

Investment Strategy

Société Générale Private Banking

February-March 2011 - # 41

Investment Strategy Newsletter

Editorial

2011 has begun on a positive note with markets definitely heading upwards. Recovery in the manufacturing sector worldwide, along with an excellent round of corporate earnings statements, has bolstered market optimism. European countries are pursuing a durable solution to their zone's debt crisis, though the path to be traversed is rife with obstacles. While inflationist pressures, stemming for example from geopolitical risks, need to be contained (which we're counting on), a solid performance in equity markets can still be expected for 2011, outpacing corporate bond markets for the first time in three years.



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EQUITIES

Worldwide growth is just now hitting its stride, helping strengthen the outlook for business activity and corporate profits.

Both macro and microeconomic factors have coalesced in support of equity prices across developed markets. The level of growth has surpassed forecasts, especially in the United States and Germany. Monetary policies are expected to hold central bank discount rates unchanged in the absence of sustained inflationist pressures throughout developed nations. Moreover, corporate results continue to exceed market analysts' projections. In this context, investors' overall feeling is much more upbeat now than at the end of 2010, motivating them to adjust their portfolio allocations in favor of equity.

Emerging markets have been experiencing more mixed trends. The return of inflation, which leads to further monetary tightening and higher valuation levels, suggests a consolidation phase, and such is already underway in a number of markets. These recent changes have not altered our positive view regarding the buoyancy of emerging equity over the medium term, yet call for greater caution over the shorter term.

We continue to increase our equity market exposure by assigning priority to developed market securities and stabilizing our exposure in emerging markets from an aggregate perspective.

- **During the upcoming months, we will continue to anticipate advances in the equity markets of developed nations.** The global economy is undergoing acceleration spurred by American growth, which on average should top 3% for 2011 (annualized 3.2% during the fourth quarter 2010). Germany also keeps growing at a steady pace, according to detailed indicators of the country's business activity. Even those countries facing a debt crisis are starting to post improved economic numbers thanks to a rebound in the manufacturing sector, with Ireland leading the way. It goes without saying that the German economy is acting as a locomotive for the rest of the euro zone. Corporate revenue trends should benefit from this improved context.

- **Profits should keep rising over the next twelve months, in both the United States and Europe.** Markets are expecting a 15% rise in earnings per share on both sides of the Atlantic. Given the strength of this recent growth, such forecasts definitely seem within reach. In the United States, the increase in domestic demand coupled with the dependence of net earnings on revenue trends would tend to confirm this projection. In Europe, the explanation for this expected rise in earnings is due instead to the focus on recovering profits following a 19% drop in 2009, combined with the impacts of worldwide growth. We are therefore raising our levels of exposure in equity markets, in emphasizing the United States, the United Kingdom and Japan as opposed to the euro zone, where financial conditions remain vulnerable.

**Annual profit growth forecast
(Market Consensus as at February 03 2011)**

Markets	2010	2011
DJ Eurostoxx (Eurozone)	35%	15%
S&P 500 (USA)	44%	14%
FTSE 100 (UK)	55%	23%
Topix (Japan)	97%	15%
Shanghai SE (China)	32%	22%

Source : IBES

- In terms of sector allocation, we continue to invest in securities that take advantage of emerging country growth and earn high dividends, yet are also returning to cyclical securities. For the past few months, growth securities have once again started to outperform yield securities.

- We are focusing on the following sectors:

- commodity sectors featuring low valuations and attractive prospects as a result of emerging country demand;
- energy, which combines high dividends with medium valuation levels, while energy prices are bound to rise owing to structural considerations;
- information technologies, which have been reinforced by the rebound in corporate investment along with the prospect of higher valuations;
- non-cyclical consumption (beverages, food) given that companies operating in this sector are enjoying rapid business expansion throughout the developing world, with the expectation of merger-acquisition transactions on the horizon. Our preference lies with food processing companies over distributors.

Among developed markets, we are more bullish on securities tied to domestic demand in countries where growth is being driven by consumption like Germany and the United States, in addition to Australia and Canada.

BONDS

The bond market is expected to post strong performance, primarily in the high-yield bond segment.

