Back to growth but not yet back to health

Investment strategy 2010

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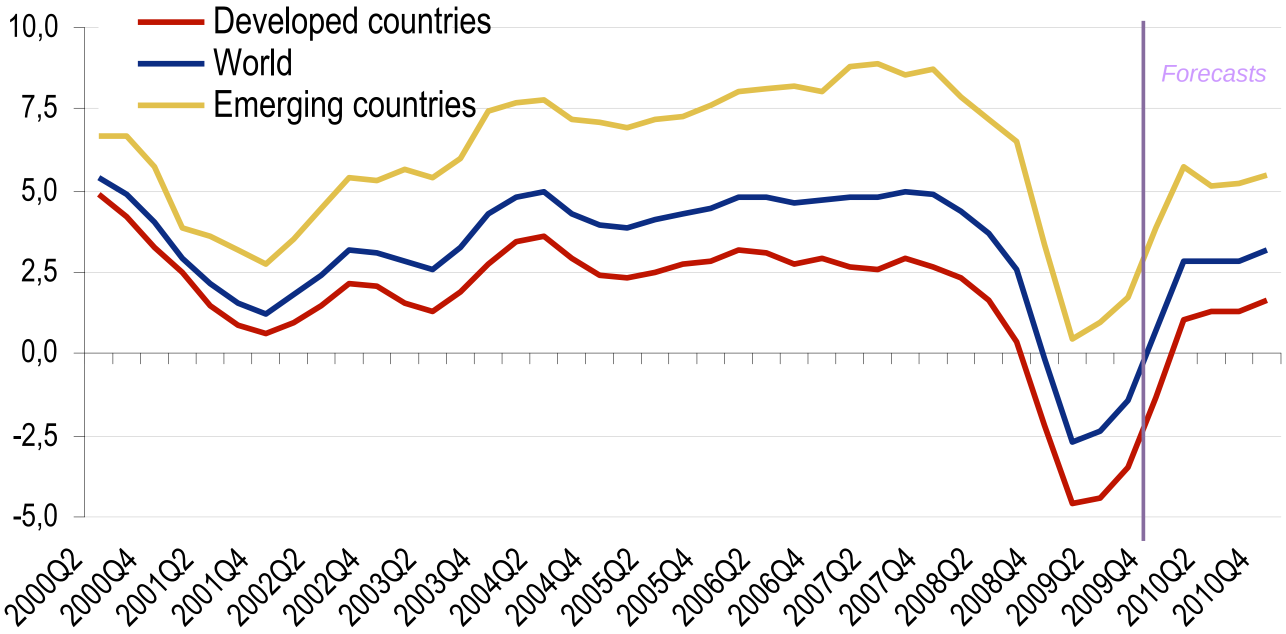
2009: growth returned in the second half

- Thanks to stimuli, industrial production started to grow again but is still 12% below peak levels
- A very severe recession for G3 countries but growth in the emerging zone

GDP by zone (YoY, %)



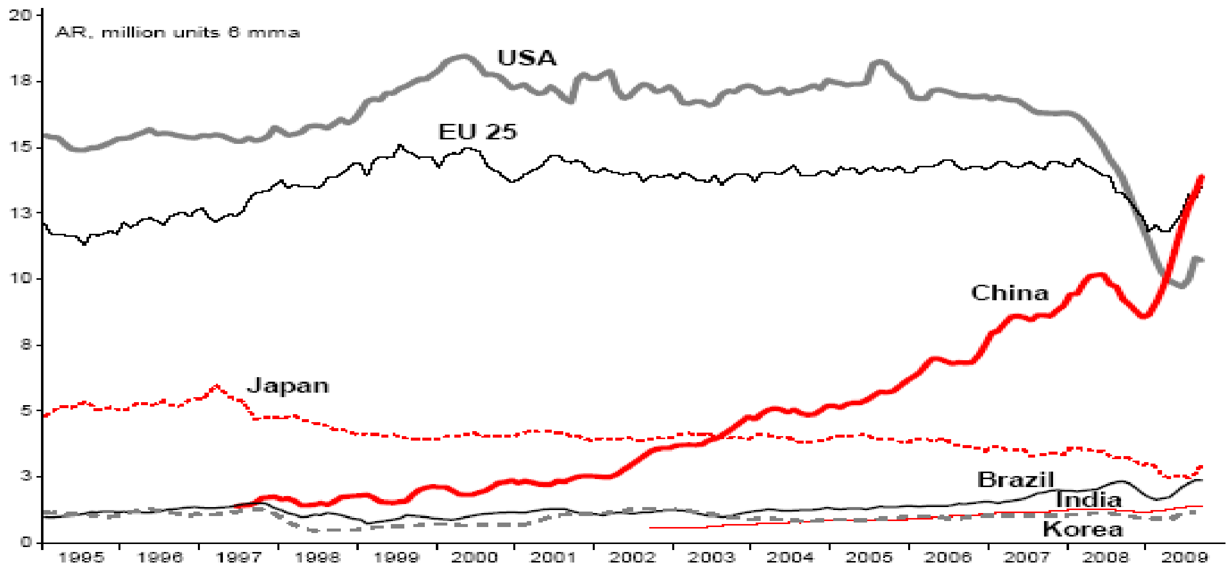
Source : IMF (WEO, oct. 2009)

