Investment Strategy

Société Générale Private Banking

Investment Strategy Newsletter

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Editorial

Equity markets are back on a bullish trend since the end of August, confounding pessimistic predictions. Even if economic data has been a little better than expected, it is rather the prospect of new liquidity injections from central banks that is supporting this enthusiastic momentum. The US Federal Reserve holds the key to future market developments: a nervous decision will precipitate a fall, whereas a massive injection of liquidity will feed the rally. But take heed: global growth is slowing and profit forecasts should be revised down over the course of the coming months. Whilst the surge in prices is not unfounded, given that valuations are still attractive, market sentiment will prevail, so a selective stock picking approach is justified.

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EQUITIES

Markets are supported by American monetary policy but this rally needs to be underpinned by economic data.

Markets continue to hang on expected US central bank decisions. Worried about the economy slipping into deflation and anxious to revive anaemic growth, the US central bank is preparing to inject new liquidity by purchasing public debt, a form of debt monetization. Markets have already anticipated this measure with continuous price increases since late August. However, this rally remains fragile: volumes are limited, the large institutions are sticking to a wait-and-see approach and profit forecasts have stopped rising.

Recently published economic data paints a mixed picture: whilst developed countries are struggling to grow, emerging countries are recording exceptional performances. Indeed, companies with a global reach and a diversified geographical spread of business are taking advantage of this emerging dynamic, in contrast to many SMEs overfocused on their domestic market which continue to suffer. We remain buyers of equities but on a selective basis, favouring large caps with low economic sensitivity and a high dividend.

- **Markets set to rise further. This rally remains fragile as it is highly dependent on the US central bank's attitude and market sentiment, which is inevitably volatile.** The global economy is slowing, but less markedly than anticipated. Thus American growth grew at 2% in the third quarter, which is higher than in the second quarter, whilst Chinese growth remains close to 10% year-on-year. Only certain European countries where public and private sectors have been forced to deleverage are still in recession (Greece) or stagnating (Ireland, Spain). The manufacturing sector continues to grow at a steady rate due to restocking but mainly as a result of demand from emerging economies. Household consumption is holding up but the outlook remains bleak given the scale of fiscal tightening measures still to come. Employment prospects will be key in determining household confidence and the propensity to consume in the coming quarters in both the USA and Europe

- **Contrasting trends in earnings outlook over the next twelve months:** in the euro zone, forecast earnings are slowing whilst in the US they are stabilizing after trending slightly downwards. However the rise in the euro since the end of the summer should depress the profit outlook for companies across the board. In the USA, analysts are likely to lower their forecasts if the economic outlook deteriorates significantly in the last quarter of the year.

Annual profit growth forecast
(Market Consensus as at October 25, 2010)

Marchés	2010	2011
DJ Eurosoxx (Eurozone)	+34%	+16%
S&P 500 (USA)	+40%	+14%
Topix (Japan)	+91%	+19%
FTSE 100 (UK)	+56%	+20%
MSCI China	+26%	+15%

Source : IBES

- **We continue to increase our exposure to equity markets.** The overall environment remains on the whole favourable for equities. Companies have low debt levels and access to cheap financing; earnings are due to rise further in 2011 (see above table), interest rates will remain at very low levels. Finally, equity valuations remain well below their historic average, even after the recent rally in markets.

-**In terms of sector allocation, we are prioritizing blue chip investments which benefit from strong growth in emerging economies, and shares with a high dividend (energy or telecommunications sectors) which offer high yields, well above government bonds (3 to 4 points higher).** We have upgraded our opinion on the materials sector (chemicals…) which benefits from strong demand from emerging economies. We continue to be in favour of the following sectors:

• **consumer staples** (beverages, food products), because this sector is not very sensitive to changes in economic outlook and companies will continue to roll out operations in emerging countries

• **energy** which continues to offer investors tantalizing payout opportunities

• **information technology companies** which are supported by the upturn in investment, consumer enthusiasm and expanding margins.

