

live from CAAM

Our market views - November 2009

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3-MONTH OUTLOOK

at 2nd November 2009

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OPINION SCALE

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- VERY POSITIVE
- VERY NEGATIVE

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Benefit from the long-term economic growth potential of China

Q&A with Raymond Chan, Equity Fund Manager at CAAM Hong Kong.



Photo: T. LEDOUX

What is the investment case for China?

China is one of our key investment areas because of its sustained economic growth and attractive equity market. Over the next 12 months the world's fourth-largest economy will benefit from credit support measures, infrastructure investments, a real estate rebound and stronger exports. And all of this amid moderate inflation.

In our view the equity markets of Hong Kong and China are attractively valued at the moment. With developed economies now stabilising, the Chinese economy expanding and the risk of preventive action by central banks now dispelled, the region's equity markets will be buoyed by higher earnings and relatively low inflation. Now that valuations are back at reasonable levels, future upside potential will depend on upward revisions to earnings forecasts. The intensity and strength of equity markets in the year ahead will hinge on global capital flows.

What are the benefits of a broad investment universe?

CAAM's management teams have chosen to focus on long-term capital growth by investing mainly in companies listed in Hong Kong or that have their registered office or a substantial portion of their business in Hong Kong or mainland China. Hong Kong is China's leading financial centre. Its stock exchange provides access not only to local and global companies; it also offers unparalleled and increasing opportunities to invest in top quality mainland companies.

"Take advantage of a network of opportunities in a fast-growing area"

The Hong Kong and Taiwanese economies are becoming increasingly integrated into China's domestic economy. The ever-increasing synergy between Hong Kong, China and Taiwan provides a network of opportunities that will benefit from the growth of Greater China.

Given this background, what kind of investment process is CAAM pursuing?

CAAM Hong Kong implements a bottom-up approach based on the quality of our proprietary fundamental research. The team concentrates on the best investment opportunities revealed by this analysis, selecting between 40 and 50 or so stocks. A long-standing research track record, regular and close contacts with companies, and the experience CAAM Hong Kong's managers and analysts combine to create genuine competitive advantage. The team is able to spot "gems" that the market has overlooked and to identify catalysts that can trigger changes in the market consensus.

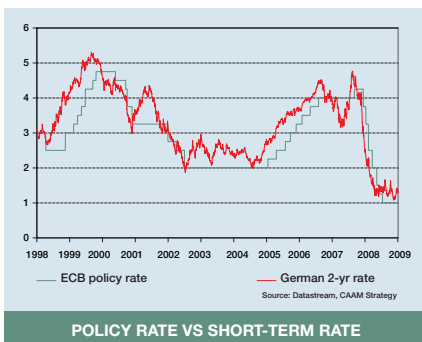
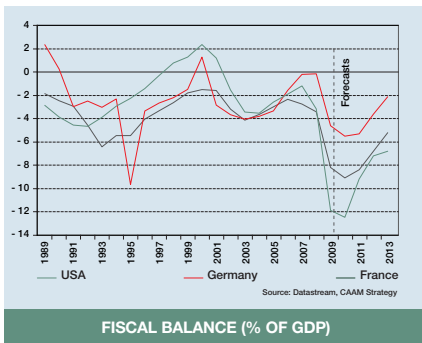
CAAM's extensive experience in Greater China has shown that its approach is well suited to the region, where the level of financial disclosures is generally low. The company has regularly won awards for its regular outperformance.



FIXED INCOME

Long-term interest rates are likely to rise in 2010

Though optimistic, central banks are still cautious on the strength of the recovery, leaving markets in a wait-and-see mood.



"On 16 October Timothy Geithner said that the USA must "live within its means""

After the massive stimulus plans launched by many governments, attention has now turned to the state of public finances. With the US budget deficit surpassing 10% of GDP in 2009, Treasury Secretary Timothy Geithner said on 16 October that the USA "must learn to live within its means," and that the Obama administration would work to reduce government debt to more sustainable levels. The plentiful supply of US Treasuries should exert an upward pull on interest rates. However, Treasuries have thus far found ready buyers, keeping long-term interest rates below their fundamental value (around 3.80% for the 10-year yield) despite good macro news and a widespread decline in risk aversion. Given the likelihood that the global economy will continue to improve and the Federal Reserve will end its Treasury purchase programme, we believe long-term yields are set to rise during 2010.