Asia ex Japan was the first to recover thanks to China and India

2009: all about cars

- ➔ The rebound in industrial production stemmed from the auto industry on the back of tax incentives
- ➔ The Chinese market unseated the US and took first place

Auto sales (in millions)

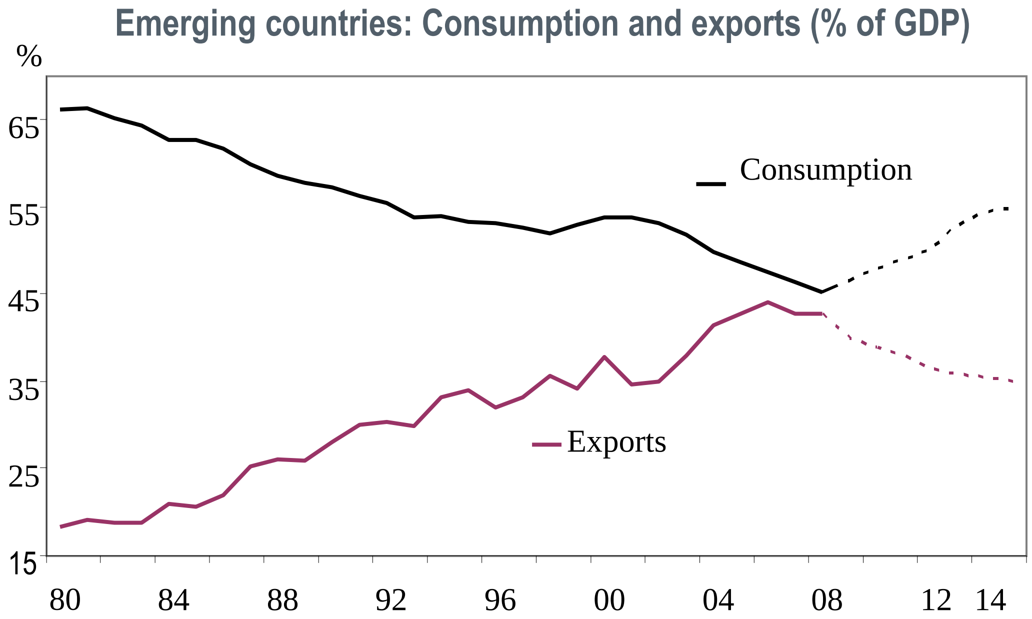


Source : Société Générale

2009's paradox: GM went bankrupt and new registrations enjoyed a boom

2009: inflection of growth model in large emerging countries

➔ Encouraging private demand to compensate for the fall in exports and to ensure long term growth



We now have to reckon with the emerging consumer who is almost as important as the US consumer

2010: the general recovery will continue but at very varying speeds

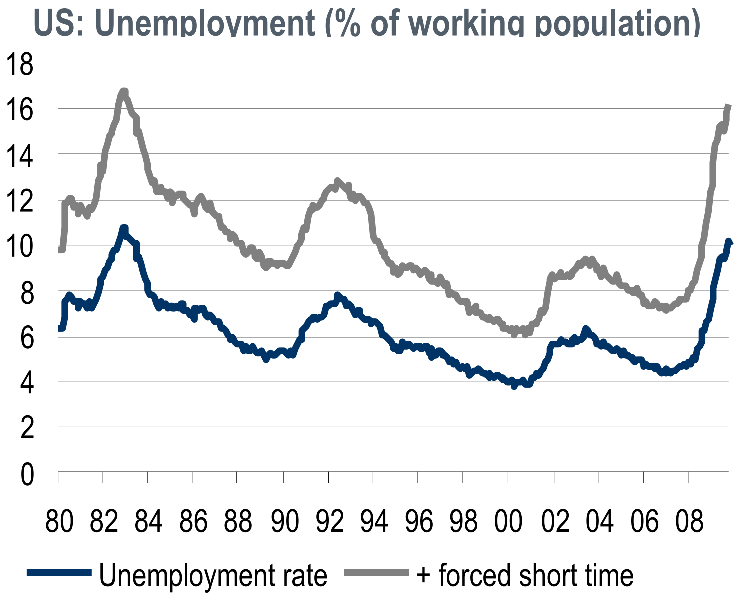
- Budgetary stimulus remains (1% of global GDP) and financial conditions are still expansionary
- Growth drivers: industrial production, a recovery in global trade, and private consumption in emerging countries
- Asia ex Japan will continue to lead thanks to China and India
  - A significant rebound in Latin America
  - A gradual improvement in Eastern European countries
- Within the G3, a slower pace than in similar situations in the past
  - USA will lead
  - Europe is midstream (growth will be roughly half as much)
  - Japan is lagging (hence a second economic stimulus plan)
- Robust growth in developed countries outside the G3, like Canada, Australia…

Global growth will be 3/3.5% thanks to a very favourable contribution in the first half

US: the highest pace of growth in the G3

- ➔ Support factors should last at least 3 quarters: restocking, the rest of the stimulus package, a modest recovery in investment. Residential property will no longer exert a negative influence.

