

Investment Strategy

SG Private Banking
Investment Strategy Newsletter

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EDITORIAL

The first signs of a thaw in the credit markets and a recovery in the equity markets appeared this spring. With fears of a depression receding thanks to economic policy actions, the markets regained a semblance of, albeit fragile, confidence. While the latest growth figures point to the extent of the recession in the US and Europe, advanced indicators show that market conditions are slowly improving.

We are certainly close to the bottom in terms of activity, if the turnaround in confidence and the resurgence of orders in manufacturing are to be relied on. Even if the markets are already pricing it in, the economic recovery is not here yet. The road there will be a winding one, with good and bad surprises in cyclical terms. Whatever happens, the way out of the crisis will be difficult, because of the needed adjustment to the balance sheet of most economic players – financial or otherwise.



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Trends

– Renewed confidence in the fixed income markets.

Since March, the money markets have posted steady improvement. Risk premiums on interbank markets continued to sink, reaching their August 2007 level, before the financial crisis began. This illustrates both the impact of the different measures implemented by the central banks to contribute to the credit market thaw, and a greater propensity among financial institutions to lend to each other. At the same time, risk premiums on corporate bond issues are on the decline. While the economic environment is showing signs of improvement, investors want to benefit from the still-high yields, creating an exceptional volume of issues in return.

– **Access to credit is still difficult:** surveys conducted on banks by the monetary authorities show that access to credit is restricted, for both businesses and households in the United States and the euro area. Nonetheless, the proportion of banks wanting to tighten their lending terms is on the decline, signalling the start of an improvement. Still, the situation is better in the United Kingdom, where banks are preparing to increase their aid to the economy. The quantitative easing implemented by the primary central banks should stimulate a gradual recovery of bank lending – a key factor in a sustainable economic recovery.

Equities

Gradually move back to equity.

After having consistently kept negative views on equities since Spring 2008, the Investment Committee considers that conditions are met to come back on equities. The main economies should bottom out soon as underlined by improved economic indicators. The worst of the economic and financial crisis seems over and a recovery should occur early 2010. On top of that, the corporate sector adjusts rapidly to the economic conditions, with better-than-expected earnings for the first quarter. We are strongly confident that investing in equities is both appropriate and timely.

– **All of the equity markets have rebounded dramatically since early March.** The rise in prices was especially marked in those sectors that had fallen farthest, such as cyclical and financial stocks. Emerging markets' stock indices also recovered, with some help from reduced risk aversion and renewed interest from international investors, after the strong divestments of the second quarter of 2008.

– **Signs of economic stabilisation and improved credit market conditions have bolstered prices.** With the risk of a deflationary scenario receding, investors have regained some of the confidence lost in past months. This has enabled them to correct the excess undervaluations. Still, the real economy is in a recession, and leading indicators – even those with a favourable bias – are at historical lows. Not all the conditions for an economic recovery have been met: access to credit is still difficult, and global demand is down. Yet economic policies aiming to consolidate bank balance sheets and sustain demand should continue to have an effect in the months to come.

