

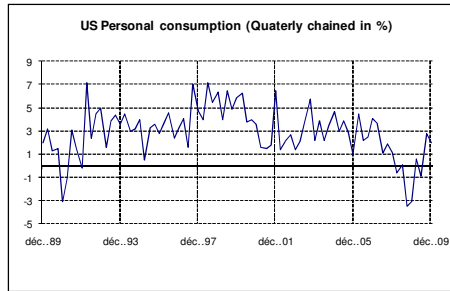
MONTHLY REVIEW

Macroeconomy and Financial Markets
Sébastien Cordoliani – Asset Manager

Macroeconomic Situation - February 2010

We are going to discuss two major subjects this month: (i) the better than expected fourth-quarter 2009 US GDP release; and (ii) a review of certain fundamentals in Southern European economies: a key topic with markets again volatile due to debt concerns over Greece, Spain, Portugal and so on.

$$G = C + I + G + (X - M) + \Delta \text{ stocks}$$



US:

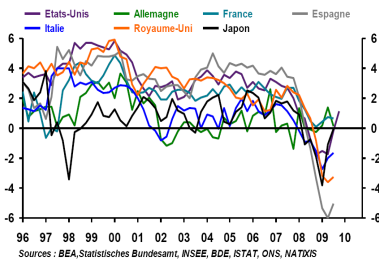
Consumer spending continued to contribute positively to economic growth in the last three months of the year. It was the second quarter running that consumption acted as a growth driver. However, we can note that the expansion was slower than in the third quarter – at 2% against 2.8% – and the trend is still below the long-term average, of which the pre-crisis level was significantly more than 3%. We already highlighted this factor in our previous newsletters and it will continue to be relevant for as long as unemployment and household debt reduction remain significant.

Southern Europe:

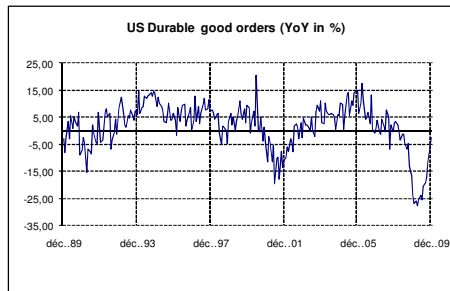
January was particularly eventful for what are considered the weaker eurozone countries of Greece, Spain, Portugal and Italy. Analysing these countries' economic fundamentals, we can see that such pressures are justified. The graph opposite shows the dramatic tumble in Spanish consumer spending. This country based its growth on the construction sector and unemployment surged when this industry's bubble burst. Consumer spending drivers now look in a precarious state and the overall standstill in the real-estate sector is going to weigh heavily on many key components of the economic machinery: local banks may be the next ones to suffer.

Greece does not feature on this chart but suffered a similar fate in 2009, with retail sales plummeting by 9%.

Consommation des ménages en volume (GA en %)



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US:

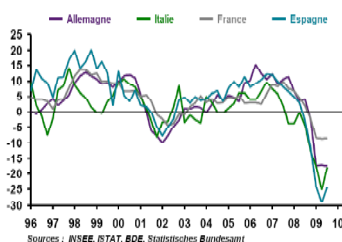
Investment is in the process of recovering from a state of considerable weakness. Let us not forget that it contracted for seven consecutive quarters. Two factors are at work in this positive news: significant base effects and the impact of the change in private inventories investment. For as long as visibility on growth remains limited we are certainly not on the threshold of major corporate investment projects. Moreover, even though it contributed slightly to growth in Q4, US residential property still lacks a driver.

Southern Europe:

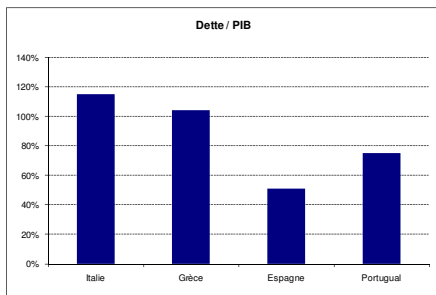
With regard to investment, there is no doubt about the situation in countries like Spain and Italy. We can see on the opposite chart that despite experiencing a modest ongoing rebound, investment remains terribly depressed.

As for real estate, in the countries that unsettled the markets in recent weeks, Spain can clearly be identified as the weak link in the chain. A redoubtable property bubble is in the process of leaving the country in a very fragile situation – one that could deteriorate. To illustrate this, we took a look at building permit figures. In 2006-2007, Spain granted more than 1.5 million permits per year. Today, we are seeing a rate of 150,000.

