Investment Strategy

Societe Generale Private Banking
Investment Strategy Newsletter

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Editorial

Despite concern over the scale of government deficits, capital markets have been on the rise since mid-February. The US market continues to deliver pleasant surprises, with Q4 profits and revenue exceeding expectations. Profits in Europe also surprised to the upside but sales figures did not, reflecting a difficult recovery. The economic and financial environment remains favourable for equity markets as long as one is aware of valuation differentials between markets and sectors.

After 2009 – a year characterised by rallies in all financial markets – 2010 looks as if it will be defined by increasingly divergent performance, whether in respect of macroeconomic growth or asset classes. A more tactical market approach is warranted to take advantage of the opportunities expected to arise.

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Equities

Take advantage of the US recovery.

Two factors continue to buoy the equity markets: highly accommodating monetary policy, reflected in the decision by central banks to normalise monetary policy very gradually, and pleasant surprises in Q4 2009 corporate profits. Despite concerns on the state of public finances, markets have been tracking higher since mid-February. However, advanced business indicators point to a drop-off in the rate of growth in Q1, which we think will be reflected in corporate performance in the coming months. However, the ability of the US to surprise favourably encourages us to prefer the American market and to increase our assessment of consumption-related sectors in the United States.

— **The Q4 results announced by US corporations exceeded analysts' forecasts.** All sectors taken together, 75% of businesses listed on the S&P 500 announced results that exceeded expectations. However, this figure was only 45% for listed companies overall. The largest firms were able to better exploit the global recovery thanks to their exposure to foreign markets. Q4 revenue also outperformed expectations for the first time – a sign that corporate performance is being driven by demand and not only by cost-cutting. We expect more pleasant surprises for Q1 but the second half of the year is looking less promising.

— The considerable efforts focused on productivity made by US companies allowed them to preserve their profits in 2009 despite the recession. They cut their workforce beyond what was needed, thereby making considerable gains in productivity. The recovery in sales in the information technology sector may be a leading indicator of a rebound in corporate investment.

— The opposite happened in Europe, where businesses opted, insofar as it was practical, to retain their employees. As the slowdown in business activity was more pronounced and the elimination of jobs less widespread, corporate profits declined. In fact, the outlook for recovery in European performance for 2010 can be partially explained by the sharp decline in profits experienced in 2009.

— **Employment trends are expected to be a decisive factor in domestic demand in 2010.** The United States is expected to return to net job creation this spring after losing more 8 million jobs over the last two years. This factor should bolster consumer confidence and the real estate market. In contrast, unemployment is expected to rise in Europe. The continuing depreciation of the euro may actually constitute a positive factor for euro area businesses.

— **The recovery remains largely dependent on economic stimulus measures, specifically fiscal policies.** Official estimates in the United States attribute more than half of all growth to economic stimulus measures in Q4.09. Thus, a drop-off in growth is to be expected in 2010 in the United States as well as in Europe. Against a backdrop of a bumpy recovery, US businesses seem to be better positioned than their European counterparts to preserve their profits by adjusting their cost structures should revenue disappoint expectations. We believe that the high valuation of US equities compared to European shares is justified.

— **We have revised our appraisal of the British market.** The combination of economic policies designed to accelerate growth and a severely undervalued pound is driving business activity. 2010 profit forecasts were recently revised significantly to the upside (+46% according to the consensus).

— **In geographical terms, we are maintaining our preference for the US and emerging markets.** US stocks continue to benefit from a more favourable economic environment. Market valuations fell below their long-term average following January's correction. Another bolstering aspect is that liquid assets are maintaining their correlation to equities while healthier corporate balance sheets are expected to kick off a new cycle of mergers and acquisitions. Overall, market valuations in emerging markets have been trending substantially higher and continue to offer prospects for solid growth in profits in light of their booming economies (see below).

— **In sector terms, we are once more bullish on consumer and manufacturing-related stocks,** with reassuring signals on the economic front coupled with sustained demand from emerging countries. **We continue to recommend investing in defensive stocks, such as healthcare (pharmaceuticals)** because of inexpensive valuations and the rosy outlook for profits. We are also buying stocks paying high dividends, such as energy sector stocks, which offer attractive returns and relatively regular earnings. Lastly, **US technology stocks** are expected to benefit from renewed investor interest as well as the recovery in consumer demand for these types of products.

Sectors performance	March 29	
	Over last month (%)	Over last year (%)
Energy	2,4%	24,3%
Materials	8,0%	65,5%
Industrials	8,7%	60,7%
Consumer discretionary	5,2%	39,2%
Health care	3,1%	33,4%
Consumer goods	7,8%	47,6%
Telecommunications	6,7%	7,2%
Utilities	3,1%	19,2%
Financials	8,7%	63,9%
Information technology	6,3%	56,1%
US equity market	**6,2%**	**45,0%**

Source: IBES, Datastream

Bonds

Return to high-yield corporate bonds. Avoid government securities with long maturities.

