

Investment Strategy

Societe Generale Private Banking
Investment Strategy Newsletter

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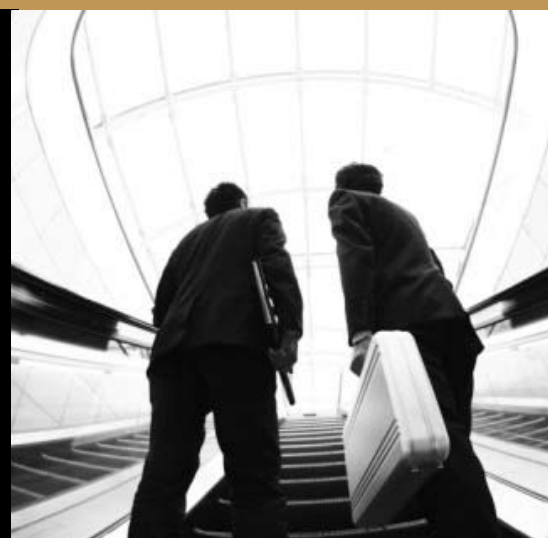
Editorial

The beginning of the year has been characterised by fears surrounding the solvency of certain euro area countries. Interest rates have soared for sovereign issuers considered the riskiest by the market, such as Greece, Portugal and Spain. The economic upturn is being driven by temporary factors, such as abating business inventory run-down and a variety of economic stimulus measures, raising doubts on the self-sustainability of growth. These two factors have been feeding market anxiety these last few weeks.

Equity markets have therefore been losing ground since mid-January even as Q4 corporate earnings for the vast majority of companies were better than forecast. This market correction is expected to be limited because companies are reporting solid performance and macroeconomic indicators point overall to the upside. We continue to invest in equities to take advantage of periods of consolidation, with a preference for stocks which offer high dividends and low volatility.



Xavier Denis
Strategist
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Equities

Favour the sectors offering the best outlook.

Looming inflation in China as well as doubts surrounding the exit strategies being developed by the central banks of major countries (United States, United Kingdom) have generated fears of early monetary policy tightening. Against a backdrop of a public debt crisis in the euro area, equity markets retreated. Corporate earnings, which surprised to the upside in Q4, should continue to improve, at least through the first half of the year. However, the gradual phase-out of stimulus packages and anaemic demand in developed countries tend to favour less cyclical businesses and those offering a better insight into future profits and dividends. In the US market our preference is for industrial, healthcare and technology stocks while in Europe we favour the healthcare and energy sectors.

— The initial Q4 earnings posted by US corporations confirmed exceptional performance. Nearly 80% of those businesses which have already posted their earnings beat analysts' forecasts. In Europe, where earnings are released later, the trend is identical, which could make this quarter the best since 2000. Revenue seems to have surpassed the expectations of the market consensus, especially in the United States, indicating a pick-up in demand. We are expecting a few more pleasant surprises in H1 but things in the second half of the year are expected to take a more negative turn.

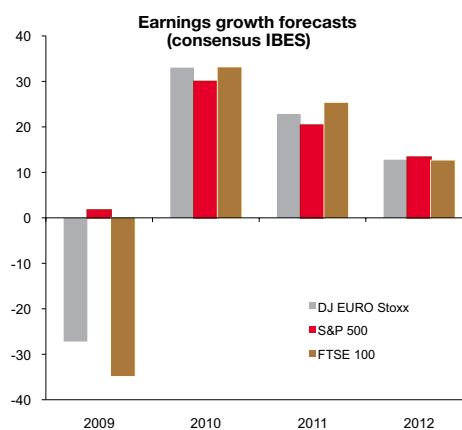
— In the United States, businesses fundamentally defended their margins and profits by reducing their workforces to levels that were even lower than demand, which led to an extraordinary increase in productivity and profit stability in 2009. The rise in revenue resulting from the pick-up in demand is therefore about to occur together with high levels of margin, which is exceedingly rare at the end of a recession. Businesses are expected to continue to benefit from the recovery in demand and may resume investing once again sometime this year.

— **We predict that the recovery will lose momentum during the year as economic stimulus measures are gradually phased out.** Demand in major countries will remain slack in 2010 because of continuing high unemployment and limited access to credit. However, the markets are betting on a 30% increase in profits in the United States and 34% in the euro area. We believe this is an overoptimistic scenario, given the lacklustre growth predicted for 2010 resulting from debt reduction in the private sector. We are betting that profits will rise by around 20% in the United States and in Europe this year.

