Investment Strategy

Societe Generale Private Banking
Investment Strategy Newsletter

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Editorial

Markets appear to be relieved by evidence that global economic growth is running out of steam.
A paradox? No, as investors have understood that the worst case scenario is no longer the most likely.
The latest economic data shows that the risk of slipping back into recession has now been ruled out, as has the danger of US or European deflation. Blue chip companies are flourishing and earnings outlook remains positive.
All of these factors should give heart to investors and incite them to move progressively back towards equities.

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Equities

An improvement in the macroeconomic environment will be the decisive factor for a lasting market rally .

The economic context is continuing to send out mixed signals. Although a slowdown in activity is widespread, affecting all economic regions - USA, Europe, emerging countries – the rate of deceleration remains moderate. Equity markets have not been mistaken, having rallied at the end of September back to early May levels. The main risks are now clearly identified: European sovereign debt and the continued dependence of certain banking establishments on liquidity provided by the ECB. The market considers these risks to be under control however, through the measures put in place by European governments (refunding facility set up via the European financial stability fund). We increased equity exposure, considering that most downside risks had already been taken into account.

— **Markets are back on a bullish trend.** The rally remains fragile however, as it is driven by economic outlook which remains uncertain. Fears of a return to recession or even a sharp slowdown in global activity have been dissipating with the publication of reassuring economic news flow (leading indicators denoting continued growth in the manufacturing sector). Household consumption remains on an upward trend due to lower interest costs, a gradual improvement in employment and subdued inflation. Rapidly tightening fiscal policies and the employment market represent the main threats to domestic demand, particularly within European economies.

— **2010 earnings outlook has improved slightly following the publication of better-than-expected second quarter corporate profit figures.** Earnings forecasts have been revised upwards since the summer. Market consensus is now anticipating a profit increase of around 40% this year for US stocks and 35% for Europe. On the other hand, analysts have begun revising 2011 and 2012 earnings forecasts downwards, taking into account the economic slowdown. We consider that actual profit growth in 2011 is likely to be below current market expectations.

Annual profit growth forecast (market consensus)

Market	2010	2011
DJ Eurosoxx (Euro zone)	+35%	+16%
S&P 500 (USA)	+40%	+14%
Topix (Japan)	+90%	+19%
FTSE 100 (UK)	+56%	+20%
China	+24%	+18%

Source: IBES

— **We have upgraded our assessment on all developed markets. Even a sluggish recovery is positive for equities.** Companies have low debt levels and available cheap funding; earnings should increase further after the sharp rally in 2010 and the absence of inflationary pressure will mean that monetary policies can maintain low interest rates. Finally, equities are very cheaply valued compared to long term averages.

— **In terms of sector allocation, we are prioritising blue chip investments, which should benefit fully from dynamic emerging economies, and high-dividend equities (energy and telecommunications sectors) which offer very attractive yields of between 5 and 7%.** We have upgraded our assessment on the technology sector which should continue to benefit from increased corporate investment. In parallel, we recommend reducing positions in industrial stocks which will be weighed down by a slowdown in growth, and also in pharmaceuticals, many of which will soon be faced with loss of protection on lucrative patents. Among the developed markets, we think that Germany could continue to outperform due to positive momentum from exports towards emerging countries and an acceleration of domestic demand.

Sectors performance	October 1st	
	Over last 3 months (%)	Over last year (%)
Energy	14,1%	8,0%
Materials	25,1%	24,0%
Industrials	14,2%	18,9%
Consumer discretionary	10,9%	14,4%
Health care	9,6%	8,8%
Consumer goods	13,4%	19,4%
Telecommunications	20,0%	15,3%
Utilities	12,2%	10,9%
Financials	7,0%	4,0%
Information technology	12,2%	14,4%
US equity market	**12,1%**	**12,5%**

Source: IBES, Datastream

Bonds

Prefer corporate and emerging debt.