These times of improved growth prospects tend to push long-term yields higher. This trend is accompanied by rising inflation forecasts, which reflect more of a harmonization in expectations than any fear of triggering rampant inflation. Against this backdrop, we have avoided any involvement with sovereign securities, given that we are maintaining our position of a gradual increase in long rates over the course of 2011. On the other hand, we'll keep buying private bonds, as defaults continue to wane and investors continue to seek greater returns. High-yield bonds undoubtedly offer the best outlook for 2011, in light of the potential for reduced risk premiums as well as their more limited sensitivity to reestablishing long-term yields.

- The market is perplexed over the potential early cessation of purchasing publicly-listed securities by the American Federal Reserve ("Fed"). In contrast, our idea is that the Fed will proceed with all announced purchases (accounting for \$600 billion through the end of June), concentrated on the 5-10 year segment of the rate curve. The recently observed yield increase is indicative of a positive phenomenon, namely resurgent market confidence riding on the strength of growth prospects. Nonetheless, the American economy remains too fragile at present to accommodate a dramatic increase in long rates, which could induce a double dip in the weakened real estate market. Financial markets have been squarely focused since the beginning of the year on inflationist risks, a concern that we feel has been exaggerated for developed countries, given the sustained high rate of unemployment and unused production capacity. The pass-through effect on retail prices from higher commodity rates can at most be only very limited. Underlying inflation remains extremely low, in the neighborhood of 1% in both the U.S. and the euro zone. It would therefore be entirely premature to envisage any monetary tightening in the U.S., the euro zone or even in Japan during 2011. On the other hand, the United Kingdom is clearly faced with an inflation problem, exacerbated by an upward shift in long-term inflation forecasts, which should force the Bank of England to tighten its policy at some point during 2011.

- **We continue to underweight sovereign bonds within our strategic allocation.** The 10-year rates should stay on an upward trajectory as a result of recovery indications and large numbers of institutional bond issues planned for 2011. In the euro zone, concerns still prevail despite markets showing less sensitivity during the past few weeks. After the refinancing agreement reached with Greece and then Ireland, it is obvious that Spain and Portugal remain exposed and cannot indefinitely refinance their debt under current conditions without jeopardizing their solvency. European governments are working on extending the bailout mechanism and devising a sustainable crisis resolution plan, for application beginning in 2013.

The most prickly short-term subject is still the exposure of euro zone banks to sovereign risk, since this risk adversely affects refinancing conditions for the most active banks, adding to their vulnerability. Public sector decision-makers must find a way to dissociate the public debt problem from issues related to bank balance sheets. To succeed in this task, the European Financial Stability Facility (EFSF) should be allowed to purchase sovereign debt in the secondary market, thus making it possible for banks to clear their balance sheets of liabilities and limit the need to recapitalize the banking sector. In exchange, debt renegotiation would involve longer reimbursement periods along with a drop in the associated borrowing rate. This whole process would entail an ordered restructuring of debt, without necessarily causing payment default in the strict sense of the term. Yet such a process encounters some major political obstacles. As long as a political solution has not been reached, this crisis will persist, in increasing the likelihood of one or more sovereign defaults within the euro zone.

- **We continue recommending the acquisition of corporate and emerging bonds (sovereign as well as private). Performance is more likely to stem from yield instruments than from capital gains in the developed markets.** Companies are typically posting healthy balance sheets, with relatively low levels of indebtedness and tremendous amounts of cash on hand. The more moderate rise in profits during 2011 constitutes a factor in favor of issuer solvency. In conjunction with these trends, issue volumes should fall during the year, while demand is expected to remain strong, especially for high-yield bonds. We remain in a buy position with respect to highly-rated (or "investment grade") bonds, though risk premiums have returned to their historical averages. We feel that these high-yield bonds provide the best potential return, given the projection for an average 100-basis point drop in risk premiums with investors' newfound appetite for returns. The main risks all concern the banking sector, which must cope with considerable refinancing needs in an uncertain regulatory environment. This observation has led us to relinquish bank debt, whether senior or subordinated. The pitfalls of this European debt crisis provide another volatility factor, even though its impact until now has only had mild repercussions on bond markets.

