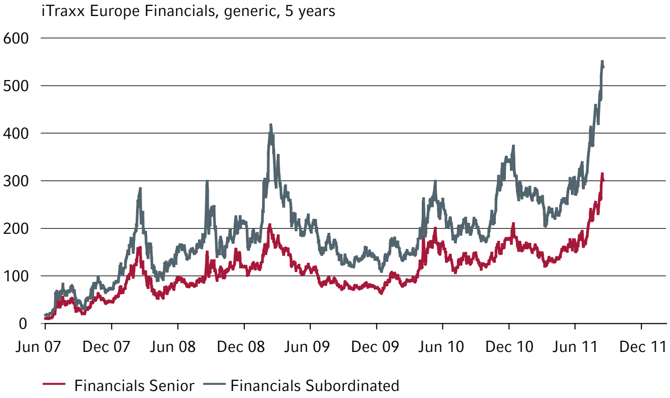
Given the evolution of the previous financial crisis, it is hard to ignore the risk that the persistent tension in banking markets threatens to spill over into the real economy. Back in 2008, falling prices of toxic assets (structured products on US housing assets) undermined confidence in the health of the financial system, which triggered further selling of asset prices and created a negative feedback loop.

Chart 1: Similar to 2008, equity markets have started to price in a sharp downturn



Source: Datastream, Commerzbank Research

Chart 2: Protracted stress levels in financial market threaten the real economy



Source: Bloomberg, Commerzbank Research

At the time of writing, the sovereign debt crisis in the Eurozone remains unresolved and continues to weigh on equity markets. Clearly, elevated government debt levels imply the need for budget consolidation in order to restore trust in government finances. Unfortunately, this occurs at a time when the global economy has started to shift down a gear. This in turn has prompted investors to question the creditworthiness of an increasing number of countries.

The key question for investors is how policy makers can successfully tackle the sovereign debt problem. The recent response of European politicians has clearly met with frustration in the market. For example, a more cumbersome approval process for any expansion of the EFSF has done little to alleviate concern. At least by the time this article has been published, the German parliament is likely to have approved a strengthening of the rescue mechanism. However, some investors have expressed concern that even a final approval of the recent bailout agreements may not be sufficient to contain the Eurozone debt crisis. While budget consolidation measures are a step in the right direction, one should not ignore the risks that austerity measures, which keep credit spreads in check, could tip economies into recession.

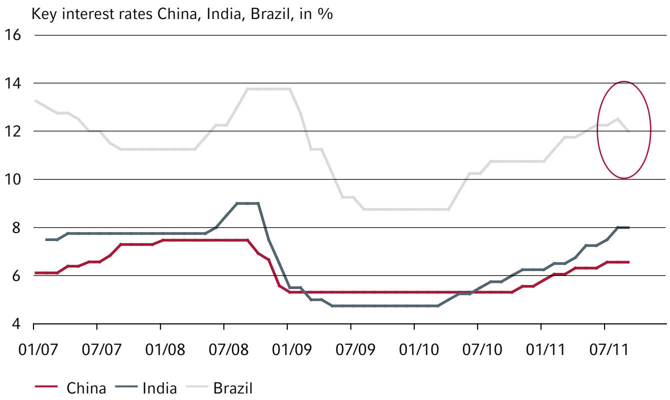
The ECB has so far tried to contain potential damage with regard to Italian and Spanish sovereign debt, yet it is far from clear whether this will still be sufficient to keep spreads from widening further. Calls for ECB rate cuts have become louder and markets have begun to price in lower rates going forward.

However, central banks in emerging markets may yet come to the rescue of the equity markets. Clearly, leading indicators in important emerging regions have started to roll-over in recent months as the central banks in these regions embarked on a rate-hiking cycle to combat rising inflation. As of late, the rate cycle in important regions has started to turn. Among the G20, Turkey and Brazil have already started to reduce rates noticing the increasing risks to the global economy. As emerging markets have been an important driver of global growth, equity markets would likely breathe a collective sigh of relief if other central banks in emerging markets were to follow suit.

While it is hard to ignore that the fundamental backdrop for equities has darkened significantly, equities have started to approach recession multiples. The DAX30, for example, is trading at a P/B multiple of close to 1.0x. Pessimists, however, point to the 0.8x trough valuation level that equities have reached during the dark days of 2008/09 (see Chart 4). While the mantra 'This time it's different' should be treated with extreme caution, nonetheless we outline arguments why P/B ratios might still remain above 2008/09 trough levels:

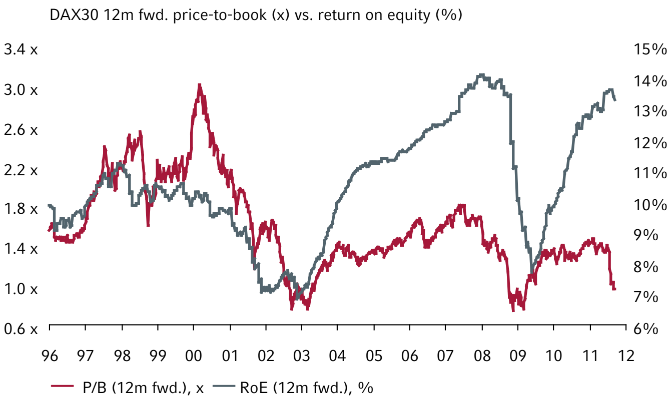
Firstly, there is the balance sheet quality. While the corporate sector entered the last crisis highly indebted, balance sheets today look reasonably sound since a re-leveraging process

Chart 3: Will central banks in emerging markets come to the rescue?



Source: Datastream, Commerzbank Research

Chart 4: Price-to-book ratios approaching trough levels again



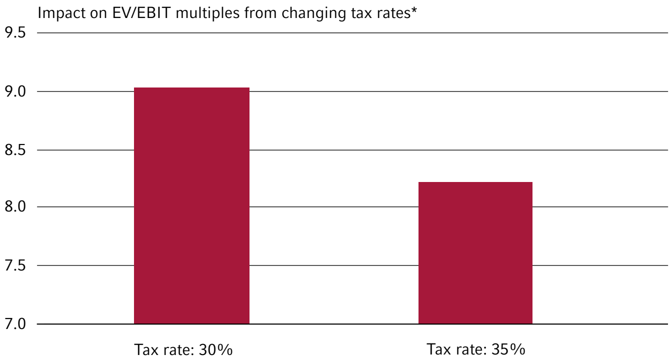
Source: Datastream, Commerzbank Research

never really occurred in recent years. Secondly, equity investors may find solace in the fact that companies have a proven crisis management track record. Thirdly, our baseline scenario currently relies on expectations for an extended period of weak growth rather than assuming a recession. Indeed, continuing robust emerging growth would support our central case.

Undoubtedly, the jury is still out on whether valuation ratios will remain above previous trough levels on the back of stronger corporate fundamentals. We would not be surprised if, for the DAX30 as a whole, a P/B ratio of approx. 0.9x might actually provide a 'floor multiple' within the current cycle. Among different stocks and sectors, however, we expect significant valuation discrepancies within the markets over the foreseeable future. Our expectations rest on two pillars:

Firstly, companies primarily dependent on the Eurozone are likely to underperform those exposed to growth rates of the global economy.

Chart 5: Higher taxation hits EV/EBIT multiples …



Source: Commerzbank Research
Notes: *Assuming a starting RoC of 9%, RIR of 20% and WACC of 8%

Chart 6: … or EV/Capital multiples

Source: Commerzbank Research
Notes: *Assuming a starting RoC of 9%, RIR of 20% and WACC of 8%

Secondly, the need to consolidate public sector finances could ultimately lead to higher taxation over the medium-term as governments will likely demand a payback for having lent their balance sheet to the private sector during the financial crisis.

However, raising the tax burden is unlikely to be an evenly distributed affair. The tax 'axe' will likely hit those businesses to a disproportionately higher extent that have few opportunities to escape the additional burden. The latter might potentially include financials, real estate, utilities and infrastructure assets. Therefore, investments into these assets on the back of currently attractive yields might lead to some disappointment.

Companies with operations around the globe, in contrast, are likely to find ways to mitigate higher tax burdens arising in one region, by shifting certain parts of their operating business to other regions. Generally, increasing globalisation has made it more difficult for governments to access the tax base. This, in part, has shaped tax policies in individual countries. In Germany, for example, previous tax reforms were aimed at reducing the direct tax burden on companies, thus narrowing the gap to low-tax regions. In contrast, indirect taxes have been raised (eg value-added tax).

If our assumptions prove correct, this will likely be mirrored by sustained valuation discrepancies resulting from higher tax rates. Fundamentally, the latter will have an adverse impact on valuation multiples. In order to get this point across, we illustrate the impact from rising tax rates on EV/EBIT and EV/Capital ratios (our example depicted in the charts below is based on the following assumptions: a starting return on capital of 9%, re-investment rate of 20% and WACC of 8%). Therefore, even adjusting for varying risk and growth profiles, business models which 'can hardly move' to escape a higher tax burden (see above) will likely trade on lower valuation ratios for quite some time.

We think German equity indices, fortunately, the potential for a medium-term higher tax burden, should be less of a threat as most of those companies remain strongly exposed to the global cycle. This should render German equities more attractive compared to some of their European counterparts.

CONCLUSION

Strongly falling share prices reflect investors' expectations of a replay of the previous financial crisis when falling asset prices triggered stress in the financial system and, ultimately, spilled over into the real economy. At the time of writing, the key question remains as to what could successfully resolve the sovereign debt problem. While a solution driven by Eurozone politicians will likely, if at all, be a long drawn-out affair, our hopes for a reversal of the recent plunge in share prices are pinned on the following:

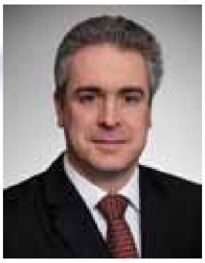
Firstly, the ECB will likely continue to keep the situation in the Eurozone in check by offering sufficient liquidity to the financial system and via their bond purchasing programmes.

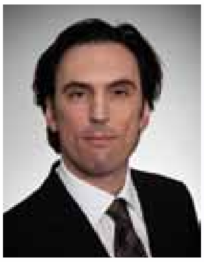
Secondly, emerging markets could come to the rescue. While their recent rate tightening cycle has started to leave its mark on growth in these regions, a turn in the rate cycle could actually support economic fundamentals and re-instil confidence in the global growth outlook.

Thirdly, valuation ratios have approached trough levels again. At the time of writing, the DAX30 is trading on a price-to-book ratio of 1.0x, not far from its previous trough level of 0.8x reached during the previous financial crisis. Stronger balance sheets and better prepared corporations, however, will prevent valuation ratios from falling below previous trough levels.

For further information, please contact:
gunnar.hamann2@commerzbank.com

German healthcare industry





DANIEL WENDORFF
CIIA, CEFA, HEAD OF LIFE SCIENCES EQUITY RESEARCH
VOLKER BRAUN
ANALYST – LIFE SCIENCES EQUITY RESEARCH

Equity markets remain in thrall to the public indebtedness crises in Europe and the US, which have led to heightened levels of uncertainty regarding the development of the global economy. While it would appear that investor decisions to focus on the healthcare segment in general or on the Pharma subsegment in particular have been validated so far, we believe that individual trends in the different sub-segments, as well as the funding situation of public healthcare systems, should also be carefully taken into account.

This analysis focuses on the global Pharma market. At first glance, prospects for Pharma companies still look healthy with the global Pharma market forecast to grow at 5-7% in 2011 (to c. USD880bn), according to IMS Health. In the US, the world's biggest Pharma market, growth is estimated to reach c. 3%-5% this year.

On second glance, however, one can argue that the IMS Health forecast for the global Pharma market in 2011, was made at a time (end of 2010) when public indebtedness in Europe and the US was not as pronounced as is the case now. Clearly, this industry is unlikely to escape unscathed. In particular, we now observe measures to curtail public healthcare expenditure in Spain and Italy. In the UK, the NICE (National Institute for Health and Clinical Excellence), the most important 'gatekeeper' for the broad-based reimbursement of new drugs, continues to adopt a tough stance when determining which new drugs should be paid for on Britain's state health system. Moreover, recent discussions in the US point to a challenging environment for drug manufacturers as well.

However, it seems fair to assume that the market has already factored in government intervention. Anticipated effects have already been communicated by the companies at their FY 2010 results releases in spring. A de-rating, based on fears over additional health reform initiatives, therefore appears unlikely.

Nevertheless, one should not underestimate the flexibility of the industry, which could help stabilise earnings momentum, despite considerable regulatory headwinds. Without jeopardising R&D productivity, many Pharma companies have started to convert fixed costs into variable costs by increasing the number of partnerships that are based on outsourcing agreements. While failure becomes cheaper, output could still be set to improve over time.

We think, Germany will play a key role in the medium-term development. When it comes to reimbursement discussions, drug prices in Germany serve as a benchmark for many European countries. With the enactment of the Pharmaceuticals Market Restructuring Act (AMNOG), the mandatory rebate for branded drug products was increased from 6% to 16% as of August 2010. While this measure will only last until 31 December 2013, a price negotiation scheme for drugs to be approved (and drugs already approved on a case-by-case basis) will come into effect; this should more than offset the reversion of the mandatory rebate as of 2014.

In our view, the pharmaceutical industry is well aware of the significance of implied changes and, so far, has been very successful in delaying implementation of the negotiation scheme in Germany. After months of negotiations between the representative bodies of the industry and the 'GKV Spitzenverband', (the Central Federal Association of healthcare funds), about how price negotiations are to be carried out, consent on critical issues has yet to be reached. The main topics of contention appear to be the comparison of prices within an international context and the possibility of price adjustment mechanisms depending on volume fluctuation. We are sceptical that the original plan to begin price negotiations in January 2012 will proceed according to schedule. It would therefore appear fair to assume that 2012 should be a comparatively manageable environment for the Pharma industry, and as such a potential refuge for investors in these challenging times.

1Y Double Digital on German Healthcare

Key features

- Term: 1 Year
- Underlying: 3 German Health Care Stocks
- Capital Protection: 90%
- Reoffer: 99%
- Product Category Rating: 3 – Partially Protected: A pre-agreed proportion of capital or coupon or both are either protected from the start or protection becomes effective on the occurrence of a pre-defined market event

PRODUCT DESCRIPTION

- **Maturity:** 1 Year
- **Issuer:** Commerzbank AG
- **Currency:** EUR
- **Capital Protection:** 90%
- **Coupon:** 12% / 6%
- **Underlyings:** **Bloomberg Ticker:**

Underlyings	Bloomberg Ticker
MRK GY Equity	MERCK KGAA
BAYN GY Equity	BAYER AG
FME GY Equity	FRESENIUS MEDICAL CARE

- At Maturity, if all stocks close above 110% of their initial level the investor will receive a coupon of 12%
- Or, if all stocks close above their initial level but not above 100%, the investor will receive a coupon of 6%
- In addition to a potential coupon, the investor receives max(worst performing undrlying, KG) where KG = EA *90%

KEY BENEFITS

- Potential Coupon of 12% if all underlyings should gain 10% within one year or 6% if all underlyings close above 100%
- Exposure to the European health care sector
- Short Maturity

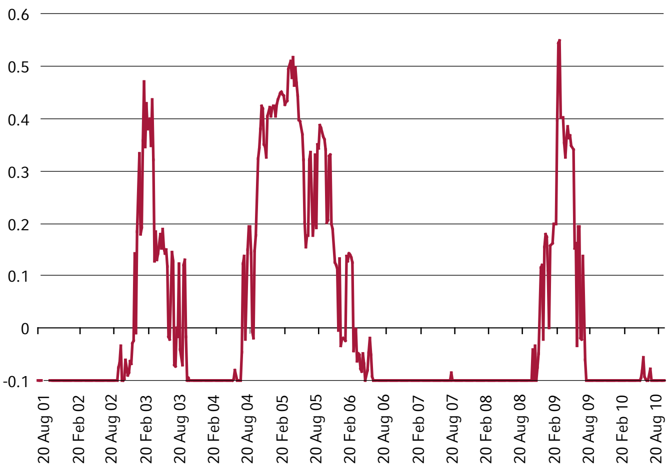
KEY RISKS

- If the worst performing Underlying trades below its initial price and depending on the level, a maximum 10% of the invested capital can be lost
- Commerzbank will endeavour to provide a secondary market on a best effort depending on market conditions

KEY SENSITIVITY FACTORS

- The investor is long delta: the higher the spot price, the higher the option price
- The investor is long correlation: the higher the correlation, the higher the option price

Historical IRR



Source: Commerzbank, Corporates and Markets

Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However, under some circumstances the secondary market for the investment may be limited.