Among the developed markets, we believe that the German and Australian markets could continue to outperform thanks to the ratchet effect of exports to emerging economies (capital goods and intermediate products for Germany, raw materials for Australia) and the strength of domestic demand.

BONDS

The credit market remains attractive in the context of sustainably low interest rates.

The prospect of new quantitative easing measures by central banks coupled with the absence of inflation will keep long term rates at very low levels at least until the beginning of 2011. In this context, we are staying out of sovereign bonds. The price of sovereign bonds for the reputedly safest issuers (US, Germany, France…) seems overvalued to us, whilst the precarious budget situation of certain countries (Spain, Greece, Portugal, Ireland…) will support uncertainty regarding the development of risk premiums. We remain buyers of credit as corporate bonds continue to offer the best risk/return profile despite the narrowing of new-issue premiums. Similarly the high-yield bond segment offers interesting investment opportunities due to favourable financing conditions and rising ratings for issuers.

- **Fears of gentle deflation have incited the US Federal Reserve to evoke the possibility of a second round of securities purchases**. The mere announcement of this measure led to a bounce in inflationary expectations, but this movement is not enough to reassure the authorities in view of the weakness of the upturn. In fact, underlying inflation fell again in September to reach 0.8% on an annual basis, its lowest level for fifty years. In the euro zone, the rate of core inflation is contained (+1.0% in September) but the likelihood of a slip into deflation is lower given the inflexibility of prices and salaries. Japan remains in deflation with more or less constant price falls for 15 years (-0.9% in September). Only the UK shows substantially higher growth in inflation, above 3% year-on-year (2.5% for underlying inflation), without any hope of a significant decline due to imported inflation. The Japanese and UK central banks are on the point of implementing new securities purchases in the markets, in order to boost the slender signs of growth. In this context, a reversal of monetary policy is not expected before the end of 2011 at best, in Europe and in the US.

- **We maintain our underweight position in sovereign bonds in our strategic allocation. Interest rates are due to remain at sustainably low levels, despite substantial issuance volumes.** In the euro zone, German 10-year government bond yields have risen slightly to around 2.5% at the end of October, but should not rise significantly in the coming months considering the fall in the economic outlook. The fading of the spectre of recession has provided support for the bounce in rates. The fragile European countries (Spain, Portugal, Greece, Ireland) have seen their risk premiums fall slightly from the high-water mark, but not sufficiently to allow them to return to the market with bearable cost terms. These countries are thus confronted with a dilemma: additional fiscal adjustments are necessary to reduce deficits, but the extent of this adjustment in turn threatens to keep, or to plunge these countries back into recession. The coming months will be crucial in assessing both the credibility and the sustainability of these countries' efforts.

- In the USA, inflation expectations have risen towards the threshold of 2%, in reaction to the announcement of probable quantitative easing. For all that, purchasing public securities in the market is not the panacea: it is difficult to calibrate the volume of operations and the Federal Reserve must avoid doing too much at the risk of losing its anti-inflationary credibility. A sharp rise in long rates would be the opposite of what is targeted: a rise in financing costs, stagnation of productive investment, another potential fall in the property market …Indeed, an increasing number of investors are split between two extreme scenarios for the USA, either a lasting fall in prices or a sustained increase, above the Federal Reserve target. Economic outlook remains gloomy, limiting the risk of a significant yield rise.

- **We continue to recommend corporate bonds. The economic context is actually favourable for the credit market: moderate, non-inflationary growth, with continual improvement in company fundamentals.** Companies, in particular the large groups, have low gearing levels and plentiful funds. Financing conditions are continually improving with low rates contributing to the fall in the default rate. Primary market premiums have fallen significantly as a result of investor appetite. However the risk-adjusted yield remains attractive considering there are practically no liquidity repayments. Whilst we remain buyers of highly-rated (investment grade) bonds, we are also turning our attention to high-yield bonds which should benefit most from extraordinary liquidity conditions and investors' search for yield.