As regards emerging bonds, we still hold a positive attitude due to the additional yield served by these issuers, in comparison with issuers of equivalent quality located in developed countries, as well as to the favorable outlook for foreign exchange appreciation on securities issued in local currency.

CURRENCIES

Projected dollar weakness over the medium term and gains in emerging currencies exchanged under State control.

- **The euro is not expected to experience abrupt movements versus the dollar over a several-month period.** The slightly higher inflation rate recorded in the euro zone, tied to rising oil prices, has sparked fears of an anticipated tightening of monetary policy by the European Central Bank (ECB). In contrast, we feel that inflation does not constitute any real risk for the euro zone and moreover that the ECB is not inclined to repeat the mistake made in July 2008 when it raised its discount rate at an unpropitious time. The debt crisis is far from being resolved, and bond market tensions are expected to remain strong enough to depreciate the euro. On the other hand, beyond the next six months, the downside risk appears to weigh more heavily on the greenback. Continuation of an extremely lax budgetary policy (running the public deficit to 10% of GDP in 2010 and 2011), coupled with a zero Fed funds rate, will eventually lower the dollar's value.

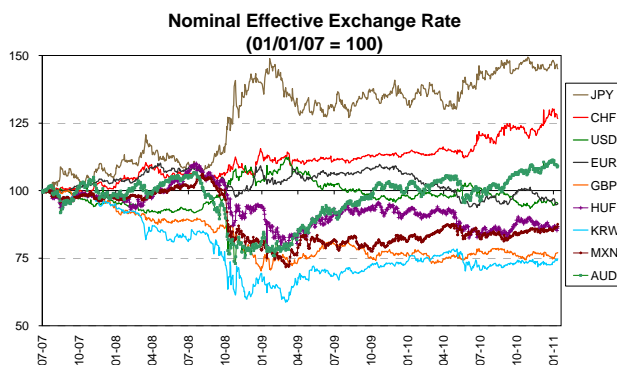
The need to cover America's current deficit is considerable (3% of GDP); our assessment is that investors may in time demand a higher return on American debt or else a lower exchange rate. When faced with such a dilemma, we believe that American financial authorities will opt for a weaker dollar, a move that would favor exports, over a hike in long-term interest rates, which would hinder the domestic economy. Our projection calls for a euro exchange rate at 1.30 USD 6 months from now (with a slight risk to the upside, depending on political progress in Europe). Over a 12-month horizon, we anticipate the euro forging ahead to the 1.40-1.45 USD range.

- **The yen might see a decline in 2011.** Deflation just may be contained this year in Japan, with price stabilization expected by the end of 2011. The growth differential between the United States and Japan should lie within a range of 1.5 to 2 points, which would be reflected, at least partially, in the two-year interest-rate spread, which serves to guide USD/JPY parity. In practical terms, this trend should lead to the yen's gradual fall, with a more pronounced impact certain to play out during the second half of the year (85 JPY/USD in 6 months, 90 JPY/USD a year out).

- **The pound on a course towards strengthening versus both the euro and dollar.** Sterling's undervaluation versus the euro and dollar, as explained by an actual short-term U.K. interest rate more negative than anywhere else in the industrialized world, has been weighing on the pound's value. Nonetheless, the Bank of England will undoubtedly be forced to raise the central bank's discount rate to rein in anticipated inflation. Such a tightening should not be expected over the very short term given the drastic budgetary cuts currently underway. The pound's upward movement will thus be limited and gradual. We maintain our scenario of a stronger pound versus the euro over the next year (0.85 GBP/EUR in 6 months, 0.80 GBP/EUR 12 months out).

- **Emerging currencies will continue their climb:** Higher inflation rates will necessitate monetary tightening measures, which in most emerging countries will be introduced gradually. The inflation rate currently observed in the emerging world stems from two sources: increases in commodity prices, and robust domestic economic activity. The appreciation in foreign exchange rates serves as an effective hedge against imported inflation, even if it cannot be controlled as directly as injecting credit into the economy.