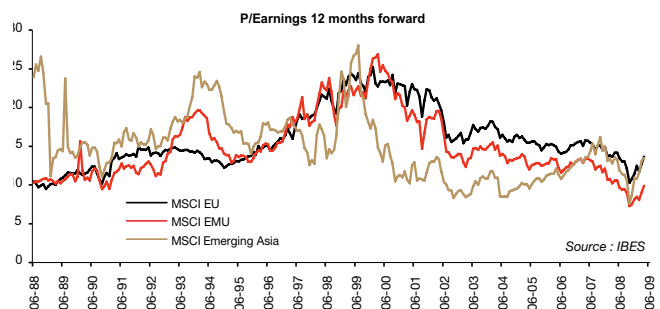
– **Equity market valuations have risen in conjunction with rising prices and downward revisions to profits.** As such, most markets, with the notable exception of Japan, have returned to valuations – measured by the PER (price/earnings ratio) – close to those of early or mid-2008. These valuations are attractive, because they are lower than their historical average and, therefore, have the potential to appreciate when a recovery is forecast. Remember that PER is logically higher in the trough of a cycle (when profits are lowest) than at its peak. The new decline in growth forecasts places the euro area behind the US, with a lower valuation. As for emerging countries, price/earnings ratios have increased significantly since the market rebound. Looking at other valuation indicators (price/net assets, comparison with bond markets), equity markets seem attractive, specifically because interest rates are low. **In all, valuations appear justified by economic fundamentals:** so it is future earnings forecasts that will play a decisive role in market developments. **On a geographical basis, we prefer Japanese, Eurozone and emerging equity markets (see below). The Japanese market was oversold after exports plummeted. We now expect a significant rebound of earnings. As for the Euro area, valuations look attractive as they stand well below historical average.**

Buy opportunities on cyclical stocks and healthcare

Two new sectors seem highly recommendable – materials and healthcare – in addition to the sectors we are bullish on, such as energy and technology.

– **Materials**, the consummate cyclical sector, **should build on the improved economic outlook, but also on widespread stimulus plans.** These plans have a large public-investment component that will benefit the sector's businesses. Likewise, the expected recovery in emerging countries should be favourable to materials. Finally, due to the sharp drop in the equity markets, those stocks most sensitive to the trough in the cycle have been dropped, which has helped to lower their valuation.

– **Healthcare**, the number-one defensive sector, **continues to be deemed attractive.** The equity markets' recent liftoff is owed to those sectors deemed most fragile (financial and cyclical stocks). Businesses in the sector have solid financial results, and the ongoing restructuring movement should lead to cost savings. Furthermore, the risk of a pandemic should last a few months longer, which should be favourable to some stocks.



Bonds

Corporate bonds over government bonds

— Special measures to improve economies' financing terms:

The central banks have recourse to unconventional measures to reduce the costs of financing the economy. The central banks purchase government or corporate bonds in the markets, so as to push down market rates and ultimately reduce financing costs for all economic agents. As a result, these measures are unlikely to foster inflation as supply and demand for credits are both contracting.

— **Since March, long term yields have gradually come back up in the US and UK, and, to a lesser extent, in the euro area.** This reveals both the receding deflationary scenario and the volume of public issues intended to cover government financing needs. Nonetheless, the likely increase in long-term rates over the next few months should be limited. In the first place, it will take time to emerge from the recession, and growth will remain anaemic, with low inflation in 2009 and 2010. In the second place, the central banks have the option of increasing their security-buying programmes to prevent an abrupt rate hike that would threaten the standardisation of credit terms. **Whatever happens, the rate curve should remain steep on both sides of the Atlantic over the coming months.**

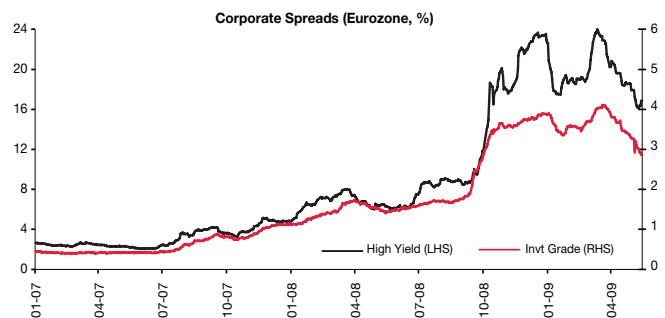
— In terms of investment in government bonds, we recommend holding off from the US and British markets.

The volume of public deficits in those two countries, the signs of economic improvement in the US, and the persistent inflationary tensions in the UK should drive yields up. Therefore, we recommend either holding off or cashing in. As for the euro area, the outlook is more complex: economy goes thru a deep recession, and other monetary easing measures cannot be ruled out. However, yields have likely already hit their low point, limiting the bonds potential appreciation. **Generally speaking, it is better to move on public agency securities, supranational issuers, or government-guaranteed bank debt to receive additional yield.** Maturities limited to 3-5 years are best for curbing exposure to rate fluctuations.