Product Category: 3
The product category indicates the payoff risk as explained below. The rating is for information only, and is intended to provide investors with the means to understand and compare the payoffs associated with our products. Rating 3: Partial Capital Protection – A portion of the capital invested, or coupon (if any), or both are either protected from the inception date of the security; or the protection becomes effective on the occurrence of a pre-defined market event. Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However under some circumstances, the secondary market for the investment may be limited.

Additional Risk Disclosures
Before investing in this product, investors should carefully consider its appropriateness and suitability, and the following additional risks:
1. Issuer Risk: Any failure by the issuer to perform its contractual obligations, when due, may result in the loss of all or part of the invested capital. 2. Counterparty Risk: Any failure by Commerzbank AG to perform its contractual obligations, when due, may result in the loss of all or part of the invested capital. 3. Market Risk: Various market factors may affect the value of the investment or the underlying assets, including but not limited to the impact of volatility, interest rates, dividends (if any), foreign exchange. 4. Liquidity/Secondary Market Risk: Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However Commerzbank has no obligation to make a secondary market in the instruments concerned. Accordingly, under some circumstances, the secondary market for the investment may be limited and subject to wide bid/offer spreads. 5. Reinvestment Risk: The risk that the investment redeems prior to maturity at a time when reinvestment opportunities are not favourable for the investor. 6. Redemption Risk: The risk that the investor may receive substantially less than the amount invested, if he/she liquidates the investment prior to maturity. 7. Tax Risk: There may be tax implications based on where the investor resides. Please consult a tax professional before investing. 8. Legal Risk: There may be legal restrictions depending on where the investor is domiciled. It is advised to seek legal guidance prior to investing.
For additional information on the product features and key risks, please contact your sales advisor or refer to the contacts page.

4Y Equity Gold Note

Key features

- Term: 4 years
- Underlyings: GOLD Commodity, DJ Euro Stoxx 50 Index
- 100% + Asian Call on GOLD (50% participation) if DJ Euro Stoxx 50 has traded below 60%
- Product Category Rating: 1 – Full Capital Protection, if held to maturity, and subject to the issuer credit risk

PRODUCT RATIONALE

- Negative relationship between GOLD and Equities: increasing incentive for investors to have precious metals or mining companies' stocks in their portfolios

PRODUCT DESCRIPTION

- **Issuer:** Commerzbank AG
- **Maturity:** 4 Years
- **Currency:** EUR
- **Underlyings:**

Underlyings	Bloomberg Tickers
Gold Commodity	GOLDS Commodity
DJ Euro Stoxx 50 Index	SX5E Index

- **Barrier:** 60% on Euro Stoxx, American, daily observation
- **Capital Protection:** 100%
- **Payout at maturity:**
  1) If the Euro Stoxx 50 has ever traded below 60%:
  100% + 50% x max (0%, GOLD avg/GOLD initial – 100%)
  Gold avg is the average of the 8 semi-annual observations made during the life of the Note
  2) Else: 100%
- **Notional:** EUR5m

KEY BENEFITS

- Full Capital Protection
- No downside risk
- Potential uncapped upside in Gold
- Opportunity to play negative correlation between Gold and Equities

KEY RISKS*

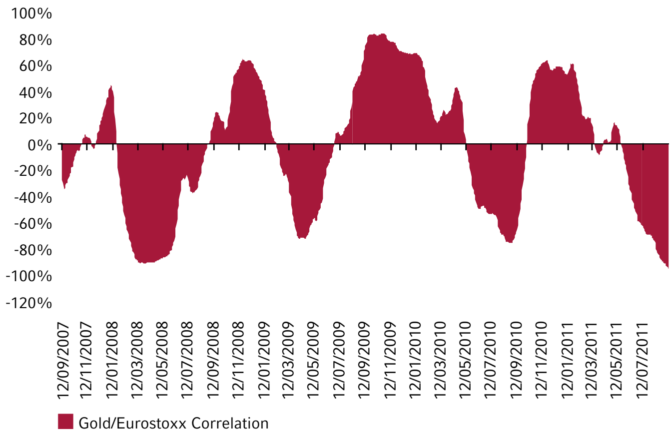
- No negative correlation between GOLD and Equities
- Average performance of GOLD is negative
- Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However, under some circumstances the secondary market for the investment may be limited.

KEY SENSITIVITY FACTORS

- Long delta on Gold, short delta on Euro Stoxx: the higher Gold price and the lower Euro Stoxx 50 price, the higher the option price
- Long vega on both Gold and Euro Stoxx: the higher the volatilities, the higher the option price
- Short Correlation: the lower the correlation between Gold and Equities, the higher the option price

*Subject to the issue of credit risk

Gold/Eurostoxx Correlation



Source: Bloomberg, Commerzbank
Note: Data from 31 December 1986 to 7 September 2011. Past performance is not a reliable indicator of future performance.

HISTORICAL PERFORMANCE

- The graph below shows the redemption levels of Euro Stoxx 50 and Gold Commodity

4Y Euro Stoxx 50 – Gold Commodity

Source: Bloomberg, Commerzbank
Note: Data from 31 December 1986 to 7 September 2011. Past performance is not a reliable indicator of future performance.

Product Category: 1
The product category indicates the payoff risk as explained below. The rating is for information only, and is intended to provide investors with the means to understand and compare the payoffs associated with our products. Rating 1: Full Capital Protection – If held until maturity, or a pre-defined early redemption date, the security holder will receive the capital invested back. Potential losses are limited to the potential gains, which are dependent on the performance of the chosen payoff. Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However under some circumstances, the secondary market for the investment may be limited.

Additional Risk Disclosures
Before investing in this product, investors should carefully consider its appropriateness and suitability, and the following additional risks:
1. Issuer Risk: Any failure by the issuer to perform its contractual obligations, when due, may result in the loss of all or part of the invested capital. 2. Counterparty Risk: Any failure by Commerzbank AG to perform its contractual obligations, when due, may result in the loss of all or part of the invested capital. 3. Market Risk: Various market factors may affect the value of the investment or the underlying assets, including but not limited to the impact of volatility, interest rates, dividends (if any), foreign exchange. 4. Liquidity/Secondary Market Risk: Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However Commerzbank has no obligation to make a secondary market in the instruments concerned. Accordingly, under some circumstances, the secondary market for the investment may be limited and subject to wide bid/offer spreads. 5. Reinvestment Risk: The risk that the investment redeems prior to maturity at a time when reinvestment opportunities are not favourable for the investor. 6. Redemption Risk: The risk that the investor may receive substantially less than the amount invested, if he/she liquidates the investment prior to maturity. 7. Tax Risk: There may be tax implications based on where the investor resides. Please consult a tax professional before investing. 8. Legal Risk: There may be legal restrictions depending on where the investor is domiciled. It is advised to seek legal guidance prior to investing.
For additional information on the product features and key risks, please contact your sales advisor or refer to the contacts page.

3M Stability Note on DJ Euro Stoxx 50

Key features

- Term: 3 months
- Underlying: DJ Euro Stoxx 50 Index (Pr)
- Payoff: 100% + quarterly coupon of 3M Libor + 5.86% pa, if no Stop Loss Event has occurred during the term of a product
- Product Category rating: 4 (see Product Category)

PRODUCT DESCRIPTION

- **Issuer:** Commerzbank AG
- **Maturity:** 3 months
- **Currency:** USD
- **Underlying:** DJ Euro Stoxx 50 Index (Pr) (Bloomberg Ticker: SX5E Index)
- **Coupon:** every quarter, the investor receives a coupon amount of 3M Libor + 5.86% pa, provided that no Stop Loss Event has occurred during the term of a product
- **Autocallability:**
  - Stop Loss Event: it shall occur if, on any Business Day from and including the Payment Date to and including the Valuation Date, the closing level of the Underlying Index is more than 10% below the closing level on the immediately preceding Business Day: SX5Ei < 90%SX5Ei-1
  - Observations: Daily (between 2 closing prices) subject to non-occurrence of Stop Loss Event
  - If Stop Loss Event occurs, the Note will redeem early and investors will receive a cash amount equal to:
    Max [0%, 100% of initial investment – (10 x Index performance below 10% drop)
    Illustration: if Index drops -11%, investor gets back 90% of his initial investment
- **Final Redemption:**
  1) If Index never drops by more than 10% between two closing prices: you will receive 100% of the initial investment at maturity
  2) If Index drops by more than 10% between 2 closing prices (Stop Loss Event):
     Max [0%, 100% of initial investment[1] – (10 x Index perf below 10% drop)
- **Alternative:** Short term to medium term maturity (3 months up to 4 years). The same structure can be offered with similar conditions on the S&P 500 Index (in USD, Coupon of 3M Libor + 4.36% pa)

KEY BENEFITS

- Attractive quarterly coupon of 3M Libor + 5.86% pa
- 100% Capital Protection if Stop Loss Event does not occur
- Stop Loss Event never occurred even during strong market crashes in 1987 and 2008

KEY RISKS

- Leveraged loss if index drops by more than 10% between 2 closing prices (“Stop Loss Event”)
- Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However, under some circumstances, the secondary market for the investment may be limited

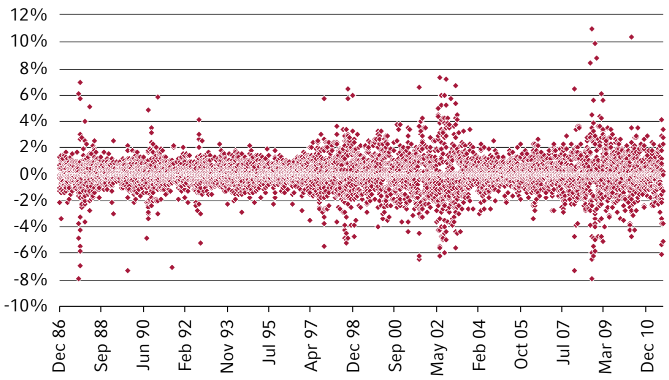
KEY SENSITIVITY FACTORS

- The investor is delta neutral: the general evolution of the spot does no affect the option price significantly
- The investor is short vega: the higher the volatilities, the lower the option price

HISTORICAL PERFORMANCE

- Stop Loss Event never occurred since the launch of the DJ Euro Stoxx 50 Index on 31 December 1986. Worst daily performance: -7.9% on 19 October 1987 and 10th October 2008. The Index dropped between -7% and -8%, only 6 times, in 25 years

Historical performance



Source: Bloomberg, Commerzbank. Data from 31 December 1986 to 7 September 2011
Note: Past performance is not a reliable indicator of future performance.

Product Category: 4
The product category indicates the payoff risk as explained below. The rating is for information only, and is intended to provide investors with the means to understand and compare the payoffs associated with our products. Rating 4: No Capital Protection – The capital invested is fully at risk. The investor may lose potential gains and initial capital. Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However under some circumstances, the secondary market for the investment may be limited.

Additional Risk Disclosures
Before investing in this product, investors should carefully consider its appropriateness and suitability, and the following additional risks:
1. Issuer Risk: Any failure by the issuer to perform its contractual obligations, when due, may result in the loss of all or part of the invested capital. 2. Counterparty Risk: Any failure by Commerzbank AG to perform its contractual obligations, when due, may result in the loss of all or part of the invested capital. 3. Market Risk: Various market factors may affect the value of the investment or the underlying assets, including but not limited to the impact of volatility, interest rates, dividends (if any), foreign exchange. 4. Liquidity/Secondary Market Risk: Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However Commerzbank has no obligation to make a secondary market in the instruments concerned. Accordingly, under some circumstances, the secondary market for the investment may be limited and subject to wide bid/offer spreads. 5. Reinvestment Risk: The risk that the investment redeems prior to maturity at a time when reinvestment opportunities are not favourable for the investor. 6. Redemption Risk: The risk that the investor may receive substantially less than the amount invested, if he/she liquidates the investment prior to maturity. 7. Tax Risk: There may be tax implications based on where the investor resides. Please consult a tax professional before investing. 8. Legal Risk: There may be legal restrictions depending on where the investor is domiciled. It is advised to seek legal guidance prior to investing.
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Commodity spotlight

Silver – gold's little brother?

EUGEN WEINBERG
HEAD OF COMMODITY RESEARCH

Silver is often already mentioned in the same breath as gold as an alternative currency and 'safe haven'. Indeed, silver served as legal tender, an official currency and a stable store of value for a long time in history. But how much of this former function has it retained? In this article, we illustrate why we deem silver, in contrast to gold, to be more of a cyclical 'industrial metal' than a precious metal and store of value, but at the same time, highlight that its old function could gain importance in future.

Silver, also referred to as 'gold's little brother', exhibits properties more akin to a cyclical, industrial commodity, than an 'alternative currency', such as gold, and there are several reasons for this.

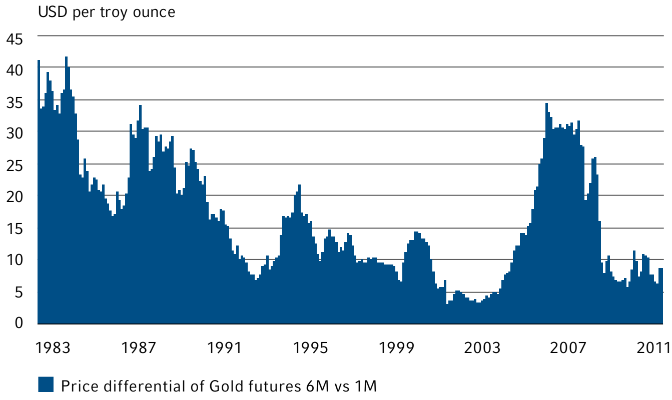
The differing demand/supply situation for the two precious metals argues for a differing valuation of their functions: Industrial demand for silver, for example, constitutes a very high share of total demand for silver, averaging around 62% in the past 10 years. In contrast, the share of industrial demand for gold was less than 12% in 2010. That means that only around every third ounce of silver went for non-industrial purposes. Hence to a large extent, demand for silver is subject to cyclical fluctuations.

Furthermore, a look at the forward curves offers a good insight into the market participants' different assessments of the two precious metals. Gold is always in 'contango', ie its forward curve is upward sloping (see Chart 1). This is mainly attributable to the fact that central banks are at all times willing to lend gold to eligible banks, the so-called bullion banks, which is why shortages can never occur and the forward price includes 'lending fees' or financing costs. This means the central banks act as lenders of last resort in gold similar to other currencies. Silver, in contrast, was in 'backwardation' (downward sloping forward curve, see chart 2) on 166 days since 1975, ie 1.7% of the time. This year alone, silver was 65 times, or 37% of the time, in backwardation. This situation is typical for commodities, but not currencies, and mainly reflects the current tightening of supply. This year it was strong demand on the part of investors and industry that caused this scarcity. This means silver does not behave like a monetary good, but rather like a scarce industrial commodity and is perceived as such.

The fact that silver does not have the same monetary characteristics as gold is also reflected in the behaviour of the official sector. The central banks, including the IMF, continue to hold more than 30,000 tons of gold in their reserves. Furthermore, with one exception, the central banks have been net buyers in the gold market since the second quarter of 2009. This shows that central banks continue to view gold as a currency. In contrast, the official sector does not show the same interest in silver. Central banks don't hold silver in their currency reserves. Apart from gold, these consist exclusively of paper money claims. One of the main arguments why silver is not used as a reserve metal is for logistical reasons. In order to store the same value in silver at current market prices would require storage capacity which is approximately 80 times larger than that required to store gold. This is because silver is not only worth much less than gold, its weight is only half as much. Thus, central banks are likely to continue to prefer gold in future.

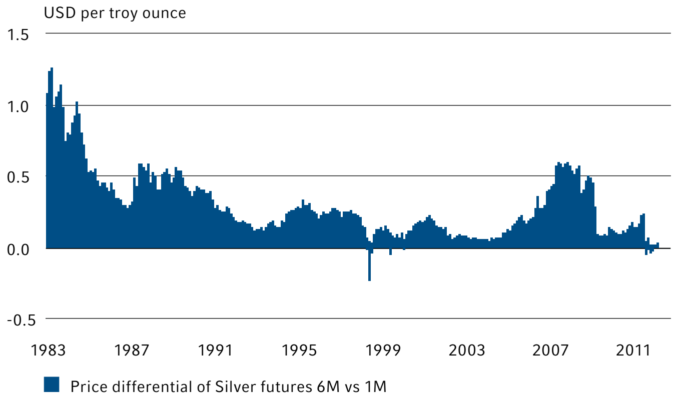
Contrary to gold, state-held silver stocks have been steadily reduced in recent years (see Chart 3). According to data from GFMS, net government sales of silver reached almost 1,400 tons

Chart 1: Forward curve for gold is consistently in contango ...