- ➔ Household confidence picking up slowly with the first signs of hope on the job market after the worst fall since the 1980s. Unemployment could weigh on consumption just like continuing efforts to reduce debt.



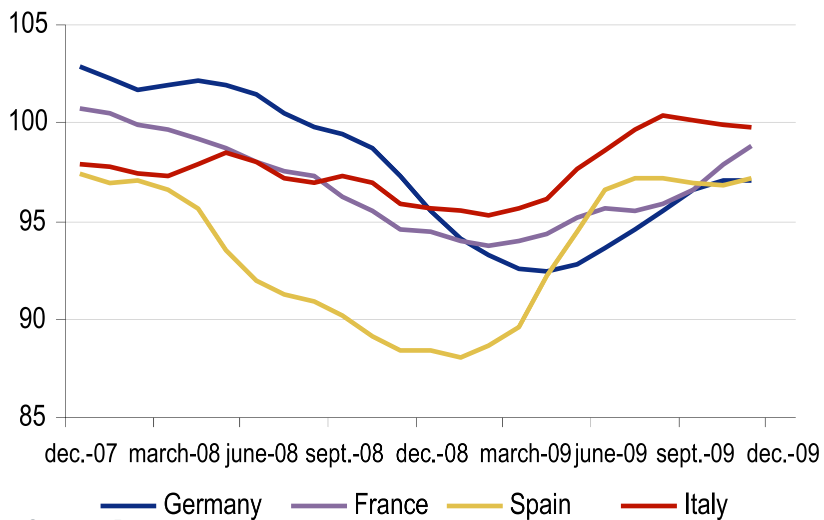
Source : Datastream

Possible good surprise if unemployment falls

Europe: a fragile recovery

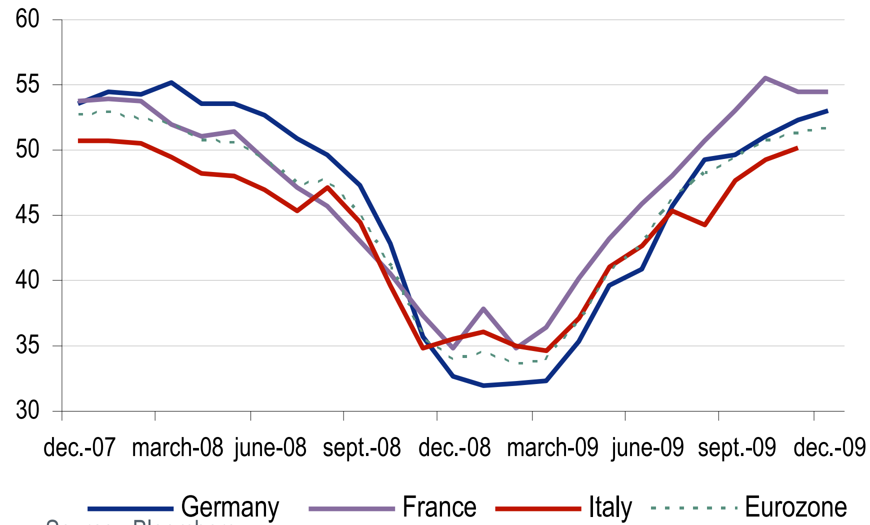
- Restocking and exports will provide the main temporary support. Household consumption expected to remain bleak.
- Germany will drive growth thanks to its economic stimulus plan. But higher taxes in some member states will have a negative impact

Consumer confidence (OECD indices)



Source : Datastream

Manufacturing PMI



Source : Bloomberg

Strong disparities in growth rates within the zone are set to continue

Key factor in 2010: exit strategies

- The move should be generalised but very modest. Returning to neutrality will be a lengthy process in both developed and emerging countries

- A tricky exercise: the risk is acting too soon or too late

- Developed countries like Australia, Norway and Israel started to raise rates in Q3 2009 and will continue to do so
    - Canada and South Korea will follow

- Large emerging countries - India, China, and then Brazil - will do so very gradually