We consider that emerging currencies will proceed along their upward path. The time has come however to emphasize those currencies that have not yet reached their pre-crisis parity versus the dollar or that have adopted a strictly-controlled exchange policy with a partial peg to a third currency. Measures for restricting capital flows, implemented in a number of countries, should only exert a limited impact on incoming flows, which should from a structural standpoint remain high. We feel that the Chinese yuan (CNY), Korean won (KRW), Malaysian ringgit (MYR) and Thai baht (THB) are to be included as currencies offering the greatest appreciation potential versus the US dollar over the next 12 months.



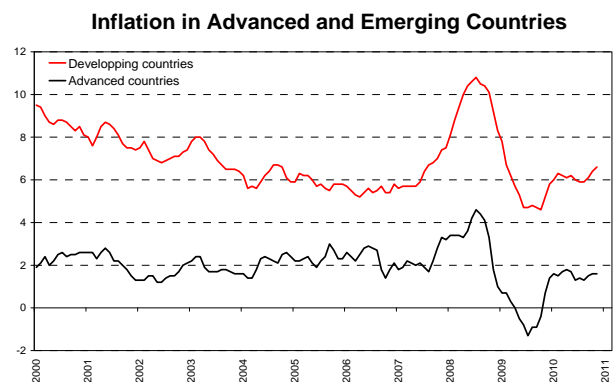
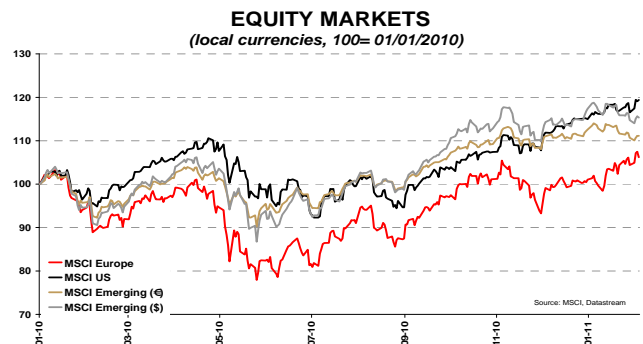
EMERGING MARKETS

In light of mounting inflation and monetary tightening, emerging markets could prove less dynamic relative to developed markets in 2011.

- The positive growth picture for emerging markets remains in place, however imbalances are starting to form. Strong domestic demand growth added to inflationary pressures from high commodity prices suggests that the risks of overheating have increased. Inflation expectations are rising throughout EM, notably in China, India, and Brazil. Interest rates are more than 200bps below pre-crisis levels despite above-potential activity, implying that many policymakers are behind the curve. Monetary tightening has begun, though is expected to be stronger in Latin America than in EM Asia (150bps vs 75bps). The effect on currency appreciation complicates the policy response, increasing room for error and/or raising concerns about the FX regime (Brazil); a notable exception is Mexico, where the MXN has upside potential without the resumption of monetary tightening, highlighting an improved growth outlook. A strategy of putting growth over price stability could set a risky stage for a harder landing in the future.

- Macroeconomic conditions are somewhat less supportive for EM outperformance relative to developed markets. Given the backdrop of rising interest rates, emerging market assets have a greater chance of underperforming. Bond and equity markets tend to be more correlated in EM than in developed markets. While EM still offer positive return potential, they are expected to post a weaker performance relative to developed markets after the strong rebound already seen following the March 2009 bottom (MSCI Emerging +101%, MSCI Developed +40% since 1/1/2009). However, in the absence of a shift to monetary tightening in developed markets, capital inflows to EM are highly likely to continue.

Given rising inflationary pressure and a resumption of monetary tightening, and the strong market performance up until now, we have downgraded emerging markets to neutral. We maintain our individual country ratings, with a preference for Russia, where valuations remain low. We also continue to prefer Taiwan and South Korea for their regional recovery potential.