In October Australia and Norway became the first G20 countries to raise their key rates. But we do not expect similar movements before early summer of 2010 for the Fed and autumn 2010 for the ECB. Moreover, short-term rates are still very low and the market still generally expects them to remain so for several more months before starting to rise next year. However, an increase in short-term rates, which generally outstrip long rates early in the cycle, will depend on the pace of recovery, which will set the tone for major central banks' actions.

In the case of the USA, which exited recession in the third quarter of 2009 with 3.5% annualised growth, the recovery seems confirmed. But with unemployment at a high 9.8%, a return to strong, lasting growth is far from certain. Indeed, persistent concerns about consumption partially explain why central bankers are still extremely cautious.

■ Bastien Drut

Interest rates (in %)

	At 2 nd Nov. 2009	Change in	
		1 month	1 year
Eurozone			
Eonia	0.33	-0.03	-3.26
3-mth Euribor	0.72	-0.03	-4.04
10-yr OAT	3.52	0.05	-0.78
United States			
3-mth	0.28	0.00	-2.75
10-yr	3.41	0.19	-0.57
United Kingdom			
3-mth	0.70	0.09	-5.13
10-yr	3.76	0.23	-0.77

Source: Datastream, CAAM Strategy

Central bank rate forecasts (%)

	At 2 nd Nov. 2009	3-mth	6-mth	1-yr
United States	0 - 0.25	0 - 0.25	0 - 0.25	0.75
Eurozone	1.00	1.00	1.00	1.00

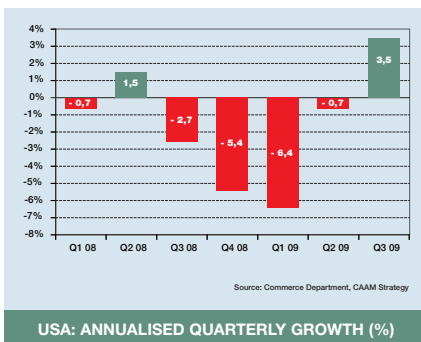
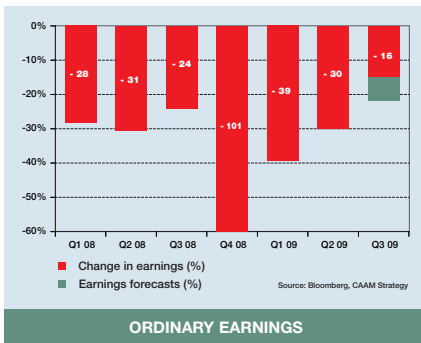
Source: CAAM Strategy



EQUITIES

Markets are unconvinced by earnings and economic data

A 3.5% rebound in US third-quarter GDP and better-than-expected revenues and earnings were not enough to convince markets, still uncertain about whether the turnaround can last.



The MSCI World fell 2.1% in October. The euro zone experienced a deeper decline (-4.5%), while markets in the UK (-1.8%) and the USA (-2.1%) resumed their defensive roles. Thus, after rising for almost constantly for seven months, markets saw a trend break in October. This was probably due, among other things, to the need for a pause after the strong run-up and to doubts about the sustainability of the fledgling recovery. On the whole, however, corporate results matched or beat expectations.

At the macro level, while the rally in Q3 US GDP was above the consensus forecast of 3.2%, it did not gain traction. Stripping out cash for clunkers (1.5% of GDP) and support for the housing market (0.5%), the rally was just 1.5%. With the scrappage scheme ending in late August and homebuyer tax credits scheduled to be discontinued at the end of November, unemployment has continued to increase and household sentiment has weakened again, so growth looks set to fall back. This has been expected for some time however, and the decline in GDP in the coming months may prove less steep than forecast, given that:

- 1- the backlash from the end of cash for clunkers is likely to be short lived,
- 2- tax credits are due to be extended for a further five months,
- 3- the inventory effect will remain strong over the next two quarters.

These technical aspects aside, job trends will be the key factor that determines whether the recovery will spread through the economy.

However, the financial stress at the height of the crisis was so intense that it caused an excessive adjustment to employment. Now that the stress has subsided, job losses should come to a virtual halt at the start of 2010, paving the way for capex to rebound in the second half.