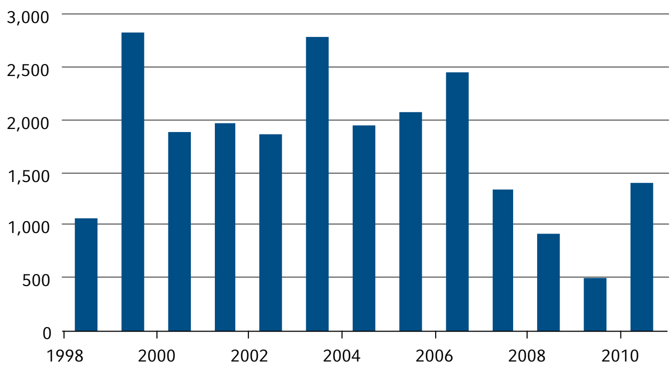
Source: Bloomberg, Commerzbank Corporates & Markets

Chart 2: Forward curve for silver, in contrast, is occasionally in backwardation



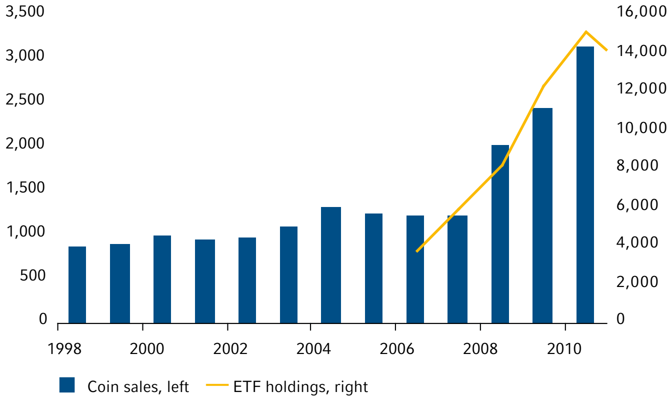
Source: Bloomberg, Commerzbank Corporates & Markets

Chart 3: Government institutions have sold silver (net government sales in tons per annum)



Source: GFMS, Bloomberg, Commerzbank Corporates & Markets

Chart 4: Silver gained popularity as an investment (coin sales and silver ETF holdings in tons)



Source: GFMS, Bloomberg, Commerzbank Corporates & Markets

last year alone. According to GFMS, government stocks of silver totalled only 3,410 tons at year-end 2010. However, these are not central bank reserves, but rather stocks that are held outside the central banking system. Russia, in particular, has been a seller of silver. Russia plays the same role also in the case of palladium, another precious metal, which is primarily used for industrial purposes. The fact that the Russian central bank continues to buy gold in the domestic market, but not silver, also makes clear the difference between the two precious metals in the eyes of the official sector.

Another significant aspect, which argues against silver as a monetary metal, is that, contrary to gold, it does not provide a store of value in times of crisis, but rather loses value during economic downturns. In the 10 most severe quarterly drops in real US gross domestic product since 1968, silver has on average lost 4.5% of its value: In contrast, during the same quarters, gold gained an average of 18%. Holding gold offers the advantage that it serves as kind of insurance against global turbulences. Silver, however, is not suitable for this purpose, but rather only performs well in good economic times.

Nonetheless, an interesting trend occurred in the past decade. At only 53% of total demand, the share of industrial demand fell markedly in 2010. Rising investment demand in the form of silver ETFs and coin sales indicates, however, that silver is gaining importance again as a store of value (see Chart 4). If this trend continues, it could be possible for silver to stage a comeback as a store of value and alternative currency. At this point in time, however, silver exhibits mainly the characteristics of a traditional commodity.

For further information, please contact:
eugen.weinberg@commerzbank.com

1Y Daily Range Accrual Autocallable on Precious Metal

Key features

- Term: 1 Year
- Underlyings: LBMA Silver Fixing <SLVRLND Index>, LBMA Gold Fixing <GOLDLNPM Index>, LPPM Platinum PM Fixing <PLTMLNPM Index>, LPPM Palladium PM Fixing <PLDMLNPM Index>
- Product Category rating: 2 – The Capital or the Coupon (if any) or both are protected, until the protection is removed due to the occurrence of a pre-defined market event, and subject to the issuer credit risk

PRODUCT RATIONALE

According to the world's largest processor of palladium, Johnson Matthey, there was a considerable demand overhang in 2010, with a deficit of 490,000 ounces. In the years prior to that, there had always been a clear supply surplus.

Similar to the platinum market, a moderate supply increase (+2.7% to 7.29 million ounces) was exceeded by an extraordinary increase in a number of demand components. Net demand for autocatalysts rose by 34%, and now represents 40% of total demand. In total, demand for palladium rose by just under 21% to 7.78 million ounces.

The debt crisis of Eurozone peripheral countries remains the dominant issue on the gold market. Rating agency Moody's has downgraded the credit rating of two major French banks because of their investments in Eurozone peripherals. High uncertainty should support the price of gold. Also, there is a strong physical buying interest. The festival season is about to start in India, for example, when a lot of gold is traditionally given as presents.

The sale of silver coins is also still extremely strong. In the US alone, 3.7 million ounces were sold in August; overall almost 29 million ounces of silver coins have been sold in the first eight months of the year.

Rising investment demand in the form of silver ETFs and coin sales indicates that silver is gaining importance again as a store of value.

PRODUCT DESCRIPTION

The product enables investors to benefit from the performance of precious metals. Every day, if all underlyings close above 85% of their respective strike prices, a 15% pa coupon is accrued and paid monthly. Maximum monthly coupon is 1.25% (15% pa).

Additionally, If all the underlyings are above 100% at a monthly observation date, product is autocalled and redeemed at par.

If the trade reaches maturity and if all underlyings close at or above 65%, 100% of the capital is returned by the issuer.

Gold is the last remaining safe haven

'Give me a little bit of security in a world where nothing seems secure'

Source: Bloomberg, Commerzbank Corporates & Markets, September 2011

KEY PRODUCT BENEFITS

- Everyday, if all underlyings stay the same or even drop by no more then 15%, investors accrue a daily coupon
- As the coupon is observed and accrued daily, digital risk is smaller than in the case when there is only one observation at the end of the month
- There is a high frequency of early redemption, so the probability of autocallability is higher> This reduces the risk of the capital
- At maturity, there is a European barrier protection

KEY PRODUCT RISKS

- If one underlying trades below the barrier for a day, the coupon for that day is not accrued
- At maturity, if one underlying trades below 65% level, the invested capital is at risk

Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However, under some circumstances the secondary market for the investment may be limited.

Product Category: 2
The product category indicates the payoff risk as explained below. The rating is for information only, and is intended to provide investors with the means to understand and compare the payoffs associated with our products. Rating 2: Soft Capital Protection – The Capital or the coupon (if any) or both are protected, until the protection is removed due to the occurrence of a pre-defined market event. Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However under some circumstances, the secondary market for the investment may be limited.

Additional Risk Disclosures
Before investing in this product, investors should carefully consider its appropriateness and suitability, and the following additional risks:
1. Issuer Risk: Any failure by the issuer to perform its contractual obligations, when due, may result in the loss of all or part of the invested capital. 2. Counterparty Risk: Any failure by Commerzbank AG to perform its contractual obligations, when due, may result in the loss of all or part of the invested capital. 3. Market Risk: Various market factors may affect the value of the investment or the underlying assets, including but not limited to the impact of volatility, interest rates, dividends (if any), foreign exchange. 4. Liquidity/Secondary Market Risk: Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However Commerzbank has no obligation to make a secondary market in the instruments concerned. Accordingly, under some circumstances, the secondary market for the investment may be limited and subject to wide bid/offer spreads. 5. Reinvestment Risk: The risk that the investment redeems prior to maturity at a time when reinvestment opportunities are not favourable for the investor. 6. Redemption Risk: The risk that the investor may receive substantially less than the amount invested, if he/she liquidates the investment prior to maturity. 7. Tax Risk: There may be tax implications based on where the investor resides. Please consult a tax professional before investing. 8. Legal Risk: There may be legal restrictions depending on where the investor is domiciled. It is advised to seek legal guidance prior to investing.
For additional information on the product features and key risks, please contact your sales advisor or refer to the contacts page.

3Y Autocall Step Up Coupon on Coffee, Sugar and Corn

Key features

- Term: 3 Years
- Underlyings: Active Coffee Future (KC1 Comty), Active Corn Future (C 1 Comdty), Active Sugar #11 Future (SB1 Comdty)
- Funding: Euribor 12m minus 0.70%
- Product Category Rating: 1 – Full Capital Protection, if held to maturity, and subject to the issuer credit risk

PRODUCT RATIONALE

The China National Grain and Oils Information centre has announced its intention to increase its corn imports in 2011/12 by 1 million tons compared to the previous season to 2.5 million tons, as even the country's anticipated record crop of 182.5 million tons should not be enough to cover rising demand.

After their annual crop tour through the US growing areas last week, the Organisation Pro Farmer now expects a poorer corn crop, at 12.5 billion bushels, than the USDA, at 12.9 billion. This would mean a crop on about the same scale as last year, despite an almost 5% greater corn acreage this year.

July and August were much too dry in the coffee growing regions of Brazil. This is not a problem for the current crop, but should the drought continue, this could cause harm to next year's crop. The coming months will see the critical flowering phase for the next crop. If the coffee plants do not get enough rain in this period, the blossoms could fall before the buds have formed. This risk increases if there is rain for a short time, followed by renewed drought. Precisely these weather conditions are feared by some meteorologists on account of the emerging weather phenomenon La Nina. Next year is a high-yield year in the cycle in Brazil, which should serve to correct the current supply shortage of Arabica. Because of the current low-yield year in Brazil, global Arabica production in this crop year is set to fall by 6.2% to 78.3 million 60kg bags, according to the ICO, which makes it impossible to build up strongly depleted stocks given the robust demand. At the start of the crop year, inventories in Brazil were just above a record low at 3.8 million bags according to the USDA. Weather conditions in Brazil should therefore continue to support coffee prices.

India's planned sugarcane acreage could increase to another record level in the next season, after already expanding by 5% this year. India has often stirred unrest on the global sugar market because of its strongly politically motivated trade policies. It will not be decided until December, for example, whether exports will be permitted.

PRODUCT DESCRIPTION

This product enables investors to benefit from the positive performance of coffee, corn and sugar. Every year, if all underlyings are above 100% of their initial levels, investor receives a coupon of 10%, and trade is redeemed.

Else if all underlyings are above 95% of their initial levels, investor receives a coupon of 5% and trade continues.

Investors only pay funding of Euribor 12m minus 0.70%.

KEY PRODUCT BENEFITS

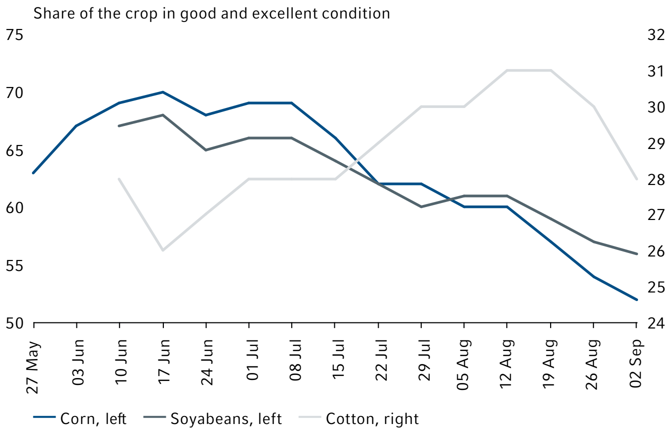
- Every year, if all underlyings are above 100% of their initial levels, investor receives a coupon of 10%, and trade is redeemed
- The structure still offers a coupon of 5% if no underlying drops more than 5%
- Investors only pay funding of Euribor 12m minus 0.70%

KEY PRODUCT RISKS

- At maturity, this product could underperform a direct investment in the underlyings, if all underlyings end above 130%
- Investors may not receive any coupon if at least one underlying trades below 95%
- Investors bear the counterparty risk

Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However, under some circumstances the secondary market for the investment may be limited.

Conditions of crops in the US continue to deteriorate



Source: Bloomberg, Commerzbank Commodity research

Product Category: 1
The product category indicates the payoff risk as explained below. The rating is for information only, and is intended to provide investors with the means to understand and compare the payoffs associated with our products. Rating 1: Full Capital Protection – If held until maturity, or a pre-defined early redemption date, the security holder will receive the capital invested back. Potential losses are limited to the potential gains, which are dependent on the performance of the chosen payoff. Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However under some circumstances, the secondary market for the investment may be limited.

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Fundamentals

HUW PRICE
SENIOR INVESTMENT MANAGEMENT STRUCTURER

"A riddle, wrapped in a mystery, inside an enigma"

Sir Winston Churchill

As potentially the European Sovereign debt crisis comes to a head the asset management industry, like all participants in the financial services arena, is facing up to the consequences of a 'paradigm shift'. This creates unquestionable opportunity but with it comes challenges, not least in the face of a 'regulatory tsunami' which will leave no participant in the value chain unaffected. Manufacturers, distributors, advisors and clients will be impacted as political will looks to stabilise the whole financial services industry and prevent a recurrence of the 2008 crisis and the contributory factors that created it. The resultant proliferation of directives, acts and reviews will shape this new paradigm. Here are my somewhat gloomy views of where the asset management industry finds itself, followed by the opportunities and threats of the regulatory tsunami.

A FLAWED BUSINESS MODEL

To paraphrase Churchill, who was originally talking about the Russian national interest before the outbreak of the Second World War, his original statement can be adjusted to:

"*I cannot forecast to you the action of the asset managers. It is a riddle, wrapped in a mystery, inside an enigma; but perhaps there is a key. That key is the collective asset management industry interest*".

The asset management industry, specifically within retail product provision, has adopted a multi-layer distribution chain and is a complex area to do business. With the recent developments of platforms and wraps with the additional cost, retail product provision has come under close scrutiny from regulators. With the UK taking the lead by undertaking the Retail Distribution Review (RDR) the European regulators are considering more stringent regulation in separating distribution and manufacturing fees to be delivered in MIFID II.

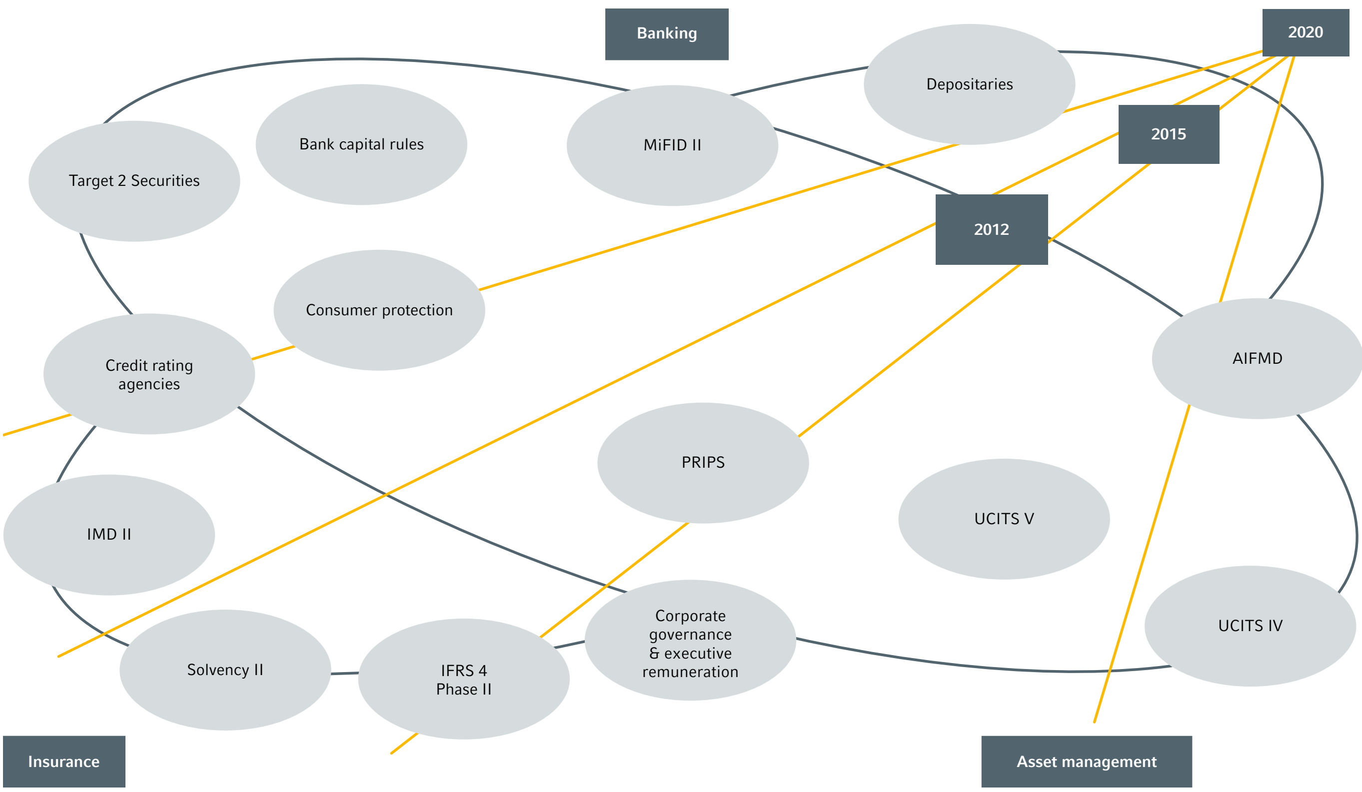
The traditional asset management industry has been created on a flawed and intransigent business model. Change is required but is structurally complex while maintaining viability.

