Investment Strategy

Société Générale Private Banking

Investment Strategy Newsletter

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Editorial

The warning shot fired by Standard & Poor's, which issued a negative outlook regarding America's debt picture, did nothing to undermine equity market optimism. Admittedly, macroeconomic data remain favourable and the initial round of corporate results released for the first quarter of 2011 did not disappoint. While economic policies are on the brink of changing their accommodative stance, especially in Europe with the ECB's rate hike in April and budget adjustment plans underway in many countries, our preference lies with American equity. The Federal Reserve has been sticking to its zero-rate policy and budget tightening is still not on the agenda, due to the Congress's failure to reach an agreement, though a breakthrough is bound to happen one day or another.

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EQUITY

The tightening of economic policies either already underway or anticipated should slow equity market performance.

Risk factors intensified over the past few weeks with the rise in oil prices, the earthquake and nuclear accident in Japan and heightened concerns once again over Euro zone public debt. Moreover, the pace of growth is expected to stall as a result of efforts to align economic policy.

In Europe, while Germany continues to lead the pack thanks to a dynamic manufacturing sector and buoyant domestic consumption, the remainder of the Euro zone has posted subpar performance, with Southern European countries and Ireland still in the throes of the economic and financial crisis.

Against this backdrop, we prefer lowering our exposure to equity in the Euro zone, the United Kingdom and Japan, even though we remain over-weighted on American equity. The Federal Reserve (FED) will continue to favour a policy of near-zero interest rates for another extended period, and current budgetary policy continues to stimulate demand. Over the timeframe of the next couple months, the Standard and Poor's warning, which placed American public debt on a negative watch, should not exert any significant impact on the nation's budgetary policy, as these considerations will play out over a longer time horizon.

From a microeconomic perspective, profits are primarily being driven higher by financial sector firms. The profit outlook for non-financials has turned less attractive. The rise in commodity prices has started to eat away at profit margins, while companies are having a hard time passing their production cost increases into their sale prices.

- Over the upcoming months, we anticipate a return to higher volatility on equity markets, as volatility indicators have surged once again to levels not seen since 2007. Sharper price increases have eroded household purchasing power and will put a drag on consumption. Moreover, corporate profitability will be affected by the higher prices charged for basic goods. In such a context, downward revisions to projected profit trend lines must be expected, and this will undoubtedly be more prevalent in 2012 than in 2011.

Nonetheless, the world's developed equity markets still retain the potential for growth between now and the end of the year. The American market offers the most positive outlook through the end of 2011. The level of earnings per share tracked since the beginning of the year has been more favourable in the U.S. than in the Euro zone. The more resilient nature of the American market provides better safeguards against downside risks. Also, many institutional investors, who remain underinvested, should increase the proportion of their equity holdings as bond investments become less attractive.

Annual profit growth forecast
(Market Consensus as at April 20 2011)

Markets	2010	2011
DJ Eurostoxx (Eurozone)	38%	11%
S&P 500 (USA)	45%	16%
FTSE 100 (UK)	56%	22%
Topix (Japan)	95%	8%
Shanghaï SE (China)	32%	22%

Source : IBES

-**In terms of sector allocation, we are emphasising** the following sectors:

- Securities in the **energy** sector, where we're extremely over-weighted, given the level of dividends (with a dividend-to-share price ratio on the order of 6%) and attractive valuations. Upward pressures on oil prices should remain intact due to a structurally higher demand stemming from emerging countries;

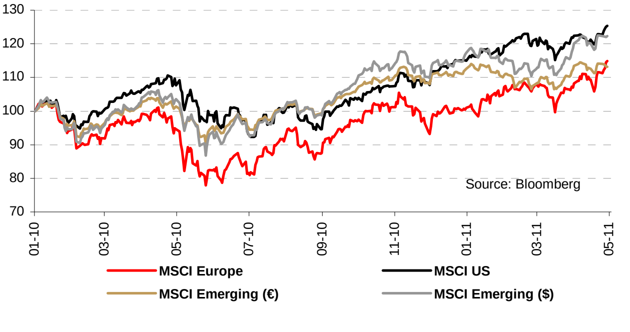
- **Information technologies**, supported by both the resumption in corporate investment and consumer preferences for online services;

- The **commodity** and **mining** sectors, spurred by higher prices, which reflect increasing needs even if prices contain a speculative component;

- The **health** sector, where we've decided to return, given the current soft valuations combined with ongoing or upcoming merger & acquisition activity.

