

# live from CAAM

Our market views - December 2009

## STRATEGY

### 3-MONTH OUTLOOK

At 1<sup>st</sup> December 2009

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Fixed income markets do not yet expect inflation to return

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*Best wishes to all our readers.  
Next publication on February 2010*

#### OPINION SCALE

- ➔ POSITIVE      ➔➔ VERY POSITIVE  
➔ NEUTRAL      ➔➔ VERY NEGATIVE  
➔ NEGATIVE

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## Dawn of a new decade after two atypical years?

Q&A with Patrick de Fraguier, Head of Strategy at Crédit Agricole Asset Management.



Photo : T. LEDOUX

Equity markets rebounded briskly, then growth forecasts were revised upward in 2009. How would you sum up the year?

It can be summed up as near-total dislocation, revaluation and normalisation. Clearly, massive and concerted government intervention overcame the deflationary spiral. As a result, leading indicators and growth were able to climb above the critical expansion-contraction threshold, while inflation expectations moved out of dangerously negative territory and "normalised".

As the performance rankings for the various asset classes show, 2009 was an outstanding year: emerging equities gained 70%, high-yield bonds 68%, commodities 45%, euro equities 21%, euro government bonds 4%, while money markets earned barely 1%. The returns on some of these asset classes exceeded those for 2008.

#### What are the main assumptions underpinning your baseline scenario?

Our scenario is based on two pillars:

- first, the current level of growth is sustainable, albeit sub-potential, and inflation is neither a risk nor a solution in the near term;
- second, the monetary and fiscal policy mix means that central banks and fiscal policies are likely to remain accommodative for quite some time.

*"Striking a new balance among the various sources of added value"*

The challenge for the authorities, which are mindful of the consequences of abnormally low risk-free rates, is to conduct their crisis exit strategies successfully in terms of expectations for interest rates and for market volatility.

#### What shifts in asset allocation do you recommend for the first half of 2010?

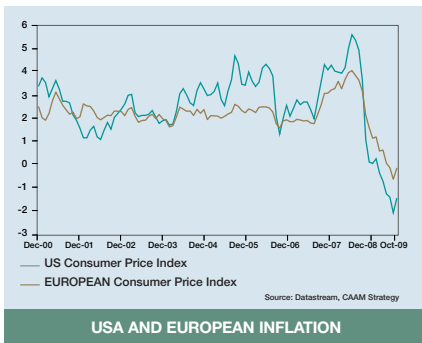
We believe that the economic and financial context is still favourable for so-called "risky" assets. We are maintaining our constructive strategic recommendations, on credit instruments – essentially corporate bonds – and equities, while exploring new themes such as healthcare, dividend yield and infrastructure. We are also maintaining a few protection positions in our portfolios, favouring the eurozone for government bonds and the US dollar as a hedge against a possible return of risk aversion as well as an opportunity in terms of historical and relative valuations. In sum, we want to strike a new balance among the various sources of added value in our investments. This involves pursuing a less pronounced directional strategy, monitoring volatility trends which are more vulnerable, and putting the emphasis on stock picking.



## FIXED INCOME

# Fixed income markets do not yet expect inflation to return

*Long-term bond yields reached their highest of the year in early summer then resumed their downward course, reassured by the absence of inflation pressures and central bank's communication about their crisis exit strategies.*



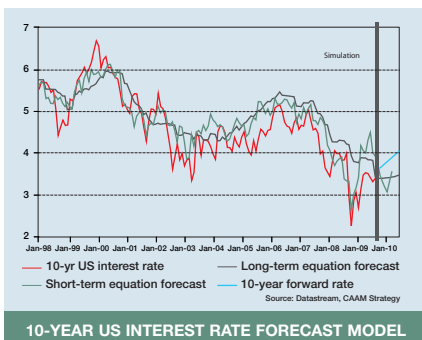
Long-term yields are again on a downtrend in Europe and the USA, even though the economic situation has improved sharply on both sides of the Atlantic. They may stay low through part of 2010 and then gradually rise at year-end. The threat of a bond market crash, which had loomed for a while because of excessive government deficits, now seems increasingly remote.

territory and is likely to remain moderate next year because the jobs market will probably be depressed for some time to come, according to the Federal Reserve's monetary policy committee, the Federal Open Market Committee. The Philadelphia Fed recently lowered its short-term and long-term inflation expectations, stressing the absence of inflation pressures.

Admittedly, the question of reducing government debt is higher on the agenda than ever. And it could remain a central theme for a long time to come, since governments have not yet decided to tackle the problem head-on for fear of weakening the nascent recovery. That said, disappointing macroeconomic figures could well translate into a very uneven pattern of recovery, thus providing support for the bond market.