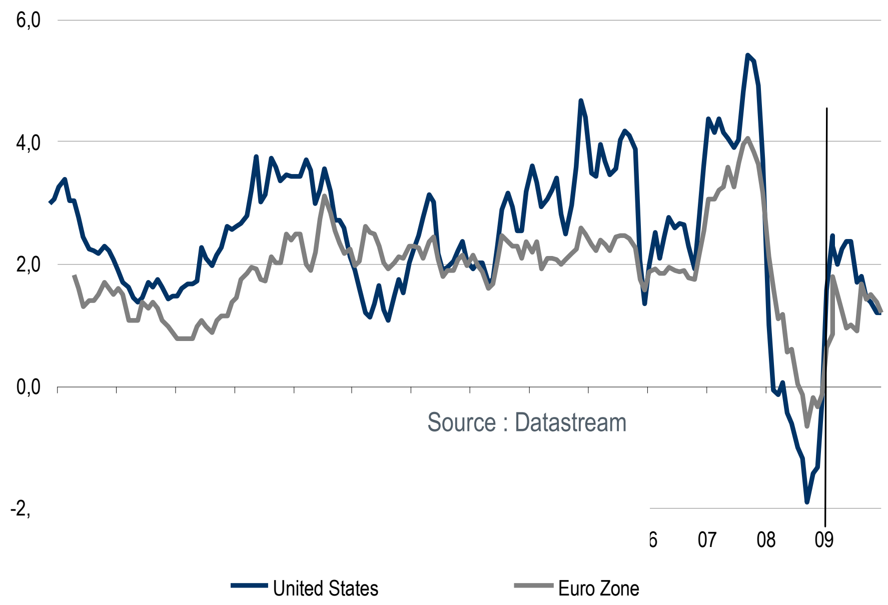
- The Fed and ECB will abandon unconventional measures and then start to raise benchmark rates very gradually during the second half

Even if central banks proceed carefully and transparently, the exercise will be tricky ... and could trigger market jolts and tension

Inflation will not be a worry in 2010

- Headline inflation has automatically returned to positive territory in the US and Europe. Underlying inflation is still very restrained
- Keep an eye on: velocity of money and commodities
- Some inflationary pressure in emerging countries

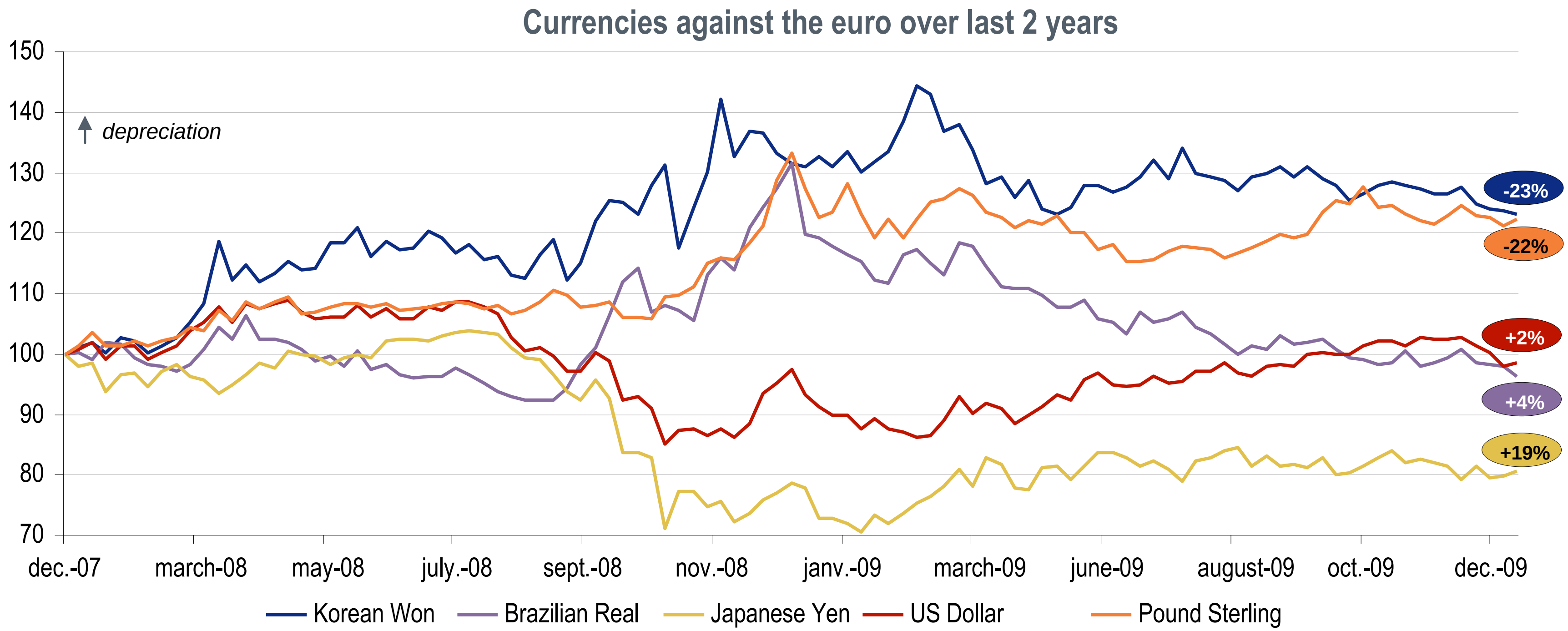
US and Euro zone: Inflation (%, annualised)



