

## Strategy and economic research

## Market Insights

### KEY TOPICS

#### Equity markets: monetary and fiscal tightening

The Greek sovereign debt crisis and China's monetary tightening have caused concern and confusion in equity markets. US and eurozone markets have corrected by 8% and 11% respectively from their earlier highs. To understand the factors influencing markets in 2010, a review of equity market behaviour in previous phases of exit from recession and early tightening is helpful.

Page 2

#### The recovery in the eurozone housing sector will be some time coming

After rising for over ten years, house prices fell in the eurozone in the first half of 2009. Mortgage rates have been falling significantly for nearly a year now. Mortgage lending is picking up, but will this be enough to trigger an upturn in residential investment and a return to rising prices? Probably not straight away. Lending conditions remain tight, the labour market is set to deteriorate further in the eurozone in 2010 and prices have not fallen enough in most countries. We expect residential investment to contract further in 2010, and prices to continue to fall on most markets. Investments in housing market have to be very selective.

Page 3

#### The Russian recovery begins

We recently visited Moscow to refresh our views on the Russian Federation in light of the deep recession that sprang from the global credit crisis. Following a large number of meetings with policymakers, companies and well-connected political and economic analysts, we depart Moscow with our views broadly unchanged regarding the macro and market outlook. We are constructive on the market, but not overly bullish on the macro story.

Page 4

#### Market Data

Page 5

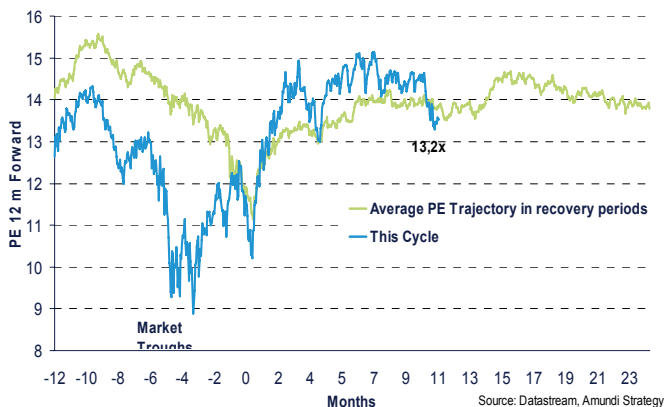
## Equity markets: monetary and fiscal tightening

The Greek sovereign debt crisis and China's monetary tightening have caused concern and confusion in equity markets. US and eurozone markets have corrected by 8% and 11% respectively from their earlier highs. To understand the factors influencing markets in 2010, a review of equity market behaviour in previous phases of exit from recession and early tightening is helpful.

### > The valuation question

Equity market multiples have expanded strongly until now. In the 11 months from November 2008 to October 2009, 12-month forward P/E ratios rose from 8.9x to 15.1x for the S&P500 and from 7.3x to 13.3x in Europe. This initial phase is thus equivalent to comparable past periods (graph). In addition, the rapid recovery in valuations in the post-recession period is generally followed by a fairly lengthy phase in which multiples stabilise or contract.

Historical S&P 500 PE Trajectory 12 month before and 24m after the trough in the Market



The beginning of this period generally coincides with renewed earnings growth. At this stage of the cycle, the still-fragile macroeconomic environment inevitably raises questions about the recovery's sustainability, and investors are not yet willing to pay for future growth. Furthermore, concerns about tighter monetary conditions and expectations of higher real interest rates are putting downward pressure on valuations. At present, aside from a possible rebound in P/E ratios (already back down to 13.2x in the USA), valuations are likely to stabilise or even contract over the next 6 to 12 months compared with end-2009 ranges of 14x-15x in the USA and 12.5-13x in Europe (11.5x at present).

### > As money starts to tighten, equities consolidate and correct

Examples of this pattern can be found in the past two episodes of initial monetary tightening in the USA. In both cases, in 1994 and 2004, equity markets fluctuated within a trading range for several months with corrections of some 10%-12% before trend-

ing back upwards when it became clearer that the economic and earnings recovery would last. The notable difference between these two episodes was the timing of the correction and consolidation phase. In 1994 it started with the first interest rate hike and ended 10 months later. But in 2004 it began six months earlier and was nearly over by the time the Federal Reserve tightened. This disparity is due to the way that the Fed has conducted monetary policy. In 1994, it did not issue statements or announce decisions after FOMC meetings, so the first interest rate hike produced a surprise effect. By 2004, however, it was communicating in greater detail and was therefore able to steer markets' expectations more gradually.