→

The result is that the traditional asset management space is becoming fragmented and has created opportunities for so called 'Alternative Asset Management' businesses while they (the traditional asset managers) address the following issues:

- A triumph of form over substance is at an end, expensive brand maintenance and marketing budgets to support intermediary distribution are unsustainable as the distribution model comes under threat from regulators
- Product manufacturers have relied on intermediated distribution in the retail space and have become disenfranchised from their underlying clients. Independent distribution has become all powerful and a disproportionate consumer of the value chain
- Product is over proliferated and scale inefficient in the retail sector tending, from the perspective of the manufacturing sector, to be low margin and dependent on high volume
- Asset management has not performed over sustained periods of time
- The advisory community is perceived to have sold rather than advised and contributed to an overall reappraisal of the industry value add. The manufacturers have not been able to criticise their distribution 'life blood' and therefore been marginalised in the value chain
- Reward expectations have been overstated while associated risks have been understated
- Complex has become erroneously associated with risk and Simple with less risky
- Fund mandates have become too restrictive and even if used in an advised asset allocated portfolio do not provide dynamic risk management for the end consumer
- Alternative asset classes have been generally ignored in the retail sector while the institutional space has adopted and increased allocations to alternative beta and Hedge fund strategies
- Lack of investment in operational infrastructure and downward pressure on administration costs has limited functionality and a pre-eminence of long only investment
- Investment banks, hedge fund and alternative asset managers have entered the sector and increased competition structured products have had a renaissance and have been increasingly seen as a risk management tool in the discretionary private client space
- Institutional businesses have come under pressure from strategic asset allocation and risk management advisory firms utilising passive vehicles to collapse cost and improve technicals attributes

The regulatory tsunami



Source: Original PricewaterhouseCoopers, replicated by Commerzbank

THE NEW ENVIRONMENT

The term ‘regulatory tsunami’ has been frequently used over the past year to complain that the Industry is in danger of being wiped out by excessive regulation. When PricewaterhouseCoopers presented their version of the ‘tsunami’ diagrammatically during the recent ALFI roadshows the phrase became less emotive and wholly appropriate.

With fourteen separate pieces of legislation phasing in over the next eight years affecting asset management, banking and insurance businesses, it is impossible to imagine anything other than wholesale change.

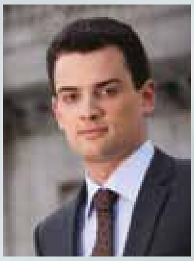
The following table indicates potential impacts of each piece of legislation.

Regulation	Description	Impact	Which Sector?
AIFMD	• Alternative Investment Fund Manager Directive • Compulsory regulation in the EU for all managers running EU funds or raising money from EU investors, requiring significant changes for managers and service providers	Opportunity	Existing robust management companies
		Threat	Shell management companies
Bank Levy	• Idea of global tax on financial institutions rejected, levy varies by individual countries • Broadly modelled on IMF’s financial stability contribution. Aims include recovering costs of bailouts, contributing to a future fund and increasing stability	Threat	Banks
Basel III	• Capital requirement Basel III rules for financial institutions	Threat	Banks
		Opportunity	Fund managers
Dodd-Frank	• Collection of reforms responding to the recent crisis • Requires registration of investment advisers, including non-US advisers	Threat	US asset managers and inward distributors Bank owned asset managers
FATCA	• Foreign Account Tax Compliance act • Reporting regulation that allows IRS in the US to detect tax evasion abroad	Threat	Non US banks, asset managers, funds and other investment vehicles
MIFID 2	• Second ‘wave’ of legislation planned for the markets in Financial Instruments Directive • Likely to extend MiFID’s transparency requirements to non-equity markets	Threat	Commission based advisors Asset manager with intermediated business in Europe
RDR/PRIP	• **RDR:** Retail Distribution Review, launched by the FSA – designed to address how investment products are sold to the retail market • **PRIP:** EU initiative on Packaged Retail Investment Products analysing whether greater harmonisation of regulations governing PRIP’s would improve consumer outcomes and strengthen the single market	Threat	Commission Based Advisors Asset Manager with intermediated business in UK
		Opportunity	Regulated fund business especially UCITS
Solvency II	• New regime for insurance companies • Will also have significant effects on asset managers around the provision of data and asset allocation	Threat	Insurance Companies
		Opportunity	Asset Managers
UCITS	• Undertakings for Collective Investment in Transferable Securities Directive • Versions IV and V being implemented/prepared	Threat	Depositaries and cost base. Potential complex/non complex split

Source: PricewaterhouseCoopers

For further information, please contact: **huw.price@commerzbank.com**

Commerzbank Monthly ETF Flow Report



THOMAS WEBER
INSTITUTIONAL FUND SOLUTIONS

Commerzbank is one of Europe's leading market makers in the exchange traded funds business. As such we see a large volume of transactional flow, both on exchange on OTC, which gives a valuable insight into recent trends and flows in the ETF market. This covers all asset classes, from equities to commodities, money markets and fixed income.

WEEKLY FLOW REPORT

Commerzbank produces a weekly ETF flow report for our clients which enables them to get an overview of recent market trends and allows them to take this additional information into account when managing their portfolios and making investment decisions. In addition Commerzbank will produce a monthly report in this publication to give a broader overview of what we have seen in the market in the past month.

If you would like to receive the weekly report, please ask your usual Commerzbank contact or get in touch with either our London or Frankfurt ETF trading desks.

London Trading Desk – **FIMETF@commerzbank.com**
Frankfurt Trading Desk – **ETFMarketMaking@commerzbank.com**

MARKET COMMENTARY – 08/08/2011– 07/09/2011

August has been a volatile month and we saw a marked increase in trading activity. Given the increased uncertainty about the European debt situation as well as the dimming prospects for global growth the more risky asset classes, such as equities and commodities saw a larger percentage of volume coming from the sell side. Safer asset classes, such as fixed income (particularly German government bonds) and money market ETFs saw net inflows via the Commerzbank platform.

Equity ETFs accounted for around 79% of total transactional volume. The most traded underlying was the DAX, while we also saw good volume in the Euro Stoxx 50 50 50 as well as the MSCI EMU. In general, buy and sell volumes were roughly equal during the month, with sells accounting for 51% of equity volume.

Asset Class in % of Total	Client Sell	Asset Class / Underlying
	48%	
79%	**40%**	**Equities**
	12%	DAX®
	2%	EURO STOXX 50
	2%	MSCI USA
	2%	MSCI EMU
	2%	S&P 500
	1%	MDAX TRI
	1%	LevDAX®
	1%	MSCI Emerging Markets
	1%	MSCI World
	1%	SHORTDAX®
13%	**4%**	**Fixed Income**
	0.44%	Deutsche Börse EUROGOV Germany 5-10
	0.39%	eb.rexx Govt. Germany
	0.39%	eb.rexx Govt. Germany 2,5-5,5
	0.33%	iBOXX EURSovereigns Germany Cap. 5-10 TRI
	0.25%	Deutsche Börse EUROGOV Germany 3-5
7%	**4%**	**MoneyMarket**
	3%	EONIA Index
	0.29%	eb.rexx Money Market
	0.06%	FED Funds Index
	0.05%	Deutsche Börse EUROGOV Germany Money Market
1%	**0.64%**	**Commodities**
	0.48%	Commerzbank Commodity EW Index TR
	0.10%	NYSE Arca Gold BUGS Index
	0.03%	Gold Bullion
	0.02%	FX Hedged DBLC – OY Balanced TRI
	0.00%	Rogers International Agriculture Commodity Index

Client Buy	Asset Class / Underlying
52%	
39%	**Equities**
12%	DAX®
3%	MSCI World
2%	EURO STOXX 50
2%	MSCI EMU
2%	S&P 500
1%	MSCI Emerging Markets
1%	LevDAX®
1%	SHORTDAX®
1%	MSCI USA
0.79%	MDAX TRI
9%	**Fixed Income**
1%	Deutsche Börse EUROGOV Germany
1%	eb.rexx Govt. Germany 1,5-2,5
0.88%	eb.rexx Govt. Germany 2,5-5,5
0.88%	Barclays Capital U.S. Govt. Inflation-Linked Bonds TRI
0.80%	iBOXX EURSovereigns Germany Cap. 5-10 TRI
4%	**MoneyMarket**
3%	EONIA Index
0.55%	eb.rexx Money Market
0.09%	FED Funds Index
0.00%	Deutsche Börse EUROGOV Germany Money Market
0.45%	**Commodities**
0.23%	Commerzbank Commodity EW Index TR
0.11%	NYSE Arca Gold BUGS Index
0.07%	Gold Bullion
0.02%	FX Hedged DBLC – OY Balanced TRIw
0.01%	Rogers International Agriculture Commodity Index

Fixed income ETFs had another strong month, accounting for around 13% of volume. The fixed income segment was very popular, with buy volume outnumbering sell volume by more than 2:1. The most popular underlyings were German government bonds, particularly of short duration (Deutsche Boerse EUROGOV Germany, eb.rexx Govt. Germany 1,5–2,5 and eb.rexx Govt. Germany 2,5–5,5). The most sold underlying by contrast was medium-term German government bonds (Deutsche Boerse EUROGOV Germany 5–10).

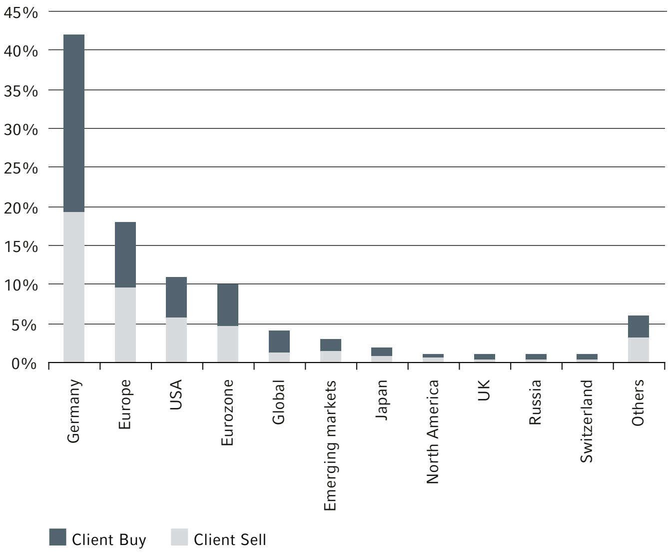
On the sector side we saw net outflows from almost all sectors, apart from basic resources and financial services. The most actively traded underlyings were automobiles & parts, basic resources, chemicals and banks. Together these three sectors accounted for around 50% of total turnover.

For more information, please contact:
thomas.weber2@commerzbank.com

Table 1: Most traded ETFs by region

In% of Total	Region	Ratio Client Sell	Ratio Client Buy
42%	Germany	46%	54%
18%	Europe	54%	46%
11%	USA	53%	47%
10%	Eurozone	47%	53%
4%	Global	34%	66%
3%	Emerging markets	48%	52%
2%	Japan	47%	53%
1%	North America	56%	44%
1%	UK	47%	53%
1%	Russia	47%	53%
1%	Switzerland	45%	55%
6%	Others	53%	47%

Chart 1: Most traded ETFs by region

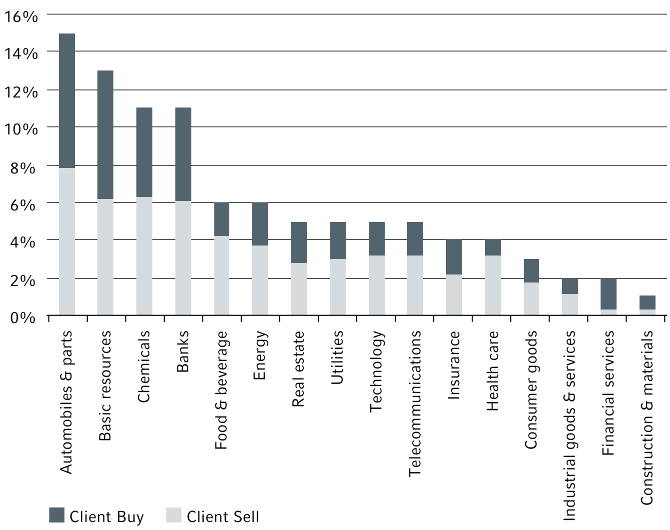


Source: Commerzbank Corporates & Markets

Table 2: Most traded ETFs by sector

In% of Total	Sector	Ratio Client Sell	Ratio Client Buy
15%	Automobiles & parts	52%	48%
13%	Basic resources	48%	52%
11%	Chemicals	57%	43%
11%	Banks	55%	45%
6%	Food & beverage	71%	29%
6%	Energy	62%	38%
5%	Real estate	56%	44%
5%	Utilities	59%	41%
5%	Technology	64%	36%
5%	Telecommunications	65%	35%
4%	Insurance	54%	46%
4%	Health care	80%	20%
3%	Consumer goods	57%	43%
2%	Industrial goods & services	56%	44%
2%	Financial services	15%	85%
1%	Construction & materials	28%	72%

Chart 2: Most traded ETFs by sector



Source: Commerzbank Corporates & Markets

5Y Note on High Yield Bond Funds

Key features

- Term: 5 Years
- Underlyings: Credit Suisse Bond Fund & Julius Baer Multibond Fund
- Price in EUR = 99.50%
- Price in USD = 100%
- Product Category Rating: 1 – Full Capital Protection, if held to maturity, and subject to the issuer credit risk

PRODUCT DESCRIPTION

This five year Note is linked to the performance of two high yield corporate debt funds, both of which have consistently outperformed their respective benchmarks over recent years. The note is designed for investors who believe that the funds will have a positive performance over the next five years and at maturity, will pay the greater between the positive basket performance plus 100% of the invested capital provided no credit event has occurred.

Underlyings:

Name: Credit Suisse High Yield Bond Fund USD
Bbg. Ticker: CSBFHYU LX
Focus: High Yield Debt
Inception: October 2000
Assets: USD44m

Name: Julius Baer Multibond Global High Yield Bond Fund
Bbg. Ticker: JBGHYBB LX
Focus: High Yield Debt
Inception: December 2002
Assets: EUR288m

The Credit Suisse High Yield USD Bond Fund is an open-end fund incorporated in Luxembourg. The fund's objective is to achieve above-average long-term returns in United States dollars. The fund invests in high-yielding fixed-income securities mainly issued by corporations, and to a lesser extent by governments and agencies with an emphasis on investments in the United States. The fund currently has USD44m in assets under management.

The Julius Baer Multibond Global High Yield Bond Fund is an open-end investment fund incorporated in Luxembourg. The fund's objective is to achieve an above-average return in the long term, achieving this through global investments in high yield bonds. Foreign currency exposure is largely hedged. The fund currently has EUR87m in assets under management.

KEY PRODUCT RISKS

- Market risk – the excess payoff of the note's embedded option is reliant on the positive performance of the reference funds
- Commerzbank credit risk – the note will protect 100% of the initial investment provided no credit event occurs over the life of the product
- Commerzbank will endeavour to provide a secondary market on a best effort depending on market conditions

Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However, under some circumstances the secondary market for the investment may be limited.

KEY PRODUCT SENSITIVITY FACTORS

- The investor is long delta – the higher the spot prices of the underlyings, the higher the option price
- The investor is long volatility – the higher the volatility of the underlyings, the higher the option price
- The investor is long correlation – the higher the correlation between the underlyings, the higher the option price

Product Category: 1
The product category indicates the payoff risk as explained below. The rating is for information only, and is intended to provide investors with the means to understand and compare the payoffs associated with our products. Rating 1: Full Capital Protection – If held until maturity, or a pre-defined early redemption date, the security holder will receive the capital invested back. Potential losses are limited to the potential gains, which are dependent on the performance of the chosen payoff. Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However under some circumstances, the secondary market for the investment may be limited.

