



INVESTMENT | STRATEGY

QUARTERLY BULLETIN

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Focus: Germany badly affected

This document is the seventh 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

The contraction in activity during the 2009 first quarter was worse than during the fourth quarter of 2008. However, the improvement in the opinion surveys of households and business leaders, as well as in a number of leading economic indicators in the United States, suggests that the contraction in economic activity is slowing, prompting even some hope of an imminent end to the recession. The second half is, effectively, opening on a more positive note. The effects of the stimulus packages will be concentrated on this part of the year; the end of destocking should give rise to a mechanical rebound in production; the easing in credit conditions, disinflation and the return of confidence to more normal levels should all continue through to the autumn, such that growth could return to positive territory during the second half in the United States. Growth forecasts, with the exception of the euro zone, are thus being revised up by a significant number of international bodies.

One worry after another. Fears about the financial sector and deflation have given way to worries of a possible return of inflation just as the latter turns virtually negative year-on-year within the G3. These worries are overdone, as are those concerning a shift in monetary policy which should remain accommodative. Questions about when and how monetary and fiscal policies will be normalised will nevertheless fuel debate and lead to volatility.

After a spectacular rebound in the equity markets which corrected the excessive undervaluation, it is difficult to predict the sequences of events in calling a continued pause for breath or a continuation of the bull run. There is still potential for upside but the easy part is now behind us.

Dominique Netter

Chairman of the Strategic Asset
Allocation Committee

Written 26 June 2009

» HOPES FOR THE SECOND HALF

The worst of the 'super recession' is behind us. The pro-activeness of governments is beginning to bear fruit at both financial and economic level. China should be the first to exit recession, followed by the USA and then Europe and Japan.

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» TOO SOON TO WORRY ABOUT INFLATION

The base effect due to commodities will still be favourable for several months. Further out, the under-utilisation of production capacity will keep a lid on inflation.

See p. 3

» PORTFOLIOS CONFIGURED FOR AN ECONOMIC RECOVERY

A continued preference for corporate bonds; without forgetting equities for which the upside potential is not yet exhausted... but priority given to diversification and holding onto some insurance policies.

See p. 4

» FOCUS: GERMANY BADLY AFFECTED

The strength of its exports has turned against Germany and the contraction in the economy will be spectacular in 2009. However, the DAX, whose composition is more cyclical and industrial than that of the CAC, gives investors exposure to the recovery in international trade and indirectly to the emerging markets.

See p. 5

While the contraction in activity during the first quarter of 2009 was, depending on the geographical region, in line with that of the 2008 fourth quarter, if not even worse, some glimmers of hope have emerged in the past few weeks. The latter point to a slower contraction in activity or even a return to positive growth in the US as of the third quarter. The steepening in the rate curve, the fall in the number of new job seekers and the current level of confidence for purchasing managers in the US manufacturing sector are all effectively advance indicators having coincided, historically, with an end to recession. Growth forecasts, with the exception of the euro zone, are thus being revised upwards by many international institutions.

GLIMMERS OF HOPE FOR THE COMING MONTHS

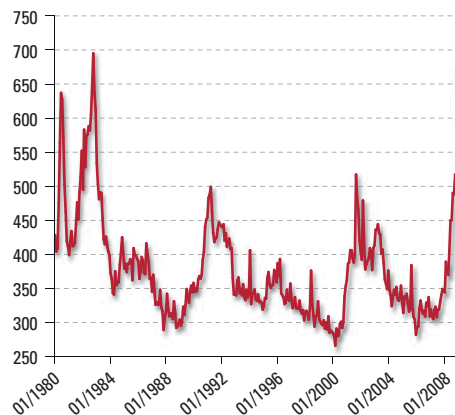
The second half of 2009 is opening on a more positive note in the United States. The massive and rapid destocking which took place during the first quarter and which probably continued during the spring should result in a mechanical rebound in production, contributing to growth during the second part of the year. The effects of the stimulus packages will also be concentrated on the second half. International trade is in the process of stabilising, the easing in the credit market and the marked fall in inflation will continue and the pace of the deterioration in activity across the different economic sectors will gradually slow.