Long-term interest rates remained stable overall in Europe and in the United States. Long-term yields are expected to increase due to the winding down of securities purchasing programmes by central banks, the prospects for the normalisation of monetary policy and the high volume of new public issues. We prefer to avoid sovereign bonds in general, particularly long-term maturities.

As short rates are close to zero, investors are flocking to the long end of the yield curve. Corporate bonds spreads are expected to continue to fall but the decline may be rocky due to the risks of a knock-on effect linked to sovereign debt. In relative terms, the high-yield market should offer a better rate of return this year thanks to high coupons.

— **Central banks have begun to roll out their exit strategies.** The ECB plans to end long-term refinancing in October and the Fed has raised its discount rate by 25 basis points ("discount window"). Central banks are proceeding cautiously because they hope to avoid a bond crash similar to the one that occurred in 1994 due to insufficient communication ahead of policy actions. Thus, liquidity will remain very soft through autumn and a hike in key rates in the United States before late 2010 and in the euro area before early 2011 is unlikely.

— For sovereign bonds, near-zero key interest rates favour the continuation of a steep yield curve (difference between long rates and short rates). Long-term interest rates currently stand below their equilibrium level because of the scale of purchases by the financial system (commercial banks and/or central banks). A recovery in long rates in the second half of the year can be expected: 10-year rates may therefore pick up by 50 or 100 basis points in the United States but more modestly in Europe.

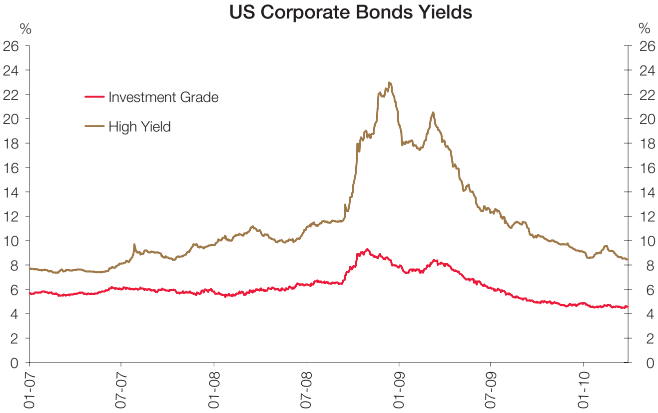
— **We are maintaining a bearish outlook on government securities in the US and UK markets.** In contrast, we maintain a more positive view of the euro area market because the level of long-term rates does not depend on policies of purchasing government securities and the ECB is not expected to raise its key interest rates prior to 2011, i.e., after monetary tightening by the Federal Reserve and the Bank of England. Nonetheless, the deterioration in sovereign ratings prompts us to favour the most solid euro area issuers.

— In terms of inflation-indexed bonds, there is no expectation of inflation in the short term. The latest published figures indicate a slowdown in core inflation in the United States and in the euro area. Only the United Kingdom stands out in this respect, registering price increases of 3% due to the weak pound. This justifies our positive outlook for the British market only.

— Corporate bonds spreads have resumed their decline due to reassuring macroeconomic news and waning risk aversion. Issuers in cyclical sectors (manufacturing, consumer goods) with a BBB rating offer a better risk/return ratio in the current economic climate.
Our top picks are securities with maturities of 3 to 5 years with a view of holding them to maturity.

— **The high-yield bond market is expected to post stellar performance this year because of the current level of yields on these instruments.** Furthermore, the squeeze on spreads is expected to continue throughout 2010 within a range of 100 to 150 basis points, thereby contributing to the appreciation of these securities. Between the beginning of the year and late March, the performance of high yield bonds exceeded 7% in the euro area compared to a little less than 3% for investment grade bonds. Nonetheless, a certain amount of caution should be exercised in selecting issuers and securities with short maturities should be favoured to offset the potential consequences of a pick-up in long rates.

US Corporate Bonds Yields



Currencies

There is still room for the dollar to strenghten against the euro. Emerging currencies should continue to appreciate.

— **The dollar is expected to continue to appreciate against the euro.** The euro is being hurt by economic uncertainty surrounding the most fragile countries: not only Greece, but also Portugal and even Spain. Furthermore, the euro area is clearly lagging behind the economic recovery cycle. The dollar is expected to continue to appreciate against the euro in the coming months with higher volatility (1.30 USD/EUR on a 6-month and 1-year horizon). However, the diversification trend in foreign exchange reserves benefiting the euro should create a floor against further decline. The yen is expected to depreciate against the dollar in the coming months. The emergence of a rate differential benefiting the dollar as the Bank of Japan finds itself compelled by deflation to maintain its key rates at the floor level is expected to drag down the value of the Japanese currency (100 JPY/USD on a 6-month horizon and 110 JPY/USD on a 1-year horizon). The British pound is expected to remain structurally weak because of anaemic recovery, the worseing of public finances and political uncertainty. A pick-up is expected late in the year which will partially correct the undervalued pound (0.90 GBP/EUR on a 6-month horizon, 0.85 GBP/EUR on a 1-year horizon).