— **In geographical terms, we maintain our preference for the US and emerging markets.** US stocks continue to enjoy favourable trends as evidenced by the revision of earnings forecasts to the upside and growing revenue. Market valuations remain inexpensive and are only slightly higher than the long-term average. Another favourable factor at play in the equity markets is that businesses are on the lookout for acquisition opportunities, which is expected to set off a wave of M&A which should underpin market valuations. Overall, valuations in emerging markets have appreciated substantially and continue to offer a rosy outlook for profit due to the booming economic climate (See below).

— **As to sectors,** we recommend getting completely out of **cyclical stocks**, which we consider overvalued, and investing in **defensive stocks**, which have a better outlook for revenue and the distribution of higher dividends. However, within cyclicals, we have initiated positions on US industrial and technology stocks which, because their market valuation is attractive, are expected to benefit from the booming growth in emerging markets and the revival of investment almost everywhere in the world.

— **The healthcare sector, which we believe is undervalued,** offers the best prospects for returns in an environment that has once again turned conducive to mergers and acquisitions. The **energy** sector, which underperformed the indexes, is expected to see substantial growth in revenue and profits this year and will continue to distribute high dividends.



Sectors performance	February 10	
	Over last month (%)	Over last year (%)
Energy	-10,7%	5,0%
Materials	-10,1%	33,3%
Industrials	-9,2%	29,2%
Consumer discretionary	-5,2%	29,3%
Health care	-4,1%	15,2%
Consumer goods	-3,6%	13,1%
Telecommunications	-6,9%	5,3%
Utilities	-9,7%	0,5%
Financials	-14,5%	36,6%
Information technology	-3,6%	16,4%
DJ Eurostoxx index	-9,5%	21,0%

Source: IBES, Datastream

Bonds

Attractive yield and the potential for appreciation play in favour of corporate bonds. Avoid long-dated government bonds.

Long-term interest rates remain low both in Europe and the United States. As central banks wind down their purchases of securities, the outlook for monetary policy normalisation and the considerable volume of government issues should drive yields higher during the second half of the year.

We prefer to steer clear of sovereign issues, especially since the deterioration in government finances is increasing risk premiums and posing a ratings risk to some governments. Against a backdrop of near-zero interest rates, bond yields look attractive. In contrast, the potential for appreciation associated with decreasing risk premiums seems more doubtful today. The corporate bond market is feeling the effects of worries over sovereign debt and the revival of risk aversion. We maintain our positive view of this asset class but this is confined primarily to the euro market.

— With respect to government bonds, current interest rate levels are lower than they might otherwise be given economic conditions and the scale of government deficits. A priori, though the effect is tricky to estimate, it seems inevitable that the end to purchases of government or public securities by the Fed and the Bank of England will translate into higher bond yields. US 10-year rates should therefore recover 50 basis points due to this factor alone.

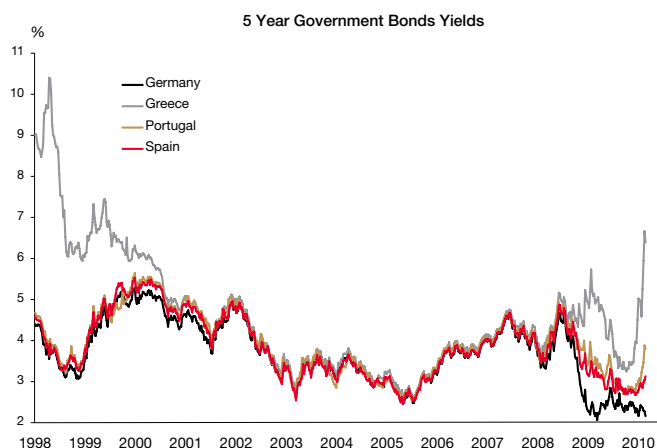
— Nonetheless, central banks such as the Federal Reserve and the ECB may extend their zero-rate policies at least until the end of 2010 and possibly into early 2011. This will help in keeping long-term rates down. Deflationary influences remain significant within developed economies given the level of underemployment, which should remain high, and unutilised production capacity. Tepid growth and fiscal difficulties in a number of countries argue in favour of very gradual measures on the part of monetary authorities.

— Our assessment of government securities remains negative for the US and UK markets. On a different note, we have a more positive opinion of the euro area market since the level of long rates does not depend on the policy of buying up government bonds and the fact that the ECB is unlikely to raise its key rates before late-2010, probably after the Fed and the Bank of England.