Additional Risk Disclosures
Before investing in this product, investors should carefully consider its appropriateness and suitability, and the following additional risks:
1. Issuer Risk: Any failure by the issuer to perform its contractual obligations, when due, may result in the loss of all or part of the invested capital. 2. Counterparty Risk: Any failure by Commerzbank AG to perform its contractual obligations, when due, may result in the loss of all or part of the invested capital. 3. Market Risk: Various market factors may affect the value of the investment or the underlying assets, including but not limited to the impact of volatility, interest rates, dividends (if any), foreign exchange. 4. Liquidity/Secondary Market Risk: Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However Commerzbank has no obligation to make a secondary market in the instruments concerned. Accordingly, under some circumstances, the secondary market for the investment may be limited and subject to wide bid/offer spreads. 5. Reinvestment Risk: The risk that the investment redeems prior to maturity at a time when reinvestment opportunities are not favourable for the investor. 6. Redemption Risk: The risk that the investor may receive substantially less than the amount invested, if he/she liquidates the investment prior to maturity. 7. Tax Risk: There may be tax implications based on where the investor resides. Please consult a tax professional before investing. 8. Legal Risk: There may be legal restrictions depending on where the investor is domiciled. It is advised to seek legal guidance prior to investing.
For additional information on the product features and key risks, please contact your sales advisor or refer to the contacts page.

Indices

The Intelligent Quantitative Absolute Returns Trading System (iQArts)

HARRY TSIVANIDIS, TONY RIELLY & MICHALIS KAPSOS
INDICES & STRATEGIES TEAM

Traditional asset classes have failed to provide investors with desirable levels of diversification. Seemingly uncorrelated asset classes exhibit high levels of correlation during crises, reducing the diversification of portfolios when it is most needed. Investors looking for higher levels of diversification have turned to innovative trading approaches, including absolute return strategies. One of these strategies is 'Managed Futures', commonly and collectively referred to as CTAs (Commodity Trading Advisors); the name betrays their initial focus on commodity futures.

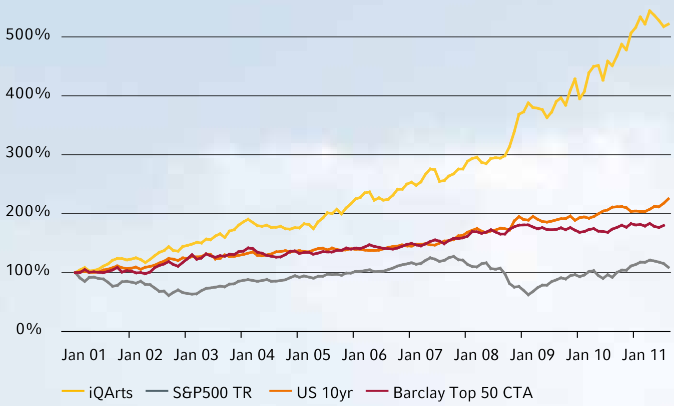
→

The Indices and Strategies team at Commerzbank, using its experience and advanced quantitative knowledge in alpha generating strategies, developed a framework for generating CTA strategies: the Intelligent Quantitative Absolute Returns Trading System (iQArts). iQArts is a set of rules and algorithms that take advantage of statistical information and robust optimisation concepts to interpret trading patterns and identify trending assets. The strategy applies an optimal allocation based on a risk-return trade-off and actively manages the risk of the ensuing portfolio. It currently monitors a wide range of assets covering equity indices, interest rates and commodities.

The evolution of iQArts is based on three major principles; consistent performance over the long run, low correlation with the traditional asset classes and high level of liquidity. iQArts also tries to address one of the well known weaknesses of the majority of Managed Futures strategies, namely performance in range trading markets. Ongoing research is aimed at keeping the system up to date with the latest market developments.

iQArts' innovative approach relies on the Indices and Strategies team's ability to transform complex models into simpler equivalents that are easier to understand and solve. iQArts seeks to identify opportunities early and initiate trades to capture them. A high level of transparency, embedded in a strategy that trades liquid exchange traded derivatives, within the highly regulated framework of a top tier European bank, mark iQArts branded products as ideal candidates for investors seeking portfolio diversification.

The iQArts strategy performance

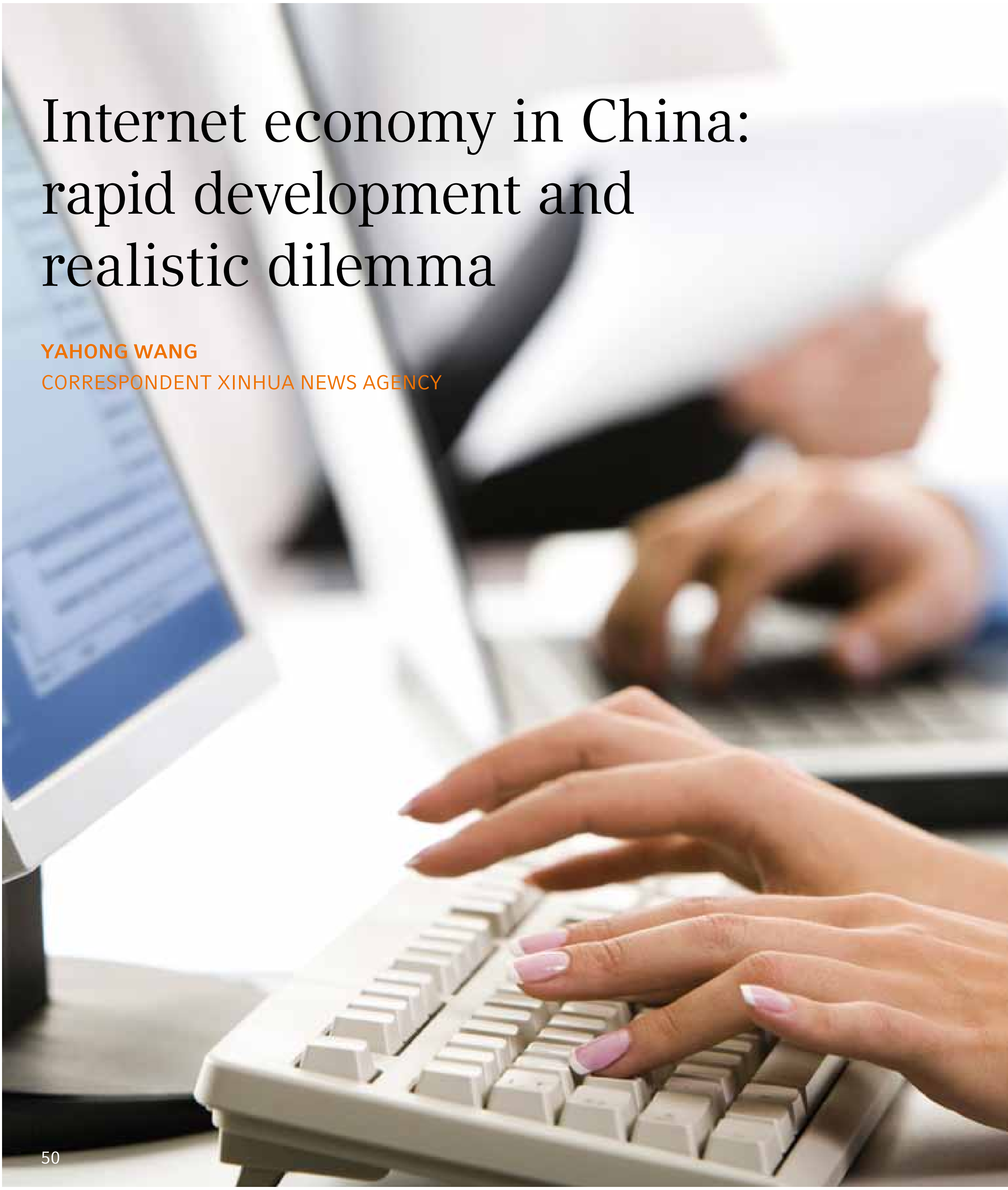


Source: Commerzbank, Bloomberg

IQARTS PERFORMANCE

The iQArts Futures Index – tracking the performance of the absolute return strategy – was launched in January 2011. The strategy was enhanced by the addition of options on the 1st of July 2011 (commodities will be introduced soon). Its performance since inception is shown below and will also appear in **http://www.commerzbank.com/emcideas** soon, replacing the pure futures strategy.

For further information, please contact:
harry.tsivanidis@commerzbank.com
tony.rielly@commerzbank.com
IndicesAndStrategies@commerzbank.com



Internet economy in China: rapid development and realistic dilemma

YAHONG WANG
CORRESPONDENT XINHUA NEWS AGENCY

Internet enterprise is booming in China. With only slightly more than one-third of its citizens online, there is huge growth potential remaining in expanding the online population and, as prosperity flourishes, online commerce growth will surely continue. However, the internet landscape for the Chinese user is significantly different than the one we are accustomed to.

Tudou.com, China's popular video website, held its initial public offering on the New York Stock Exchange in August 2011. According to Tudou's filing, the company has received a 43-fold jump in annual revenue since 2007. Net revenue, excluding sales tax, was around USD53m in the 12 months up until March 2011.

Tudou offers user-generated videos as well as licensed and proprietary content. It has developed so quickly that its users, mostly in China, have little need to use YouTube; the video website giant. Also, Chinese internet users are not able to visit YouTube directly, which allows Tudou space to secure profit in a big market. However, the ambitious Tudou wants to rival YouTube at an international level, not only emulating YouTube's profit model, but surpassing it.

Its IPO on the New York Stock Exchange was Tudou's first step; the company tapped the public market to finance technology upgrades, bandwidth expansion and rights to videos with a view to increasing its share of the world's largest online market.

Tudou is a microcosm of Chinese internet companies. In a country with enormous potential, Chinese companies are innovative and the internet economy in China has brilliant prospects.

Since the introduction of the internet in China in 1993, which acted as an information explosion, China has witnessed rapid growth of the internet as well as public networking services. After rapid developments for many years, dozens of internet companies like Tudou now want to challenge the industry's giants.

INTERNET ECONOMY EXPLOSION: HUGE MARKET

Chinese Premier Wen Jiabao has held online chats with internet users across the country and overseas for three consecutive years. The latest one held in February, covered the issues surrounding China's internet development, and how 'netizens' have became a more and more important social group.

China's online population has grown faster than anyone could have imagined. By October 1997, when the first statistical report on China's internet development was released by the China Internet Network Information centre (CNNIC), China had a total of 620,000 internet users, most of whom obtained their access to the internet through dial-up services.

Compare this to 485 million internet users at the end of June 2011, according to the CNNIC. This meant over one-third, or 37.2%, of China's population is now using the Internet. In other words, China's internet population is more than double that of the 215 million internet users in the US as of July, according to the Virginia-based researcher ComScore Inc.

As the internet converges with traditional sectors, it could well help boost economic restructuring and social development. For example, the internet economy has the power to create additional jobs, reduce operational costs for companies and encourage new entrepreneurs.

The size of the Chinese internet economy in the second quarter of 2011 has reached CNY62.2bn, with quarter-on-quarter growth of 19.2% and year-on-year growth of 77.5%. According to data, the internet economy has experienced a rapid increase in this quarter with a higher growth rate compared to the quarters in 2011. The key driver of the steady increase of the internet economy in the second quarter of 2011 is the rapid development of e-commerce and the country's mobile network.

It is expected that the size of China's internet economy will reach CNY74bn in the third quarter of 2011.

Now China is home to fast-growing start-ups and established multi-billion dollar enterprises in social networking, games, video, music and e-commerce. Three of the world's top 15 websites – Baidu, Tencent and Taobao – are located in China. In terms of market capitalisation, Tencent and Baidu are ranked third and fourth in the world – at USD43bn and USD34bn respectively – behind only Google and Amazon.

Taobao.com, a Chinese-language website for online auctions and shopping founded by Alibaba Group, the country's biggest ecommerce company, reported nearly 200 million registered members and more than CNY200bn (USD29.07bn) in turnover, creating at least one million online sales related jobs.

MOBILE NETWORK: FASTEST GROWING SECTOR

China's star internet companies have developed in different stages. At the beginning, the portals such as Sina, Sohu and Netease were winners, just as Yahoo dominated the market in the 1990s. Following that, instant messaging, on-line game and search engines all enjoyed success. But now, it is mobile networks which are coming of age.

In the second quarter of 2011, shares of the Chinese mobile networks in the whole internet economy steadily rebounded to 12.5% compared to 11.8% in the fourth quarter of 2010.

Nearly two-thirds of Chinese 'netizens' use the mobile web. With the increasing popularity of devices such as the iPhone and the expansion of the third-generation network, more than 277 million people were accessing the internet via their phones. By the end of June, more than 65% of China's 'netizens' do so.

Companies are stepping up efforts to cash in on the popularity of the mobile Internet. According to the Chinese Telecommunication Equipment Certification centre a WiFi-ready iPhone was approved for sale in China on 5 July 2011. Prior to this iPhones had to be sold in China without WiFi.

Research in Motion, with their Blackberry, have also teamed up with China Mobile to provide smartphones targeting individual users. The growth of mobile internet will be further fuelled by more applications designed for mobile users. With the rapid development of mobile network market segments such as mobile ecommerce, mobile advertising and mobile gaming, the share of the mobile network economy as part of the whole internet economy will continue to expand in the coming quarters.

INSIDE THE MARKET: REGULATION AND CREATION

Chinese 'netizens' refer to the World Wide Web in China as 'the biggest local area network'. This self-deprecating nickname reflects the fact that Google has been pushed out of China, while Facebook, Twitter and YouTube are censored.

Critics believe China's 'netizens' lack freedom of speech. However, according to a white paper on internet policy published in 2010, the Chinese government stressed the guarantee of citizens' freedom of speech on the internet. The report noted that the Chinese government actively advocates and supports the development and application of the internet across the country, stressing the government's internet policy: active use, scientific development, law-based administration and ensured security.

In order to better regulate the internet to ensure its healthy development, China's government set-up a 'State of internet Information Office' in May. The objective of the office is to direct, coordinate and supervise government authorities' management of online content and handle administrative approval of business related to online news reporting.

It works to direct the development of online gaming, video and audio businesses and online publication industries. It is also responsible for investigating websites and enforcing punishments if laws or regulations are violated.

The State of Internet Information Office displayed its power right at it's inception, launching a two-month campaign to crack down on illegal publishing activities on the internet. In June, authorities closed down 55 websites engaging in illegal online publishing based on information provided by the public.

According to officials, these websites recruited 'internet mercenaries' to engage in improper competition against rivals, actions such as fabricating or distorting facts which may have led to blackmail or seeking to reap profits by sensationalising issues via the internet.

On the one hand, the authorities wish to control the internet tightly, on the other hand, the government realises that the internet has served as a new platform for public supervision, producing great influence and featuring a wide range of participation. Therefore, it is making an effort to enact laws and regulations to ensure a convenient and unimpeded channel for the public.

INTERNATIONALISATION: COULD CHINA EXPORT ITS MODEL OVERSEAS?

Baidu's successful listing on NASDAQ in 2005, encouraged more high-tech companies to seek IPOs in the US. On the Chinese mainland cultural differences and governmental policy have left the West's household names behind. China's online population already favours Baidu over Google. They don't need eBay because they have Taobao. It's also the same with Facebook which has an equivalent, Kaixin. QQ is used for instant messaging, online games and social networking. All these services have one thing in common: they are very popular.

Many of these companies are not satisfied with just dominating the domestic market. Chinese internet companies are beginning to project their power overseas, through partnerships, investment and mergers and acquisitions, or through their sheer scale at home influencing global trends. Some recent examples are Tencent's USD300m investments in Russia's DST, giving it an indirect stake in Facebook and Zynga, Changyou's acquisition of San Francisco-based Mochi Media.

China's biggest online marketplace Alibaba also launches platform AliExpress as it sets its sights on the US, India and Japan. In recent months, Alibaba has made its first two US acquisitions, Vendio and Auctiva. It is pushing to expand its overseas presence with AliExpress, its new online venture.

Chinese firms have started to invest in or acquire companies in the US. They export not only funds but also innovative business models. More crucially the sheer size of China's market means that future global business models in areas such as virtual currencies, online media and e-commerce will be increasingly 'Made in China' just like the consumer electronics for which the country is currently famous.

For example, the online Chinese gaming market has become the biggest, internationally recognised, potential market. In 2010, the scale of the online Chinese gaming market reached CNY32.37bn, an increase of 26% from 2009. Such strong growth can be attributed to the 'free service' model. It is undeniable that there are still gaps between China and other nations in terms of software development. However, the innovative business mode of Chinese game providers has won approval from many of their foreign counterparts.

Consequently, the Chinese domestic market presents huge potential commercial opportunities, but for those foreign companies jealously eyeing the market from the outside, the reality is that the business environment is already fiercly competitive, populated with highly innovative Chinese technology firms benefitting already from scale and foothold, the hurdles to success are not to be underestimated. Equally, these Chinese companies which have survived and flourished in the super-competitive domestic markets, may be well positioned to challenge the established global players on a global scale.