Our bias in favour of American securities has also led us to an overexposed position on cyclical securities tied to consumption, by virtue of the improved jobs outlook, as well as on industrial securities benefiting from USD weakness and the attraction drawn to emerging countries.

EQUITY MARKETS
(local currencies, 100= 01/01/2010)



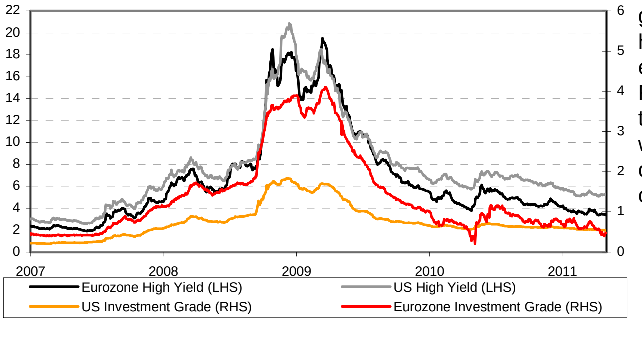
BONDS

Less upside potential for the fixed income market, though opportunities remain in US and UK corporate credit.

Rising yields against a backdrop of accelerating economic growth and inflationary pressure argue for a continued hiatus from increasing exposure to sovereign bonds. This is particularly true for Europe while in the US the view is also clouded by uncertainty regarding the end of QE2. Corporate credit still offers opportunities, though is more of a carry play than a search for spread tightening. The US and UK offer the best upside here. More caution is warranted with European high yield and high grade given the ongoing sovereign struggles in the Eurozone.

- **Much as the market expected, the ECB raised interest rates 25bps at its April meeting, starting the process of monetary policy normalization expected to lead to a total 75bps in hikes before the end of the year.** The economic strength seen out of Germany, however, is not mirrored in much of the rest of Europe, leaving the region as a whole to struggle out of recession amid less accommodative conditions. As such, growth will likely soon peak, turning down thereafter in the latter half of the year. In the United States, growth is also likely to lose steam due to the removal of monetary stimulus triggered by the end of QE2 in June combined with the fading effects of fiscal stimulus. The US outlook has been further weighed down by the ongoing battle in Congress regarding the FY2012 budget and the debt limit. The recent announcement by Standard & Poor's to put the US AAA debt rating on negative outlook sends a strong signal to the administration that the current trajectory of fiscal policy is unsustainable.

Eurozone and US: Corporate Credit Spreads



-**Our underweight on sovereign bonds remains unchanged**. In the US, long-term risks continue to cloud the outlook for US Treasuries. This is particularly centered around the end of QE2 (June). The expectation is that the Fed will reinvest its holdings in the beginning, the eventual winding down preceding any shift to higher interest rates. This could thus support stable yields initially, with the risk tilted to higher yields as additional demand is eventually needed to pick up the slack created by the Fed's ultimate unwinding. Short duration US bonds (2-3 years) are nevertheless preferable to Canadian bonds, as Canada is seen as hiking rates earlier.

A side note concerning the S&P action: if the US administration is quick to tighten fiscal policy, USTs could see some upside, as tighter policy would lead to slower growth, implying easier monetary policy for even longer than currently forecast. In Europe, yields in Germany and in other European core countries appear unattractive against the backdrop of accelerating economic activity and inflationary pressure. At current interest rates, we favor 3-5 year bonds, with the expectation that the flattening of the curve will stabilize. Along the same lines, current inflation breakevens appear too high given the ECB commitment to fight inflation; as such, we remain underweight inflation-linked bonds. Concerning the periphery, although Portugal, Greece and Ireland continue to warrant caution, our view on Spain has improved.

