



INVESTMENT | STRATEGY

QUARTERLY BULLETIN

N°5 → JANUARY 2009

P.2-3 → **ECONOMIC OUTLOOK**

P.4 → **INVESTMENT
RECOMMENDATIONS**

P.5-6 → **THEMATIC FOCUS**
India, the other Chindia giant

This document is the fifth edition of a quarterly bulletin on investment strategy and asset allocation produced by the investment strategy team at La Compagnie Financière Edmond de Rothschild Banque.

→ EDITORIAL

Please accept our very best wishes for this new year.

In the precarious world of forecasting, 2009 is no longer a real test since just about everyone agrees that it will probably be the worst for the global economy since 1982. Since the autumn, the collapse in global activity and in credit has been spectacular. The economic growth of the G3 countries looks to be significantly negative at the turn of the year. This is why the monetary and political authorities are resorting to shock therapy, after a whole battery of measures some of which have been in place for several months.

This frenzied pro-activeness should succeed but there will be periods of deep doubt since the way back to a more stable economic situation and a climate of confidence will be long and complex despite the imaginative policy responses, both conventional and unconventional, that have been deployed. The global economy should start to recover in the second half of the year provided there is no delay in implementing the promised measures. Currency volatility and possible competitive devaluations represent the main risk factors to be monitored closely.

In this difficult environment, portfolios must start the year configured to weather this complex and high-risk context.

Dominique Netter

Chairman of the Strategic Asset
Allocation Committee

Written 9 January 2009

» THE RECESSION SPARES NO ZONE

A calamitous year for the global economy that will probably see a contraction in Q4 2008 and Q1 2009. All economic players are being affected. Despite the shock therapy, the global economy will be on a crash diet in 2009. Against this backdrop, the spectacular fall in inflation is good news.

See p. 2

» SHOCK THERAPY

While the action taken by the monetary and political authorities has succeeded in reducing the financial strains in a number of areas, they must now combat the credit paralysis. Quantitative fiscal and monetary policies will be centre stage. The next six months will be critical.

See p. 2

» THE EQUITY MARKETS; PATIENCE STILL NEEDED

Valuations are low and earnings momentum will remain negative. There will be some false dawns but, over the course of the year, it should be possible to adopt a more positive stance.

See p. 3

» GOVERNMENT BONDS

European government bonds should prove defensive in the event of bad economic news.

See p. 4

» FOCUS: INDIA, THE OTHER CHINDIA GIANT

The economy is being impacted by both internal and external shocks. The government is focused on mitigating the slowdown. The excessive valuation has been corrected on this market. It looks attractive on a medium-term view.

See p. 5

As this year begins it is difficult to escape the word recession which figures in the 3R scenario (recession, deflation, revaluation) as opposed to the 3D scenario (depression, deflation, depreciation). While we shall no doubt have to endure periods of deep doubt, we favour the former. Currently, there are powerful recessionary forces at work. The way back to a more stable economic situation and a climate of confidence will be long and complex despite the imaginative responses being deployed. The shock therapy implemented by governments to combat the economic and credit contraction should succeed but the global economy will not escape a crash diet.

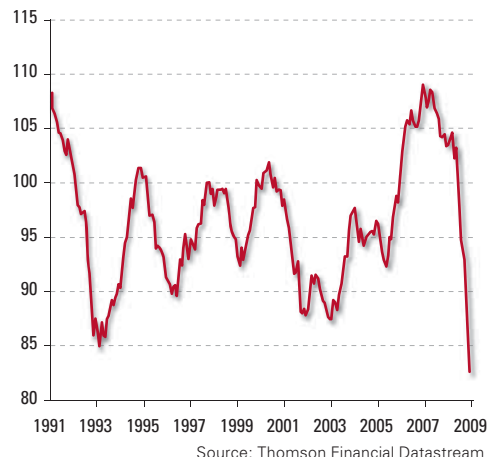
SHOCK THERAPY; MEANS BEFITTING THE RISKS