### > This time, tightening on several fronts is a source of volatility

Although the timing of the Fed's first target rate hike, expected in late 2010, is crucial, attention should also be paid to plans for fiscal tightening (which is already starting to affect growth expectations in the eurozone), the end of quantitative easing and China's tightening. Equity markets seemed to have started the year in the belief that tightening would be orderly and far off. But since January (earlier than expected), they have been faced with the risks arising from withdrawal of exceptional monetary and fiscal support measures amid a sluggish recovery. In some eurozone countries, fiscal tightening is likely to begin sooner than expected. Despite eurozone's fragile and lacklustre recovery, fiscal policies will probably be more restrictive in Portugal, Greece and Spain, whether to comply with budget rules, calm fears over government debt levels, or respond to pressure from financial markets. Thus the bullish momentum of eurozone growth expectations has been checked. The theme of large-scale government deleveraging is unprecedented, so the accompanying uncertainty is considerable. Moreover a watchful eye must be kept on the effects of central banks halting the asset purchase programmes that have sharply reduced risk premia and interest rates.

### > High hopes for the earnings season

The US earnings season has confirmed that top-line growth has resumed, restructuring efforts are still paying off and operational leverage is in full swing at this stage of the cycle. In fact 74% of companies published earnings that beat analysts' forecasts for the fourth quarter of 2009, and 2010 estimates for most US sectors have been revised upwards. US companies are also confirming that cash flow is strong – a positive sign for dividends.

*Delphine Georges*

## The recovery in the eurozone housing sector will be some time coming

After rising for over ten years, house prices fell in the eurozone in the first half of 2009. Price trends vary considerably between countries, and unsurprisingly those countries where prices rose the most have seen the sharpest decline. Mortgage rates have been falling significantly for nearly a year now. Mortgage lending is picking up, but will this be enough to trigger an upturn in residential investment and a return to rising prices? Probably not straight away. Lending conditions remain tight, the labour market is set to deteriorate further in the eurozone in 2010 and prices have not fallen enough in most countries. We expect residential investment to contract further in 2010, and prices to continue to fall on most markets.

### > An upturn in mortgage lending

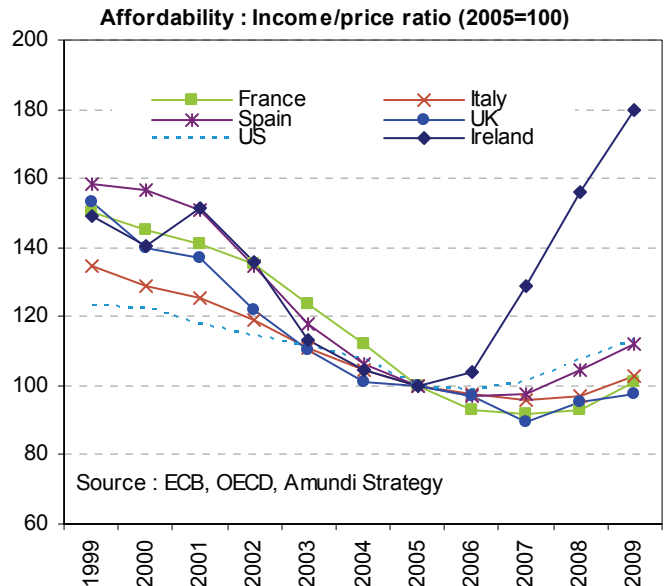
After declining for seven consecutive months, mortgage lending is picking up (+1.4% in December y/y). This is in stark contrast to bank lending to non-financial corporations, which remains depressed (-2.7% over the same period) and consumer credit, which has risen only 0.6% year on year. This is encouraging but does not reflect a major improvement.

Average mortgage loan rates have fallen sharply since the beginning of the crisis, declining from 5.5% in mid-2007 to 3.8% at the end of 2009. However, according to the ECB's Bank Lending Survey, bank credit standards remain very tight, even for housing loans, as the number of banks tightening their credit terms has outstripped the number of banks easing their terms quarter after quarter since mid-2007. The net difference is moving towards zero, which suggests that the tightening of lending conditions is nearing its end. But the easing has not yet begun. The same survey shows that demand for housing loans is picking up, as the number of banks reporting increased demand is rising. The reason given is that the outlook for the housing market is positive for the first time since 2006.