— **Emerging currencies could appreciate further against the G3 currencies (euro, dollar and yen):** the strength of the recovery in these economies, especially the Asian economies, is expected to drive Asian currencies higher. This movement should be bolstered by the expected tightening of monetary policy. Many central banks were slow to raise their rates out of fear of encouraging carry trade positions on their currencies. As inflationary tensions are confirmed, central banks (notably China, South Korea and Taiwan) will at last be compelled to raise their key rates following the March example of Malaysia and India. The unpegging of the Chinese yuan from the dollar, still expected this year, could prompt a concerted general appreciation trend in Asian currencies. Continuing international pressure could prompt China could to delay this inevitable move to avoid giving the impression of caving in to US insistence. **The currencies of commodity-exporting countries have peaked.** Continued appreciation seems to be due to trends in commodities where no price rise is expected over the next few months. There is still potential for appreciation but most likely late in the year and in early 2011.

Emerging markets

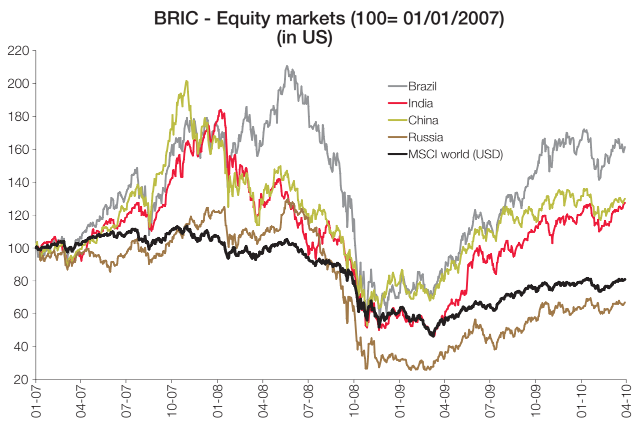
Favourable economic outlook but a rise in volatility is to be expected.

— Emerging markets are at the forefront of global recovery. Macroeconomic indicators over these last few months continued to exceed expectations. Nonetheless, advanced business indicators point to a deceleration in the Chinese economy as a result of cooling-off measures implemented by the authorities. Many economies now face the risk of overheating due to the combined effect of stimulus measures and accommodating discount policies. Any further upswing in real estate and retail prices would be indicative of the need to tighten monetary policy. Following the current recovery phase, driven by inventories rebuilding and the rebound in global trade, growth is expected to taper off due to slack US and European demand.

— Emerging markets experienced stronger growth than other markets in 2009. Nonetheless, since early this year, emerging markets have posted performance that is very slightly lower than that of the US market but higher than euro area markets. In 2010, profits are expected grow by 33% in emerging Asia, 28% in Latin America and 25% in emerging Europe (versus 29% on the MSCI World index) compared to 2009.

— Solid fundamentals, dynamic growth, and negative real interest rates are expected to buoy emerging equity markets throughout 2010. Despite the bright outlook for profits, valuations are high and above their 10-year average, with the exception of Central and Eastern European markets and, in particular, the Russian market, where valuations are exceedingly cheap. Sporadic consolidation can be expected, especially if there is a hike in key interest rates during the year or a sudden spike in risk aversion.

— **We are bullish on emerging markets overall with a preference for Russia (inexpensive valuations, favourable energy price trends) followed by Latin America (Brazil and Mexico) and Asia (especially South Korea and Taiwan),**



Source : MSCI, Datastream

Oil

Stability in the short term but the trend is to the upside.

— Since last autumn, the price of oil has continued to float within a range of USD 70 to 80/barrel. This movement should continue over the next few months. Unutilised manufacturing capacities as well as inventory remain at high levels. Demand for oil should increase along the lines of 2 million barrels/day in 2010 compared to 2009, due almost entirely to demand from emerging countries. Oil-producing countries, especially OPEC, are satisfied with current prices, which, at this level, do not constitute a threat to world growth. The question mark remains China, which continues to import oil products on a massive scale, far beyond the needs of the economy. A sharp slowdown in the Chinese economy may cause a short-term correction.

We continue to forecast a gradual recovery in oil prices between now and late 2010 within the range of USD 85-90/barrel due to increasing demand and the restoration of discipline within the ranks of OPEC.