While, thanks to the slashing of official interest rates and the widening in the suite of tools deployed, the central banks have succeeded in normalising the interbank lending market, shoring up the bank sector and starting to unlock mortgage lending, credit distribution and the private debt market remain frozen. Rate cuts have yet to feed through to the real economy since the banks are increasingly reluctant to lend, preferring to park their liquidity with the central banks for a zero return. They could maintain this attitude for several months as they are going to have to contend with new write-downs leading to a fresh round of recapitalisations. This is why the US Federal Reserve must replace the banks in purchasing securities issued by the private sector and creating a boost to confidence. It has started with mortgage-backed securities and will do the same with corporate bonds in order to lower rates. It also stands ready to purchase Treasury securities to finance stimulus plans and maintain long-term interest rates at a very low level. Alongside this unconventional policy, which will be reflected in swollen central bank balance sheets, the monetary and political authorities will continue to mobilise traditional methods. The slashing of official interest rates will continue wherever there is still room for manoeuvre, which is to say in Europe and the emerging countries, the USA, Japan and Switzerland having already adopted the zero interest rate policy. In parallel, the governments of both developed and emerging countries are launching more or less massive fiscal stimulus packages. These include tax cuts, support for sectors in difficulty (automobile or semi-conductors in Taiwan) and infrastructure spending. According to the IMF, this expenditure should amount to 2% of global GDP in 2009, or USD 1,100bn, with the plans being implanted rapidly which has not always been the case to date. The United States is by far the most pro-active, as witnessed in the incoming President's plan for a minimum of USD 800bn over two years, or 6% of GDP. China is doing the same (7% of GDP this year), while Europe lagged behind with packages amounting to around 1 to 1.5% of GDP. However, the German change of stance could influence the other countries.

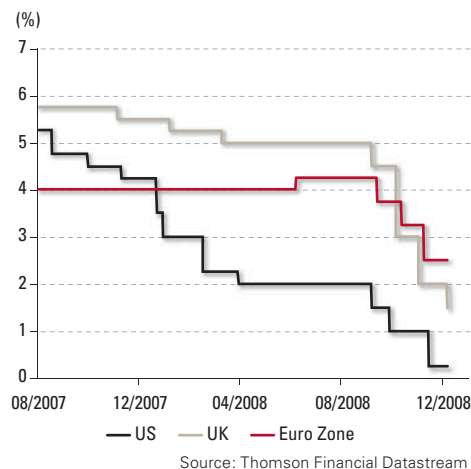
CRASH DIET FOR THE GLOBAL ECONOMY

2008 ended with very pronounced contractions in the US, European and Japanese economies as seen in the vertiginous drops in the business confidence indicators. Industrial production is effectively collapsing, led by the automobile and commodity sectors, with order books melting like snow in the sun. The emerging economies are also affected, as with China whose exports are down. Global growth could be close to zero in the fourth quarter. During the past few weeks, there have been increasingly aggressive downgrades to global activity forecasts consistent with the slump in the indicators. It is difficult to commit to a firm number in this context (1 to 1.5%?), but 2009 should be the worst year for global growth since 1982. For the first time since the end of the Second World War, the USA, Europe and Japan will all be in recession at the same time (-1%). All the components of activity are affected. Companies are going to reduce their inventories and investment spending to counter

GERMANY: BUSINESS CONFIDENCE INDICATORS



USA - UK - EURO ZONE: OFFICIAL INTEREST RATES



the pressure on margins. The employment market will continue to deteriorate, particularly in Europe and the USA. The reports on job destruction are spectacular (693,000 in the USA in December) and this environment will encourage households to save rather than spend at a time when they will be looking to reduce their debts and cope with a negative wealth effect. This trend will be particularly marked in the USA where the wealth destruction is massive (twice as high as in 2001) even though real estate prices continue to fall. This is why the Obama plan should contain a real estate component.

The European economy will be negatively impacted by the continued fall in real estate prices and activity as well as by the difficulties of the Central and Eastern European countries.