### > Housing markets are slightly more affordable

The countries that saw the strongest price rally between 1999 and 2005 are those that have seen the sharpest decline since the start of the crisis. Over the past two years, housing prices have fallen by 22.3% in Ireland, 7.5% in Spain and 9.8% in France, after posting an average increase of between 11.2% and 13.8% between 1999 and 2005 (ECB data). The German housing market was sluggish during the boom years, and has remained that way as Germany has not yet absorbed the over-investment of the early 1990s that followed the country's reunification.

One of the decisive elements in housing demand is affordability, and one of the indicators of this is the ratio of disposable income to house prices. This ratio is rising sharply in Ireland and improving considerably in Spain (by as much as the US), but has only just begun to turn around in France and the United Kingdom.



### > But it is too early to envisage a recovery

Consumer debt levels rose sharply in most countries during the house price boom, as consumers considered that the increase in their debt was offset by the rise in the value of their property assets. With the decline in the value of these assets, the need to reduce debts will limit demand for new loans. This is particularly true in Spain and Ireland, but is also the case – to a lesser extent – in France and Italy, where debt levels rose by 23 pp and 13 pp respectively between 2000 and 2008, to 76% and 42% of disposable income.

The economic recovery is set to be very modest in the eurozone. As unemployment continues to rise, consumers will be the weak link in the economy in 2010. Therefore, after falling 15% from its peak, we expect residential investment to contract further in the eurozone, especially in France and Spain. According to European Commission surveys, confidence in the construction sector, and in new orders has stabilised, but remains low. For the region as a whole, we therefore expect a continued decline, or at best a stabilisation, in prices this year again. Selective investments could, however, pay off, as there are considerable disparities within the different markets.

*Nathalie Navarre*

## The Russian recovery begins

We recently visited Moscow to refresh our views on the Russian Federation. Our views broadly unchanged regarding the macro and market outlook. We are constructive on the market, but not overly bullish on the macro story.

As time passes the more it becomes clear that the country will remain a soft dictatorship with a state-directed capitalist model. It's very difficult to see this changing with Putin at the helm, irrespective of whether he is PM or President. To use an American football metaphor, the policy game in Russia is played between the 40-yard lines. It's probably the case that the ball is currently closer to the market side of the 40 than to the statist side. But it's very difficult to envision breakout changes in the area of structural reform, energy sector policy, tax policy, or other areas of perennial interest to the market. Having said this, Russian officials seem increasingly good at using buzzwords that investors like to hear – economic diversification, privatization, modernization, improving the investment climate, etc. In theory, these are concepts that most Russian officials support. Implementation is where the rubber hits the road, of course, and where the story doesn't quite hold together.

### > Promises from the government

All of the public comments from Russia's economic policymakers these days are about diversifying the economy, attracting foreign investment, reducing corruption, eliminating red tape, etc. Few policymakers provide much detail about these topics, with the occasional exception of less significant issues such as immigration policy (e.g. the government says it wants to make it easier for large foreign companies to move foreign workers in/out of Russia). More generally, officials talk about continuing their ongoing efforts in housing reform (to promote greater internal labor mobility), better education (to increase human capital), and improved public health. They also talk of judicial reform. Alas, all of these areas have been stated priorities for many years without producing significant progress. Talk of privatization is more interesting, in our view. Many entities saved by the state during the 2008-09 crisis will eventually be re-privatized. This may bring about some interesting opportunities, although we see this as more of a story for 2011-12 than for 2010. Investors should also watch this process carefully as Russian re-privatization could in some cases prove insufficiently transparent, perhaps motivated by personal gain for well-connected allies of the government.

### > The temptation not to diversify

The run-up in oil prices during 2H.09 has pleasantly surprised Russian officials. On a less positive note, the impetus to diversify Russia's economy away from energy products predictably declines whenever world oil prices are high. Thus, while many officials express a desire to promote other sectors (high-tech, biotech, auto parts, healthcare), investors should watch both the follow-thru and the methods for driving economic diversification.

We understand that some senior level technocrats responsible for diversification efforts have recently noted (privately) that Germany's diversified economy contracted by 5% last year while commodity-dependent Russia contracted "only" 8%. In other words, why go thru all the struggle and expense of promoting alternative sectors if global recessions have similarly terrible impact on two such distinct economies. No Russian official would be silly enough to voice such views publicly, but it's nevertheless disconcerting to hear privately.