China's high speed train may slow down for good

DIAO YING
FREELANCE JOURNALIST

My first experience with high speed rail in China was in September 2008, when I went from Beijing to Tianjin to cover the summer session of the World Economic Forum. At that time, the developed world was experiencing the worst financial crisis since the 1920s. Western leaders came to the meeting with thorny problems to solve at home. Yet for Tianjin, the host city, the atmosphere was anything but subdued. It treated the event as an opportunity to showcase its ability to handle world class events and its advanced infrastructure, among which the newly completed high speed train was the most exciting.

It takes less than 30 minutes to travel from Beijing to Tianjin with the bullet train, known as the 'Harmonious Express', while a normal, cheaper train would take two and half hours. It was air-conditioned, bottled water was complimentary, tickets were sold in accordance with available seats to ensure every passenger had one. All these might be common practice in the West, but, in China these are quite unusual. Standing tickets are available most of the time to make sure trains carry as many people as possible. After years of taking trains in China that are slow and overcrowded with even the aisle full of the people, it was an exciting experience for me.

The bullet train connecting Beijing and Tianjin for guests of the WEF Summit was only the start of the nation's ambition to build high-speed railways. In less than seven years, China has established the world's largest high speed railway network. Its investment in high speed trains has been rocketing especially since 2008, when the government planned CNY4 trillion to stimulate the economy as a reaction to the financial crisis. The total investment in high speed railway reached CNY700bn in 2010, more than triple the CNY208.8 billion in 2006, when the high speed railway project was first started. New projects have begun almost very month since then.

While the outside world watched in awe at the huge investment and projects completed at breathtaking speed in China, its railway system got more criticism than compliments at home. This year in particular, the sector is dominated with corruption scandals and accidents – even disasters.

Liu Zhijun, head of the railway ministry since 2003, was removed from his position in February this year amid investigations related to corruption. He was accused of taking advantage of his position as a minister to help his relatives make profits from projects related to the high-speed railway. The minister, also known in China by his nickname 'Leap-forward Liu,' is famous for promoting the rapid expansion of the country's high-speed railway network. Only five months after Liu's removal, a deadly disaster happened as the collision of two high speed trains near Wenzhou in eastern China on 23rd July killed at least 40 people, with 191 injured.

These cases show that the fast railway expansion within a short period of time has brought many problems. They have been neglected before, and now this neglect is coming to light. First, the rapid development appears to have happened at the cost of security. China claims it has used its own technology to develop the bullet train. The accidents showed that the technology might not be as reliable as people like to believe. Second, the railway management in China is operated in a closed system, with the railway ministry functioning both as the regulator and operator. It sets the rules and it is the only player in the market.

That has lead to corruption as well as inefficiency. In fact, the rapid expansion has already burdened the ministry with heavy debts. In the first half of 2011, the ministry had total assets of CNY3.57 trillion, compared to debts of CNY2.09 trillion, according to figures released by the ministry this month. The liabilities-to-assets ratio is c. 58%.

The series of problems this year might lead to a change in the country's railway development strategy. The leap-forward development of the country's high speed railway network expansion might be put on hold. After the accident in July, the State Council, China's cabinet, started a security check of the high-speed railway programmes. It will also start the re-evaluation of many projects approved before.

Statistics show that investment in railway development has started to slow down. Spending on railway construction plunged 50% last month after the crash. China spent CNY33bn on railway construction in August, compared with CNY65.5bn a year earlier, according to the railway ministry. In total, railway investment in the first eight months of the year dropped 11% to CNY316.5bn compared with the same period last year.

Despite these accidents and interruptions, the development of China's railway is unlikely to stop. Demand for railway in shipping goods and passengers in China is still outstripping supply. Getting a train ticket is a headache for most Chinese people, especially during holiday seasons and in the vast less developed regions. Poor railway capacity remains a bottleneck for its economic development, as transporting natural resources from remote western provinces to feed the industrial needs of the southern provinces is still difficult. The high-speed train projects mirror the World Exposition in Shanghai and the Beijing Olympics. It shows prosperous and dynamic side of China, but cannot convey the whole picture. These are exciting but exceptional, in sharp contrast with the development in the rest parts of the country.

The length of China's railway system is 91,000 kilometers, about one-third of the total length in the US, which is 260,000 kilometers. The country aims to increase the length of the railway to 120,000 kilometers in the coming five years, with 16,000 of high speed railway, according to government's 12th Five Year Plan which runs through 2015. Officials have said that that goal has not changed despite these accidents.

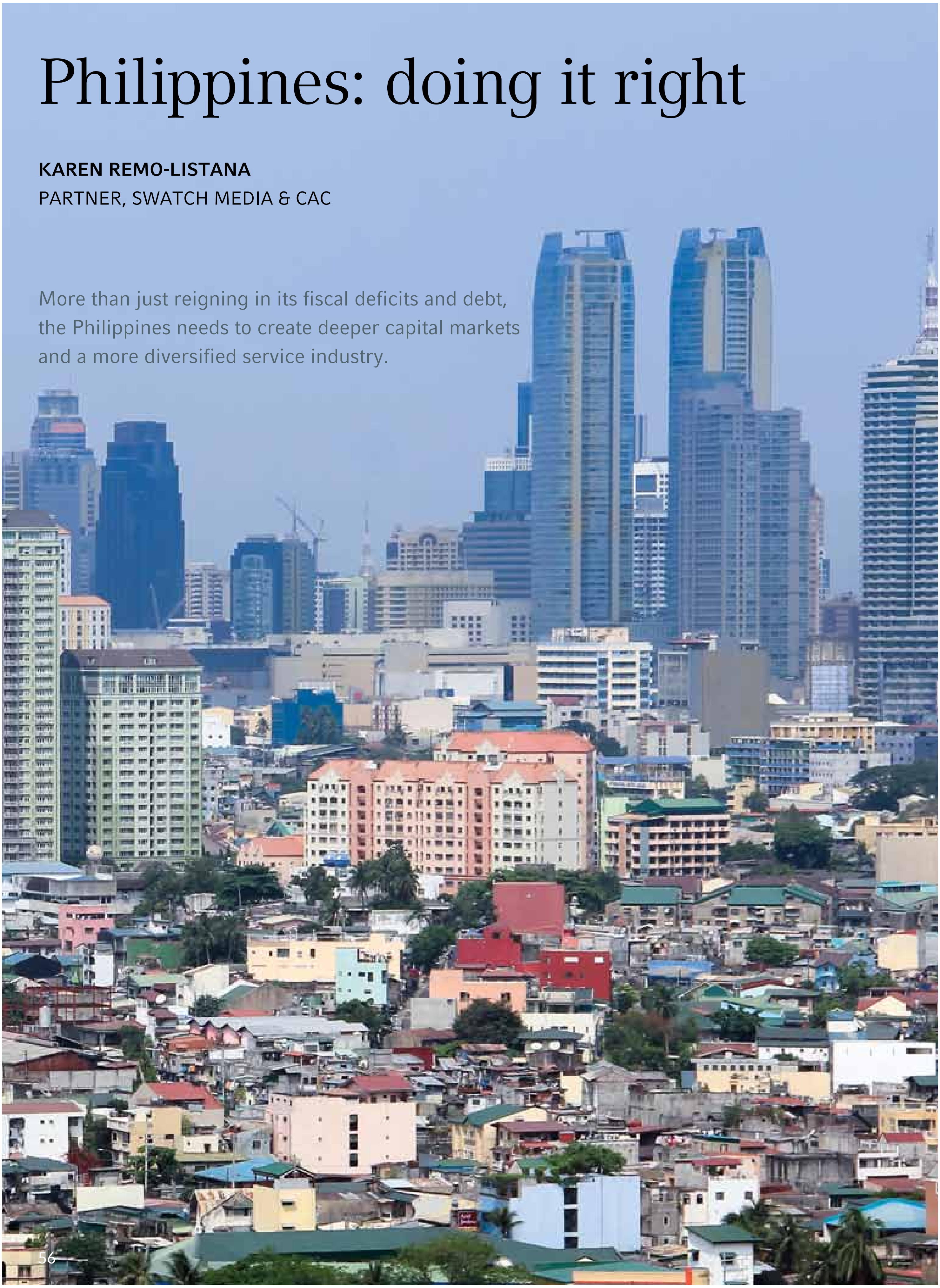
In fact, China's railway network development is a perfect example of the imbalance in China's economic development. The world's largest high-speed railway system is in co-existence with the least developed railroads. On one side is super high-speed, clean and efficient, the other side is much less developed, badly equipped and crowded. The latter is the one that needs change the most. What is going to happen after the tragedies this year, I hope, is a more balanced railway network expansion, instead of the emphasis on high-speed railways only.

As a student from an obscure little town in the northeast of China, I personally experience the contrast constantly when traveling by train in China. My hometown is not far away from Beijing – it is merely 480 kilometers away from the capital. A car drive takes around five hours but it takes more than 12 hours by train. When I studied in Beijing 10 years ago, my biggest problem was to get a ticket home for the Spring Festival, the Chinese equivalent of Christmas. I took the same train in a recent trip to China, and was disappointed to find that time hardly changed anything. I sighed knowing that I was going to sit there for the whole night, but I knew that I was not the most unlucky person. Opposite me sat a businesswoman, who would have to sit for more than 24 hours, because her destination was further north of the country. She told me that she had never taken a bullet train. A better railway network will help her, I thought, and that does not have to be a bullet train.

Philippines: doing it right

KAREN REMO-LISTANA
PARTNER, SWATCH MEDIA & CAC

More than just reigning in its fiscal deficits and debt, the Philippines needs to create deeper capital markets and a more diversified service industry.



After close to 400 years of foreign domination – Spanish colonisation and then US rule from 1898 to 1946, the Philippines must have learned not to fully trust any foreign entity that offers only sweet promises.

Despite its strong economic relationship with the US, the Philippine banking sector – which makes up 80% of total financial system resources – had limited direct exposure to distressed financial institutions overseas. Conservative regulatory policies, including the prohibition of investments in structured products also shielded its insurance sector.

With less exposure to toxic assets and OFWs (Overseas Filipino Workers), which has reached more than 10% of the Philippine population, showering their remittance even during tough times, Philippine real year-on-year GDP growth in 2009 still rose by 1.1% which is a reduction from 3.8% growth during 2008; a remarkable achievement compared to many countries who saw major contractions.

Come 2010 and GDP growth rebounded to 7.3%, the best performance in almost 25 years, and remittances from overseas workers rose sharply. Overseas workers' remittances expanded by 8.2% in 2010 to USD18.7bn (nearly 10% of GDP) and helped support the balance of payments and international reserves.

This growth is fuelled in part by election-related spending, optimism over the peaceful transition to a new government, and an accommodating monetary policy. And to start with, 2010 growth performance was a big leap considering a lower base rate in 2009.

"A number of factors contributed to a rise in consumer spending, with money flowing into the economy in 2010 due to the general election and the feel-good factor of voting in a new president providing an extra boost," Oxford Business Group writes in a report.

The slowing down of the economy this year is therefore expected. Annualised GDP growth fell to 4.9% during the first three months of 2011, the third successive quarter to post a decline in the rate of expansion. This deceleration will make it difficult to achieve the 7–8% growth target set by the government for 2011.

According to the US Department of State's estimates, the country will need sustained economic growth – at least 7–8% per year – to make progress in poverty alleviation given the Philippines' annual population growth rate of 2.04%, one of the highest in Asia.

The portion of the population living below the national poverty line increased from 24.9% to 26.5% between 2003 and 2009, equivalent to an additional 3.3 million poor Filipinos, data from US Department of State showed.

Nonetheless, Philippines' current growth is in line with the general consensus. The World Bank and the IMF both projected a 5% increase in GDP for this year, followed by 5.4% in 2012. Metrobank, the country's second largest bank by assets, has also projected an annual GDP growth of 5%, albeit this is a trim down from bank's previous forecast of 5.7%.

Externally, the slowdown is blamed on global factors, including the March earthquake in Japan, political unrest in the Middle East and the US and Western economies' woes.

Internally, the slowdown is also caused by the sluggish flow of state funds, with a number of major programmes behind schedule. Metrobank's previous forecast of 5.7% was based on strong personal consumption expenditures, business spending and continued fund injection by the state. "However, it looks increasingly clear that the last part didn't happen as planned since government spending actually dropped from year-end 2010," Marc Bautista, the head of research at Metrobank, said.

There is also a trickled effect on the retail sector, which contributes 12–15% of GDP, with sales expected to top USD31bn this year. Data from UN shows more than 60% of the country's population is economically active, and its 20–44 age group – the highest-spending bracket – comprises almost 40% of the total in the range.

PricewaterhouseCoopers (PwC) has taken a slightly more conservative view on the retail sector, forecasting that it will expand by around 3.2%, less than half the estimated 7% growth spurt it enjoyed in 2010. Though this year may see less of an increase, the 3.2% expansion predicted by PwC is in line with the projections for Singapore and Indonesia, with the retail sectors of all three forecast to grow by 3–5% annually for the next five years.

The economic slowdown can also be good in totality. One concern economists have about any shopping spree is that heated demand could help fuel inflation, with Bangko Sentral ng Pilipinas (BSP) predicting consumer prices will rise by around 4.4% this year, up from the 3.8% posted in 2010. In late February, the reserve bank warned that demand-side pressures could develop in the near future as actual domestic output continued to expand above the historical trend.

"Inflation has remained moderate, averaging 3.8% for the year ..." However, pressures could build during this year, the report suggests. "Going forward, BSP will need to stay ready to respond to price pressures, in order to head off liquidity and inflation risks," the IMF warns.

Along with a slowing of the economy, there has also been a widening of the trade deficit. As of the end of March, exports

stood at USD12.2bn, well short of the USD15.58bn paid out for imports. This is despite the fact that merchandise exports, which rely heavily on electronics shipments for more than 60% of sales, grew by nearly 35% during 2010; electronics export revenues increased 38%, beating industry forecasts and recovering to pre-crisis levels. Trade analysts however point out that although there has been some improvement over the years, the local value added of electronics exports remains relatively low.

To reduce the trade gap, the country has started looking for trade relationships with non-traditional partners. Another way to address the trade deficit is to boost its business process outsourcing (BPO) and to develop other service segments such as tourism.

The Philippines' business process outsourcing (BPO) industry currently accounts for about 15% of the global outsourcing market and has been the fastest-growing segment of the Philippine economy. Although industry revenues slowed from 40% growth during 2006 and 2007, the BPO sector exhibited resilience amid the global financial turmoil, generating more than USD6bn in revenues in 2008 (up 26%) and USD7.2bn in 2009. BPO revenues rose 26% to nearly USD9bn in 2010. The sector created about 100,000 new jobs in 2010, bringing total BPO employment as of end-2010 to about 525,000.

Macro-level wise, the Philippines over the last few years has been able to control the fiscal deficit, bring down debt ratios, and adopt internationally-accepted banking sector capital adequacy standards.

Although still relatively high, the debt of the national government has declined to under 56% of GDP (from a 2004 peak of 78% of GDP); and the consolidated public sector debt has declined to about 75% of GDP (from a 2003 peak of 118% of GDP), figures from US State Department, showed.

The national government worked to reduce its fiscal deficits for five consecutive years to 0.2% of GDP in 2007 and had hoped to balance the budget in 2008 but opted instead for measured deficit spending to help stimulate the economy and temper the adverse impact of global external shocks on the already high number of Filipinos struggling with poverty. The national government ended 2008 and 2009 with deficits equivalent to 0.9% and 3.9% of GDP, respectively. The deficit-to-GDP ratio declined to 3.7% of GDP in 2010, consistent with the Aquino administration's medium-term goal to reduce the deficit to 2% of GDP by 2013.

Meanwhile, the Philippine financial sector withstood the global crisis well, and asset bubbles have not been a concern so far. Non-performing loan ratios have remained low and banks' capital adequacy ratios and profitability have improved. Moving ahead, the IMF says, it is critical to further strengthen the banking supervisory and regulatory framework.

With banking taking the lion's share of total financial system resources, the country obviously needs deeper capital markets. And with foreign capital flows increasing, one of the main beneficiaries is the equity market.

Last year, the Philippines capital market saw a couple of IPOs taking advantage of the high levels of liquidity in the marketplace and the increasing momentum in the country's economy. The buoyancy of the Philippine Stock Exchange (PSE), which has seen its main index rise by around 40% last year, has attracted investors.

One of those who IPO'd was the local low-cost airline Cebu Air Inc., which closed its IPO in mid-October, and raised more than USD540m through the listing of more than 186m of its shares on the PSE, with 70% going to overseas investors. This, according to PSE chairman Hans Sicat, was the second largest in the local stock market's history.

Internet data centre services provider IP Converge also IPO'd, with the raised funds earmarked for network expansion. Mining company Nickel Asia on the other hand earmarked the funds to make acquisitions to further strengthen its position in the sector.

A handful more are looking at going public, thanks to the continuing inward flow of capital from overseas. This spike in the IPO market has also prompted overseas brokers and traders, such as Credit Suisse, to enter the Philippines.