Gold

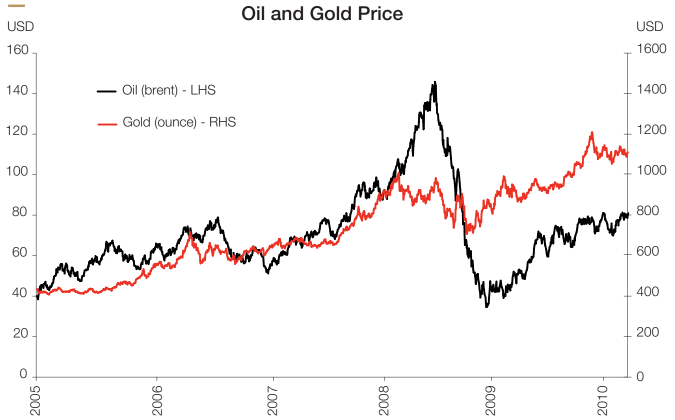
Consolidation expected in 2010.

— Gold prices have been hovering around USD 1,100/oz. since late 2009 with no distinguishable trend. Any decline below this level will likely be interpreted as a signal to buy. However, should the price then rally to around USD 1,050, this will kick off a selling spree. The negative correlation with the dollar has lost its strength. The appreciation in the greenback since December did not produce the expected decline in the price of gold. Apprehensions over the economic situation in developed countries and persistent fears of inflation in the long term are contributing to gold's appeal to investors. Sales of gold by the IMF directly to emerging central banks and not via the market have put a stop to speculation.

— While the medium-term trend is upward, the price of gold is stable for now. If the trend by emerging central banks to diversify their foreign exchange reserves continues in the medium to long term, it is unlikely that they will make massive purchases on the market to the point of initiating a further surge in the price of gold. Demand for physical gold for industry and jewellery should grow only slightly because of the high price of gold in real terms. Lastly, monetary policies are expected to normalise as excess liquidity is drained off and key interest rate hikes follows. Fears of a sudden surge in inflation appear to be largely unfounded in light of low capacity utilisation and high unemployment. Unless there is a sudden spike in risk aversion and/or a widespread government debt crisis, the price of gold is expected to decline between now and the end of the year.

— We believe that gold will stabilise around $1,000/oz between now and late 2010 ($1,100/oz. on a 6-month horizon) due to the normalisation of monetary policy and the absence of inflationary tensions.

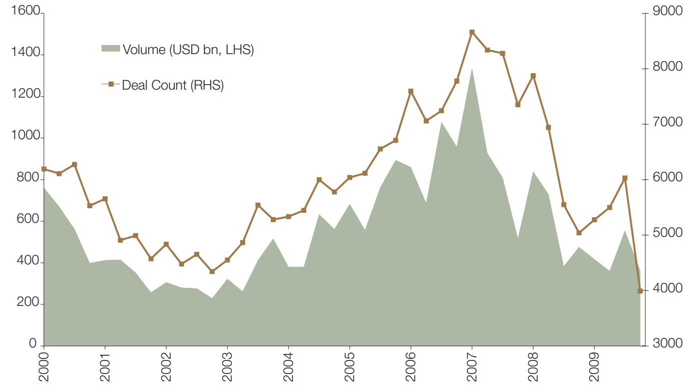
Oil and Gold Price



Increase your diversified exposure to the Hedge Fund asset class to take advantage of the growing decorrelation of Corporate Credit strategies.

Though concern over the Greek deficit has caused securities correlation in the same sector or asset class to temporarily strengthen, we still expect the ongoing weakness in securities correlation to continue throughout 2010. This increasing divergence in performance is expected to favour Event Driven managers and securities specialists, whether they are Long/Short Corporate Credit or Long/Short Equity managers.

M&A Activity



Source : Bloomberg

— As to the major strategies, the Committee has always maintained a preference for **Event Driven** strategies and, to a lesser extent, **Relative Value** strategies. These two strategies have been posting superior performance since the beginning of the year as they had been doing for the last several quarters. Indeed, these strategies are enjoying a very favourable environment, notably Corporate Credit-based strategies, especially **Corporate Distressed.**

— In fact, we are very positive on the outlook for the **Corporate Distressed** strategy because the corporate restructuring sector is perhaps the last area in the credit markets that has not completed its recovery following the autumn 2008 financial crisis.

— For **M&A Arbitrage,** we have downgraded the outlook from very positive to positive because of the sharp narrowing of spreads (from 12% to 7%) on new transactions initiated over the last two months.

— Despite the downgrade, we remain positive on the outlook for this defensive strategy, which we esteem for its transparency and liquidity.

— We increased our grading of the **Equity Special Situations** strategy, which has a very positive outlook, because of the potential rebound in the number of M&A transactions. Indeed, we believe that those managers who try to anticipate future M&A transactions are likely to post improved performance.

— Nevertheless, it is important to highlight that this strategy can be an alternative to traditional equity exposure as it has a similar risk profile and a strong correlation to the equity markets.

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