Investissement productif (volume, GA en %)

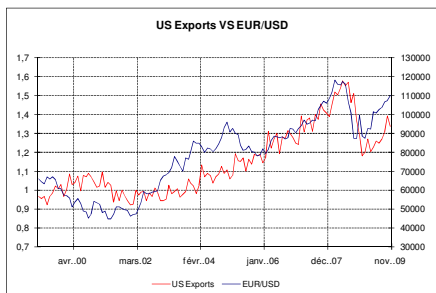


$$G = C + I + G + (X - M) + \Delta \text{ stocks}$$



There are large differences among the levels of government debt in southern European countries. Indeed, despite the weak points we underlined for the country, Spain has one of the smallest debt ratios, at 65%, even though it is increasing rapidly. Greece, which encompasses the full range of concerns, has more than 105% in debt. Italy is at the same level. Above all – and beyond debt ratios – it is governments' credibility for embarking on structural reforms that is in question. The size of a country is also important, with Italy not experiencing an increase in rates in the same way as Greece or Portugal. We can see that many eurozone countries have ceased to comply with the Maastricht debt criteria, not just Mediterranean countries: France is an instructive example. The government debt crisis is widespread, from the US through the UK to Greece, and this is the cost of the crisis we have just weathered. Even before the crisis, potential European growth rates did not allow for debt reduction. Now European countries are up against the wall; they must take hard structural decisions to cut deficits.

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US:

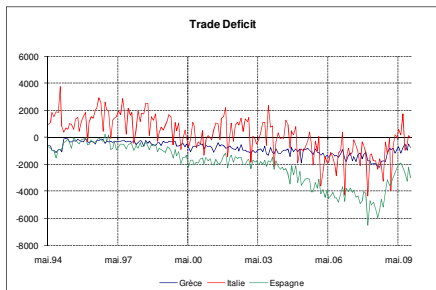
The fourth-quarter's exports increased compared with the preceding three months, although November's figures were down on October and December's data is not yet available. Consequently, the contribution made by foreign trade to GDP will only be definitive in the next GDP estimate.

Southern Europe:

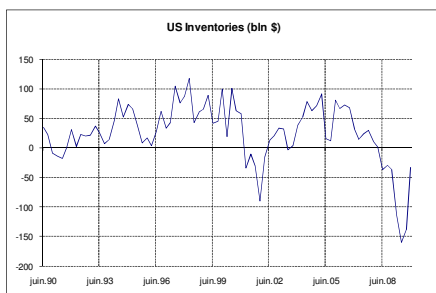
Greece and Spain have the same trade balance profile:

- a long-term structural deficit; and
- a strong cyclical improvement since mid-2008.

Meanwhile, Italy appears to be different. It has undergone two clear stages: a long-standing positive structural balance and then – faced with competition from Asia and the Maghreb – its foreign trade figure became much more volatile and is now often negative.



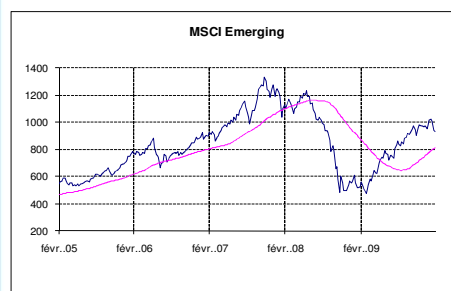
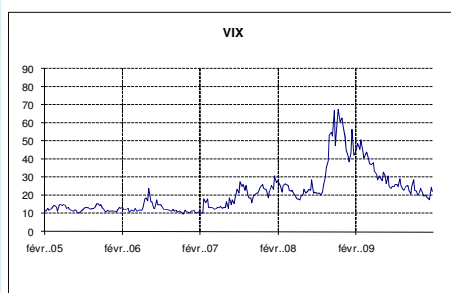
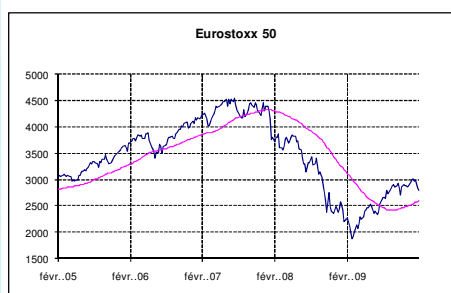
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Figures for changes in inventories support our analyses of the last few months. Indeed, although we expect economic recovery, this should be driven by increases in inventories and so be largely technical – at least initially. The fourth-quarter GDP figure showed that favourable developments continued thanks considerably to the contribution (+3.39%) from private inventory investment. It is worth noting we are still not in a phase of restocking, just one of less destocking (USD -33.5 billion against USD -139.2 billion in the third quarter of last year). This still shows that while growth is returning, for now it is neither healthy nor structural.

Market Situation - February 2010

Stocks – Bonds – Risks



After a positive first session, turbulence returned to the stock market. Indeed, the Vix volatility indicator rebounded sharply, to 30, after having declined to less than 20. This was the result of several factors:

- both Barack Obama's speech and other policies that increasingly advocate constraints on banks, particularly in their trading activities; and
- concerns over government debts in the eurozone's weaker economies (Greece, Italy, Spain, Portugal and so on).

It is now clear that the banking landscape will differ in future, with much smaller ROE ratios. The government debt of some countries will also weigh on growth. Uncertainty and renewed political pressure have stepped up pressure on stock markets again, despite better than expected US company results. Indeed, up to now, 75% of corporate results have beaten the consensus. This welcome information was not flagged up, meanwhile, showing that news flow on politics is in the ascendancy and such results were already anticipated.

