INVESTMENT STRATEGY

August 09

Committee meeting of July 29, 2009

Recession eases

A more favourable economic scenario for the near term is gradually taking shape, as may be seen by the recent increase in projected GDP growth for 2010. This upturn is most apparent in the United States where private-sector forecasters and the Federal Reserve both agree that economic activity should pick up in the second half of 2009. **Indeed, signs of stabilisation in the manufacturing sector, and to a lesser extent in the housing market, are beginning to appear.** Recovery in the emerging economies, and especially in Asia, has been surprisingly strong and has encouraged observers to raise their forecasts for the next few quarters. Monetary and fiscal policies have played a key role in the recovery of the Asian economies and are likely to continue to support activity over the next few months.

Investors like quarterly earnings

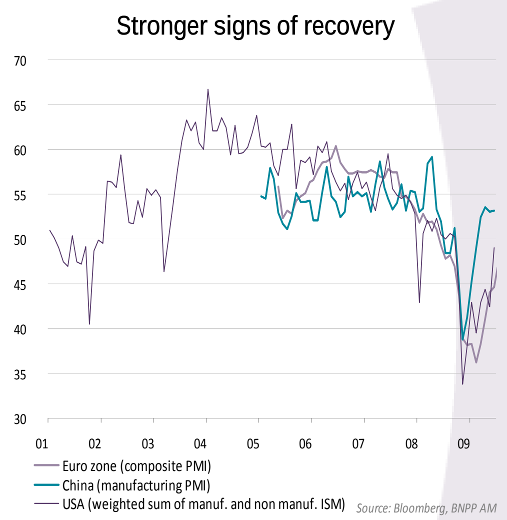
US corporate earnings for the second quarter were better than expected. Although this may be credited mainly to cost-cutting efforts rather than to rising sales, and CEOs are still quite cautious in their guidance, **the outlook for earnings has improved.** Furthermore, investors have responded enthusiastically to earnings figures, as reflected by the 8% increase in the MSCI AC World index since July 3rd, when our Investment Committee last met.

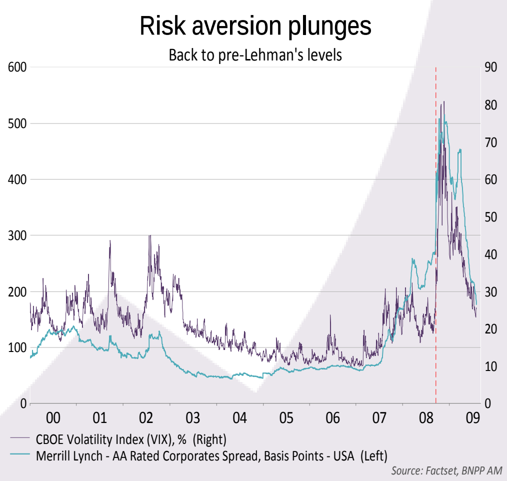
Better near-term visibility for equities

Both macro and microeconomic factors thus seem to be providing a healthier environment for equities and investment-grade credit. As for concerns about the consequences of returning to more "normal" monetary policies, central banks are now explaining their positions in greater detail and Ben Bernanke seems to have convinced observers that the Fed will be able to conduct its "exit strategy" in a relatively smooth manner. How US monetary authorities are going to "manage" their shift away from their ultra-accommodative policies has been a risk factor not only of major importance but also of great uncertainty, since the result could be either inflation or in the contrary a brutal smothering of recovery.

As a result, visibility has improved in equity markets over the next two to three months, although some markets are starting to be overbought and investor enthusiasm in response to "good news" could dim if their growing expectations for the economy are disappointed. The recession however is still underway, as may be seen by the 3.9% drop in US GDP in the second quarter year-on-year.

We maintain our slightly positive bias in equity markets. Over the longer term however some investor concerns will reappear. These mainly have to do with the pace of global economic growth over the coming years, which may be restricted by deleveraging and less accommodative monetary and fiscal policies next year. We believe this concern will not be factored in right away however, but perhaps this fall or even at the end of the year, when strategies for 2010 are implemented.





July 31, 2009

The September issue of the Investment Strategy will resume its usual longer format.

ASSET ALLOCATION

Falling risk aversion reflects stronger fundamentals

"Exit strategies" are under close scrutiny

During his half-yearly testimony before the House Finance Committee, on July 21, Ben Bernanke described the Fed's strategies for reversing its highly expansionary monetary policy but said that “economic conditions are not likely to warrant a tightening of monetary policy for an extended period”.

The Fed's chairman presented each of the tools at his disposal and assured that they would be sufficient. In particular he emphasized the need to monitor bank reserves (which have increased from about $10 billion in mid-2007 to almost $800 billion recently) to ensure that they do not feed a credit bubble as soon as the economy recovers. The possibility of raising the interest rate paid on bank reserves with the Fed was mentioned and there are also other tools for reducing reserves and other items on the Fed's balance sheet in a "smooth and timely" manner. By explaining the means available to tighten monetary policy, despite the Fed's swollen balance sheet, Mr Bernanke seems to have convinced most observers that the Fed is able to control the consequences of its monetary policy measures.