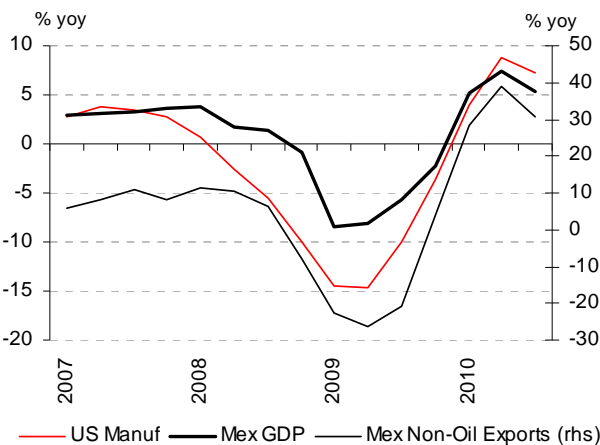
Peso strength expected on the back of growth pickup

- Mexico suffered a more significant shock to its economy in the wake of the global financial crisis than did the rest of Latin America. While the region's GDP posted a 1.8% contraction in 2009, Mexico's fell by 6.1%. Also dissimilar to other Latin American countries, Mexico's export-led recovery in 2010 has been slow to reignite domestic demand, failing as yet to close the output gap. GDP is forecast to have risen 5.4% in 2010, but unemployment remains stubbornly high and consumer confidence beneath pre-crisis levels. The recently upgraded outlook for the U.S. economy provides Mexico with an unexpected boost. We forecast GDP growth of 4.0% in 2011. In light of relative overheating in other Latin American countries, where monetary tightening has resumed course, Mexico is well-placed to catch up with its Latam peers.

Weak domestic growth drivers highlight the importance of stronger U.S. growth

With 80% of its exports directed to the U.S., Mexico is highly sensitive to shifts in its manufacturing sector. According to the IMF, a 1 percentage point increase in US industrial production is followed by a 0.9 percentage point increase in Mexican GDP. In other words, a US growth shock is passed on to Mexico almost one-for-one. When U.S. demand dried up, so did Mexico's growth engine.

The US, Export, Growth Link



Commodities account for a smaller fraction of total exports

Whereas solid growth in Asia and its impact on global commodity prices have provided a welcome buffer to the global economic slowdown for many Latin American countries (Brazil, Chile, Colombia, Peru), where commodities represent more than half of total exports, Mexico was hit by a deterioration in its terms of trade. Despite being an oil exporter, commodities count for less than a quarter of Mexico's total exports (and Mexico is a net importer of food items). This exacerbated the drag on income, and thus on domestic demand.

Consumption is Mexico's primary growth driver, at 65% of GDP, yet exports (25%) its most dynamic.

The services sector is Mexico's largest, responsible for two-thirds of activity, the bulk of the remainder in externally-driven manufacturing production. In absolute terms, Mexico's industrial production is dominated by domestic-focused manufacturing even if its most dynamic sectors are export-driven (automobile, electronics, machinery).

While investment grew at a double digit pace throughout much of Latin America, it rose less than 3% in Mexico. Put simply, investment spending has not rebounded more sharply because Mexico still suffers from excess capacity.

Latin America: Exports (% of total)

	Exports (% GDP)	Commodity Exports	Exports to		
			US	China	EU
Brazil	9,7	55,4	10,2	13,7	22,2
Mexico	26,2	21,9	80,0	1,0	5,4
Latin America	18,9	47,8	40,1	7,5	14,0

Domestic demand set to firm up in 2011

Domestic demand is starting to pick up. Retail sales have expanded for seven consecutive months, economic activity (IGAE) showed 5.8% yoy growth in November with continued growth in the services sector, and the December trade balance showed a 15% yoy jump in consumer goods imports. Key factors for a more anchored domestic growth driver include credit growth and employment, both of which are improving, yet with some caveats. Credit to the private sector turned positive, up 3% in Q3 2010, though this follows a 2-year 30% contraction.

Total private sector credit in Mexico remains below 15% of GDP. Employment growth has gained some steam (+3.6% since Q1 2009), yet the quality of those jobs remains low (more jobs have been created at 1-2 minimum wages than at a higher pay scale) and concentrated in the informal sector.