All the above will have a powerful psychological impact on the confidence of households and industry leaders to the point that a positive surprise on growth for two or three quarters cannot be ruled out. There is thus a real hope that the improvements coming from the confidence surveys are reflected in tangible signs of a recovery. All the more so in that two key conditions for a return to economic growth are now in place. Firstly, the relative opacity of the US banks' balance sheets has largely been resolved thanks to the implementation of stress tests. Secondly, the volume of transactions and the number of housing starts show increasingly robust signs of a stabilisation in the residential real estate market, even if asset values continue to fall.

In Europe, given the lag in economic cycles, the smaller scale of economic policy responses together with a lack of transparency on the toxic assets held by the European banks, suggests that the exit from recession will take longer and is unlikely to materialise before early 2010. As for China, it is now benefitting from one of the most massive stimulus packages and, having bottomed out during the 2009 first half, growth there should gather pace, drawing in its wake, with something of a lag, its Japanese neighbour. China should thus be first to exit recession, followed by the USA, then Europe and Japan.

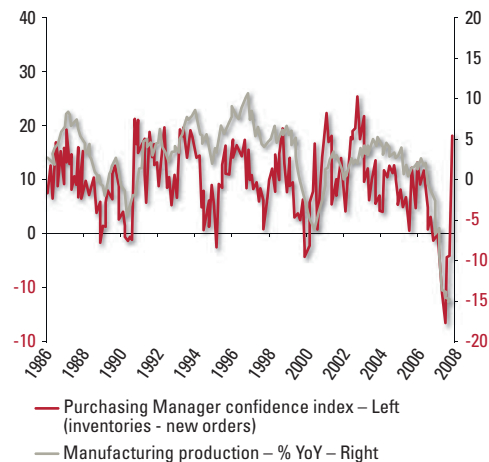
The uncertainties surrounding this scenario are, however, significant, the precondition being to return to positive growth. This then raises the question of the degree of autonomy and the sustainability of activity, which is why the risks of a setback in 2010 cannot be ruled out. The catalysts of a sustained return to growth are currently difficult to see. The need for households to deleverage, coupled with rising unemployment, is likely to encourage them to increase their savings rate to above the current level. On the supply side, in addition to the uncertainty on the demand outlook, the re-pricing of risk will sustainably increase the cost of capital for companies.

UNITED STATES: NUMBER OF NEW JOB SEEKERS (IN THOUSANDS)



