Investment Strategy

Societe Generale Private Banking
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Editorial

The public debt crisis in Europe has had repercussions on the banking system, reminding us that emerging from a financial crisis is not the same as emerging from a run-of-the-mill recession. The process, which is necessarily long and delicate, requires the consolidation of the situation regarding banks.

The publication of stress tests carried out by the banking supervisory authorities in Europe has provided the necessary clarity to find a panacea where it is required. The longevity and solidity of the recovery depend on the banks' capacity to lend to the rest of the economy. We wager that this effort by European countries to be more transparent will provide a renewed source of confidence for the markets.

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Equities

A volatile environment for any length of time will penalise equities over the short-term.

While the signs of a slowdown in business activity are evident in most segments, the equity markets have been more turbulent than most due to market sentiment. Bolstered by the hopes of reassuring results from European banks and the prospect of solid second quarter earnings, this euphoria may only be short-lived. The fragility of the US recovery and the impact of fiscal consolidation in the eurozone, point to a sluggish second quarter. The bearish sentiment is likely to continue over the next few months, which explains our negative outlook on the equity markets.

— **Markets are looking for a direction, somewhere between excess optimism and excess pessimism.** While many forecast that the economic recovery would lose steam, the markets have nonetheless penalised the recent disappointing economic data. Weaker growth has fuelled fears of a double-dip recession, but this scenario is very unlikely. However, high unemployment and jittery household sentiment point to flat consumption both in the US and Europe, and therefore to disappointing sales figures, at least for the sectors and companies with little exposure to global demand.

— **Corporate profits for the second half of the year are looking promising given the impetus of the recovery and the productivity gains achieved.** One interesting sign is that the first earnings results released for the second quarter are in line with or above expectations, whereas sales figures have disappointed. The dynamic of profits has flattened in the US and continues to pick up in Europe, but less strongly. We will have to wait until the market analysts begin to revise their forecasts selectively, to take into account a less buoyant economic environment. The outlook for the total increase in earnings for 2010 (+37% for the S&P500, +32% for the DJEurostoxx index) are overly optimistic and will accordingly be revised downward.

— **We maintain our preference for the US market.** The macroeconomic context, along with the situation of corporates, seems to be relatively more favourable than in the other developed economies. In addition, the fiscal policy will remain more expansive than in Europe with a very accommodative monetary policy. Furthermore, US companies have more flexibility than their European counterparts in terms of maintaining earnings in an adverse economic environment, justifying higher valuations. For the emerging markets, we believe that the prospects of monetary tightening and continued risk aversion argue in favour of finding more advantageous entry points.

— In this turbulent environment, there is growing discrimination among sectors and stocks. **We favour large companies, which are highly exposed to emerging countries or less dependent on the economic cycle, namely the healthcare and food sectors.** However, there are two exceptions to this recommendation. First, technology stocks are benefitting from the upturn in capex. In addition, manufacturing stocks are being buoyed by the demand from emerging countries, particularly eurozone companies, which are also profiting from the fall in the euro. In this respect, the German market is one of the rare markets to have risen since the start of the year, due to the weight of manufacturing stocks in the DAX 30 index, and the positive impact of the euro's decline on exporting companies.

Sectors performance in the US

Sectors performance	july 20	
	Over last 3 months (%)	Over last year (%)
Energy	-11,4%	6,3%
Materials	-11,3%	20,7%
Industrials	-11,7%	23,2%
Consumer discretionary	-4,9%	15,4%
Health care	-10,6%	8,6%
Consumer goods	-10,9%	20,9%
Telecommunications	-5,0%	3,7%
Utilities	0,2%	9,0%
Financials	-14,1%	16,5%
Information technology	-9,2%	16,5%
US equity market	**-10,3%**	**14,9%**

Source: IBES, Datastream

Sectors performance in the Eurozone

Sectors performance	july 20	
	Over last 3 months (%)	Over last year (%)
Energy	-14,0%	-2,3%
Materials	-8,6%	25,1%
Industrials	-10,8%	21,2%
Consumer discretionary	0,0%	28,7%
Health care	-10,4%	9,4%
Consumer goods	-8,2%	16,3%
Telecommunications	-8,1%	0,8%
Utilities	-18,2%	-6,2%
Financials	-14,7%	-0,7%
Information technology	-17,5%	7,0%
DJ Eurostoxx index	**-11,1%**	**8,6%**

Source: IBES, Datastream

Bonds

Continued preference for corporate debt.