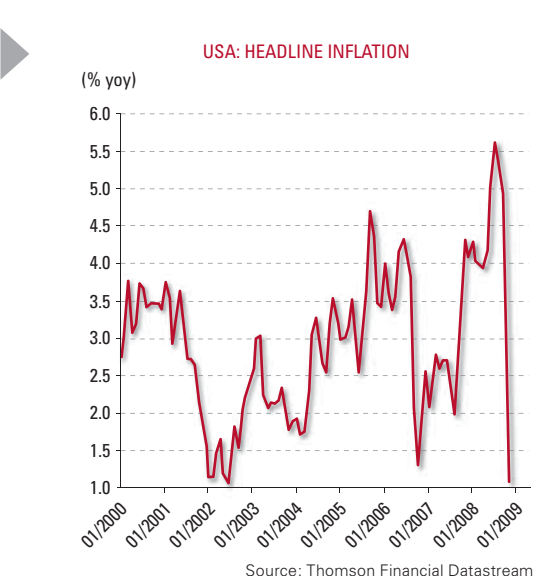
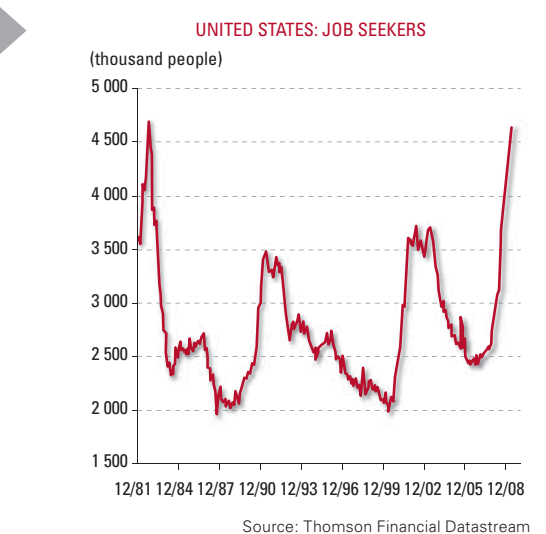
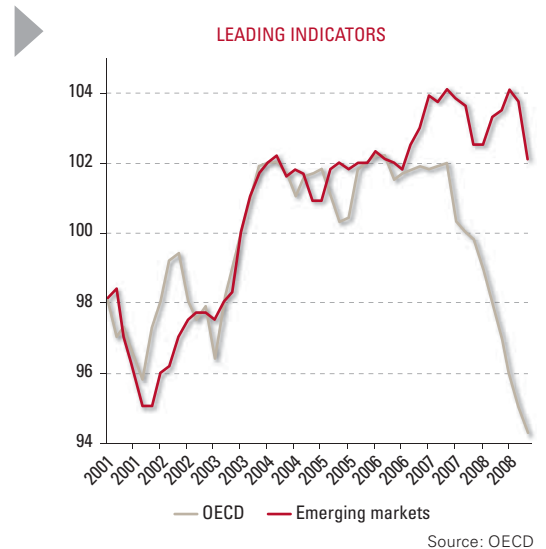
Japan, which is highly sensitive to international trade, is additionally penalised by the appreciation in the yen. The emerging countries are also seriously affected but their growth rate will remain positive thanks to India and China.

The bottom of the global cycle could be reached during the second quarter. Economic growth could again turn positive in the USA as of the third quarter if the boost to confidence works. Europe will take longer as the monetary and fiscal stimulus is less aggressive. In reality, the real question is about 2010. The level of activity should be penalised by the continued reduction in household debt (principally US and UK). Previous experience has shown that this process could last 30 months on average which, if history repeats itself, corresponds with the end of 2010.

DISINFLATION OR DEFLATION?

The latest reports show a spectacular fall in the annual inflation rate in the USA, Europe (a halving between October and December) and Japan due to the collapse in oil and commodity prices and the slowdown in demand. The inflation rate should show a further significant fall and the headline rate could even turn negative this summer, given the base effect. A lower capacity utilisation rate and a difficult economic environment could prompt companies to reduce certain prices. US inflation-indexed bonds are pricing in price falls over a 5-year period. The pro-activeness of governments should stop the deflationary effect of the reduction in debt and get liquidity circulating again. This is why we do not believe in deflation which is also reflected in a fall in revenues. This fall in inflation is good news for households and central banks however the very high volatility in inflation over the past two years is worrying economic players across the board.