Like the Fed, the ECB seems determined to make it clear that it will be able to implement the appropriate tools when necessary. At the central bank's press conference early last month, Jean-Claude Trichet pointed out that "Once the macroeconomic environment improves, the Governing Council will ensure that the measures taken can be quickly unwound and the liquidity provided absorbed" but did not give any further details.

Clearly central bankers are talking more and more about their exit strategies. The ECB's vice-president brought the subject up late last month when he pointed out that fears of high inflation triggered by highly expansionary economic policy were unmerited, since the ECB would never allow this. Although investors seem to have regained confidence in monetary authorities it is still too early to say how solid this confidence is. We will know much more about this when we see how investors react to the upcoming decisions and statements of the Bank of England, which should be one of the first central banks to retreat from unconventional monetary policies.

Still neutral in equities but with a stronger positive bias. We prefer emerging markets

The second-quarter earnings reporting season, which is now in mid-course, is strongly underpinning equity markets for the time being. Earnings are much better than expected, mainly thanks to ongoing cost-cutting efforts. Sales however are still disappointing, albeit less than for the first quarter. In the financial sector, most of the pleasant surprises are the result of extraordinary income and trading and capital markets activities. However, many banks have expressed concern about the rising cost of risk, which continues to weigh on the financial sector. The outlook for earnings should normally continue to improve as the global economy strengthens.

Against this background, although valuations have weakened a bit they are still not excessive but remain neutral to slightly positive, mainly thanks to rising earnings expectations.

The pickup in equity markets over the past few weeks has pushed many indices into overbought territory and increased the risk of a near-term consolidation. However, the continuation of this rally has confirmed the turn in many trend indicators, as seen by the increase in the 200-day S&P 500 moving average for the first time since late 2007. Furthermore, this key US index is currently very close to major technical and psychological levels, which if crossed would also be a very positive signal. The wariness of institutional and individual investors (which are still relatively underexposed to the riskier asset classes and to equities in particular) is clearly diminishing in response to the pickup in equity markets and the improving outlook for the economy, which continues to underpin this rally. Nevertheless, over the next few months we will be keeping a close eye on sentiment indicators, since signs of over-optimism in equity markets will once again signal risk, particularly if the global economy fails to recover as expected, which is not yet the case.

Given these conditions, we continue to ride the bullish trend and to maintain our exposure at neutral to slightly overweight, while paying very close attention to the risk that economic recovery may falter over the coming quarters and the disappointment this could mean.

ASSET ALLOCATION

Is a bubble forming in emerging markets? According to our technical and economic indicators, after consolidating briefly last June, emerging equity markets will continue their bullish trend. Although valuations have reverted to their historical level, strong fundamentals, excellent news on the economic front and upward revisions in earnings estimates augur well for higher equity prices and expanding valuation multiples, and perhaps for even a premium over developed markets. Abundant liquidity in the form of relatively low real interest rates, high savings rates and positive mutual fund flows continue to support emerging equity markets, although much of the good news has already been priced in and there seems to be a very strong "popular" consensus.

Although there are anecdotal signs that a bubble may be forming in some markets (such as the incredible success of Chinese IPOs, the high participation rate of small investors and record trading volumes), markets may remain irrational and speculative longer than our nerves may be able to stand. We are therefore maintaining an overweight in emerging markets, while standing ready to adjust our allocation given the much higher volatility.

Bonds – neutral on government bonds, overweight on investment-grade credit and cautious about high yield

Government bond investors will be paying more and more attention to the nature and speed of economic recovery, central bank "exit strategies" and the risks associated with both. And although sluggish growth for a few more quarters and slack capacity utilization will prevent yields from rising sharply, over the next few months investors will be paying more and more attention to the initial efforts of central bankers to retighten monetary policy, when they feel the time is right. If the US and UK governments soon end their bond purchases, which we expect, two major sources of demand will vanish and the outlook for government bonds will be even more uncertain. We are currently navigating through this environment with a neutral position that reflects the opposing forces mentioned above. Over the longer term, our bias will become negative.

As for credit, it continues to benefit from declining investor risk aversion. But even if the momentum in this market continues it will slow and the margin for further improvement is gradually shrinking. We still believe the outlook is brightest for the investment-grade market, where we continue to be overweight, rather than for the high-yield segment, where we still advise caution.

Commodities – caution recommended until valuations improve

Although euphoria in equity markets has boosted commodities considerably, they are still physical assets. Thus although the general increase in confidence has driven oil prices upward, US inventories of petroleum products keep bringing investors back to Earth by reminding them that fundamentals will not improve overnight. Since current prices for both energy and base metals may therefore be a bit high we suggest waiting for a better entry point. Although gold is still an attractive asset it is likely to have little upside potential until jewellery demand shows signs of recovering. Grain prices have suffered from the recent improvement in weather conditions but are likely to benefit from the resurgence of risk appetite and solid long-term fundamentals.

Currencies – euro-dollar should stabilize over near term

Volatility in currency markets declined over the past month, with JP Morgan's VXY index returning to its lowest level since September 2008, as did EUR/USD 1-month implied volatility, which fell back to 11.5%. Among the various usual explanations for day-to-day movements in currency markets, declining investor aversion to risk still seems to be the dominant theme. The return of risk appetite could therefore still cause some investors to turn away from the dollar and yen. As we have already mentioned, given the upward and downward pressures on the dollar and the euro we continue to expect EUR/USD to consolidate over the coming months.

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