Long-term interest rates remain at historically low levels in the US and Germany. Two factors underpin this situation: the cooling of growth within developed economies and investor appetite for securities with a longer duration against a backdrop of continuing low short-term interest rates. Accordingly, we are underweighting our sovereign bond investments in light of the high valuations for the best-rated issuers and continued sovereign risk for other issuers.
In terms of corporate bonds, the solid corporate balance sheets and favourable financing conditions are the rationale for investing in this asset class. With the exception of certain sectors, corporate bonds have been relatively unscathed by the sovereign debt crisis. In our view, corporate debt still has one of the best risk/return ratios.

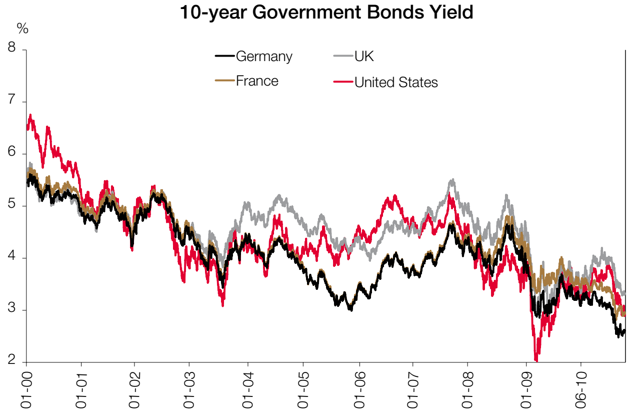
— Within the developed economies, inflation is still very moderate with zero or negative risk of inflation for countries affected by the severe austerity measures. The UK is the only exception with price inflation remaining above 3%, which is a concern for the Bank of England. Against this backdrop, uncertainties surrounding the growth of the advanced economies should lead the central banks to postpone hiking their key interest rates until 2011. However, liquidity conditions are already beginning to tighten, particularly in the eurozone.

— **We remain negative on all government bonds, including those from the eurozone.** Within the eurozone, long-term yields remain at very low levels, even below those recorded at end-2008 when fears of deflation were strong. Resident and non-resident investors continue to invest heavily in bonds, which is helping to absorb the sizeable amount of issues. Nevertheless, risk premiums for countries deemed to be the most risky, i.e. Greece, Spain, Ireland and Portugal, continue to be at high levels despite the ECB's purchases, while rating agencies continue to revise downward the ratings of these countries. In the US, long-term yields have also fallen below 3% since end-June, reflecting the concerns over short-term growth. While signs of a recovery are weakening, long rates could remain at low levels for some months to come. However, a rise in long-term interest rates is inevitable. 10-year interest rates could therefore increase by 50 - 100 basis points in the US over the next twelve months, and by 30 - 60 basis points in the eurozone.

— **We continue to recommend buying corporate bonds.** The debt crisis has had a moderate impact on the credit market, with the exception of some sectors (telecommunications, local government services). Issue premiums on the primary market have returned to low levels in light of investor appetite. In addition, the fall off in the number of issues since the start of the year is primarily due to the decline in bank debt issues. It is true that the financial reform in the US and questions over the exposure of European banks to sovereign risk have weighed on bank debt issues. The context remains favourable to the credit market with low interest rates, easier access to bank credit and prudent dividend distribution policies. For the first time since 2007, there have been more rating upgrades than downgrades according to Standard & Poor's. However, the tightening of risk premiums now seems to have petered out. The market jitters linked to the sovereign debt crisis could still affect some issuers, particularly financials. **We favour bonds with a maturity of 3-5 years to be held until maturity and issuers that are benefiting fully from the global economic recovery.**

— **The high-yield bond market has been penalised less by the renewed pressure on the financial markets.** The fall in interest rates has driven the increase in risk premiums. Given the current yields, the European high-yield bond market is offering an annualised return of around 10%. Fundamental factors are still strong particularly for manufacturing stocks, which are benefiting from the weaker euro. In view of the increasing economic uncertainty, we prefer BB or BBB-rated companies, which are subject to less refinancing risk.

10-year Government Bonds Yield



Currencies

The euro still has further to fall against the dollar. Monetary tightening will favour emerging currencies.