The shock therapy should work and kick-start the global economy during the second half of the year if all the promised measures are rapidly put in place. This will take time. Furthermore, we will be watching a number of risk factors very closely: the instability of currency exchange rates, the time taken to implement the policy responses and the temptation to engage in competitive devaluation and protectionism.



After a disastrous year for all asset classes, with the exception of government bonds, the most risky assets look distressed with valuations low. However, it seems wise at this stage to be a little patient before taking on more risk given the length and complexity of the path to be covered in order to stabilise the economy and unfreeze the credit market. Furthermore, the direct intervention of States in certain economic sectors or asset classes may make a significant difference to the latter's financial returns. In coming years, the behaviour of stock markets could also be affected by more regulation, by State interventionism and by the reduced recourse to leverage. This will all weigh on the return on equity which, while reduced, will perhaps be more sustainable and worthy of a higher rating. We consider it reasonable to begin this new year with a mostly recession-oriented portfolio before a gradual move back into risky assets whose valuation should normalize.

GOVERNMENT BONDS: TOO SOON TO BAIL OUT

While the return on cash continues to fall it remains defensive. European government bonds (5 to 10-year) still look attractive in our view. Even if we have come a part of the way, the growth-inflation balance and continued cuts in official interest rates should enable a further fall of at least 50 basis points. It is difficult to believe that bonds look dangerously exposed in coming months as some commentators are suggesting.

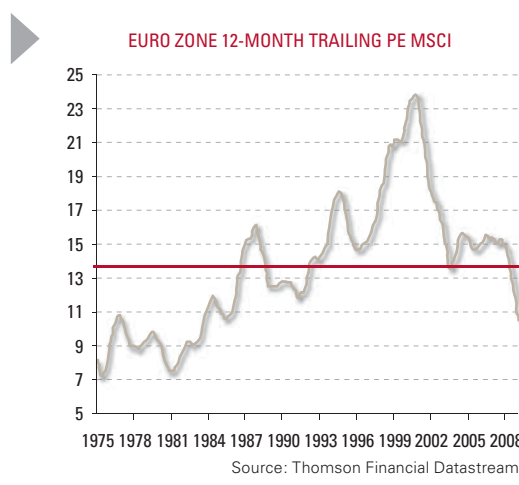
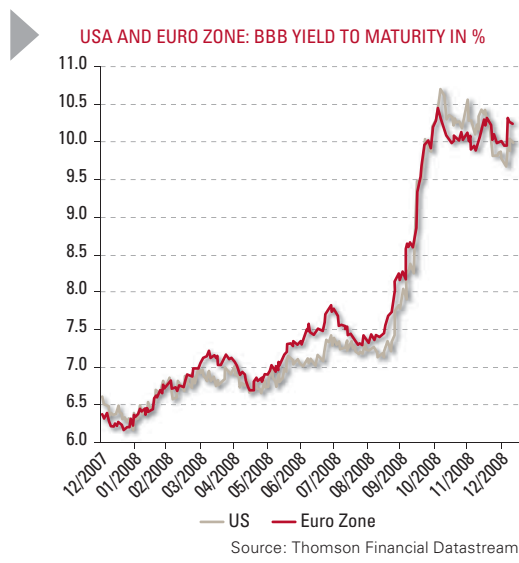
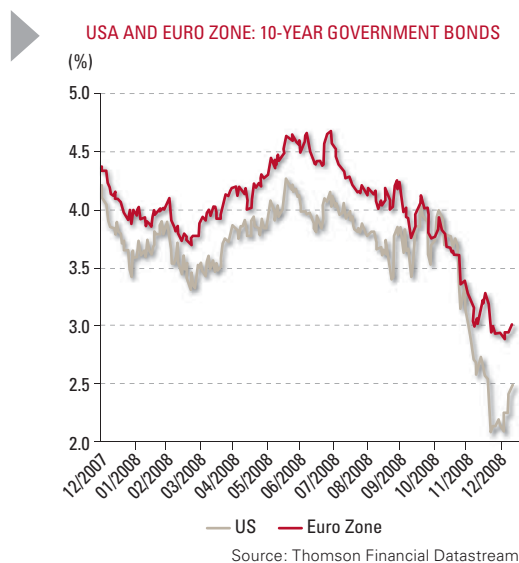
CREDIT MARKET: A GRADUAL, SELECTIVE RETURN