Spain, however, has shown its ability to rein in fiscal imbalances (having met its fiscal objectives last year through wide-ranging structural reforms) and advance in the restructuring of the banking sector.

-**Corporate credit in the US and UK continues to offer value in terms of carry, however our view on EU corporate bonds has turned less favorable.** Year to date, global credit markets have performed well, offering remarkable resilience despite mounting geopolitical uncertainties. For the time being, the negative impact of supply disruptions related to the Japanese earthquake is hard to quantify. The only exception is the European investment grade market, due to ongoing sovereign debt tensions and bearish flattening on the yield curve. In our view, current spreads here do not appear high enough to compensate for adverse yield shifts. In the US and UK, although capital appreciation seems to have run its course in both high yield and investment grade markets, the carry remains attractive. Our view is supported by the fact that default rates are improving (expected at 1.5% in the US and for FY2011) as companies continue to deleverage. Improved cash flows are expected to support the pickup in merger and acquisition activity, which has so far led to 130 deals globally this year valued at nearly USD800bn. Strong global corporate bond supply, as companies refinance—high yield reached USD114bn and IG USD234bn in Q1—is expected to continue to be met by strong demand. Financials could be particularly positioned to strengthen on the back of Basel III and Solvency II, and thus might soon warrant less caution. Finally, given our more constructive outlook on Spain, we see the potential for investment opportunities in strong corporate bonds there.

CURRENCIES

The U.S. dollar should remain structurally weak, while emerging currencies display the potential for further gains, yet varying markedly from one currency to the next.

The Euro is being fully supported by ECB's monetary tightening policy, underway since April. Heightened Euro zone inflation (2.7% in March, 2.8% in April) served as the rationale for raising the central bank's refinancing rate to 1.25%, marking the first monetary tightening move since 2008. The market anticipates three additional 25-basis point rate hikes by the end of 2011, which will lead to widening the short rate differential between the Euro and USD. As for the two-year rate, the differential now exceeds 100 basis points. On the other hand, the deliberately accommodative tone struck by the FED suggests their next rate increase is still a long way off. Even if the quantitative easing strategy winds down as planned at the end of June with no subsequent purchases, the FED President hastened to reassure the markets by stressing that the revenue generated from maturing securities held in the portfolio would be reinvested, thereby avoiding any contraction in the FED's balance sheet. With this backdrop, the Euro has already surpassed the 1.45 USD threshold and could continue its course to close in on or even break 1.50. It remains unlikely however that the Euro would be able to maintain such levels over a longer stretch due to the impact of curbing business activity, which would only stir tensions in the Euro zone regarding the direction of monetary policy and heighten the risks surrounding debt crisis resolution measures. From our perspective, inflationary tensions should ease by year-end within the Euro zone; under these conditions, standing behind a strong Euro position could allow the ECB to refrain from raising its benchmark rate as much as expected. Let's recall that the problem with financing America's current deficit, which is tied in part to the colossal public debt, constitutes a factor behind continued greenback weakening and the country's deteriorated budget situation.

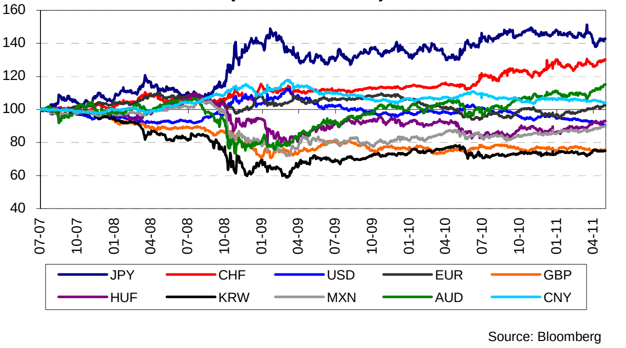
We're counting on a Euro at 1.45 USD over a 6-month time frame. Over the 12-month horizon, we foresee a bit of softening in the Euro, to a level of 1.40 USD, once the interest rate differential begins to narrow.