### > No miracle on corruption

Regarding corruption, we remain cynical about crackdowns. Everyone knows that rent-seeking in Russia is a chronic, serious and long-standing problem. Big progress in this area will require many years and big reforms to multiple layers of the bureaucracy. We are also disheartened by the fact that many of the freshly-scrubbed officials promoting anti-corruption may not be above reproach. How else to explain the expensive German cars they drive and the swanky central Moscow apartments they call home. None of these luxuries is affordable on typical Russian government salaries unless one has "alternative" income sources.

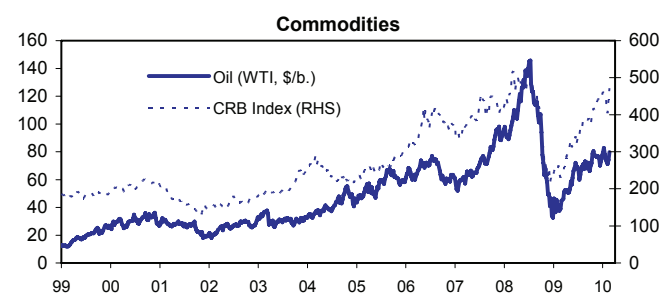
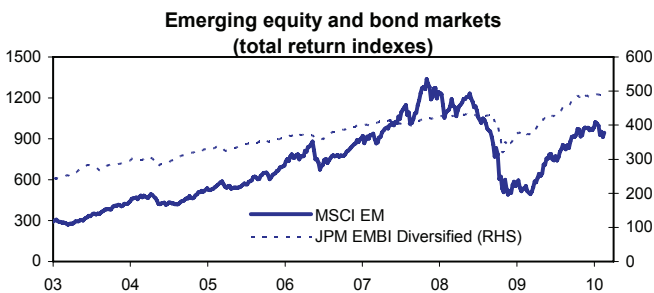
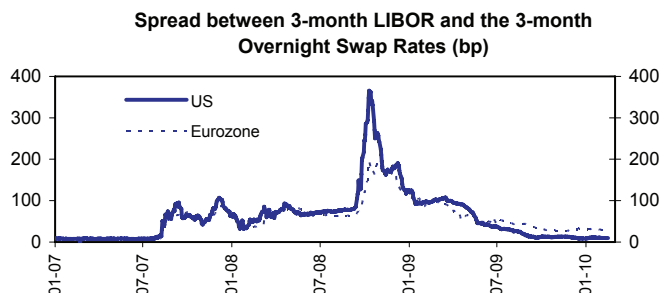
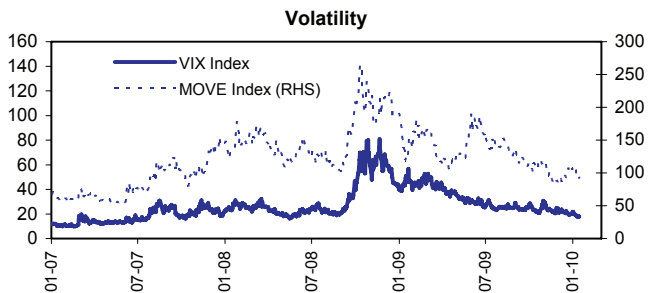
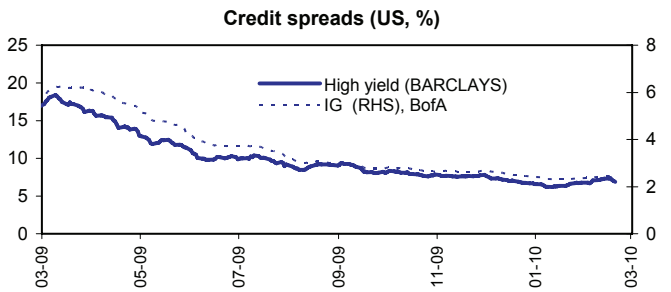
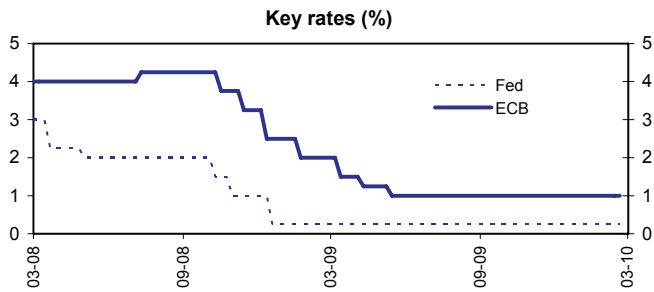
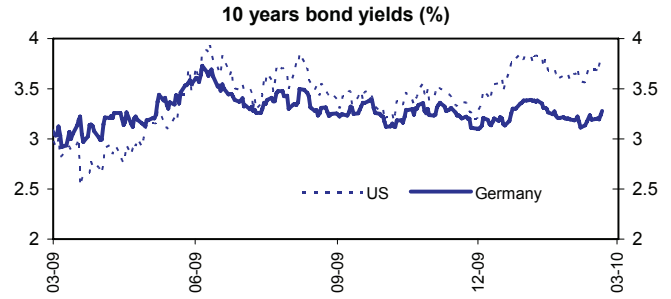
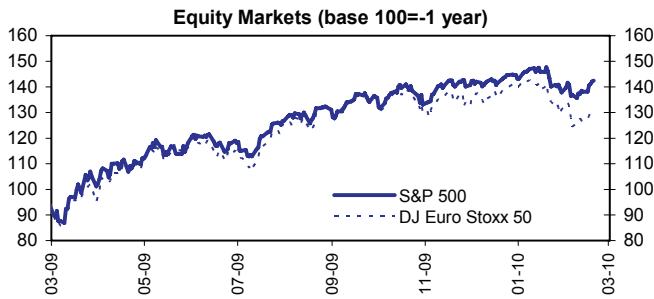
### > 2010, the year of recovery