The credit market is at the heart of both the financial crisis, via the increased cost and scarcity of company refinancing, and the liquidity crisis. Consequently, spreads have soared and their current level is pricing in a scenario as gloomy as that of the 1930s. This looks excessive in our view, even if the default rate is increasing markedly. This asset class offers the attraction of a very high yield, enabling the absorption of any bad news. Gradual and selective investment in credit throughout the year looks interesting.

EQUITIES: YIELD AND PATIENCE

Earnings momentum will be key. The major stock market indices have priced in an earnings contraction of around 35% from the 2007 high, a fall compatible with a classic recession (1993 in Europe). Currently, there is an extreme level of uncertainty as to earnings (currency and commodity volatility, higher cost of finance, weakness of global growth). The fall could be even greater. This is what index-linked bonds and investment grade corporate bonds are telling us. Current valuation levels are well below the historic averages of the past 20 years, but still far from their absolute lows (30%). These levels may not necessarily be reached. The most likely scenario is the formation of a base around the lows with periods of hope and doubt which could be reflected in some significant rallies (between 30% and 50% based on historic precedents) and renewed setbacks. This is why a few more months of patience do not seem excessive. A number of indicators need to be watched closely before adopting a more positive stance but the unfolding economic scenario does not necessarily correspond with the typical recession cycle. Our equity stance remains concentrated on a core defensive portfolio focused on companies likely to pay high dividends with modest debt levels and low earnings volatility.

To this portfolio, two pockets could be added; a touch of gold in order to offset currency volatility and exposure to two key alternative multi-management strategies (global macro and long/short).



» INDIA: THE OTHER CHINDIA GIANT

A nuclear power since 1998, India is the largest democracy in the world with 1.1 billion inhabitants and ranks number twelve globally in terms of GDP – USD 1,171 billion in 2007. This is a country of many contrasts and while ‘bolligarchs’ such as Lakshmi Mittal embody the symbol of financial success, GDP per inhabitant remains barely above USD 1,000.

A SERVICE ECONOMY

Services dominate the economy with 55% of GDP, thanks to IT services with leading global companies such as Infosys, Wipro and Tata Consulting, to the pharmaceutical sector and financial services without forgetting cinema with Bollywood. This segment (52% of GDP in 2004) has seen very rapid growth. Industry contributes 26.6% of GDP, with textiles and chemicals predominant. A number of companies are known globally, like Tata Motors (the number two car manufacturer world-wide), Arcelor Mittal and Reliance (specialised in petrochemicals). Finally, agriculture, the number three cereals producer globally, accounts for close to 18% of GDP. Exports are less significant for India (22% of GDP) than for China (37%).