— **The euro will continue to fall against the dollar.** After recording a virtually uninterrupted 20% decline against the dollar since December 2009, it rebounded briefly above the 1.30 level in mid-July. This trend has defied the doomsters and gloomsters who had forecast a return to parity for the euro. Increasing concerns over the budgetary situation in the eurozone, a short-term interest rate differential favourable to the euro and disappointing economic indicators in the US enabled the single currency to rebound for a short time. That said the euro is likely to resume its downward trajectory due to the worsening economic environment, which will end up dragging it down. We reiterate our forecast for a decline in the euro with a return to a level close to purchasing power parity, but exclude a sustained decline below this level (1.15 for USD/EUR at 6-month and 1-year horizon).

— The Japanese yen's strength has once again surprised the market. The major currencies, i.e. USD, euro, yen (in that order) have a safe-haven status. This has been the case for the yen against the dollar and euro whose economies have been facing various difficulties. However, this trend seems likely to reverse as the economic and financial uncertainties clear up in the US and Europe. In parallel, the deflationary environment will mean that the Japanese central bank will have to maintain an ultra-accommodative policy, leading to a weakening of the yen in comparison to all currencies. (90 for JPY/USD at 6-month and 100 at 1-year horizon).

— The pound sterling is likely to regain some ground versus the euro. The scope of the budgetary measures undertaken by the new government and the currency's undervaluation justify a return to parity, which is more in line with a long-term equilibrium. (0.75 for GBP/EUR at 6-month and 1-year horizon).

— **Emerging currencies continue their upward trend:** the buoyant emerging economies, particularly the Asian economies, combined with generally healthy public finances are two powerful factors supporting the appreciation of emerging currencies. The interest rate hikes in some countries (India, Malaysia etc.) will continue, reigning in inflation. In addition, a decline in risk aversion would lead to new flows of investment on the emerging markets, which will be reflected in the appreciation of local currencies. **The currencies of commodity exporting countries have weakened.** The slowdown in business naturally weighs on the commodity markets, resulting in a weakening of currencies such as the Australian dollar, Canadian dollar and rouble. A rebound therefore depends on trends in commodities, for which we do not expect any substantial price increases in the coming months. The appreciation potential remains but for the longer term, i.e. by the end of the year and beginning of 2011.

Emerging markets

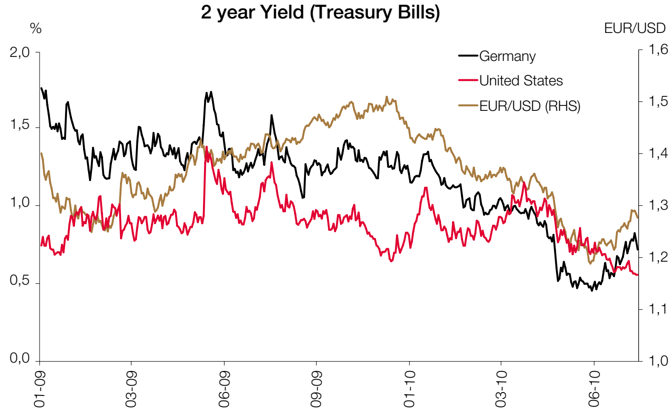
Favourable economic outlook with the equity markets continuing to adjust in the short term.

— The emerging economies have also seen a slowdown in activity. From a macroeconomic standpoint, this slowdown is welcome as it will temper the growth in the economies that were overheating. In Asia, in particular, inflationary pressure is currently weakening. This will not stem the strong growth forecast for 2010 (8.5% in Asia, 5% in Latin America). In addition, the slowdown is likely to continue as budgetary and monetary policies offer less support to business activity, and these economies will have to generate growth via domestic demand as exports will be stymied by the austerity measures implemented in Europe, in particular. The consequences of the European stagnation and a limp recovery in the US will be felt more in Latin America due to its commercial ties with the advanced world. This is especially the case for Emerging Europe, due to its strong industrial and financial integration with the rest of Europe.

— The emerging markets have been impacted fully by the increase in risk aversion and the overvaluation seen on some markets. The Shanghai stock market posted the weakest performance of all the equity markets, shedding 23% since the start of the year. Other markets such as Thailand, the Philippines and Indonesia have posted positive performances, amplified by the appreciation of local currencies against the euro and the dollar. Continued inflationary pressure calls for tighter monetary policies, therefore resulting in a decline in liquidity on these markets. These factors naturally weigh on the equity markets and we expect a new bear trend during the summer.

— **We maintain a favourable stance with regard to emerging country equities. However, we prefer to wait before making more purchases at price levels lower than the current levels. We maintain a preference for the Russian market, which in our view is strongly undervalued and for Asia, where we believe Taiwan and South Korea offer good opportunities. We believe that Mexico seems to be the most promising market in Latin America.**

2 year Yield (Treasury Bills)



Oil

Growth uncertainties weigh on prices.