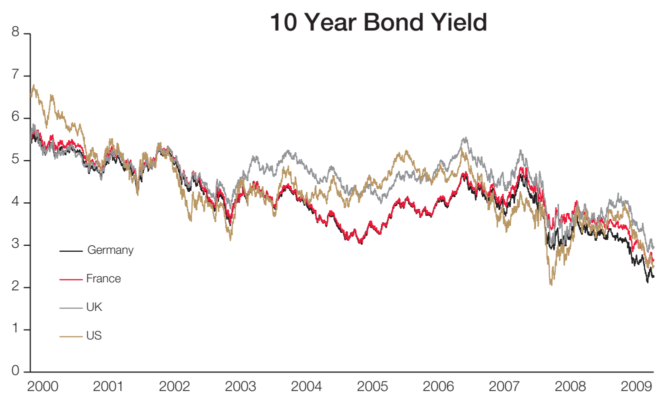
Long-term bond yields fell further over the summer to extremely low levels in both the USA and in the euro zone. Furthermore, markets are nervous about sovereign risk again, forcing risk premiums higher. We are staying out of sovereign bonds issued by mature economies. We consider they are currently overvalued for the safest countries or too risky for the weakest countries.
We think that corporate bonds continue to offer an attractive risk/return profile, despite narrower risk premiums. Corporate financing conditions are highly advantageous, accounting for the large number of bond issues which are still meeting with a high level of demand. Emerging bonds are very attractive as the subscriber benefits from a remuneration premium compared to developed market bonds of an equivalent maturity and rating.

— Within the developed economies, inflation is moderate and remains at low levels, not seen since the 50s. The decline in underlying inflation to around 1% in the USA has even become a concern for the Federal Reserve which is about to start buying securities in the market again to stabilise anticipated inflation. The inflationary context is very similar in the euro zone, where excess capacity is weighing on price outlook. Inflation has held above 3% since the beginning of the year only in the UK, and is unlikely to decline significantly due to imported inflation. This context postpones any increase in base rates sine die. No change in monetary policy is expected before the end of 2011 at the earliest in Europe and in the USA.

— **We are remaining underweight sovereign debt in our strategic allocation. Despite high primary market volumes, long-term interest rates have fallen**. In the euro zone, German 10-year government bond yields remain at extremely low levels: just over 2%. The “flight to quality” has benefited the best-rated issuers, and long-term interest rates have been pushed lower by investors rolling into longer-dated maturities. Fresh fears concerning the more fragile euro zone countries have revived upward pressure on interest rates. The short and medium-term government security tenders by Spain, Portugal and Greece, were successful but costly. The fiscal position remains fragile in these countries. In addition to deepening deficits and further downgrades in sovereign debt ratings, high debt refinancing costs are also having an impact. Greece seems to be respecting its commitments regarding public deficit reduction, but the weight of the debt which now represents more than 130% of GDP means that debt restructuring is likely, possibly on a voluntary basis by extending maturities. In the USA, lower interest rates illustrate market anticipations regarding quantitative easing already announced by the Federal Reserve. From the summer onwards, the Federal Reserve has opted to reinvest the proceeds of its maturing mortgage backed securities into Treasuries. With growth decelerating, long-term rates could remain at low levels for several quarters. The development of a favourable scenario, with growth picking up again over the course of 2011, should be anticipated by the bond market through slightly higher long-term yields as of the beginning of next year.