- The yen should ultimately reverse course this year. The Japanese disaster will have lasting consequences. Rebuilding expenses will spiral upward and production will continue to experience power outages at least until this summer. In any other country but Japan, this combination of factors would be sufficient to send the currency sharply lower. The yen however has reacted oppositely, remaining solidly anchored in the vicinity of 81 to the USD. Nonetheless, we consider that the yen is bound to lose ground, though modestly, vs. the dollar as a result not only of the Bank of Japan's intervention in March to stem the yen's rise, but also the reappearance of a rate differential to the yen's detriment, working to favour reestablishment of carry trade positions on high-yield currencies financed by the yen. It remains likely however that this weakening will be gradual and limited, since the yen's current exchange rate does not indicate substantial overvaluation (85 JPY/USD in 6 months' time, 90 JPY/USD a year out).

- **The pound is looking to consolidate versus both the euro and dollar.** The pound's undervaluation versus the dollar and euro, as explained by Great Britain posting the most highly negative real short-term interest rate throughout the developed world, has been a drag on the pound's value. The Bank of England is expected to raise its benchmark rate by summer, thus partially correcting this anomaly. Even though the pound clearly seems to be undervalued, the upward adjustment will be gradual. We continue to stand by our prediction of a strengthening pound vs. the euro over the next year (0.85 GBP/EUR in 6 months and 0.80 GBP/EUR in 12 months).

The emerging currencies will maintain their upward course. Such is especially true of Asian currencies, whose move higher was hindered by central bank intervention and by holding real interest rates below zero. For now, inflationary pressures are seriously hampering central banks' efforts; chief among them, Chinese monetary authorities have had to prevent any speeding of monetary tightening and any demonstration of a greater inclination to let their currency appreciate. The capital control measures adopted in some countries should only exert limited effect on capital inflows, which remain structurally high. We consider that the Chinese yuan (CNY), Korean won (KRW), Malaysian ringgit (MYR) and Thai baht (THB) make up the set of currencies offering the greatest potential for appreciation versus the USD over the next twelve months. Some Latin American currencies, despite their countries' insistence on a foreign exchange policy without central bank intervention, should still rise versus the dollar as well. These currencies include the Brazilian real (BRL), which has always benefited from sizeable capital inflows and high real rates, and the Peruvian sol (PEN), buoyed by surging commodity prices.

Effective Exchange Rates - Broad Nominal (01/07/07 = 100)