— Still, the corporate bond market continues to offer attractive yields.

The decline in risk premiums, which had reached highs early in the year, illustrates the easing of financial markets in connection, and the reduced risk aversion. When risk-free rates are at historical lows, investors looking for yields are drawn to corporate bonds. Despite the strong increase in issues, which reached €140bn in the euro area over the first four months of the year, demand continues to outpace supply. Bond yields continue to factor in higher implicit default rates than those priced in by rating agencies.

— **In spite of a marked decline, rate premiums on corporate bonds are still at historical highs, which preserves attractiveness in the investment-grade issuer segment.** In terms of maturity choice, 3-5 year maturity, which applies to most issues, appears the most attractive because they provide the best compromise between yield and sensitivity to rate fluctuations. From our viewpoint, though, high-yield bonds carry too high a risk, while the already-high default rates will continue to grow over the coming quarters in this segment to reach 15% in the US and 19% in the euro area by end 2009.



Currencies

Reduced volatility in the exchange-rate markets and strengthening emerging currencies

— **A stable dollar... for now:** the dollar has been the safe-haven currency for the last six months, rising markedly after the collapse of Lehman Brothers in conjunction with the increase in risk aversion. More recently, with the renewed appetite for risk, it has weakened again. In the short term, the dollar should benefit from an earlier exit from the crisis in the US than in the euro area, and from investors' renewed appetite for risky US assets. In the longer term, the Federal Reserve's ultra-accommodating monetary policy, and the size of the budget deficit (12% of GDP in 2009, 10% in 2010) will fuel inflationary expectations in the US, thereby hurting the dollar. These fears could arise all the more easily because the US public deficit results in record issues of US Treasury securities. In the absence of an additional increase in long-term rates in the US, the dollar would have to adjust downward to attract investors.

— **The yen will remain stable or even appreciate slightly:** the yen has had an especially bumpy road for the last year. Beginning in the summer of 2008, it appreciated amply due to the unwinding of the yen-financed carry trade. Since the start of the year, it has weakened rapidly, while the Japanese economy has been hit with the collapse of its exports. Stabilisation occurred in early March, with two forces working against each other: the reinstatement of carry trade positions – a weakening factor – and the maintenance of a sharp surplus in the current account balance – a strengthening factor. This second factor should prevail over time, and result in an upward trend against the dollar.

— **Emerging currencies are rallying:** liquidity constraints weighing on investors and the collapse of the Lehman Brothers bank had triggered the collapse of emerging currencies at end 2008. Some currencies had become sharply undervalued, such as the Korean won and Mexican peso. With the partial return to confidence in the markets, they have regained some ground. The resilience of certain emerging economies, such as Brazil, combined with the return of investors, should result in a continued appreciation, especially when the global economic recovery gets under way. On the other hand, Central and Eastern European currencies are still fragile, due to the imbalance in those countries' current account balances and excessive leverage of the private sector.

Emerging markets

The economic rebound should happen in emerging countries first

— Despite the global economic environment, emerging countries should, on the whole, have an earlier recovery phase than developed economies. This is especially true for countries that have solid fundamentals and have implemented strong stimulus policies, such as China and Brazil.

— Faced with the brutal drop in their exports, authorities have reacted with massive stimulus plans and rapid monetary easing. The most significant stimulus plan is the one applied by China (whose discretionary moves are estimated at 3.1% of GDP in 2009 and 2.7% in 2010), and the effects are already being felt. Activity indicators are up sharply, and credit growth is especially buoyant in China (25.5% year-over-year in March, compared to 16.4% on average over the last 10 years). It also has a ripple effect on other emerging economies that export commodities, like Brazil. Furthermore, Asian banks are underexposed to toxic assets, and the results posted for the first quarter were better than expected by the market.