The Philippines insurance sector on the other hand is threading a stable growth path thanks to the country's positive economic indicators and an increased demand for insurance products.

Mayo Jose B. Ongsingco, president of both the Philippine Life Insurance Association Inc. (PLIA) and Insular Life Assurance Co, forecast that Philippines life insurance market expects premiums will rise by 23 to 24% this year.

The Philippines experienced some of the worst natural catastrophes in its history at the end of 2009, with Typhoon Ketsana causing severe flooding in the heart of Manila, the country's business and economic centre. As a result, property insurance rates significantly spiked during 2010. However, other lines of insurance remained relatively stable, as capacity, competition and demand for cover continued to be well-balanced.

According to Marsh, rates for casualty insurance remained stable. "In general, there has been an increase in awareness due to legislative changes, consumers becoming more assertive with their rights and the desire for companies to align with international standards. Despite all of this and higher losses, participating insurers opted to maintain their premiums for business retention," it said.

Looking ahead, it said the Philippine insurance industry, being thinly capitalised in general, will continue to be dependent on the international insurance market for capacity and underwriting capabilities.

"Insurance buyers will see at least a 5 to 10% increase in rates in the coming year for high risk operations, but some will still be willing to be competitive to retain and increase market share," Marsh said.

Employers Liability and Workers' Compensation are statutory lines of insurance handled exclusively by the state through its agencies – the Social Security System and PhilHealth. Private sector insurers and intermediaries are not allowed to play a role in its procurement or administration. Since the mandatory benefits are considered inadequate even by local standards, private sector employers generally supplement these with supplementary voluntary Employee Benefits programmes or Contingent WC/EL coverage under CGL policies as second layer once the statutory coverages are exhausted.

Other insurance lines such as trade credit, environment (despite some highly publicised environmental incidents) and professional indemnity remain a small part of the insurance sector.

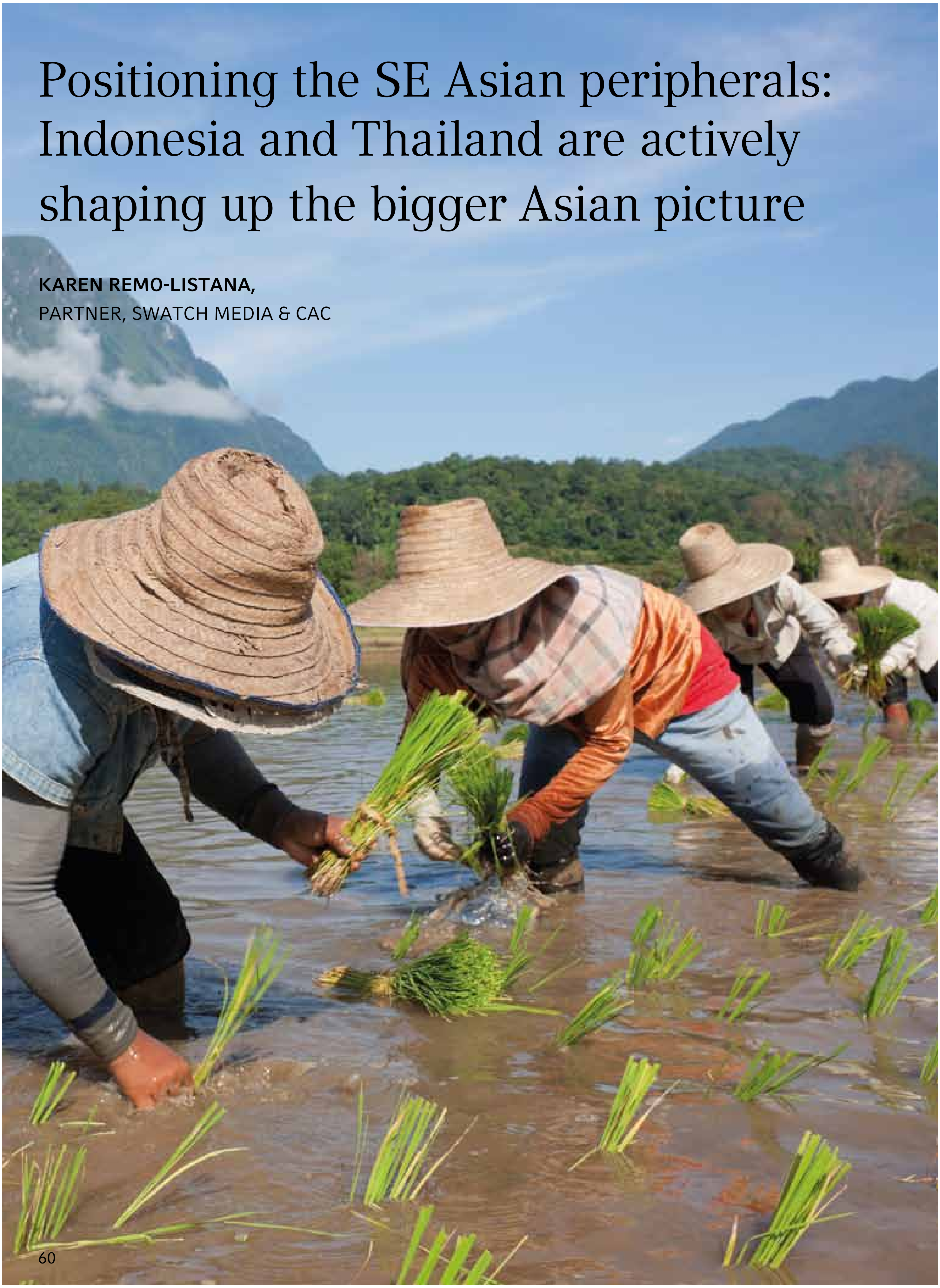
Overall, while the World Bank commends the economic improvements in the country, it also pointed out the need to do more to develop its tourism industry, which would help create employment and alleviate poverty.

The World Bank said major impediments to tourism competitiveness are largely the result of poor transportation infrastructure, which reduces accessibility to tourism destinations and discourages private sector investments.

According to the US State Department, currently, potential foreign investors, as well as tourists, remain concerned about law and order, inadequate infrastructure, policy and regulatory instability, and governance issues. While trade liberalisation presents significant opportunities, intensifying competition and the emergence of powerful regional economies also pose challenges. "Philippine anti-corruption efforts have been inadequate and inconsistent and more needs to be done to improve its international image – an effort that will require strong political will," it said.

Positioning the SE Asian peripherals: Indonesia and Thailand are actively shaping up the bigger Asian picture

KAREN REMO-LISTANA,
PARTNER, SWATCH MEDIA & CAC



When the 'rich' economies' secret was cracked open – in that they are nearly drowning with debts and that they, themselves are getting help from the so-called 'emerging' ones – people began to turn their heads to a new hero: Asia.

And why not? While the United States lost net six million jobs since January 2008, over the same period, millions have been created in Asia supporting a strong rise in consumption.

And we're not talking developed Asia here such as Japan and Singapore but emerging Asia, whose car sales have risen from 18 million units in 2007 to almost 33 million in 2010, according to J.P. Morgan.

This growth is spurred by China and India – China whose economy is growing at around 9% per year and will make up the largest part of the increase in wealth for the region; and India, whose economy is the tenth largest in the world by nominal GDP and the fourth largest by purchasing power parity (PPP).

But the Asian picture is much more than just 'Chindia' alone.

South East Asian peripheral states are also making a name in the global economy and trade map. Indonesia and Thailand, the two largest economies in this region, have been seeing growth trends that are shaping up the world economy.

Indonesia, for one, is positioned for the fastest growth in HNWI (high net worth individuals) making it among the favourite topics of wealth and asset managers.

In local currency terms, Indonesia's nominal GDP is set to grow at 16.5% per year over 2010–2015, according to 'Wealth Report: Asia', jointly published by CLSA Asia Pacific Markets and Julius Baer.

This rupiah is also one of the strongest currencies with still 29% upside to its PPP value. Over the coming five years, it is estimated that the rupiah will appreciate close to 6% per annum.

The report surmises that in US dollar terms, the Indonesian economy will grow at 23.5% per year. In line with these, the Indonesian property values could also rise 11% per year, while stock market is slated to provide returns close to 15% per year, matching earnings growth, estimates from the report show.

The IMF has little to negate. Milan Zavadjil, Senior Resident Representative of the International Monetary Fund in Indonesia said: "Indonesia is experiencing strong economic growth, supported by solid export income and investment. Recent falls in food prices and the postponement of a planned reduction in fuel subsidies have reduced immediate inflationary pressures. Sales and production indicators remain solid, while measures of business and consumer confidence continue to improve".

Thailand is also within the growth's radar, registering 8% growth in 2010 making it one of the fastest growing economies in Asia and the fastest growing economy in South East Asia.

The country has a GDP net worth of THB9.5 trillion or USD584bn PPP making it the 24th largest economy in the world. This classifies Thailand as the second largest economy in Southeast Asia after Indonesia.

In July, the World Bank upgraded Thailand's income categorisation from a lower-middle income economy to an upper-middle income economy. The World Bank annually revises its classification of the world's economies based on gross national income (GNI) per capita estimates using the Atlas method. As of 1st July 2011, upper-middle-income economies are those with average incomes of USD3,976 to USD12,275. Using the Atlas method, Thailand's GNI per capita is currently at USD4,210.

The upgrade, according to World Bank Senior Economist Kirida Bhaopichitr, is in recognition of Thailand's economic achievements in the past decade in which GNI per capita has almost doubled, while poverty has been significantly reduced.

"The country has been prudent in macroeconomic management with a strong fiscal stance and low public debts and inflation," Bhaopichitr said, "Thailand has a friendly business environment and has been successful in attracting foreign direct investments and achieving greater diversification in manufacturing production, both in terms of higher value-added production and expansion into new emerging export markets".

BANKING

Indonesia is a rising giant – it is set to be one of the economic powerhouses of the twenty-first century, is the fourth most populous in the world, has the world's largest tin mining industry, and has a rapidly developing industrial sector. According to PricewaterhouseCoopers (PwC), by 2050, Indonesia's economy could be bigger than the UK or Germany.

"Although international organisations have built up a significant presence in the Indonesian banking sector through the sale of banks following the Asian financial crisis of 1997, the recent pace of investment has been tempered by high interest rates and high levels of non-performing loans", it said.

→

Now, Indonesia is moving to the centre of the radar as interest rates decline, bad debts come under control and credit demand begins to accelerate. As per PwC's estimates, by 2050, the size of the Indonesian banking sector could rival that of France or Italy, while returns could be considerably higher.

After the recession dust has settled, Indonesia's banking sector is now poised to boosting its profitability.

HERE ARE A FEW OF PWC'S FINDINGS

The compound annual growth rate (CAGR) of consumer lending between 2002 and 2006 was 30%. By 2050, projected domestic credit is expected to be some 70 times larger than 2004.

Acquisition (up to 99% foreign ownership permitted) could prove a relatively quick and effective way to establish a market presence, especially if the strategy is to enter niche segments.

Takeover prices are relatively high (2.5 to 3 times book value) on account of the limited supply of available targets in Indonesia, along with the increasing demand for banks in growth markets regionally. However, further privatisation, government curbs on multiple ownership and changes to capital adequacy requirements will mean that there are more banks available to acquire.

Over the years, several leading international groups have established greenfield (up to 99% foreign ownership permitted) or branch operations. However, gaining new licenses could prove difficult at a time when the government and regulators are keen to reduce the number of banks.

Similarly, Thailand's banking sector is also on an upward trend. Throughout 2010 Thai commercial banks have enjoyed higher earnings and better profitability, mainly attributable to growth in loans, core business performances, along with increasing revenues from fees and services.

This year has also seen positive developments. According to Bank of Thailand, the Thai banking system performed well in the second quarter of 2011 – the sector remained strong and profitable due to continued loan growth and decline in non-performing loans (NPL).

Nawaporn Maharagkaga, Senior Director, Financial Institution Policy Group, said liquidity was slightly tightened although fund mobilisation via deposit and Bill of Exchange (B/E) accelerated. Meanwhile, capital remained strong from increased profit, and adequate to support ongoing credit growth.

In the second quarter of 2011, loans expanded by 15.1% year-on-year, increasing from 13.4% in the last quarter, attributable to corporate loans (comprising 71.4% of total loans) which grew by 14.9%, compared to 12.2% in the last quarter.

The growth in corporate loans was in line with the economic expansion and resumption of production in industries previously affected by supply disruption from the disaster in Japan in March 2011.

Although the banking system continued to record positive profit and robust, going forward, it is important to remain vigilant in

risk management, in the light of the uncertainty in economic environment, particularly volatile global economic conditions.

RISKS AND CHALLENGES

Both Indonesia and Thailand have lesser external exposures. This has of course pros and cons. On the positive side, countries with significant domestic demand are expected to be one of the most resilient economies in the event of a synchronised global slowdown. It has often been argued that domestic demand orientation, as opposed to export dependency, has insulated the country from external headwinds.

In the case of Indonesia, with private consumption making up the lion's share (57%) of GDP, a decline in global demand should theoretically have a relatively small impact on the economy as a whole.

In 2009, Indonesia's economic growth did slow to 4.6%, according to DBS Research, but the figure is commendable compared to a contraction suffered by export-oriented economies such as Singapore.

However, any internal conflict could also drastically pull down a country's economy. In the case of Thailand, political uprising caused severe disruption in major industries and lead business confidence to drop.

According to the Economist Intelligence Unit, Thailand's political problems do not appear to be over and Thailand's political outlook for 2011 does not seem to be a positive one.

Another potential problem that could add even further uncertainty and struggle to Thailand's political outlook for 2011 and beyond, is the health of the very popular reigning monarch. The current monarch has long been seen as a stabilising force in Thailand's domestic affairs, but has not been seen in nearly a year.

According to the forecast of the Economist Intelligence Unit, GDP growth in the Thai economy will come in around 4% in 2011, with political uncertainty continuing to undermine consumer and business confidence. However, as in the first half of 2010, although political risks could hinder future investment, business operations in Thailand (particularly in the country's industrial zones) are likely to be generally unaffected in any direct way by political unrest. Thus, as long as global demand continues to grow, Thailand's export-oriented manufacturers should continue to reap the benefits.

Indonesia and Thailand are two important countries that investors need to closely monitor. Although the longer-term outlook is positive, negative sentiment will inevitably spill over into the export market as well as the capital markets.

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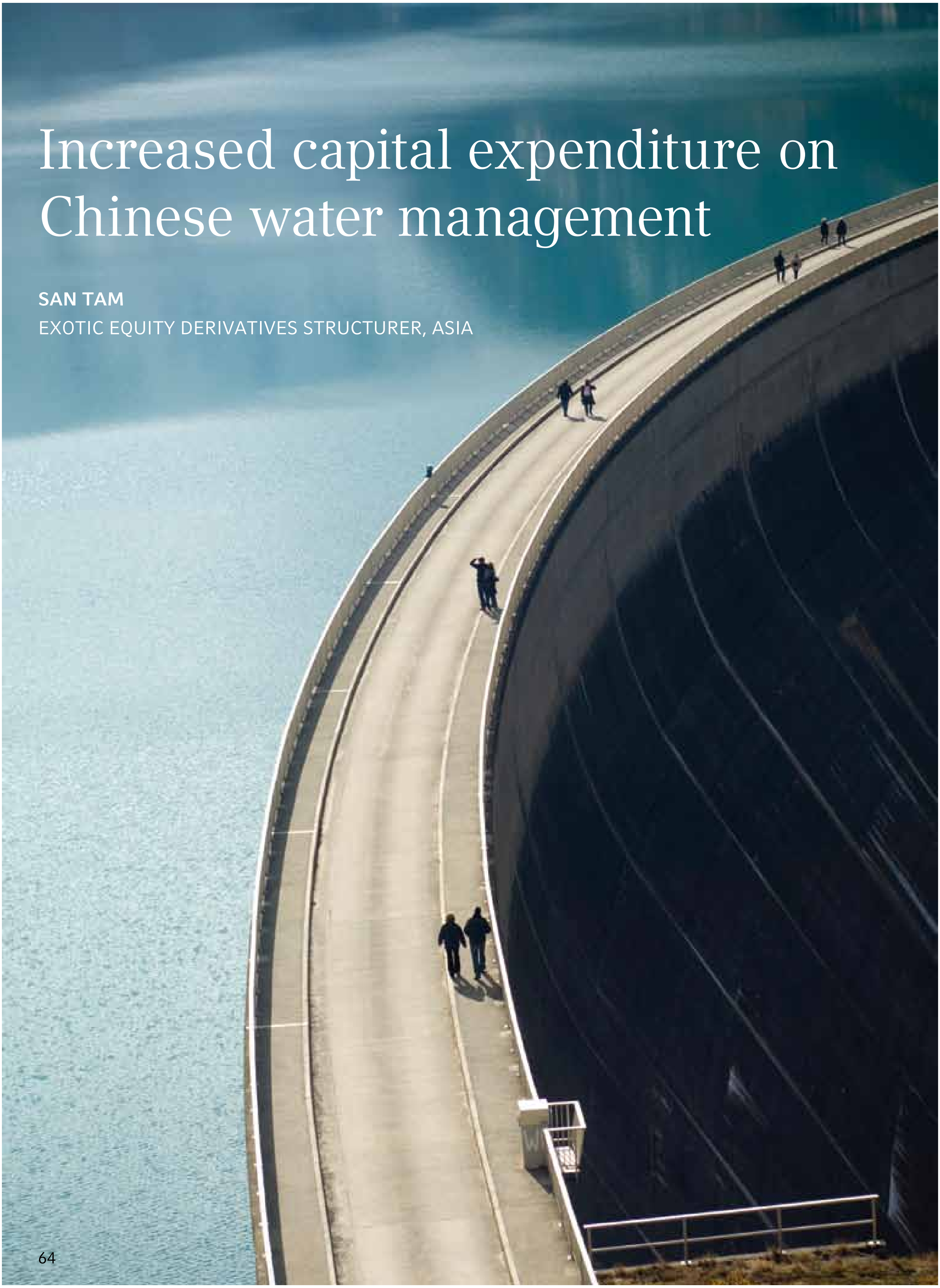
Increased capital expenditure on Chinese water management

SAN TAM
EXOTIC EQUITY DERIVATIVES STRUCTURER, ASIA



The Water Supply & Drainage Works Conference held by the Chinese Central Government concluded in July 2011. Considering the serious damage caused by a number of natural disasters in recent years, and the spoiled environment resulting from the development of an industrial economy, the government is aiming to speed up the enhancements on water supply systems, water safety, and flood prevention & drainage works.