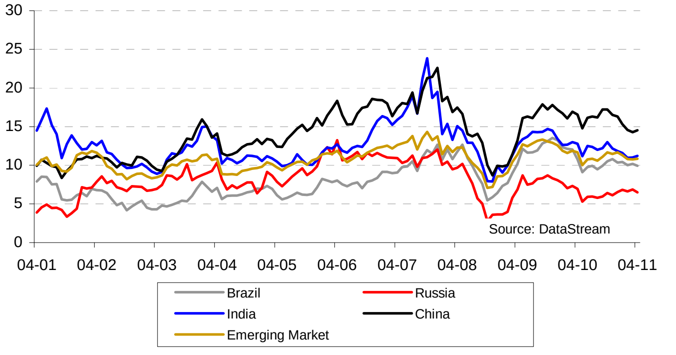


Source: Bloomberg

EMERGING MARKETS

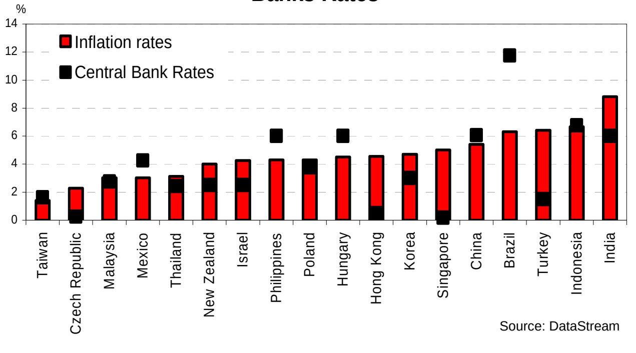
Despite a constructive long-term view on emerging markets, current valuations do not compensate for short term risks linked to global turmoil.

P/Earnings 12M forward



-**Emerging markets growth remains buoyant but the risks from global turmoil have joined those regarding overheating, leading to a conservative stance on EM equities at this time.** Strong domestic demand combined with high commodity prices, most recently exacerbated by the uptick in world oil prices, has heightened inflation pressures and the risk of overheating. The impact on inflation expectations has prompted monetary tightening throughout EM, notably in China, India and Brazil. In addition to interest rate hikes, macroprudential measures (hikes to reserve and bank capital requirements) are being used to rein in prices in an effort to limit currency appreciation. Nevertheless, most EM currencies have come under continued upward pressure and, in some cases, have been allowed to strengthen (CNY, RUB). While ongoing risks remain—overdependence on commodity markets, China's GDP sustainability, effects of the Japanese earthquake—we remain overall constructive on longer-term EM growth prospects.

Emerging Market Inflation Rates and Central Banks Rates



- Current valuations and growth slowdown on the back of monetary tightening do not argue for EM outperformance relative to certain developed markets. While EM equities still offer positive return potential, they are expected to post a weaker performance relative to developed markets (US in particular) and corporate credit. We maintain a solid overweight on Russia given high commodity prices on the back of the oil rally, stable growth and attractive market valuation. On the other hand, we have turned less constructive on industrialised Asian countries such as South Korea and Taiwan given the supply chain disruptions following the Japanese earthquake; both have been downgraded. India has also been downgraded due to high inflation and twin deficits, and an overall lack of momentum in the market at this time. Our view on Latin America remains neutral, as we expect both Brazil and Mexico to perform well though not to outperform the market.

Oil

Strong demand coupled with geopolitical uncertainties will hold prices high

The political situation in North Africa and the Middle East remains unsettled and uncertain. The Libyan uprising significantly reduced the country's production and exports, while unrest across many Middle Eastern countries attests to an unstable political situation. As a result, the geopolitical risk premium included in the price of a barrel is high, no doubt on the order of USD 15. Moreover, demand continues to climb at a steady pace due to a rebound in United States growth and robust activity within emerging countries.

Several factors will continue to exert upward pressure on oil prices:

-Crude inventory levels within OECD countries, which until now had been above their 5-year averages, should once again fall below this threshold in the near future.

-The summer driving season in the United States should be accompanied by a rebound in gasoline consumption with a more substantial rise in automobile traffic than in years past.

-Japan's nuclear accident will have the short-term effect of raising the country's reliance on fossil fuel plants.

-American monetary policy now promotes identifying alternative investments and indirectly supports investor attraction to commodities, which winds up exerting upward pressures on both futures prices and cash prices.

On the supply side, thanks in large part to Saudi Arabia, OPEC's production capacity currently exceeds the level of demand.

This safety margin however tends to be shrinking, which will not necessarily affect current prices but should be an upward force in years to come.

We have thus raised our price predictions for a barrel of Brent crude. Over the second half of 2011, the price of a barrel should average USD 110 and then slightly retreat to a price point of around USD 105 during the first half of 2012.

Gold

Still some room left to climb?

Gold has exceeded the threshold of USD 1,500 per ounce, which was our previous target. Several factors have combined to raise the price of this precious metal: geopolitical risks in the Middle East, renewed concerns over Greece's budgetary situation, the perspective of American interest rates remaining flat for a long time, and especially the return of inflation.