— As to inflation-linked bonds, anticipations of inflation have risen to their pre-crisis levels. The rate of inflation has slightly accelerated over the last few months – primarily reflecting rising energy prices – but shows no signs of getting out of control because of slow wage growth. Conversely, there are clearer signs of inflationary pressures in the United Kingdom, justifying a positive opinion of this market.

— The market seems to have adjusted to the notion of a volatile recovery and is attaching greater importance to the government debt problem. As a consequence, risk premiums on corporate bonds have only modestly tightened during the last three months (down 15 basis points in the euro area). Though there is still room for decline, a revival of volatility in risk premiums can be expected this year.

— In fact, the potential for a revaluation of private bonds seems more remote as the year starts out, with fears of a contagion effect between sovereign risk, the banking sector and the business sector. However, investor demand for these instruments continues unabated because yields on money market investments are near zero and the default risk has been ebbing since late 2009. On the buy side, it is advisable to keep focused on euro area issues with terms of 3 to 5 years with a view to holding them until maturity. High-yield bonds may also continue to perform well in 2010 due to the recovery and stronger corporate balance sheets.



Currencies

The dollar will continue to appreciate against the euro. The re-appreciation of emerging currencies has come full circle.

— **The dollar is expected to continue gaining ground against the euro.** The dollar was benefited by increasing concerns regarding the sustainability of Greece's government finances and, more recently, those of Portugal and Spain. The lack of an institutional framework to address the fiscal crisis of a euro area member state has dragged the euro down. As a result, the dollar neared the 1.35 barrier in early February after having been below 1.50 in early December. This trend is expected to be confirmed as cyclical lag plays in the favour of the United States. Normalisation of US monetary policy (moves to reduce the Fed's balance sheet, followed by a hike in key interest rates) as well as the unwinding of carry trade positions financed by the greenback are also expected to boost the dollar. We are confident that the dollar will continue to appreciate against the euro between now and the end of 2010 (1.40 USD/EUR in June 2010 and 1.30 USD/EUR by year-end 2010). Meanwhile, the yen experienced a brief depreciating trend in late December, which was quickly reversed in January. Continued quantitative easing by the Bank of Japan by increasing the supply of yen to the market is ultimately expected to drag down the value of the Japanese currency while setting the stage for gradual release from the grip of deflation. The yen is expected to weaken against the dollar over the course of the year (95 JPY/USD on a 6-month horizon, 100 JPY/USD by the end of 2010). In the short term, however, Japan's scant reliance on external financing of its debt and the repatriation of profits earned overseas by Japanese companies before the end of the fiscal year are expected to continue to support the yen.

— **The potential for appreciation of emerging currencies against the G3 currencies (euro, dollar and the yen) is limited in the medium term.** Until now, emerging currencies or currencies linked to commodities had been buoyed by investors attracted to emerging markets or commodity speculation. Over the last few months, this has led to the reconstitution of carry trade positions encouraged by the rate differential existing between the dollar and these same currencies. We believe the nominal trend in appreciation is pausing, especially because of the strengthening US dollar and the over-valuation of some currencies, such as the Brazilian real. However, the strength of the recovery and resurgent inflation in emerging countries have cleared the way for the tightening of monetary policy, which is expected to underpin the value of these currencies. For the time being, most central banks prefer to postpone raising interest rates for fear of hindering the recovering export market. The unpegging of the Chinese yuan from the dollar expected to occur this year could lead to the general appreciation of all Asian currencies. But for now, the Chinese authorities are turning a deaf ear to pressures from the US and Europe. Concurrently, the currencies of commodity-exporting countries are expected to appreciate due to rising prices and interest rates hikes designed to curb soaring asset and consumer good prices.

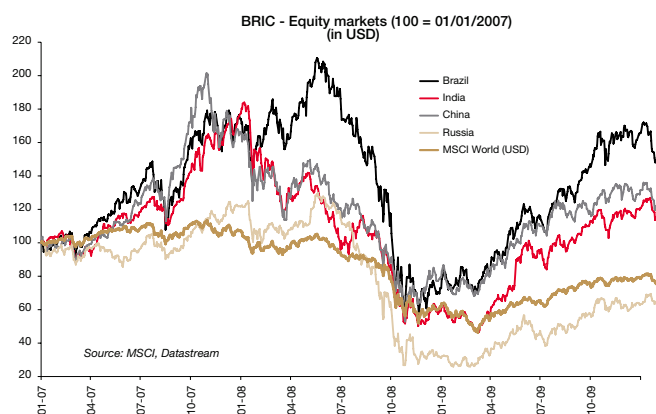
Emerging markets

Emerging markets will continue their recovery in 2010.