— **We continue to recommend corporate bonds. The economic crisis has revealed the fragility of some government states but highlighted, in contrast, the financial solidity of major groups with abundant treasuries.** Financing conditions are extremely advantageous which is helping bring down default rates. The long-dated maturity of some issues is a sign of a healthy market. Primary market issue premiums have narrowed again due to keen investor appetite. Several companies’ dividend yield now exceeds their bond yield. Risk-weighted yield nonetheless remains attractive in view of the fact that remuneration for liquidities is close to zero. However, we prefer the highly-rated (investment grade) issuers over high-yielding (high Yield) bonds which would be hit harder by any increase in risk aversion. **We are focussing on securities of 3 to 5-year maturity, intending to hold until maturity, prioritising issuers which will benefit fully from the global economic recovery.**

— **The emerging bonds segment presents some interesting opportunities.** Emerging blue chip companies offer higher yields on foreign currency-denominated issues (dollar, euro) for equivalent creditworthiness. The relatively recent rise of this market accounts for this phenomenon, as it attracts less research coverage and fewer major institutional investors. Another reason lies in the quality of corporate balance sheets which often have lower gearing and higher profitability than their European or American peers. Finally, these companies will continue to benefit from upgrades by rating agencies over coming years.



Currencies

The dollar is on a downward trend. Monetary tightening will benefit emerging currencies.

— **The dollar's weakness is chiefly due to monetary policy announcements.** The Federal Reserve announcing its intention to inject fresh liquidities into the market explains the weakness of the dollar. Whereas the euro had fallen below 1.20 during the sovereign debt crisis at the beginning of June, it has remained constantly above 1.25 since July, reaching almost 1.40 at the end of September. Furthermore, the political debate in the USA regarding the effectiveness of budgetary stimulus policies is another reason for investors to shun the greenback. The intrinsic situation in the euro zone however, does not justify the single currency making such a strong rally. Aside from this overreaction, the euro should return to the 1.35-1.25 corridor over the next few months.

— **The yen should remain strong, particularly against the dollar.** Intervention in the forex market by the bank of Japan at the beginning of September, for the first time since 2004, aiming to curb its currency's rally did not have a lasting effect. The intervention was not carried out in concert with other central banks and only caused a temporary downturn in the price of the yen. The trade surplus, along with Japanese savers coming out of foreign currency-denominated assets provides structural support for the currency. The yen's strength should be seen in perspective, the real exchange rate is effectively currently at its historic average, well below the 1995 highs, due to the country's persistent deflation over the past 15 years. We are nonetheless expecting the yen to dip against the dollar but only slightly (90 JPY/USD on a 6-month horizon, 95 JPY/USD on a 1-year horizon).

— **The British pound which is currently undervalued by around 15% against the euro, should ultimately claw back some lost ground.** The credibility of the budgetary commitments to be announced in October by the British government could provide a catalyst. However, the Bank of England's highly supple monetary policy and the possibility of fresh quantitative measures will curb the speed and the extent of the rally (0.80 GBP/EUR on a 6-month horizon, 0.75 GBP/EUR on a 1-year horizon).

— **Emerging currencies remain on a bullish trend: several emerging central banks intervened in the forex market to hold down their currency, at the risk of starting a currency war.** This attitude leads to the creation of potentially inflationary liquidity if it is not sterilised. On the contrary, the dynamism of emerging economies would argue in favour of tighter monetary conditions through higher interest rates or exchange rates. This type of move which has been undertaken by certain countries is set to become more widespread in order to curb inflation. **Further potential upside in raw material exporting country currencies (CAD, AUD, NOK…).** With these countries enjoying solid growth and healthy economic fundamentals (limited public debt, low inflation…) their currencies are playing an increasing role as alternative reserve currencies. Accordingly, these currencies should remain strong over coming months.

Emerging markets

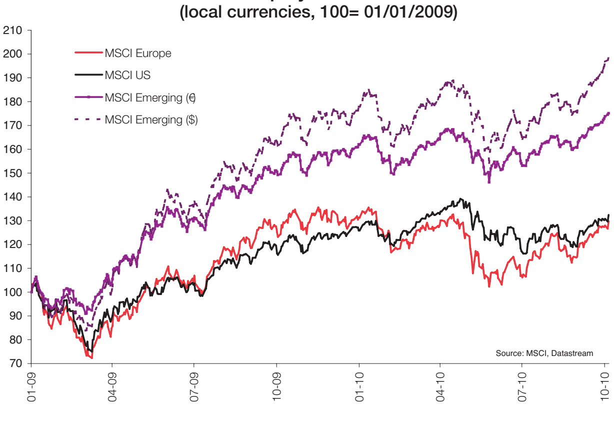
Dynamic growth but monetary tightening will penalise equities.