Yet beyond these contextual factors, a number of structural factors continue to attract investors. In 2010, central banks became net purchasers of gold for the first time in over 10 years, illustrating the search for diversification in their holdings outside of USD-denominated securities. This appetite should persist for quite some time given that at present China only holds a very small share (less than 2%) of its official reserves in the form of gold, just like Russia and other Asian countries.

Moreover, private investors have turned to buying once again via ETF, whereas they had begun to stabilise their positions at the end of 2010.

American monetary policy provides the primary factor behind higher gold prices and this should not change before 2012. As long as short-term interest rates remain so low in the U.S., gold will have very good reason to increase in value.

Let's recall however that the speculative side of a gold investment, as is the case for other precious metals, makes it prone to price adjustment shocks. In relative valuation terms, gold seems particularly expensive compared to equity.

- We feel that the price of gold could continue to rise over the next few months and even top USD 1,700/ounce by the end of the year.

Hedge Funds - Trends and Recommendations

1st Quarter Assessment:

Despite the unpredictable events occurring in North Africa and the Middle East as well as Japan's triple disaster, the Hedge Funds posted a positive performance for the first quarter (+2.2%)1.

Among the Hedge Funds' four major strategies, all produced significant gains with the exception of "Directional Trading", which lost a bit of money (-0.7%):

Within this particular strategy, the Global Macro (+0.7%) and Short Term CTA (+1.4%) managers were responsible for slightly positive performances. On the other hand, the "Long Term CTA" trend tracking models were adversely affected by an unpredictable downturn tied to events in the Middle East and Japan (-2.6%).

Recommendations:

We continue to remain upbeat about the four major strategies, with our lone preference now favouring Global Macro managers in adopting a defensive bias.

The Global Macro strategy, and in particular this strategy's defensive managers, strike us as the most appealing within this investment universe, which has been shaped by geopolitical uncertainties. This strategy actually allows for attractive diversification, drawing from the current dynamic of world-wide growth via exposure to emerging currencies, while maintaining protection against political crises through exposures to both oil and gold.

During this period of rising rates, the Long/Short Credit strategy still offers a worthwhile alternative to government bonds. Long/Short Credit managers are in fact mainly exposed to high-yield corporate debt. The rate premium level associated with this type of bond (4% to 7%) obviously provides the buffer to absorb any new rate hike. Moreover, the majority of managers add specific protections so as to neutralise the impact of higher rates.

We however have scaled back this strategy's outlook from very positive to positive since the expected gain has declined somewhat in light of the low levels obtained by the credit risk premium (or "spread") on high-yield bonds.

More opportunities for convertible arbitrage strategies

Despite equity market weakness during March, the valuation level of convertible bonds since the beginning of the year continues to lie near their theoretical value. Activity on the secondary market has been sustained by significant demand.

The best valued market segment would be the "Investment Grade" category, which benefits from purchasing flows routed through funds dedicated to convertibles, by taking advantage of equity market increases via convertible instruments.

This situation has led to sharp disparities in terms of theoretical valuation and winds up creating many opportunities for Hedge Fund managers specialised in convertible bond arbitrage.

As opposed to investors playing the equity market through convertible bonds, Hedge Fund managers are seeking to gain from the credit component or the optional feature of convertible instruments. In this effort, they have become purchasers of convertibles and, simultaneously, short sell equity in order to neutralise the equity component of convertible bonds.

As an example, the volatility peak that occurred in March, accompanied by the sudden drop in equity markets, served to demonstrate that the convertible bond arbitrage strategy was once again performing normally. Funds operating according to this strategy successfully preserved the capital invested thanks to the optional dimension associated with convertible bonds, and this was confirmed even during the week when equity markets took the hardest hit. For a defensive strategy, results since the beginning of the year have posted a strong increase between 3% and 4%.

(1) DJ Credit Suisse index

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