Diverging inflation rates mean different monetary stances

Causes for worry: exchange rate trends

- Damaging exchange rates: yen/dollar, real/dollar, yen/won, dollar/euro,
- Asian currencies (except for the yen) remain undervalued and should appreciate
- The dollar could rise against the euro and the yen

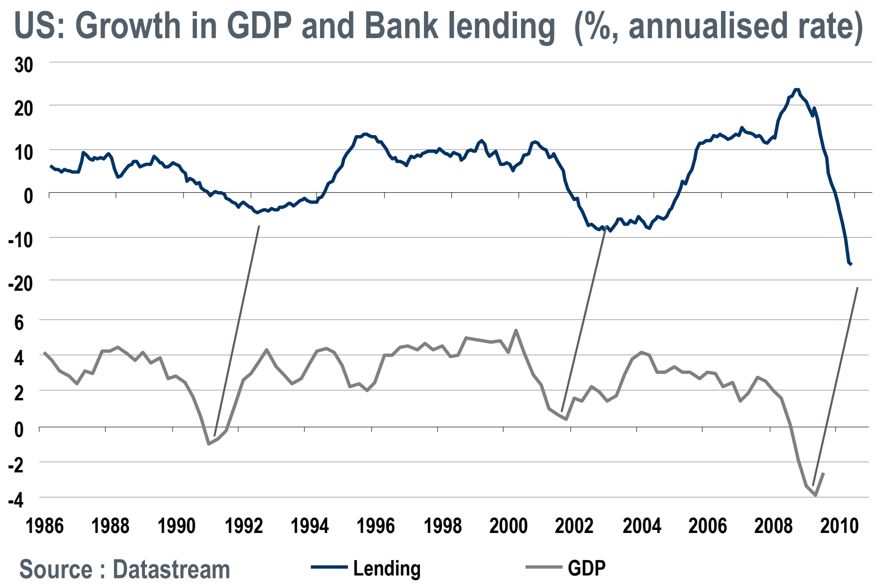


Source : Datastream

A modest rise in the remmimbi would ease tension

Causes for worry: bank lending

- ➔ Significant credit contraction in 2009 in the US and Europe
  - …due to soft demand and restrictive conditions
- ➔ Banking sector is still fragile and new regulations are going to be introduced

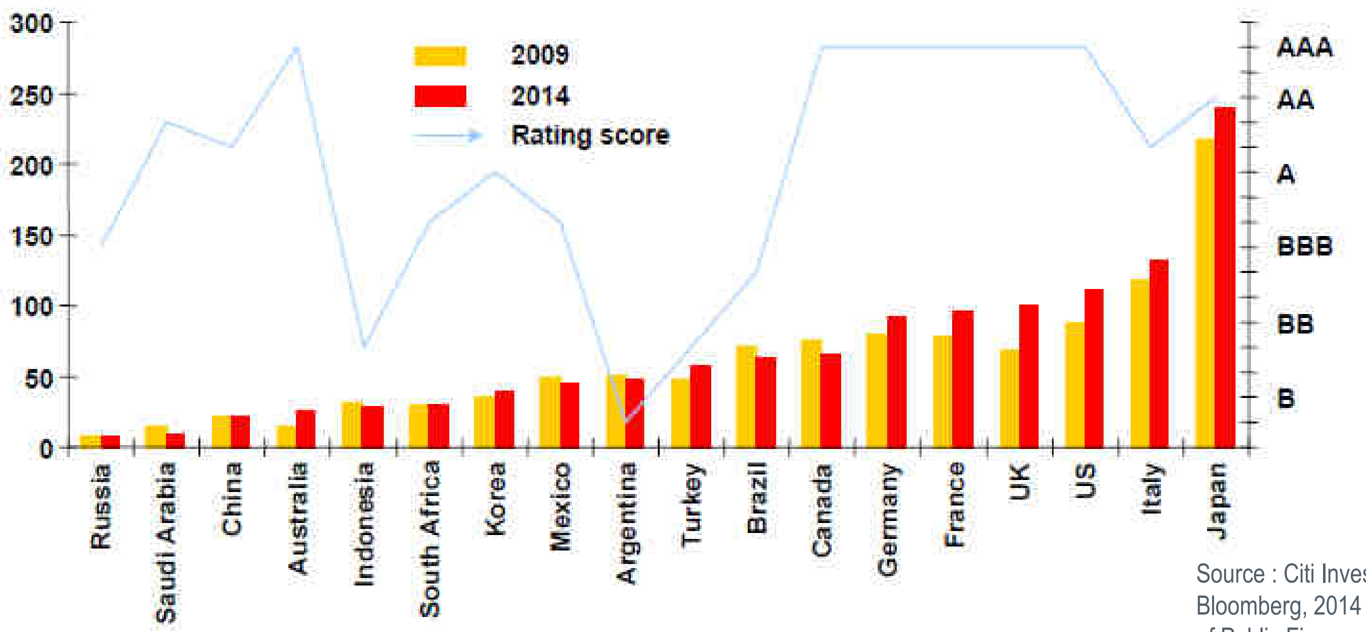


Banks expected to remain cautious: this will hit Europe and SMEs

Causes for worry: soaring public debt

- The higher the debt, the better the credit rating!
- Changes in fiscal policy will occur in 2011 at the earliest. It will take time to reduce budget deficits and stabilise debt levels