THE INDIAN ECONOMY FACING ITS OWN CREDIT CRUNCH

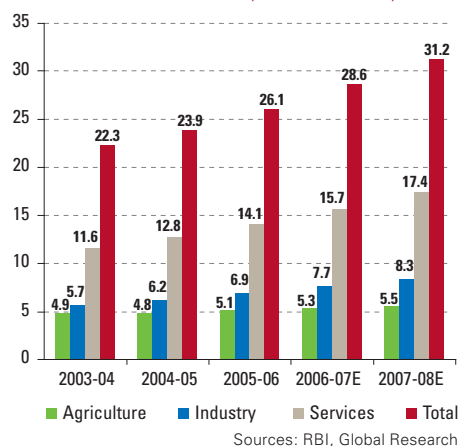
Economic activity has seen strong growth over the past three years (9.3% annually through to March 2008) compared with 6.3% for the three previous years thanks to massive inflows of foreign capital (USD 150bn in three years). This has enabled the financing of the investment cycle and of credit. Between 2003 and 2008, outstanding credit thus increased from USD 214bn to USD 643bn. However, as of the 2007 second half, the fight against inflation due to soaring commodity prices had led to a significant increase in interest rates weighing on the economy. This cyclical slowdown is being amplified by the global financial and economic crisis. Indian companies are very dependent on the capital markets and external financing which has dried up: even Tata Motors is experiencing refinancing difficulties. Massive outflows of capital have burdened the current account deficit. In these conditions, the economic environment has continued to deteriorate, with industrial production stagnating for the first time since 1993 and consumption declining (domestic car sales fell by 23% between November 2007 and November 2008). The flight of capital also led to a 15% depreciation in the currency over the year. In order to support it, the Reserve Bank of India sold USD 70bn of foreign exchange reserves which had peaked at USD 316bn last May. Economic growth should be close to 6.5% for the year ending in March.

A STIMULUS PLAN

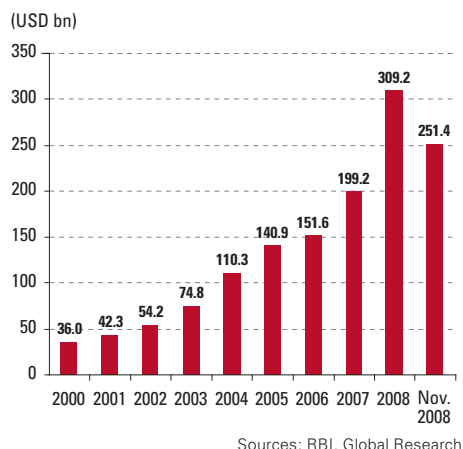
In order to head off this slowdown, the government launched a first stimulus plan (0.5% of GNI) in November and has just introduced wider-ranging measures, targeting the financing of companies and infrastructure projects, fiscal stimulus (a VAT reduction), and interest rate cuts. These should be implemented between now and the end of March. The fiscal stimulus will be limited since, unlike China (5% of GDP), the budget deficit is sizeable: it is approaching 8% including the subsidies on staple products (including fertilizers and oil). These subsidies, financed by the publicly-owned banks, were very costly in 2007/2008, since the market prices are capped. The interest rate weapon will again be massively used to support activity which should grow by 5% in 2009/2010 but significant uncertainty remains.

to be continued p. 6 >

INDIA: GNI BY SECTOR (TRILLION RUPEES)



INDIA: FOREIGN EXCHANGE RESERVES



SOME MAJOR CHALLENGES

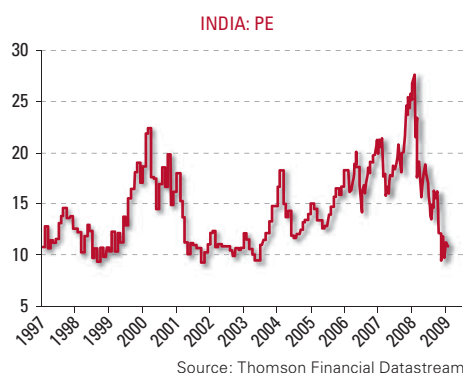
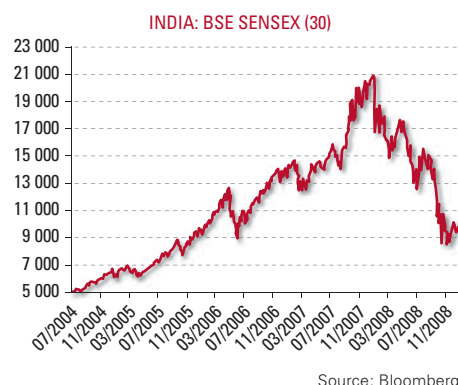
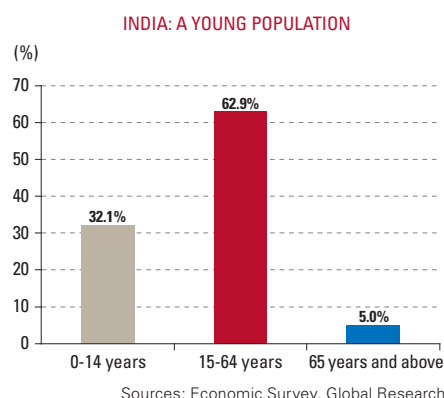
The forthcoming national elections will be held between now and the end of May. The terrorist attacks and security issues may lead to a change of government or a new coalition. The most important point is that the next government has a convincing majority in order to be able to implement a coherent economic policy and achieve the necessary reforms: dismantling of the subsidies, streamlining of administrative procedures, abolition of the significant legal differences between States and the privatisation of State-owned companies. The improvement in educational standards will also be key to leveraging the strengths represented by a young population (average age 25 years) and to knowledge of English.