— Emerging markets are experiencing brisk economic recovery, surpassing all expectations. This is particularly the case of China, which, in Q4 of 2009, returned to a growth rate that is certainly higher than 10%. There are signs of overheating in several countries exemplified by climbing real estate prices and accelerating inflation associated with energy and food prices. Fears over early monetary tightening in China caused the markets to falter beginning in mid-January. The dynamics of the recovery seem solidly underpinned. The largest emerging countries were able to sustain internal demand, which has taken over the reins from exports. However, the rebalancing of growth drivers will take several years and for now lacklustre US and European demand will be a drag on their performance. After the current acceleration phase associated with rebuilding inventory and the resumption of international trade, we predict that growth will taper off and that it will not recover its pre-crisis momentum.

— Emerging markets, which are traditionally more cyclical, reacted more sharply to the downturn in late 2008 and to the upturn initiated in March 2009 than developed markets. The valuation of these markets is still inexpensive, given the outlook for profits. Furthermore, since May, profit forecasts have been continually revised upwards month after month. In 2010, forecast profits should grow by 31% in emerging Asia (38% in Korea, 23% in China), +24% in Latin America and 31% in emerging Europe (compared to +29% for the profits of the MSCI World Index). Good fundamentals, dynamic growth and the prolongation of accommodating monetary policies are also factors which are expected to drive equity markets higher in emerging countries throughout 2010. However, there is some reasons to expect episodic periods of consolidation, notably in the wake of monetary policy tightening expected later this year.

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



Gold

Consolidation expected in 2010.

— The price of the yellow metal has risen sharply since the end of August, briefly breaking through the barrier of \$1,200/oz in early December before falling back to just below \$1,100/oz. Low short-term interest rates, close to zero, have cancelled out the opportunity cost of holding gold over the last few months. Central banks, holding 18% of the world's supply of gold, have once again become net buyers of gold on the market, as notably demonstrated by Russian, Chinese and Indian purchases. This trend is expected to continue given the low weighting of gold in the official reserves of emerging market central banks (2% of Chinese reserves compared to 15% in the euro area and 77% in the United States!).

— Although the medium-term trend is to the upside, the price of gold has begun to undergo a correction. Upside speculation seems to have waned as the dollar regains strength. Because the dollar is expected to continue to appreciate, we can expect gold to decline further. Demand for physical gold for industry or jewellery is expected to recover only moderately because of high prices and a tepid economic recovery. Monetary policy is expected to normalise as excess liquidity is drained off and hikes in key interest rates follow. Lastly, fears of a sudden spike in inflation appear to be largely unfounded given underutilised production capacity and the level of unemployment. Unless there is a sudden increase in risk aversion and/or a generalised government debt crisis, the price of gold is expected to gradually decline.

— **We believe that gold will stabilise around \$1,000/oz between now and the end of 2010 (\$1,100/oz on a 6-month horizon), notably because of the strengthening dollar, accompanied, however, by periods of high volatility.**

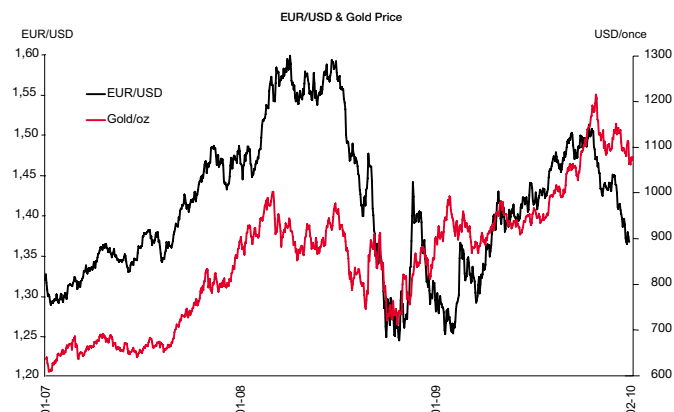


Oil

Short-term price stability but the trend is to the upside.

— Since mid-October the price of oil has been fluctuating within a range of USD 70-80 per barrel. Against a backdrop of moderate recovery, a sharp rebound in the price of oil seems unlikely. Inventory levels remain high as unutilised production capacity nears 5 million barrels/day. Thus, there is sufficient supply to absorb the growth in demand predicted for 2010 (+1.2 million barrels/day compared to 2009). Furthermore, Chinese imports account for the lion's share of emerging market demand: the current sustained pace of oil purchases seems too high for the needs of a growing economy. We cannot completely rule out episodic price declines during the year. For the time being, oil producers, especially OPEC, regard current prices as satisfactory and their level does not constitute a threat to global recovery.