- **The emerging bonds segment still offers interesting opportunities.** This is the case for sovereign bonds where the rating should continue to improve for many countries. It is equally true for corporate bonds. Emerging blue chip companies offer higher yields on foreign-currency denominated issues (dollar, euro) for equivalent creditworthiness. **However it is important to remain selective as this market has seen a massive inflow of capital in the last few months which could eventually lead to excessive valuations.**

CURRENCIES

The euro should weaken whilst emerging currencies should continue to rise in the medium term.

- **The dollar's weakness is mainly due to monetary policy announcements.** Hence the euro has broken the 1.40 level several times without however being able to hold it. Actually it seems to us that the outlook for the euro zone speaks rather for a slight weakening of the single currency against the dollar: its rise will dampen export growth and the sovereign risk has not disappeared. Aside from this temporary overreaction, we forecast that the euro should return towards 1.35 on a 6-month horizon, 1.30 on a 12-month horizon, these levels are still above its fundamental value (1.15-1.20 USD)

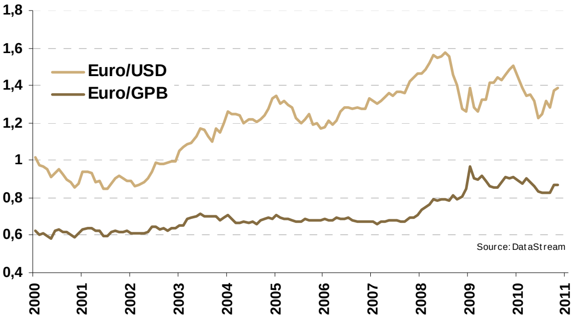
- **The strength of the yen should run out of steam.** The Bank of Japan's intervention in the forex market at the beginning of September, the first time since 2004, aimed at halting the appreciation of the Japanese currency has not had a lasting effect. The yen rallied again approaching the 80 threshold. At this level, the competitiveness of Japanese products is affected which should handicap exports and therefore growth. Moreover, the Bank of Japan is preparing to intervene with new financial securities purchases in a renewed attempt to halt deflation. We therefore anticipate a retreat of the yen versus the dollar, but only to a limited extent. (85 JPY/USD on a 6-month view, 90 JPY/USD on a year).

- **The pound should gradually regain lost ground.** The British pound, already around 15% undervalued against the euro, has weakened further since the beginning of September to approach 0.90 towards the end of October, thus following the relapse of the dollar. The drastic budgetary measures already announced should enable the gradual reduction of the deficit chasm, which is favourable for the currency. For all that growth should suffer as a result in the short term. In addition, the possibility of new quantitative measures from the Bank of England will increase money supply. All things considered we anticipate a slow correction of this undervaluation against the euro. (0.85 GBP/EUR on a 6-month view, 0.80 GBP/EUR on a12-month view).

- **Emerging currencies remain on a bullish trend:** several central banks of emerging countries have intervened in forex markets to slow down the appreciation of their currency at the risk of sparking a currency war. This approach creates liquidity which is potentially inflationary if not sterilized. On the contrary the dynamism of emerging economies in particular in Asia argues for a tightening of monetary conditions through higher interest or exchange rates. Such a move instigated last spring by certain countries (India, Malaysia…) will continue and spread in order to curb inflation. It is also likely that new measures aimed at slowing the inflow of capital will be put in place selectively following Brazil's example, but their long term effectiveness is doubtful.

Further upside potential for the currencies of commodity-exporting countries (CAD, AUD, NOK…). The slow-down in activity is of course dampening commodity markets, which is depressing the currencies of exporting countries. However these currencies are increasingly serving as alternative reserve currencies, as these countries benefit from solid growth and sound economic fundamentals (limited public debt, low inflation…). Accordingly these currencies should remain strong in the coming months.