Performances:

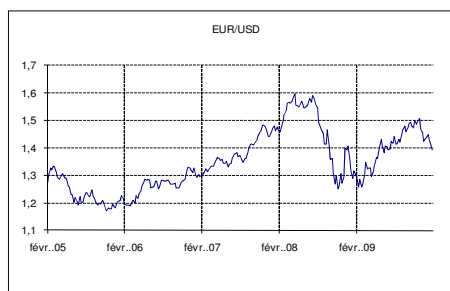
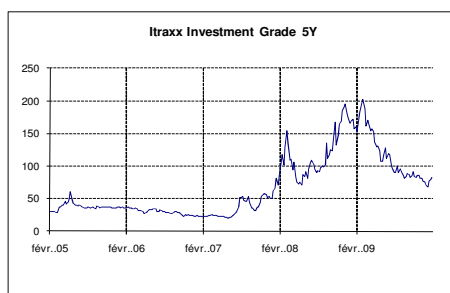
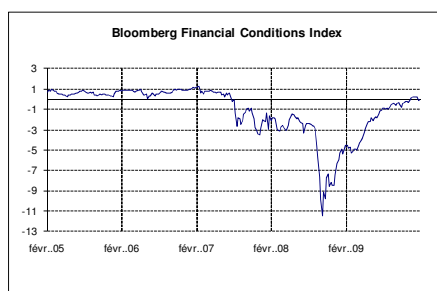
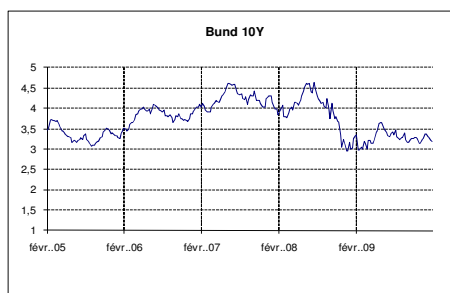
- -6.35% for the EuroStoxx 50;
- -3.7% for the S&P 500;
- -5.37% for the Nasdaq; and
- -3.3% for the Nikkei.

Emerging Markets:

Most emerging economies suffered the same type of disappointment in January, particularly China. Beijing announced several measures to limit an expansion in credit that risks generating bubbles. As can be seen on the chart opposite, the Chinese market has been trading sideways for several months. Despite the vigorous expansion in emerging economies, as we highlighted in our previous newsletters, emerging equity prices were a bit too removed from their moving 200-day average and so were liable to correct in the near term. The exception at the start of this year has been Russia, posting positive returns. It is also worth pointing out the stunning performances in the Baltic states, which have already recorded more than 30% in gains so far this year.

Performances:

- -4.65% for Brazil;
- -8.78% for China; and
- +2.02% for Russia.

Stocks – Bonds – Risks**US/Europe:**

Bond market performance has been mixed, with German and US yields declining under pressure from risk aversion, as already referred to in the section on stocks. The key factor is of course intra-European spread widening. The most significant case is Greece, with its 10-year yield exceeding 7% in the month. The calamitous fiscal situation and debts of more than 100% of GDP have left the country in a vicious circle that is very difficult to stop. Indeed, many countries would find such a situation problematic in any event, yet Greece is also experiencing political difficulties. There are serious question marks over the government's credibility for implementing an austerity plan. Other countries like Portugal also experienced spread-widening. Spain is mired in an historic property crisis and could suffer the same fate. Although the situation is challenging, we do not expect Greece or any other eurozone country to default, since it would purely and simply represent the end of the European project and single currency.

Emerging Economies:

Emerging market debt underwent two stages in January:

- satisfactory performance in the first two weeks of the year thanks to ongoing spread-narrowing and the outlook for tighter monetary policies in these regions; and
- then, China's announcement of an increase in the reserve requirement – from 15.5% to 16% – and southern European countries' public deficit financing problems, sending a chill through the markets. The return of a certain amount of risk aversion required Hungary, for example, to offer a larger yield than Turkey, while Vietnam delayed a placement and increased its issue's yield to ensure success.

Corporate Bonds:

Risk aversion resulted in an albeit modest widening of corporate spreads. With systemic risk no longer as it was in 2008, spreads should remain at such levels. However, in fragile economies where government yields have soared, the risk on corporates could again become worrying. Selection of companies will be predominant and it is perhaps worth avoiding categories where regulators are exerting pressure, such as subordinated bank debts.

Raw Materials and Currencies:

The inverse relationship between the US dollar and stock markets persisted, under the weight of risk aversion. Indeed, the US currency appreciated strongly against the euro. Intra-European spread-widening did not help the euro's performance. As long as this more or less institutional crisis is unresolved, the single currency will remain under pressure. Following the same reasoning regarding de-risking, the yen appreciated further, particularly against the euro, thus continuing to weigh on exporter groups' competitiveness.

In the wake of the rising greenback, oil tumbled sharply. The lack of a clear recovery in OECD economies together with large inventories have put downward pressure on prices. Moreover, recent risk aversion undoubtedly brought certain speculators onto this market. The undetermined intentions to dampen credit in China are also prompting some investors to speculate on a slowdown in growth and therefore demand.