In a low-inflation environment, long-term interest rates now appear fairly valued and should fluctuate very little in the near term. Further out, the return to firmer growth and inflation will put upward pressure on long-term yields.

■ Kokou TOPEGLO



*"Central banks will probably not raise interest rates until the second half of 2010 at the earliest"*

The monetary authorities, too, have to reveal their crisis exit strategies. Central banks are still cautious on both the timing and the procedures for withdrawing the liquidity they had injected into financial systems to stimulate the economy. The Federal Reserve will probably not raise interest rates until the second half of 2010 at the earliest. The ECB is unlikely to abandon its stand-pat policy until end-2010.

Although the recovery is taking shape, the risk of deflation should not be completely ignored. Inflation is barely back into positive

### Interest rates (in %)

	At 1 <sup>st</sup> Dec. 2009	Change in	
		1 month	1 year
<b>Eurozone</b>			
Eonia	0.34	-0.05	-2.59
3-mth Euribor	0.72	0.00	-3.10
10-yr OAT	3.40	0.13	-0.15
<b>United States</b>			
3-mth	0.26	-0.03	-1.96
10-yr	3.29	-0.09	0.57
<b>United Kingdom</b>			
3-mth	0.69	-0.01	-3.22
10-yr	3.65	-0.07	0.00

Source: Datastream, CAAM Strategy

### Central bank rate forecasts (%)

	At 1 <sup>st</sup> Dec. 2009	3-mth	6-mth	1-yr
United States	0 - 0.25	0 - 0.25	0 - 0.25	1.00
Eurozone	1.00	1.00	1.00	1.25

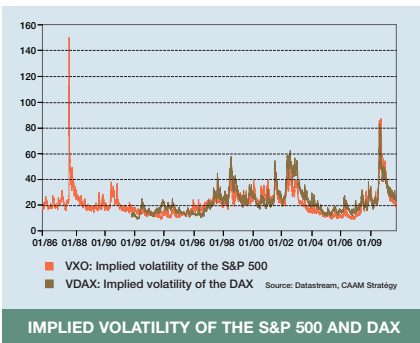
Source: CAAM Strategy



## EQUITIES

# Don't rule out a 2010 earnings rebound

*Risk aversion fell and multiples expanded in 2009. Earnings growth is now set to take up the slack.*



	2008	2009	2010	2011	base 100 in 2007	
					2007	2011
U.S.A	-24 %	-3 %	21 %	19 %	100	106,4
EUROPE ex UK	-31 %	-12 %	26 %	21 %	100	92,7
UNITED KINGDOM	-9 %	-29 %	20 %	20 %	100	92,6
JAPAN	-114 %	ns	ns	27 %	100	ns
PACIFIC ex JP	-13 %	-18 %	10 %	19 %	100	94,5
EMERGING MARKETS	-18 %	0 %	27 %	19 %	100	124,2
EM ASIA	-32 %	23 %	30 %	16 %	100	127,3
EM LATIN AMER.	-11 %	-9 %	25 %	17 %	100	118,0
EM EASTERN EUR.	-2 %	-33 %	25 %	29 %	100	105,5
<b>WORLD</b>	<b>-31 %</b>	<b>-5 %</b>	<b>25 %</b>	<b>20 %</b>	<b>100</b>	<b>97,5</b>

Source: Datastream, CAAM Strategy

EPS (EARNINGS PER SHARE) GROWTH  
IBES BOTTOM UP FORECASTS

*"Has the market changed gears?"*

The MSCI World index gained 21% between 1 January and mid-October. With the exception of Japan, off -5%, western markets all rebounded to the same extent, and emerging markets were riding high with gains of 50%. Since then, however, the rally has petered out everywhere, with declines of -2% for the MSCI World index, -1% for the USA, -2% for Europe, -3% for emerging markets and as much as -10% for Japan. Meanwhile, the economy and earnings have exceeded expectations overall. How to interpret the standstill, and what does 2010 hold in store? In hindsight, the first bull phase, from the 9 March low to the 15 October peak, was driven by two factors:

- risk aversion returned to normal, with the standard deviation from the mean plunging from 6 to 1,
- ratios rebounded across a broad range of indicators, but not excessively so in view of the position in the cycle.

But since both these factors have more or less run their course, earnings growth should now take up the slack against a backdrop of normalising monetary and fiscal stimulus measures and long-term bond yields. The market appears to be entering a second upswing characterised by lower, more volatile returns, but the trend for equities should remain bullish. Until governments' crisis exit strategies start to show results – not for another two quarters at least – markets are likely to be supported by positive news on earnings.