Euro/USD & Euro/GBP Spot Rate



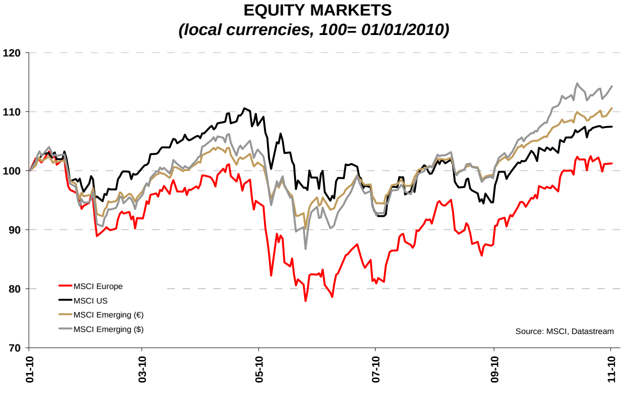
EMERGING MARKETS

The outlook for growth and earnings speaks in favour of emerging equity markets.

- Emerging economies are starting to show the first signs of decelerating activity. From a macroeconomic point of view, this is a welcome slowdown as it provides a counterbalance to the dynamism of economies which were at risk of starting to overheat. In Asia, in particular, inflationary tension remains, as evidenced by the recent acceleration in prices increases in China (+3.6% year-on-year in September). Domestic demand is starting to provide a growth relay for many emerging economies. However leading indicators underline lower order books particularly from Europe and the USA which will translate into contracting exports over the course of the next few months. On the other hand, dynamic trade between emerging countries represents a powerful factor for global growth.

- Emerging markets offer a favourable outlook in terms of both growth and earnings. Domestic demand continues to show solid growth in the major countries. The outlook for earnings in the various regions in 2011 appears robust (+12 % in emerging Asia, +15% in emerging Europe, +21% in Latin America) after substantial increases already in 2010. Valuations are reasonable and not excessive. Finally, liquidity will remain plentiful due to inflows of foreign capital in these markets. Several risk factors remain regarding the short-term development of markets but they are of limited scope: growth in China, the short-term impact of monetary tightening in many emerging markets, the continuing imbalance of public finances in India and in Brazil which calls for corrective measures.

- **We increase our exposure to emerging market equities, given the favourable environment for high-risk assets generally and the positive momentum for these markets in particular. We continue to prefer the Russian market which we consider extremely undervalued and Asia where we favour Taiwan and South Korea. At the same time we raise our opinion on Brazil due to its solid fundamentals.**



Oil

No sustainable price rally whilst global growth is decelerating

- Following weakness at the end of August, the oil price has resumed its bullish trend, breaking the 80 USD/barrel threshold at the beginning of October and subsequently remaining above this level. The slowdown in global growth will curb demand thus considerably limiting any potential for price increases

- Demand should remain robust, driven essentially by the requirements of emerging countries. In parallel, supply from OPEC countries remains very stable, whilst non-OPEC countries have accelerated investments in terms of output which has substantially increased market supply. All things considered stocks should remain at high levels, above their 5-year average. In this context, supply–demand balance will drive prices although speculation could provide some price support.

- Oil price in a USD 75 – 85 per barrel range during the next six months given the global economic context and a stable and plentiful supply.

Gold

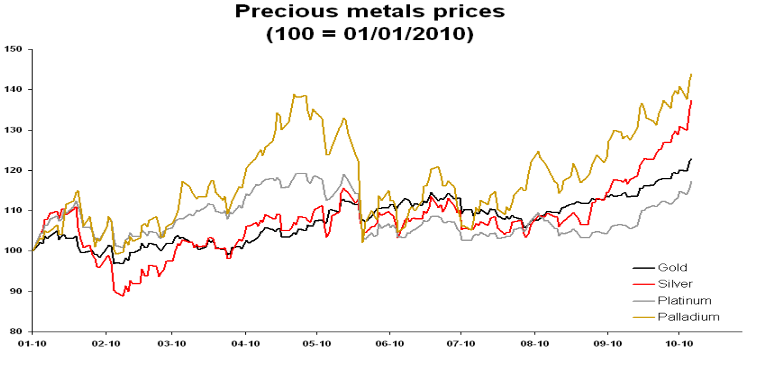
Close to peak?