On the earnings side, 82% of firms that have reported have beaten expectations. Profits are down by "just" 16%, compared with a forecast 23%, confirming the slowdown in the earnings slide that has been underway for the last nine months. Moreover, excluding financials, the comparison base was not particularly favourable, at +15% excluding financials in Q3 2008. Accordingly, the 19% slide excluding financials, compared with the expected 31% decline, is a strong performance. Furthermore, whereas cost cutting mainly saved first-half earnings, Q3 earnings are of a higher calibre. Sales have held up better than expected, falling just 6%, compared with 15% in the second quarter.

■ Delphine GEORGES / Ibra WANE

"Results were on target"

Equity market indices

	At 2nd Nov. 2009	Performance in euro (in %)	
		1 month	1 year
Europe			
DJ Euro Stoxx	258	-0.37	8.60
Cac 40	3 639	-0.29	4.37
FTSE 100	5 105	3.93	1.16
United States			
Dow Jones	9 789	1.70	-10.16
S&P 500	1 043	0.27	-7.87
Nasdaq	2 049	-1.38	1.90
Asia			
Nikkei	9 803	-2.12	6.30
MSCI Asia Pac. ex. Japan	399	-0.09	36.60
MSCI World	783	0.41	-0.83

Source: Datastream, CAAM Strategy



SECTORS (Equities)

Shift in sector themes

Sector performance at 2nd Nov. 2009*

	% change 1 month	% change year on year
Energy	4.68	-3.12
Materials	2.31	18.34
Industrials	-0.99	-0.63
Consumer Discretionary	0.59	2.73
Consumer Staples	2.57	-2.59
Health Care	-0.77	-8.40
Financials	-1.16	-3.54
Technology	0.67	9.54
Telecom. Services	-1.06	-2.47
Utilities	-3.49	-14.92
MSCI World Index	0.41	-0.83

* Performance in Euro
Source: Datastream, CAAM Strategy

We have been upbeat on cyclical stocks since April, but they are now demandingly valued so we are looking to adopt a more balanced allocation and re-weight some defensive sectors. Cyclical re-rating, led by risk repricing and expectations of economic recovery, is nearing an end and the market thus seems to be entering a new phase. Since the rally began, it has been driven by the search for value and renewed appetite for risk. These two drivers should now give way to more fundamental factors such as earnings momentum and the medium-term growth outlook to differentiate between stocks. This "style" shift is likely to affect the

sector allocation and prompt a reweighting of attractively valued defensive sectors such as telecoms, healthcare and energy.

Nevertheless we are still positive on some cyclical sectors that are linked to capex, including technology and industrials, even though they may take a breather in the near term, as there is still considerable scepticism about whether the recovery will last beyond the "automatic" rebound, and no immediate answers will be forthcoming. We are now more cautious on consumer discretionary sectors where valuations are stretched.

■ Delphine GEORGES / Ibra WANE



CURRENCIES

Diversify emerging currency risk

Exchange rates

	At	% change	
	2 nd Nov. 2009	1 month	1 year
EUR/USD	1.48	1.45	16.85
EUR/GBP	0.90	-1.55	15.28
USD/JPY	90.34	0.60	-8.27

Source: Datastream, CAAM Strategy

The combination of global recovery, weak inflation and ultra-expansionary monetary policies forms a heady mix that lifts financial assets. These assets have appreciated sharply year to date, and some have even returned within range of their pre-crisis levels. But the uptrend now looks set to falter because of over-pricing, excessive positioning and the prospect that monetary policies will return to normal, thus reducing liquidity.

Policy tightening has a positive impact on the forex universe, in contrast to conventional risky assets, because it pushes up the carry and the fundamental value of a country's currency. What really counts, naturally, is the relative degree of tightening between countries, hence the strong attraction exerted thus far by the currencies of the countries furthest advanced in the cycle, namely

Australia, China and Brazil. Positioning and valuation for these currencies have become extreme, and opportunities are therefore shifting towards the next group of countries that are likely to tighten monetary policy and whose currencies are still undervalued: South Korea, India, Poland and Mexico.

These countries' banking systems did not experience the same difficulties as those of the G3, so credit distribution reacted swiftly to interest rate cuts. As a result, inflation expectations are less firmly anchored and a degree of monetary activism is likely in 2010. Exposure to these currencies offers another advantage: it will behave better than a position in other risky assets if global liquidity tightens.

■ Loïc CADIOU

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