Public debt as % of GDP and credit rating



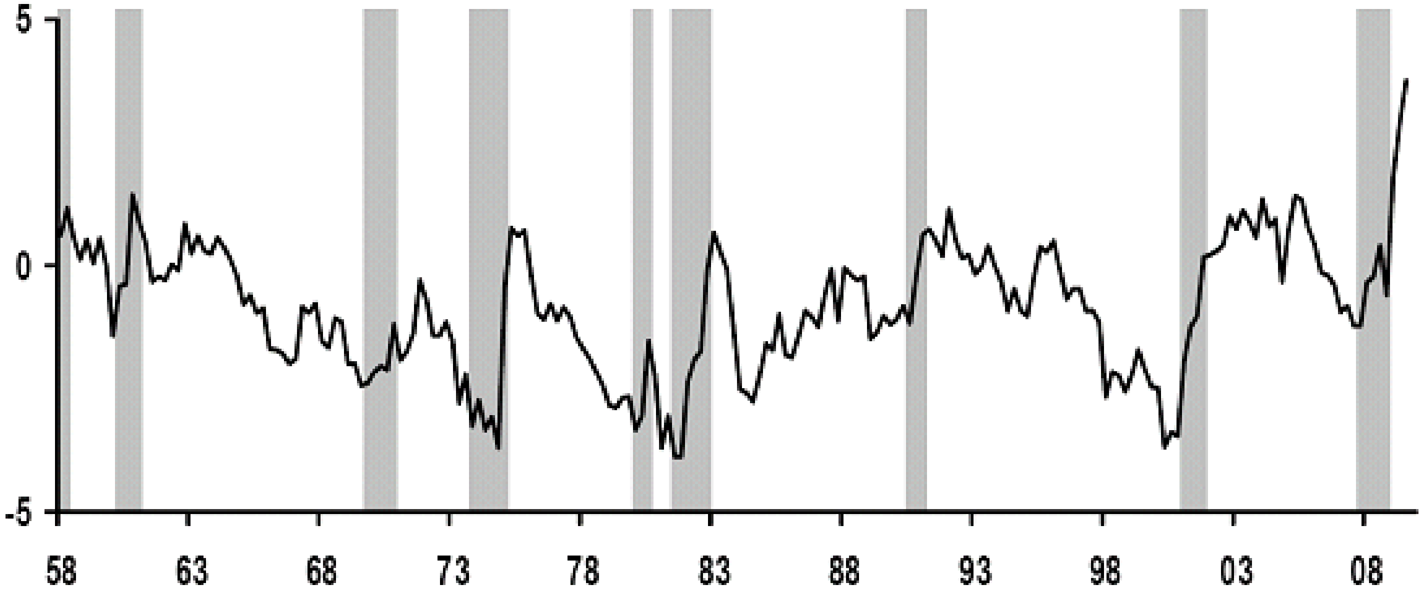
Source : Citi Investment research, IMF, S&P, Bloomberg, 2014 projections from The State of Public Finances

Ratings are likely to be revised

Cause for satisfaction: companies in good health

➔ Thanks to a drastic reduction in costs and investment, US companies are swamped with cash flow (unlike the government)

Share of corporate free cash flow in US GDP formation (%)



Source : BCA

Companies can invest, pay out dividends, acquire rivals and still have cash left

Investment strategy

- General recovery to continue thanks to life support. The pace of growth will be uneven and irregular.
- Divergence in exit strategies with a knock-on impact on interest rates and currencies
- Global economy is not yet back to health: households and governments are overburdened with debt, the financial system is still fragile and it remains to be seen if the recovery is self sustainable. These drawbacks are especially present in developed countries.