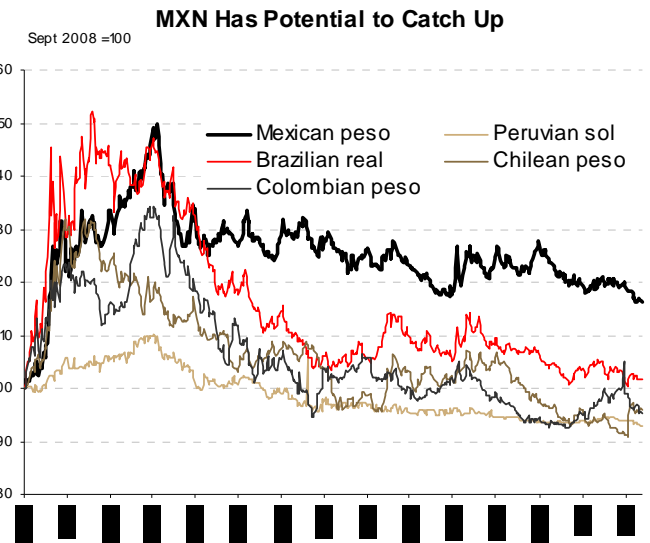
The Mexican peso has potential to catch up

The bright side to all this is that, against the backdrop of stronger US growth in 2011, Mexico is expected to grow with manageable inflation. We expect 2011 GDP growth of 4% given the outlook for strong export production, recovering domestic demand, and the fact that the pre-election year could support a resumption of infrastructure investment.

While other Latin American countries are faced with the increasingly tricky policy dilemma of limiting FX appreciation while fighting inflation, the still negative output gap in Mexico argues for policy rates to be held steady this year. The tightening cycle may not begin before Q12012. If growth surprises to the upside, this could be brought forward. But right now inflation expectations remain well-anchored at 3.6%.

The stronger economy combined with low interest rates should be positive for Mexican local markets.

Mexico's inclusion in Citigroup's World Government Bond Index (October 2010) is also a supportive factor for the economy. We expect the MXN to strengthen in the coming months, whereas the implementation of capital controls looks unlikely.



Oil

Political tensions coupled with robust growth pushing prices higher

- **The political upheaval spreading across North Africa has sent the price of a barrel of oil above the 100-dollar mark.** Besides political tensions and their unpredictable outcome, the harsh winter season and accelerated growth in the United States and China have spurred the rise in demand for petroleum products. China, for instance, broke its all-time record for oil imports with 9.6 million barrels a day in December, which is more than Saudi Arabia's total output for the month (8.25 million barrels a day). This increase in emerging country imports is a structural phenomenon and the main factor behind the higher demand.

- **Nonetheless, the recent spike in oil prices strikes us as too abrupt to be entirely justified by fundamental economic factors.**

- Several factors relative to the current economic context or specific conditions seem to be acting in concert to sustain today's high price for oil:

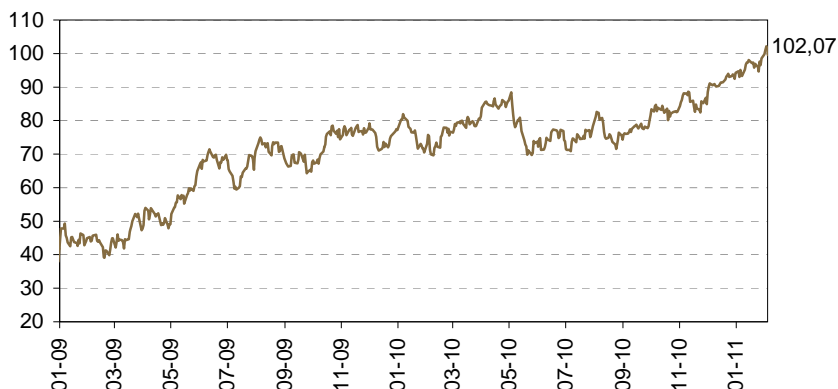
- The harshness of this winter season across North America and Europe has raised the overall demand for energy;
- The reluctance to revise OPEC quotas, as approved last December, has prevented raising output and hence has constrained supply;
- An all-time record in net long positions on the New York oil futures market was recorded in January.