— For all practical purposes, the equity markets have already anticipated this movement, with a sharp price jump since the start of the year – higher than the one seen in developed markets. Profit forecasts, which are higher than in Europe and the US, should continue to sustain valuations. Still, export-dependent sectors continue to suffer from sagging global trade. **The outlook remains positive in the medium term for emerging equity markets. They should benefit from improved outlook in the global economy and from higher earnings forecasts.**

Sectoral preferences (Equities)

OVERWEIGHT

Energy
Health care

MEAN

Materials
Utilities
Consumer staples
Information technology
Telecommunications

UNDERWEIGHT

Financials
Industrials
Consumer discretionary



Oil

Since end March, oil has slightly surpassed January's \$50/b threshold, to then pass the \$60/b mark. This development seems somewhat decorrelated from the fundamentals. True, OPEC's credibility is being asserted, with 80% of production cut targets being respected. In March, OPEC's production was 27.6 mb/d, a decrease of 3.8 mb/d since September's peak, for a target reduction of 4.8 mb/d.

However, despite these production cuts, crude inventory continued to rise, regaining levels in OECD countries that had not been seen since the early 1990s. The demand for crude is down everywhere – including in China. **According to the International Energy Agency's April report, global demand should fall by 2.4 mb/d in 2009,** and China's demand by 0.1 mb/d. If OPEC's discipline continues to be applied, the global oil market would not be unprofitable again until end 2009 at the earliest, thereby allowing inventory to be absorbed. Elsewhere, renewed investor interest for "energy" indexes observed in the first quarter, when the barrel was nearing \$45, should collapse at these prices.

In all, we consider that the price of oil should consolidate into a range of between \$50 b and \$60/b within 12 months.

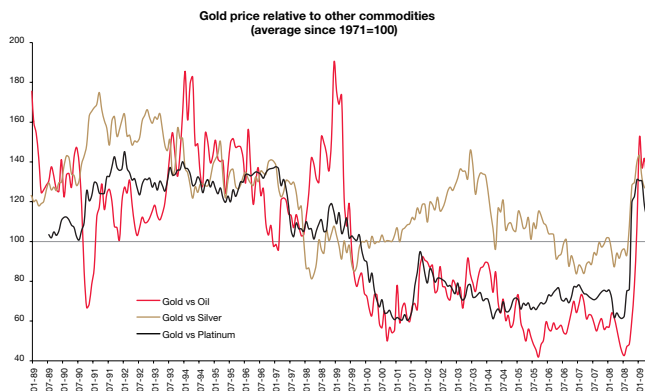
Gold

Gold came through the resurgence in market optimism, staying above \$900/ounce overall since last March. Investors realised that the more deflationary risk receded, the closer the risk of inflation or currency devaluation moved in. Bloated public deficits could cause countries like the US to tolerate higher inflation to bring about the end of the crisis. And so gold is perceived as the perfect reserve currency against most fiat currencies.

The law of supply and demand will prevail, and the price of gold should fall.

Physical demand (jewellery and production) should continue to shrink in 2009 after coming down 12% in 2008. The \$900/ounce level is close to the historical highs of the early 1980s (in constant dollars). This destroys physical demand (which represents 70% of total demand). Recently, we have seen investment flows being channelled for other precious metals (silver and palladium) considered less expensive in relative value.

In the medium term, we predict gold prices will return to \$850/ounce by end 2009.



March/April

After a good start to the year due to a highly defensive position, the Hedge Funds suffered slightly from the sharp financial market rebound in March. In April, although they maintained a highly defensive position, the Hedge Funds adapted by tactically and strategically reducing their short positions. They benefited from the rebound in risky assets, posting positive performances (+0.8%).