While we are ever mindful of Russia's dark underbelly, we are not particularly negative. Among the more positive aspects of the Russia story, 2010 will clearly be much better than 2009 from a macro standpoint. Credit growth remains largely absent post-crisis, but GDP is likely to expand by around 4% this year - supported by positive base effects, the higher oil price, and continued counter-cyclical fiscal policies. At the same time inflation is trending lower with the consensus looking for CPI below 8% this year (this would be a post-Soviet low for Russia). Fiscal performance depends largely on the oil price. The budget will balance if oil averages around \$80 per barrel in 2010. The budget was written with an assumed oil price of \$58, which is why Russia intends to issue external sovereign debt this year for the first time since 1998. Officials have made it clear that the Russian Federation intends to issue bonds in April-May. Locals are divided over how much the RF will issue this year, but we look for at least \$8-10bn, mostly in USD as the MoF looks to establish a few key benchmarks along the USD curve. The RF is also considering a global bond in rubles due to the high level of foreign investor interest in RUB.

Speaking of the ruble, it's hard to find Moscow-based analysts who aren't constructive. Most of the bullishness is against the USD:EUR basket, but even against the dollar the RUB is seen appreciating between 3-8%. We are on the conservative side of this spectrum due to lingering concerns about a global deceleration in 2H.2010 and continuing EUR weakness in the short term (Greece, etc), but a somewhat stronger ruble remains the base case over the next 12 months.

*Blaise Antin*

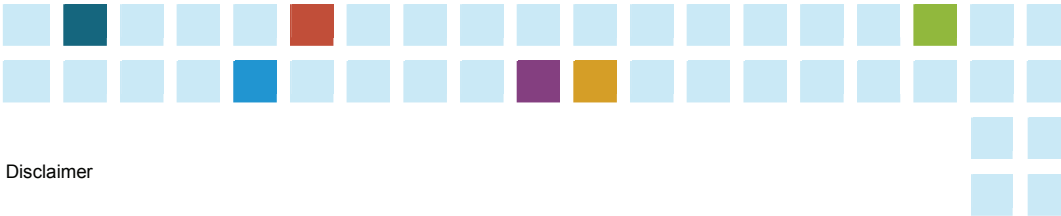
Market Data



Select Global Exchange Rates (February 19, 2010)

	F/X Rate	% Ch. WoW	% Ch. YTD	End year			
				2009	2008	2007	2006
USD/EUR	1.36	0.0%	-5.8%	1.44	1.39	1.47	1.32
USD/GBP	1.56	0.0%	-3.7%	1.62	1.46	2.01	1.96
GBP/EUR	0.87	0.0%	2.2%	0.89	0.95	0.73	0.67
JPY/USD	90.13	0.0%	2.6%	92.43	90.64	112.04	119.16
JPY/EUR	122.3	0.0%	8.9%	133.2	126.1	164.9	156.9
CHF/USD	1.08	0.0%	-4.6%	1.03	1.07	1.12	1.22
CHF/EUR	1.47	0.0%	1.3%	1.48	1.49	1.65	1.61

Sources: Strategy and Economic Research Amundi Group, Datastream and Bloomberg.



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