- These factors taken together naturally exert upward pressure on the price of oil, although to an extent that remains difficult to estimate. The purely speculative aspect has undoubtedly added at least 10 to 15 USD to the barrel above the supply-demand equilibrium price.

- **While we are projecting that oil prices will continue their upward climb over the next few years, the risks during the upcoming months tend to favor the downside:**

- Oil inventories within OECD countries, though lower since the beginning of 2010, are still above their average over the past five years;
- Unused production capacities in OPEC remain high: Saudi Arabia could easily expand production, like it did in the summer of 2008, pushing prices back down;
- which in turn will dampen activity and reduce the country's demand for commodities;
- Lastly, as the world recovers from this major downturn, the barrel at a price steadily above 100 USD would clearly induce inflationist effects, thus exerting a recessionary influence on the global economy. Such a price level would raise business production costs, squeeze profit margins and reduce household purchasing power.
- **The price of oil should range between 85 and 100 USD a barrel over the next 12 months given world growth projections in conjunction with unused production capacities that are now able to absorb a demand shock.**

Oil price (Brent, USD/b)



Gold

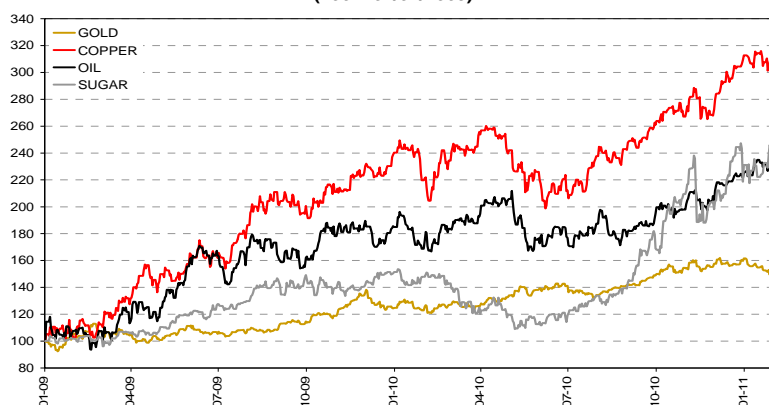
Short-term consolidation

- At the beginning of January, gold entered a slight correction phase, returning to a price below the threshold of 1,320 USD / ounce, before rebounding to nearly 1,350 USD / ounce with the outbreak of political strife. A reduced interest in gold on the part of investors, as manifested by the very weak investment flows on ETFs combined with a considerable jump in selling positions on futures markets (at a 5-year high), has contributed to this price drop. Moreover, the decline in risk premiums on euro zone sovereign debt has also played a role. This decrease however has been moderated by the physical demand for gold stemming from Asia (primarily India and China).

- Over the medium term, the demand for gold as an investment purchase will remain solid. The demand for gold as a financial asset will continue to benefit from: low interest rates, the search for a substitute to paper money, and inflationist fears. The geopolitical context has once again become a decisive factor in favor of gold, should the Egyptian crisis last longer or spread to oil producing nations on the Arabian Peninsula.

- We feel that the price of gold could over the next few months stay at its current level, as downside and upside factors balance each other out. By the end of the year however, gold has the potential to rise as high as 1,500 USD / ounce.

Commodity Prices
(100 = 01/01/2009)



Hedge Funds - Trends and Recommendations

2010 results:

Despite major variations in risk aversion behaviour over the course of the past year, the Hedge Funds still posted an overall solid performance (+11%)¹. However, 2010 results recorded by the funds of Hedge Funds were disappointing, showing just a 5% gain, due to excessive prudence.

Among the 4 main Hedge Fund strategies, all produced significant increases within a range lying between +9% and +13%.

Managers of the **Event Driven** strategy were responsible for generating a strong performance (+12.6%) in 2010. The **Special Situations** strategy, which ended the year on a very positive note (+10%), fully benefited from the December rebound in the equity market (rising +4.3%). On the other hand, the **Mergers & Acquisitions fund managers** sustained losses during the fourth quarter 2010 (-1%), due to several transaction cancellations, and wound up the year with a disappointing outcome (+3.2%).