— **We continue to bet on a gradual rise in oil prices within the range of USD 85-90 per barrel between now and late 2010, given growing demand and the restoration of discipline within the ranks of OPEC.**

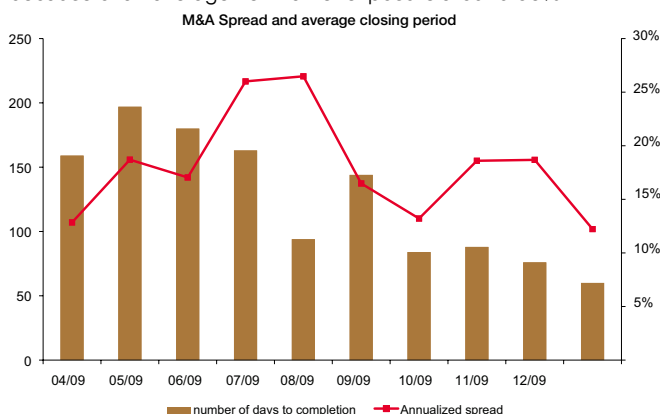


Increase diversified exposure to the Hedge Fund asset class to take advantage of the growing decorrelation between credit strategies.

Though there was strong correlation between risky asset classes in 2009, the hallmark of 2010 is likely to be the return of greater dispersion within asset classes.

2010 should be a better year than 2009 for securities specialists, such as Long/Short Corporate Credit or Long/Short Equity managers with a fundamental analysis bias.

- With respect to major strategies, the Committee has always had a preference for Event-Driven strategies and, to a lesser extent, Relative Value. Indeed, these strategies are enjoying a very favourable environment, notably strategies based on corporate credit and M&A Arbitrage.
- Conversely, **the Committee is now more positive on the outlook for Long/Short Equity strategies than for Trading Directional strategies (CTA & Global Macro).** Indeed, unlike last year, the financial markets should feel a greater impact in 2010 due more to changes in the fundamentals associated with securities than to economic trends.
- Among sub-strategies, **the Committee has a preference for M&A Arbitrage and credit-based strategies**, such as Corporate Distressed and, to a lesser extent, Long/Short Corporate Credit.
- Indeed, we are very bullish on the Corporate Distressed strategy because the debt of defaulted companies is perhaps the last area in the credit markets which has not completed its recovery after the stabilization of the financial markets.
- As to Long/Short Credit strategies, through the high-yield spread has already fallen below the 10-year average in January, **Long/Short Corporate Credit strategies should get a boost in 2010 from the increase in the number of corporate credit rating agency upgrades. It is worth noting that the average positioning of Long/Short Corporate Credit managers provides protection in the event of a correction because of an average net market exposure around 50%.**



Increase exposure to M&A Arbitrage to take advantage of high spreads.

The M&A Arbitrage strategy is the preferred strategy in the hedge fund universe. Indeed, this strategy offers excellent visibility into the outlook for short to medium-term returns (10-15%) coupled with substantial liquidity.

- **The crisis of autumn 2008 demonstrated that this strategy is one of the most defensive in the hedge fund industry.** Indeed, in autumn 2008 as equity markets collapsed, losses using this strategy were limited to 3%. This resiliency is due to managers' responsiveness, enabling the deals that subsequently fell apart to be avoided and to the strategy's high liquidity. It also owes its success to the defensive nature of investing in the arbitrage of announced M&A – that is, deals for which the terms are disclosed, as opposed to anticipating future transactions in order to benefit from the premium offered by the buyers.
- Investment in announced mergers provides managers with good insight into the potential for return. Indeed, once the terms are disclosed, the manager has a good idea of the gain that can be realised, with the only risks being delay in closing the deal or cancellation.
- **In 2009, this strategy delivered excellent performance (+12%) during a year in which M&A volumes were low is due to the virtual disappearance of the investment banks which once employed this strategy.**
- As to volume, we saw a rebound in the last quarter of 2009, with the return of large-scale transactions including, notably, the announcement of the XTO Energy/Exxon Mobil deal (\$30 billion) after Warren Buffet's acquisition of Burlington Northern a month earlier, with still attractive spreads.
- As to non-annualised spreads, we noted a decline over the last few months but this drop is associated with a reduction in the average length of such transactions, which translates into good expectations of returns as shown in the chart.

— **The average annualised spread is currently 12% on transactions of over a billion dollars, which is still very attractive. We therefore recommend continuing to favour this strategy.**

Spread: the difference between the price offered by the buyer and the price of the target on the stock market.

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