Public interest and benefit were placed as the top priority, for which the enhancement works targeted to protect and improve standards of living. They agreed to spend the next 5 to 10 years upgrading existing infrastructures as well as extending its building plans.

Senior level government officials attending this conference included the President, Hu Jintao, and Premier, Wen Jaibao, the Central Political Bureau Committee members Wu Bangguo, Jai Qinglin, Li Changchun, Xi Jingping, Li Keqiang, Zhou Yongkang and others. In fact, this was the first time ever since the People's Republic of China was established, in 1949, a meeting was held discussing this topic under the names of both the Central Government & the Communist Party of China. The target was set to develop a systematic way to prevent flood damage, efficiently allocate water supply, protect and enhance safeness of drinking water including rivers and lakes and allocate more resources on relative researches and studies.

President Hu Jintao declared that they will give priority to related projects and stabilising agricultural water supply is going to be one of the major tasks. 'The new economy and society in China demand more and higher standards of water supply. There is a conflict seen between developing the country and water resources. Water supply is critical to the Chinese economy, ecology and homeland security'.

There were a few particular tasks the President outlined during the conference:

- Boost agricultural production by building and upgrading the current water supply system in rural areas
- Raise the capability to prevent flood and focus on controlling the rivers including strengthening embankments
- Set up a water supply network linking the major rivers, lakes and reservoirs to ensure the stability of water supply
- Protect the aquatic environment with a priority on natural recovery and protection
- Increase the efficiency of water supply and apply strict water control especially on the aspect of water pollution
- Improve science and technology on water management and promote innovation across the nation

The rapid climate change which took place in past years has pushed the government to speed up and decide to allocate more resources and effort to the water supply management. In fact, several serious natural disasters have occurred. For instance, Chongqing and five other provinces across the southwestern region suffered serious droughts in 2007 and 2010 respectively. On the other hand, in 2008, the southern region of China experienced fatal snow storms and the torrential debris in Gansu province led to harmful damages to the embankments and the reservoirs. The floods and droughts have caused thousands of people losing their lives and homes plus billions of dollars loss in the economy.

In China, currently the water resources per capita is 2100m^3 and it is about only 28% of the world's average which ranks at 125th. Two thirds of Chinese cities are experiencing different levels of water shortage. With the rapid development of the economy and the growth of population, the demand for water is booming. Even though water supply has increased from 444m^3 (billion) in 1980 to 597m^3 (billion) in 2009, China is still facing a shortage of 50m^3 (billion) annually. Not only the shortage of water resources is threatening but also the problem of waste is serious. The rate of sewage treatment in Chinese cities only reaches around 70%.

The central government's twelfth five-year plan is targeted to provide safe drinking water for 200 millions rural residents. This project includes upgrading and transforming 41,118 small-scale reservoirs plus another 190 large-scale, 800 medium-scale and 1,500 medium-scale agricultural watering systems. For the past five years, the central government and local authorities have already invested CNY105bn dollars in water management related projects. Further investment is anticipated, and therefore those Chinese companies in the water treatments and engineering sectors might potentially be benefited by these government policies in the near future.

For further information, please contact:
san.tam@commerzbank.com

4Y Individual – Cap Note Linked to four Chinese Water Management Companies

Key features

- Term: 4 Years
- Underlyings:
  CHINA EVERBRIGHT INTL LTD (257 HK Equity)
  BEIJING ENTERPRISES WATER GROUP (371 HK Equity)
  CHINA WATER AFFAIRS GROUP (855 HK Equity)
  GUANGDONG INVESTMENT LTD (270 HK Equity)
- Pricing in EUR: 98.50% (Indicative Re-Offer)
- Product Category Rating: 1 – Full Capital Protection, if held to maturity, and subject to the issuer credit risk

PRODUCT DESCRIPTION

This 48 Month EURdenominated investment product is linked to four Chinese companies which operate in the local water management sector. The product will pay at maturity a redemption equal to 100% of the investment notional plus the upside performance of the semi-annual average of the basket, with an individual cap of 135% on each underlying stock, on each of the semi-annual fixing date.

PRODUCT DETAIL

- **Tenor:** 48 Month
- **Currency:** EUR
- **Observation Date:** Trade Date + (6 x k) months, where k = 1 – 8
- **Quarterly Fixing(k):** Sum of Min [Cap, S(i,k)] / 4
- **S(i,k):** Official closing stock price of Underlying (i) on Observation (k) / Initial stock price of (i)
- **Cap:** 135%
- **Final Redemption:** Notional Amount x [100% + Max (0; Sum of all Quarterly Fixings / 8 – 1)]

KEY PRODUCT BENEFITS

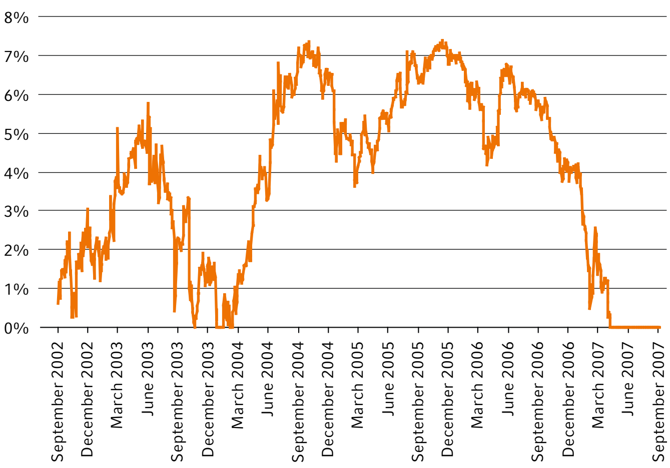
- Exposed to shares related to the water management business in China
- 100% Investment Capital guaranteed
- 8.75% max yield pa
- Great backtesting result

KEY PRODUCT RISKS

- Market risk – the return is reliant on the future performance of the reference stocks
- Commerzbank credit risk – the note will protect 100% of the initial investment provided no credit event occurs over the life of the product

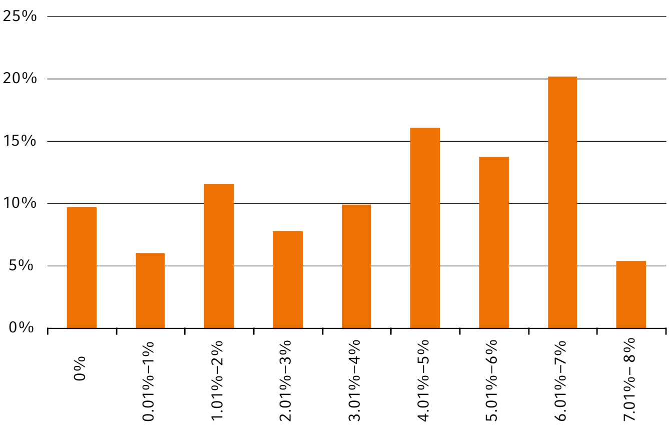
Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However, under some circumstances the secondary market for the investment may be limited.

Chart 1: Yield pa



Source: Commerzbank Corporates & Markets

Historical yield distribution



Source: Commerzbank Corporates & Markets

Product Category: 1
The product category indicates the payoff risk as explained below. The rating is for information only, and is intended to provide investors with the means to understand and compare the payoffs associated with our products. Rating 1: Full Capital Protection – If held until maturity, or a pre-defined early redemption date, the security holder will receive the capital invested back. Potential losses are limited to the potential gains, which are dependent on the performance of the chosen payoff. Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However under some circumstances, the secondary market for the investment may be limited.

Additional Risk Disclosures
Before investing in this product, investors should carefully consider its appropriateness and suitability, and the following additional risks:
1. Issuer Risk: Any failure by the issuer to perform its contractual obligations, when due, may result in the loss of all or part of the invested capital. 2. Counterparty Risk: Any failure by Commerzbank AG to perform its contractual obligations, when due, may result in the loss of all or part of the invested capital. 3. Market Risk: Various market factors may affect the value of the investment or the underlying assets, including but not limited to the impact of volatility, interest rates, dividends (if any), foreign exchange. 4. Liquidity/Secondary Market Risk: Under normal market conditions Commerzbank will endeavour to provide a secondary market price. However Commerzbank has no obligation to make a secondary market in the instruments concerned. Accordingly, under some circumstances, the secondary market for the investment may be limited and subject to wide bid/offer spreads. 5. Reinvestment Risk: The risk that the investment redeems prior to maturity at a time when reinvestment opportunities are not favourable for the investor. 6. Redemption Risk: The risk that the investor may receive substantially less than the amount invested, if he/she liquidates the investment prior to maturity. 7. Tax Risk: There may be tax implications based on where the investor resides. Please consult a tax professional before investing. 8. Legal Risk: There may be legal restrictions depending on where the investor is domiciled. It is advised to seek legal guidance prior to investing.
For additional information on the product features and key risks, please contact your sales advisor or refer to the contacts page.

Views from the trading floor

JAMES LAM
EQUITY DERIVATIVES TRADER

MARKET RECAP

Equity markets bore the brunt of the increasing risk aversion, with investors dumping shares and fleeing to bonds and gold. Lack of consensus on how to deal with European sovereign debt; combined with weaker leading indicators only highlighted the macro headwinds investors are facing. Asian equity markets dropped in the first two weeks of September. Investors became net sellers of equities globally, in the amount of USD15.1bn, for the week ended 7 September, after Ben Bernanke failed to provide specifics on further monetary easing during the meetings at Jackson Hole in the US state of Wyoming.

Not surprisingly, government bond yields around the world plummeted as investors fled risk in search of safer assets. Interestingly, US Treasury continued to rally and treasury yield plummeted at one point to a low of 1.92%, despite the S&P downgrade. Foreign investors fled from Asian equity markets with strong fund outflow across the board. China offshore market was the worst performer of the region with the benchmark Hang Seng China Enterprises Index retreating 8.9% month-to-date. It is noteworthy that South East Asian markets kept outperforming the region. Overall, it seems that investors are less concerned about valuations at this time and would rather be long on markets with the best earnings momentum. Thus, Indonesia, The Philippines, and Thailand have stood out.

VOLATILITY OUTLOOK

With the crisis looming, volatilities in Asia remained bid significantly as in previous market crashes. One thing noteworthy is that the correlations across equities remain high compared to previous cycle lows, owing to still high macro uncertainty and an

elevated equity risk premium. High correlations between equities are often associated with 'macro markets', in which the markets, sectors and countries drive equity volatility, implied levels increased again in the recent equity de-risking.

INVESTMENT STRATEGY

With recent macro data such as manufacturing surveys pointing to faltering momentum in the developed world, there are renewed concerns about the risks of the US and Europe turning into sustained deflation, prolonged asset market declines, and semipermanent economic stagnation. Apart from the global macro issues driving significant volatility, investors were also contending with the plethora of earnings reports associated with the main August reporting period.

However, since growth momentum in China, India and other emerging Asian economies is clearly slowing on the back of tightening measures to curb inflation, we anticipate that policymakers in these countries will eventually shift to a more accommodative stance. In particular, investors are wary of equity exposure to Chinese banks due to local government debt risks; and domestic investment cyclicals due to funding/growth concerns. We believe that the de-rating has already reflected expectations of meaningful earnings cuts in the future. If a right balance could be achieved, then these earnings cuts may not be as deep as first envisaged.

Sectorwise, only the telecom (China Mobile, China Unicom and Chunghwa Telecom) recorded positive performance as defensive plays; industrials, insurance, and healthcare are laggards. Except for telcom, all other sectors are de-rated. In the current environment, investors are more in the risk-off mode and thus, high-beta names experienced valuation compression year-to-date. For example, cement names such as Anhui Couch Cement are now trading at 5.5 times their 12-months forward earnings, based on IBES consensus. Investors seeking rebound should focus on consumption-oriented domestic cyclicals, as the outlook for inflation over the near-term is still relatively unclear and policies may tighten further. However, the likelihood of further tightening is decreasing given the gloomy global economy. Once policymakers take their foot off the pedal on the tightening cycle, the underperformed sectors will start to materialise their strong earnings growth. Meanwhile, global cyclicals such as chipmakers and companies that are in the low-end of the supply chain are likely to suffer from earning downgrades and deterioration of earnings outlook due to fragile global economic outlook.

For further information, please contact:
james.lam@commerzbank.com

Contacts

Jorge Masalles & Jaime Uribe
Co-Heads Financial Institutions Marketing

Equity Markets and Commodities
Fimemcmgt@commerzbank.com
+44 (0)20 7444 9350

Product Specialists
FIMEMCSPL@commerzbank.com

Flow Equity Derivatives
FIMFlowEquity@commerzbank.com
+44 (0)20 7475 7175

Flow Commodity Derivatives
FIMCOMDT2@commerzbank.com
+44 (0)20 7475 1339

Institutional Fund Solutions
FIMIFS@commerzbank.com
+44 (0)20 7444 9378

Contracts For Differences
FIMCFD@commerzbank.com
+44 (0)20 7475 3072

ETF Market Making
FIMETF@commerzbank.com
+44 (0)20 7475 1759

Strategic Solutions
FIMSS@commerzbank.com
+44 (0)20 7444 9350

Asia
FIMEMCASIA@commerzbank.com

Institutional Greater China
FIMGreaterChina@commerzbank.com
+852 3988 0862

Private Wealth Management Team
FIMPWM@commerzbank.com
+852 3988 0881

Institutional South East Asia
FIMSEAsia@commerzbank.com
+852 3988 0875

Institutional North East Asia
FIMNEAsia@commerzbank.com
+65 6311 0191

Commodities LM
+852 3988 0873

EUROPE / MENA
FIMEMCLDN@commerzbank.com

Benelux – France
FIMFrBenelux@commerzbank.com
+44 (0)20 7475 7175

Germany – Austria
EqDer.Institutional@commerzbank.com
+49 69 136 22024

Iberia – LatAm
FIMIberia@commerzbank.com
+44 (0)20 7444 9350
+44 (0)20 7475 3134

Italy
FIMItaly@commerzbank.com
+44 (0)20 7475 3775

MENA
FIMMena@commerzbank.com
+44 (0)20 7475 1566

Scandinavia
FIMScandi@commerzbank.com
+44 (0)20 7444 9389

Switzerland
SwissInstitutionalDerivatives@commerzbank.com
+41 44 563 69 90

UK – Ireland
FIMUKIRE@commerzbank.com
+44 (0)20 7444 9378

CEE – CIS
FIMCEECIS@commerzbank.com
+44 (0)20 7475 1447
+49 69 136 47734

North America
FIMNY@commerzbank.com

Fund Derivatives Institutional Products
FIMUSInst@commerzbank.com
+1 212 895 1769

Flow Equity Derivatives
FIMUSFlow@commerzbank.com
+1 212 895 1582

Support
FIMContributions@commerzbank.com
+44 (0)20 7475 1582

Banks Relationship Management
MSB-FI Financial Institutions
fi.banking-products@commerzbank.com
+49 69 136 24016 / +49 69 136 45393
http://www.fi.commerzbank.com

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