— Since May the price of oil has fluctuated between $70 - $78/barrel falling from close to $90/barrel at the start of May. Although the price of oil has gradually trended upwards since May 2009, the slowdown in growth has meant that the price of black gold has recently plateaued.

— Crude oil inventories have hit high levels in the US, and in the second quarter investors reduced their long positions on the futures markets. However, physical demand remains high globally, and is even slightly above the International Energy Agency's initial estimates. The oil spill in the Gulf of Mexico will lead to the redefining of offshore drilling regulations on a global scale. This will have consequences on the production volume and therefore on prices in the years to come.

— The prospects of a decline in global growth in the second half mean that we expect the price of oil to fluctuate in the $75 - $85/barrel range by the end of the year.

Gold

Close to its peak.

— The eurozone debt crisis has without doubt bolstered the price of gold. With market jitters appeasing, the price of gold has fallen below $1,200/ounce. Concerns regarding the budgetary positions of governments are far from over: the position of the US federal states is now the focus of attention. However, with gold currently over $1,200/ounce, you would have to go back to the 1980s to see the price of gold (deflated by inflation) at similar levels. It is therefore logical that some investors are now hesitating with regard to strengthening their positions and would like to take profits.

— In the short term, the factors supporting the price of gold are less powerful after a sharp increase in investments in gold via ETFs during the first quarter (up 16%). Although a significant fall in prices is unlikely given the gold's status as the ultimate reserve asset, it is likely that the price of gold will flatten in the very short-term. In this respect, maintaining monetary policies at interest rates of close to zero in the advanced economies, which limits the opportunity cost of holding gold, constitutes an indirect factor supporting the yellow metal.

— In our view gold is likely to fluctuate in the $1,000 - $1,400/ounce range by the end of this year, with a high probability of prices remaining in the intermediate range ($1,100 - $1,300).

Hedge Funds: Second quarter

— There has been a sharp correction on the financial markets over the last two months. Fears of contagion of the European government debt crisis triggered a spike in volatility in May and the subsequent correction.

— While the main equity markets recorded double-digit underperformances and US Treasury bond interest rates fell below the 3% mark at end-June, hedge funds were able to preserve their capital during the first half of the year with a performance of 0.5%[1]. Against this very difficult backdrop, hedge funds fell 2.4% in the second quarter, losing the most part of the gains posted in the first quarter.

— In the second quarter, of the four main hedge fund strategies, the relative value strategy was the only one to record a stable performance. In terms of sub-strategies, the majority of the indices ended the quarter in the red. Three sub-strategies stood out achieving positive performances: CTA short term (+2%)[1], global macro (+1.5%)[2] and long/short corporate credit (+0.1%)[3].

— The main losses came from strategies with a long equity bias, with the long/short equity strategy posting the biggest loss of 6.1%[2]. Defensive strategies such as government bond arbitrage (-0.4%)[3] and merger/acquisition arbitrage (-1.5%)[2] were able to limit their declines during the especially difficult quarter.

— In this deteriorating environment, the capital markets remained active with several issues on the high yield market in June. The outlook for the second half of the year therefore remains positive for hedge funds due to their defensive risk profile. However, the effective functioning of the capital markets is an indicator worth watching in terms of credit strategies.

Reallocating strategies with a long equity bias to directional trading strategies (CTA short term and global macro)

— In view of the changing environment on the financial markets we recommend a further repositioning of the portfolio, which began in mid-May, by increasing exposure to directional trading strategies and by reducing exposure to strategies with a strong directional equity bias, such as long/short equity, equity special situations and to a lesser extent the distressed strategy.

— With regard to the major strategies, we prefer directional trading strategies. In contrast, we remain very cautious with respect to the long/short equity strategy.

— Within the directional trading strategies, we favour the CTA short term strategy due to its uncorrelated nature, which has proved to be profitable with the strategy posting 2% performance[1] in May.

— Also within the directional trading strategies, the Investment Committee has also issued a preference for the global macro strategy, which has also proved resilient in this difficult environment, preserving capital over the last two months (-0.1%)[2]. We recommend, in particular, global macro managers with a government bond and currency bias, and who are not betting heavily on the US economic recovery.

— Conversely, we recommend reducing exposure to strategies with a strong long bias, particularly on equities. i.e. long bias long/short equity and equity special situations strategies.

(1) Lyxor index, (2) Tremont Index, (3) HFR Index.

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