- Since last spring, the gold price has been supported by market fears concerning sovereign debt. The prospect of an increase in the money supply by central banks has driven investors back to gold. Investor wariness regarding the anchor currencies (dollar, euro) is unlikely to reverse soon in view of the lasting degradation of government public finances and monetary policies which have the potential to create inflation.

- Reduced gold sales by G10 central banks combined with emerging country central banks' desire to diversify by seeking alternatives to the dollar has created additional upward pricing pressure for the yellow metal. At over USD 1,300/ounce, gold has returned to levels last seen at the beginning of the 1980s in real price terms. Even if excess liquidity is fuelling the risk of a bubble, the price increase could persist whilst monetary policies in major countries keep interest rates close to zero and continue with the partial monetization of public debt. Only a consolidation of the recovery in developed countries signalling a normalization of monetary policies could provoke a lasting decline in the gold price.

- It should be noted that other precious metals (silver, platinum, and palladium) have followed in the wake of the soaring gold price. This move is also due to an increase in demand of these metals from the industrial sector.

- We think that the price of gold should continue to rise to levels close to USD 1,500/ounce on a six months time horizon.



Hedge Funds - Trends and Recommendations

Trends:

Hedge funds performed well (+5%)(1) during the third quarter in a context of high volatility characterised by doubts about the robustness of the US growth in August and the strong rally in equity markets in September, supported by the prospect of the Federal Reserve's asset purchase programme.

For the year as a whole hedge funds showed an increase of 5.8% (1) which compares favourably to performance in the equity markets at the end of September (+0.7% (2))

Of the four principal strategies, the Equity Long/Short strategy showed the best performance (+5.9%)(1) for once this year, thanks to the rally in equity markets in September. The other strategies also showed good performance, all up between 4% and 5% on the quarter.

Recommendations:

In terms of outlook, we continue to favour the Global Macro-CTA strategies, which seem to be the most appropriate in this period of uncertainty.

Of the Directional Trading strategies, we are very positive on the outlook for the Global Macro strategy (+9%) which came through the turbulent periods of May and August successfully, whilst still managing to benefit from the rally in markets in September. Within the Global Macro universe, we prefer managers with a bias towards government bonds and currencies.

We remain positive on the outlook for the Relative Value strategies, favouring the Government Bond Arbitrage sub-strategy, which should benefit from new opportunities associated with the Federal Reserve's asset purchase programme. We are also confident in the Corporate Credit Long/Short strategy.

Finally we remain neutral on the outlook for Equity Long/Short strategies which despite the rally in September continue to suffer from the high correlation of stocks amongst themselves.

Benefit from dynamic corporate credit markets

Whilst the macroeconomic situation remains uncertain with the consensus now looking for weak growth in the coming quarters, the microeconomic trend for companies remains good. Companies continue to improve balance sheet quality thanks to increasing earnings and access to financing at a reasonable cost in the credit markets.

At the moment companies continue to show a significant increase in earnings enabling them to generate substantial cash flows. What's more, companies are devoting most of their newly available cash (68%) to reducing debt.

At the same time markets for high-yield bond issuance are running at full capacity, a new record had already been established by the end of September with issues of 211 billion since the beginning of the year. This is enabling a broad spectrum of companies' access to refinancing at reasonable conditions

This is all helping to keep the default rate low. In September, only two companies defaulted representing a total of 1.2 billion dollars of debt. Since the beginning of the year, the default rate has stayed close to zero. On a 12-month rolling basis, the default rate is 2.5% and should continue to fall from now until the end of the year.

This context is favourable for the Corporate Credit Long/Short strategy. At the moment in addition to the favourable performance trend in the high-yield bond market, there are still plenty of opportunities for managers of Credit Long/Short managers.

For instance, many companies are bringing forward their refinancing operations in order to extend their debt maturity by several years. Against this backdrop, companies are offering favourable conditions to their former creditors upon early repayment, which is providing fund managers with opportunities uncorrelated to the general market trend.

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(1) Dow Jones Crédit Suisse Index; (2) MSCI World

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