— **Emerging economies are also going through a phase of decelerating activity.** From a macroeconomic point of view, this is a welcome slowdown as it is controlling the dynamism of economies which were overheating. Inflationary tension has abated, particularly in Asia. Domestic demand is starting to provide a growth relay in many emerging economies. However, leading indicators are denoting lower order books especially concerning demand from Europe and the USA which will lead to fewer exports over coming months. On the other hand, South-South dynamics remain intact, with the cross-integration of emerging economies providing a positive factor for global growth.

— **Emerging markets are still sensitive to an increase in risk aversion due chiefly to a lack of local institutional investor base.** Nevertheless, average valuations have returned to their long-term levels, but remain higher than in mature equity markets. Market performances have resulted more from currency appreciation against the euro and especially the dollar, than from the indices rallying. Persistent inflationary tensions have led to tougher monetary policies. Furthermore, fresh measures designed to restrain capital inflow could be introduced. This would logically be negative for equity markets and emerging markets would not perform well over coming months.

— **We remain positive on emerging market equities for the medium-long term. Nevertheless, the downturn in global activity leads to incertitude. Furthermore, we are still at the beginning of a monetary tightening cycle which will reduce liquidities in these markets. We prefer to await buying opportunities below current prices. We continue to prefer the Russian market which appears significantly undervalued and Asia, privileging Taiwan and South Korea.**

Equity Markets
(local currencies, 100= 01/01/2009)



Oil

No lasting price rally as global growth decelerates.

— Following weakness at the end of August, oil prices turned bullish again to break through 80 USD/barrel at the beginning of October. Beyond this temporary blip, the upward trend will be curbed by slower global growth.

— **Demand should remain firm, essentially driven by the needs of emerging countries.** In parallel, supply from OPEC countries remains very stable whilst non-OPEC countries have accelerated their investments in terms of output capacity which has substantially increased market supply. Stocks are set to remain at high levels, above the 5-year average. In this context, supply–demand balance will drive prices although speculation, fuelled by a weaker dollar, could provide some price support.

— **Slower global growth in the second half of the year should maintain oil prices in a USD 75 - 85/b range over the next six months.**

Gold

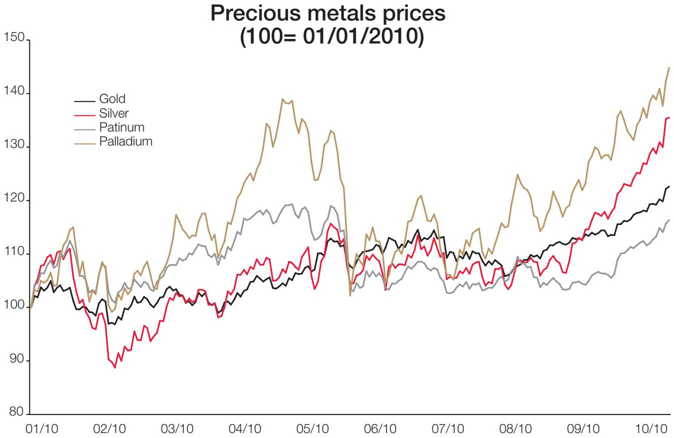
New highs.

— Since the spring, the gold price has been supported by market fears concerning sovereign debt. Since the summer, the prospect of an increase in the money supply by central banks has driven investors towards gold. Investor wariness regarding the anchor currencies (dollar, euro) is unlikely to abate quickly in view of the long-term degradation of public finances.