After plunging -35% since end-2007, earnings per share are expected to rebound by

around 25% in 2010 and 20% in 2011, according to analysts' consensus forecasts. This would mean that in 2011, EPS would be only marginally lower than in 2007, or even higher in the USA and emerging countries. We believe this figure is attainable, because the expected rebound is not as aggressive as it might seem:

- early in the recovery, it may be very strong, and some brokerage analysts are even starting to publish estimates for earnings growth of around 40% in 2010,
- despite the weak economy, earnings have surprised on the upside because of wage moderation, productivity gains and China's growth,
- because of low comparatives in sectors such as finance, technology, oil and materials, the median estimate for 2010 EPS growth is closer to 10% than 20%, putting the rebound into perspective.

So, if earnings do live up to expectations, market movements will depend on the clarity and skilful execution of crisis exit strategies.

■ Delphine GEORGES / Ibra WANE

### Equity market indices

	At 1 <sup>st</sup> Dec. 2009	Performance in euro (in %)	
		1 month	1 year
<b>Europe</b>			
DJ Euro Stoxx	267	4.15	27.12
Cac 40	3 776	4.66	22.57
FTSE 100	5 312	3.83	22.17
<b>United States</b>			
Dow Jones	10 472	5.39	7.23
S&P 500	1 109	4.60	13.37
Nasdaq	2 176	4.00	29.87
<b>Asia</b>			
Nikkei	9 572	-2.62	2.97
MSCI Asia Pac. ex. Japan	414	1.70	50.87
<b>MSCI World</b>	<b>817</b>	<b>3.56</b>	<b>17.78</b>

Source: Datastream, CAAM Strategy



## SECTORS (Equities)

# A comeback for dividend yield strategies?

### Sector performance at 1<sup>st</sup> Dec. 2009\*

	% change 1 month	% change year on year
Energy	2.08	10.99
Materials	11.23	52.83
Industrials	4.84	16.41
Consumer Discretionary	2.95	26.54
Consumer Staples	2.67	7.22
Health Care	5.86	9.13
Financials	1.18	23.46
Technology	2.75	32.75
Telecom. Services	4.06	1.55
Utilities	3.45	-6.62
MSCI World Index	3.56	17.78

\* Performance in Euro  
Source: Datastream, CAAM Strategy

Equity markets returned 21% in 2009, totally dominated by cyclical and financial stocks. We expect the 2010 environment to produce more moderate performance and higher volatility, accompanied by a lower cyclical profile in terms of sector and style. We are now moving to a more balanced sector allocation and have recently increased the weighting in undervalued defensive sectors, such as healthcare and energy. At the same time, we are maintaining a positive outlook on sectors linked to business spending. Our baseline scenario is based on a technical rebound in capex in the second half of 2010, in response to the financial counter-shock.

At that point, the Obama stimulus plan should start to have an impact on investment. A combination of financial accelerator effects and the Keynesian multiplier could create positive surprises with regard to the consensus outlook for business spending in the year ahead. In terms of style, we are stressing dividend yield strategies, which have always performed well at this stage of the cycle due to better visibility on dividends, the search for yield, and possible pressures on equity valuations.

■ Delphine GEORGES / Ibra WANE



## CURRENCIES

# The US dollar: the phoenix of 2010?

### Exchange rates

	At	% change	
	1 <sup>st</sup> Dec. 2009	1 month	1 year
EUR/USD	1.51	2.30	19.83
EUR/GBP	0.91	1.42	6.96
USD/JPY	86.66	-3.82	-6.83

Source: Datastream, CAAM Strategy

With the new year approaching, this is an excellent time for a medium-term analysis based on structural elements.

Currency fundamentals are tightly stretched and, in some cases, running counter to trend. This is particularly true of the US dollar, which has set yet another record for under-valuation. This has led to several rebalancing factors. The US trade deficit (excluding oil) has been narrowing continuously since end-2006. Also, not only has the external deficit contracted sharply; it is now finding easier financing thanks to the very attractive value of US assets.

The trend depreciation of the dollar since 2002 basically reflects the deep-seated shift that has taken place in US portfolios, starting from the almost 100% dollar allocation inherited from the "new economy" and ending up with today's extreme underweight. The powerful wave of dollar selling by its largest holders, namely US savers, reached a peak in 2009 with the perception that monetary policy was off the leash. However, the Federal Reserve's return to greater orthodoxy in 2010 should herald a strong comeback for the greenback.

■ Loïc CADIOU

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