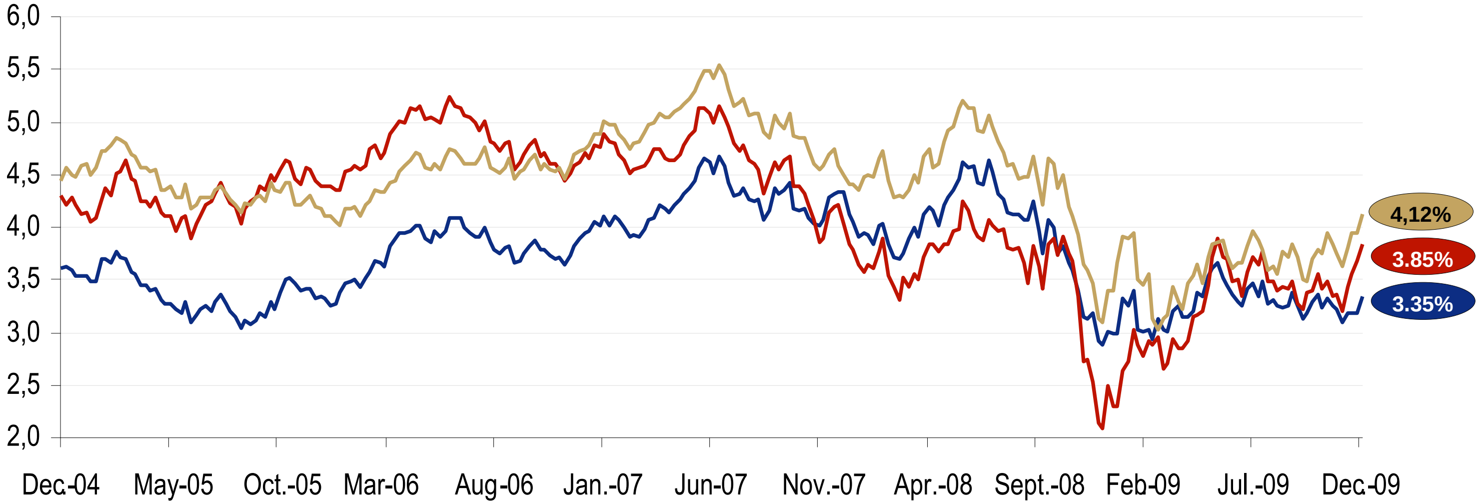
- We prefer the corporate sphere rather than the public sphere, especially in developed countries
- Decent performance for certain asset classes as undervaluations in the riskiest asset classes are a thing of the past

Will 2010 be almost a normal year after 2008 and 2009?
Flexibility, in any case, is still essential

Investment strategy: government bonds

- US and European rates are likely to rise by 50bp
  - Rebound in activity
  - Record bond issues from the US and UK
  - End of central bank buying of government debt
- Euro zone: rate differential between fragile countries and core members will persist

10-year government bonds: US, Germany, UK (over last 5 years)



Source : Datastream.

Not very attractive returns expected on US and European government bonds

Investment strategy: focus on companies

Through corporate bonds

- Coupons are attractive
  - Rate spreads have shrunk significantly both for investment grade and high yield bonds
- Favourable environment: balance sheets more robust, earnings growth is back and default rates have declined
- Preference for BBB-rated bonds and longer maturities
- Not forgetting convertibles for their equity sensitivity

Through equities

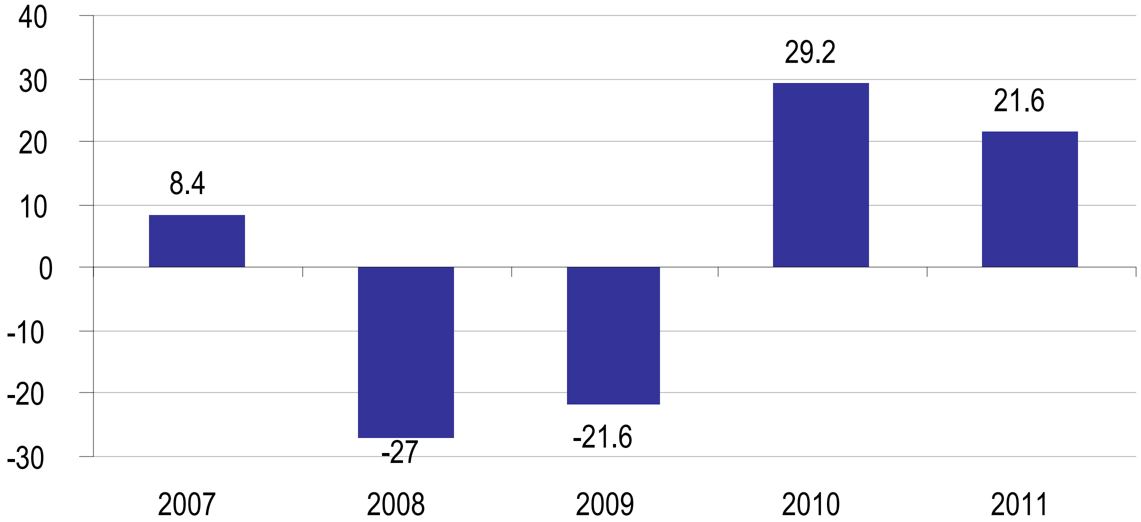
- Return to earnings growth in 2010
- Valuations still reasonable
- Risk premium remains high
- Fund flows will benefit equities