3-6 month outlook

Despite the rally in risky assets over the last two months, there are still numerous investment opportunities for Hedge Funds. In fact, the yields on corporate bonds are still very high, the number of assets that have defaulted has soared over recent months and arbitrage opportunities are numerous.

The Investment Committee has noted the improvement in Hedge Fund performance thanks to improved functioning of the credit markets and the drop in risk aversion. The Committee recommends to maintain the current exposure to this asset class but expected returns do not justify to overweight hedge fund strategies.

Although the Committee still prefers Global Macro & CTAs and Long/Short Equity strategies, the outlook for Relative Value and Event Driven strategies have improved, due to a more favourable environment, which is notably associated with improved credit market functioning.

Relative Value: outlook is becoming more normal

Arbitrage strategies continued their rebound in March and April (+7.3% at the end of April), with all strategies posting positive performances with the exception of volatility arbitrage.

Convertible Bond Arbitrage continued to outperform other arbitrage strategies, benefiting from the reopening of the primary convertible bond market. The Committee prefers to remain conservative on this strategy which could suffer in the event of a sharp rebound in risk aversion.

The Committee has noted an improvement in the outlook for the corporate bond arbitrage strategy. The risk-reward trade-off has improved significantly for this strategy due to primary market buoyancy and the improvement of liquidity on the high yield secondary market.

Event Driven: outlook is becoming more normal

The Mergers and Acquisitions Arbitrage strategy continued to post positive performances over the last two months (+2.2% at the end of April). Transaction flow should increase over the coming months thanks to the decline in risk aversion enabling the return of aggressive transactions. Moreover, the sharp fall in systemic risk, which is a key point in the improvement of this strategy's risk-reward trade-off, is encouraging the Committee to increase its rating for this strategy. The Committee has also noted that the outlook for the Special Situations strategy is becoming more normal, as the strategy is benefiting from more abundant investment opportunities, due to the increasing amount of corporate restructuring (spin-offs, restructuring of company capital). Lastly, the Committee prefers to remain cautious on the Distressed strategy due to a very slow return of liquidity for certain segments as well as the impending sharp rise in default rates. At this stage, the Investment Committee prefers limited and opportunistic exposure to the Distressed strategy through multi-strategy event driven managers.

Long/Short Equity: positive outlook

Following a moderate rebound in March, the Long/Short Equity strategy (+6.4%) benefited more broadly from the equity market rebound in April despite major disparities between managers' performances. The strategy (+6.1% year-to-date) continues to significantly outperform the main equity market indices which remain in negative territory (-3.4% for the S&P 500 at the end of April).

The major disparities between performances are linked to the degree of defensiveness adopted by managers. Beyond net equity market exposure, long or short positions on the sectors that have been hardest hit by the crisis has been the determining factor in managers' performances. In fact, the equity market rebound is essentially due to the sharp rebound in the sectors that have suffered most during the crisis (financials, cyclical stocks).

It is therefore important to note that a major portion of managers remain sceptical regarding the continued upswing in share prices and prefer to maintain a defensive position as, above all, they believe that the financial sector's problems are not yet over.

The Investment Committee is positive on the Long/Short Equity strategy which is an attractive investment vehicle to increase equity market exposure while benefiting from protection in the event that the markets slump again.

Global macro/CTA: positive outlook

Within the "Global Macro & CTAs" strategies, the Committee now prefers the Global Macro strategy. In fact, the qualitative selection of market trends by Global Macro managers is more effective against the current backdrop. In particular, managers with a fixed-income bias should continue to profit from the marked economic cycle.

For CTAs, the Committee is now slightly less positive on Short-Term CTAs which are suffering from intra-day volatility peaks, notably on the fixed-income market due to the interventions of the Fed. Nonetheless, their performance rebounded in May, enabling them to post positive performance this year as of mid-May (+0.6%). Although Long-Term CTAs have suffered in performance terms since March, the Investment Committee remains positive on this strategy for the medium term, even though, in the short term, it may continue to suffer.

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