The other challenge concerns the upgrading of the wholly inadequate infrastructure, particularly in electricity generation. The same is true for transport networks and the cold chain. For the 2008/2012 period, investment should amount to USD 500bn, of which one third for the energy supply, 15% for roads, 12% for railways and 11% for irrigation. In the short-term, however, the scarcity of credit is holding back this development. The government has understood this and is looking to support spending in this area.

THE INDIAN STOCK MARKET

The Sensex 30, India's benchmark stock market index, is currently capitalised at EUR 233bn. India has 6,000 companies which are listed for trading, whose market capitalisation is approaching EUR 500bn. The Indian stock market has had a fully automated trading and clearing system since 1994 and is considered to be one of the most efficient. It has benefited significantly from the introduction of the derivative products platform on the BSE and NSE in 2000.

Between December 2002 and December 2007, the index soared by nearly 500%, boosted by inflows of foreign capital and by an expansion in valuation multiples. The Indian market was the most expensive in Asia (20 times 2007 net profits and 5 times book) This premium was explained by the high level of company profitability and sound corporate governance. Between the high (January 2008) and the low (26 October 2008), the index plunged by 64%, falling by 60% in euro terms in 2008, foreign investors having withdrawn some USD 13bn. Currently the market trades at 11 times earnings forecast for the next twelve months and twice book. While these multiples are not as depressed as in a number of Asian markets, the excessive valuation has been corrected. In the very short term, uncertainties remain as to the level of activity and earnings, the outcome of the elections and corporate governance issues raised by the Satyam fraud. However, an investor with a longer time horizon should start to look at this market: it is one of the few in Asia to offer such a wide range of quality stocks, backed by a strong entrepreneurial culture. Furthermore, if the infrastructure is upgraded, as we expect, India will be the Asian country with the most solid domestic growth story.



Disclaimer: The data, comments and analysis in this document reflect the opinion of the LCF Rothschild Group and its subsidiaries with respect to the markets and their trends, regulation and tax issues, on the basis of its own expertise, economic analysis and information currently known to it. However, they do not represent a commitment or guarantee of any kind by LCF Rothschild Group or by any of its subsidiaries. The LCF Rothschild Group is not responsible for any decision to invest, sell or hold a security based on the afore-mentioned commentary and analysis. The indices cited have been calculated with dividends not reinvested.

LA COMPAGNIE FINANCIÈRE EDMOND DE ROTHSCHILD BANQUE

A French limited liability company (S.A. or Société Anonyme), with a Management and Supervisory Board and capital of 83,075,920 euros, registered with the Paris Register of Commerce, under registration number 572,037,026 and the ORIAS under No. 07 033 943
 47 rue du Faubourg Saint-Honoré - 75401 Paris Cedex 08 - Tel.: +33 (0)1 40 17 25 25 - E-mail: info@lcf.fr - site: www.lcf-rothschild.fr
 NON-CONTRACTUAL DOCUMENT - PUBLISHED 9 JANUARY 2009 - WRITTEN BY: DOMINIQUE NETTER