The **Relative Value strategy** once again posted a sizable gain (+11.8%) in 2010, and the **Long/Short Credit strategy** proved to be extremely viable (+12.4%), with support provided by the underlying dynamics in the high-yield corporate bond market.

The **Directional Trading** strategy produced a satisfactory performance figure (+9.5%)², overcoming a difficult beginning of 2010. **Managers in both the Global Macro (+13.5%) and Long-Term CTA (+10%)** lines made the most of their strategic approach, thanks to a strong fourth quarter performance, by taking advantage of upward trends in high-risk assets (commodities, especially agricultural, and the emerging equity and currency markets).

In accordance with the rebound experienced in equity markets during December, **Long/Short Equity** managers closed the year with a very satisfactory performance reading (+9.3%). After the summer season, managers correctly anticipated the decline in risk aversion, which translated into a significant increase in their level of market exposure.

Recommendations:

Though we are now positively disposed to the four main strategies, buoyed by a higher rating assigned to the Long/Short Equity strategy, we still maintain our preference for the Global Macro and Long/Short Credit sub-strategies.

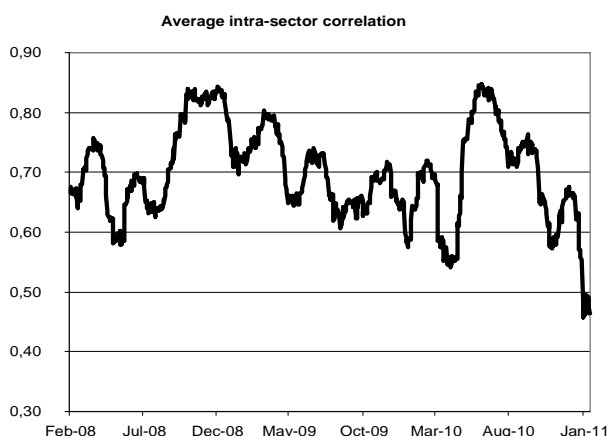
The Global Macro strategy provides an attractive opportunity to diversify equity portfolios while continuing to focus on the ongoing economic recovery through exposure to commodities, with an emphasis in the agricultural sector, as well as to emerging currencies.

During a period of interest rate hikes, the Long/Short Credit strategy offers an appealing alternative to government bonds. The current exposure profile of Long/Short Credit managers tends heavily towards high-yield corporate debt. The rate premium level associated with this type of bond instrument (5% to 8%) clearly serves as a cushion in absorbing another rate increase. Moreover, the majority of managers add specific protections to mitigate any rate hike impacts.

2011, the year of fundamental equity management?

After two difficult years for the team of equity selection specialists, the recent drop in intra-sector correlation levels on equity markets bodes very well for 2011.

As observed in the following graph, the intra-sector correlation for equities has been sharply declining for the past several months, plummeting to levels not seen since the onset of the financial crisis in 2008. This indicator reflects the dominant return of factors specific to each individual equity in their overall valuation. Such a trend will enable fund managers to create value by proceeding with their fundamental equity selection.



For reasons beyond these correlation levels, equity today constitutes one of the most attractive high-risk assets. The anticipated rise in profits remains very relevant for 2011 as well, despite failing to reach the soaring figures posted in 2010. Valuation levels, particularly in developing countries, are appealing since they remain positioned below their long-term averages.

Lastly, the abundance of liquidity, due to highly accommodative monetary policies, is another factor in favor of equity markets, just as it helps support all high-yield asset markets.

As regards the fundamental Long/Short Equity managers, we have detected the return of a higher level of confidence. In fact, these managers have been resuming their net exposure to the equity market for the past several months and have now reached a level slightly above their long-term average.

FOCUS ON ALTERNATIVE INVESTMENT ASSET CLASS

Despite the presence of risks related to efforts aimed at resolving the European sovereign debt crisis, all factors cited earlier lead us to believe that 2011 should be the year of fundamental equity management. Long/Short Equity managers are expected to successfully generate alpha (by beating the market) over and above the equity market beta performance (matching the market).

(1) DJ Credit Suisse index

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