Equities: Return to earnings growth in 2010

➔ Ambitious growth in 2010 and 2011 after a 50% contraction between 2007 and 2009. Return to peak levels in 2012

- But high operational leverage and distorted base effects

EPS growth (EuroStoxx index, %)



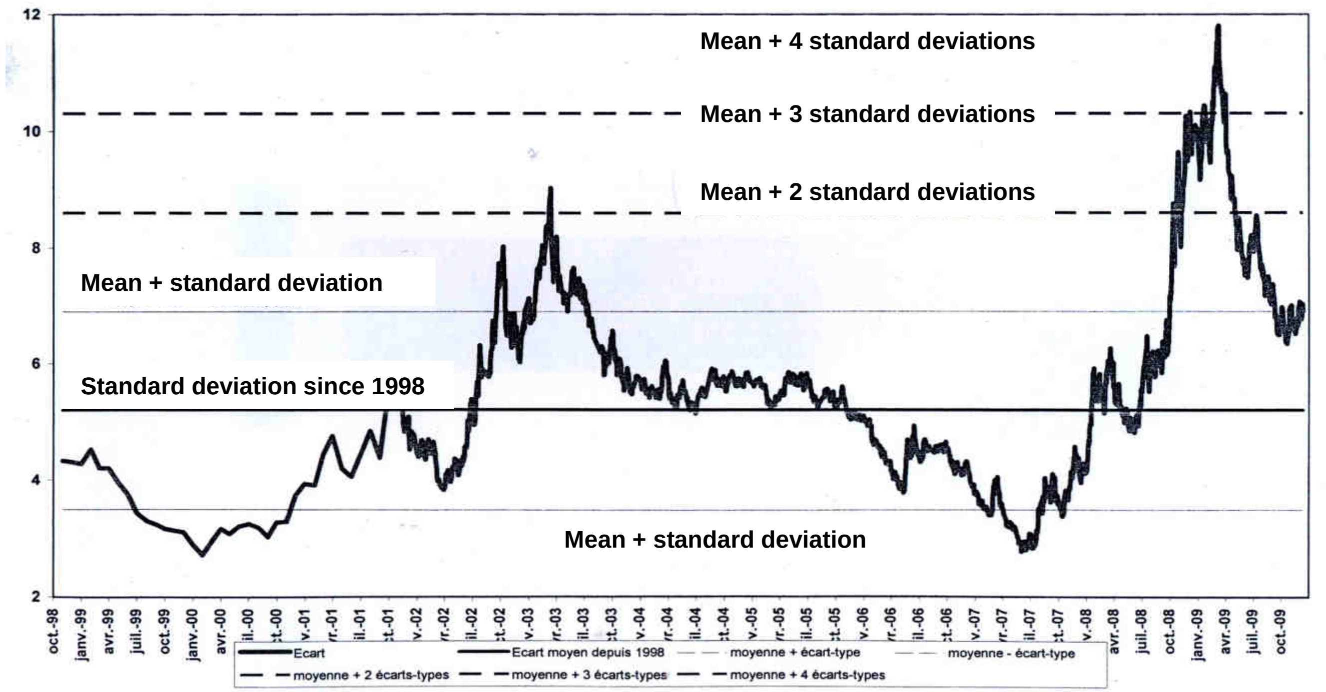
Source : Datastream

Average growth for non-financial companies is expected to be an achievable 15%

Risk premium still very high

➔ The differential in expected equity returns relative to bonds is still largely above the long term median

Equity vs. Bond returns since 1998



Source : Club de Gestion Financière : Associés en Finance

Reduced risk aversion would trigger upside potential

Equities: decent potential

- ➔ Potential upside of 10-12% for European and US markets
  - Based on long term PEs (16.5 and 14), which suggests a contraction in multiples
- ➔ Emerging markets: generally higher potential for the MSCI EM… but big variations between countries
- ➔ NB: favourable comparison base in first half but many question marks on the second half
- ➔ Rate increases could lead to a correction
- ➔ Risks in this scenario: exchange rate tensions, disappointing results, too much growth or not enough

Equities: zones, sectors, themes

- Zones:
  - Do not overlook the US
  - Still strong convictions on emerging countries for structural reasons…
  - …but some short term reservations after spectacular performance over recent months and policy changes
  - Cannot rule our outperformance from US and European markets

- Sectors:
  - Healthcare/biotechnology
  - Oil/energy
  - Technology/telecoms
  - Agrochemicals

- Themes:
  - Domestic consumption in emerging countries (through US and European companies that are often cheaper than their counterparts)
  - Higher Asian currencies
  - A weaker yen: a joker for the Japanese market

Conclusion

2010: an initial convalescence phase with its highs and lows so flexibility is essential to be able to seize opportunities

"Man today seeks laws and institutions fit for a convalescent that restrain him without breaking him and lead him without crushing him"

Albert Camus