— Reduced gold sales by G10 central banks combined with emerging country central banks' desire to diversify by seeking alternatives to the dollar has increased upward price pressure. At over USD 1,300/ounce, gold has returned to levels seen at the beginning of the 1980s in real price terms. Despite talk of a gold bubble, the rally could continue until major countries' monetary policies revert to a more normal phase. This will depend upon a more solid recovery which is expected during the first half of 2011.

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

— **We think that the price of gold should continue to rise to around the USD 1,500/ounce mark by mid-2011.**



Hedge Funds – Trends and Recommendations

There Trends

— From June to August, hedge funds have posted a positive performance (+1%) in a context of high volatility characterised by doubts about the robustness of growth in America. In the third quarter, performances should improve, approaching 4%.

— Of the four principal strategies, Relative Value (+3%) and Global Macro-CTA (+1.9%) delivered satisfactory performances over the last three months. However, the Event Driven (-0.4%) and Equity Long/Short (-0.7%) strategies suffered from the various movements in the equity markets, having a very high level of correlation with equities.

— In terms of sub-strategies, the Government Bond Arbitrage (+3.1%), Global Macro (+2.7%) and Convertible Bond Arbitrage (+3.6%) strategies posted the best performances over the last three months.

— Conversely, the Equity Statistical Arbitrage (-3.3%) and the Equity Long/Short with long bias (-1.3%) or variable bias (-1.2%) strategies posted the worst performances over the same period.

Our views on the main strategies

— We continue to favour the Global Macro-CTA strategies, which seem to be the most appropriate in this period of uncertainty.

— We are also maintaining a positive view on the outlook for the Relative Value strategies, favouring the Government Bond Arbitrage sub-strategy, which should benefit from new opportunities associated with the new Treasury purchases by the Federal Reserve. We are also confident in the Corporate Credit Long/Short strategy that will continue to benefit from significant opportunities linked to businesses' extensive refinancing requirements. We are taking a more prudent approach to the Equity Statistical Arbitrage sub-strategy, which is currently suffering from the stocks' high correlation among themselves.

— Even though we are also maintaining a positive view on the outlook for the Mergers and Acquisitions Arbitrage and the Distressed strategy, we have lowered our exposure to the Event Driven strategy as a whole because it seems to be more sensitive to the favourable development of the equity markets, especially the Equity Special Situation strategy.

— Finally we are maintaining our position unchanged on the Equity Long/Short strategies, which are suffering from the high correlation of stocks among themselves.

Reallocation in favour of the Directional Trading strategies (Global Macro and CTA)

In the current climate of macroeconomic uncertainty, we are recommending that the portfolios be reallocated in favour of the Directional Trading (Global Macro & CTA) strategies and we suggest a balanced allocation over the three strategies in this category (Short Term CTA, Medium/Long Term CTA and Global Macro).

— We are still confident about the outlook for the Global Macro strategy, which has come through this difficult period well. Within the Global Macro universe, we prefer the managers with a bias towards sovereign bonds and currencies and who do not speculate significantly on the economic recovery in America.

— For CTAs, we recommend to reallocate overexposure to Short Term CTAs towards Medium/Long Term CTAs in order to obtain a more balanced allocation between the two strategies.

— While the Short Term CTA strategies still offer substantial decorrelation, the current level of performance does not justify maintaining a significant overexposure to this strategy.

— On the contrary, the trend-following models with a medium/long-term horizon (Medium/Long Term CTA) are of interest at this stage because of the higher weight of medium term component.

— Indeed during the last two years, the long term component of models was dominant because of the strong financial crisis of 2008 and the sharp rebound that followed. The sharp market correction in May put an end to this cycle and so contributed to reduce significantly the weight of the long term component of the trend following models for equities and commodities.

— So currently trend follower models are more biased towards medium term trends which is clearly positive in this environment.

— Moreover the Medium/Long Term CTAs have net exposure levels that are relatively low for equities and commodities; they are therefore in a good position to pick up on upward or downward trends in the markets.

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