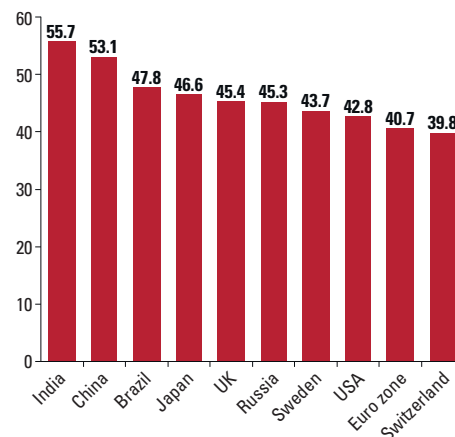
Source: Thomson Financial Datastream

UNITED STATES: PURCHASING MANAGER CONFIDENCE INDEX AND MANUFACTURING PRODUCTION



Source: Thomson Financial Datastream

CONFIDENCE INDEX OF PURCHASING MANAGERS IN THE MANUFACTURING SECTOR – MAY 2009



Source: Thomson Financial Datastream

TOO SOON TO WORRY ABOUT INFLATION

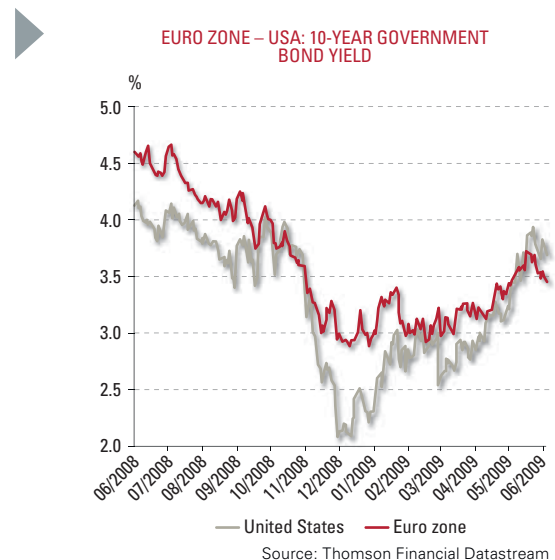
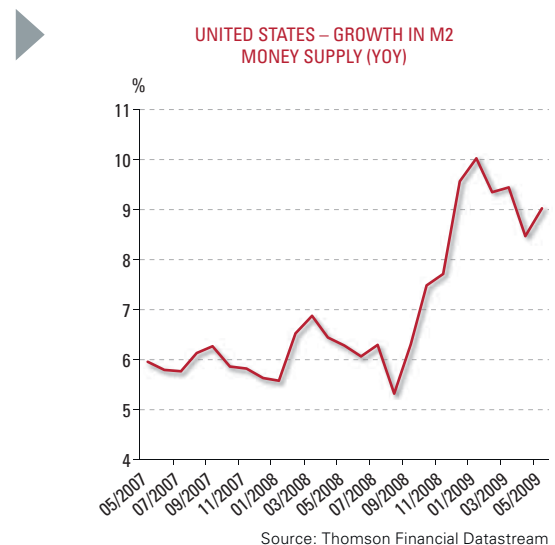
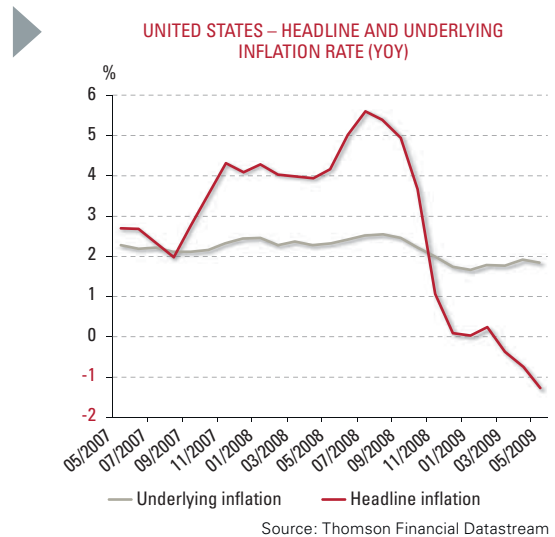
One worry after another. After the fears about deflation, the mounting public debt and the financing of budget deficits is prompting worries of a return of inflation. Inflation expectations in the markets have thus been raised into line with the levels targeted by the central banks, i.e. 2% (over ten years) just as year-on-year inflation turns negative in the USA for the first time since the 1950s, or zero as in Europe. This significant fall in inflation is a world-wide phenomenon and is mainly due to the collapse in global commodity prices, particularly oil, during the 2008 second half. Underlying inflation, which stands at around 1.5% on both sides of the Atlantic, should fall in coming quarters due to the slowdown in salaries and the surplus production capacity. On the costs side and the ability of companies to increase prices, there is no inflation risk. Barring a new oil shock, headline inflation should not exceed 2% in the next few quarters and could even have some downside surprises in store. Fears of a return to inflation thus seem overdone.

TOO EARLY TO UNWIND MONETARY POLICIES

Expectations of an increase in official interest rates by the Federal Reserve are also very premature, as Ben Bernanke recently reiterated. Investors are starting to reflect on the measures needed to normalise the monetary and fiscal situation which the public authorities have pushed to unprecedented levels. Monetary creation by the central banks has not led to an excessive acceleration in the growth of the broad monetary aggregates given the collapse in credit. No inflation in the short term... But the next few years will be challenging for governments and central bankers. Just how easy will it be to mop up the liquidity created by quantitative easing through the acquisition of government bonds? What would be the consequences for the bond market and the cost of financing public debt? How do you reduce the soaring fiscal deficits and stabilise public debt?

The exit strategy could prove delicate on two fronts: the type of measures to take and choosing the right moment. This change in stance requires economic activity to have returned to positive territory and its growth rate to be both strong and sustainable. We are still far from this, which is why the central banks are going to leave interest rates unchanged at least until the end of the year and, in all likelihood, well beyond this. In the past, the Federal Reserve has started to raise interest rates when the unemployment rate stabilises, which should not happen before the first or second quarter of 2010. It has, moreover, other tools it can use to withdraw liquidity before touching interest rates. The central banks are well aware that their task is to ensure price stability, but they also remember that the increase in Japanese money supply did not create inflation. On the other hand, the too-rapid tightening in fiscal policy in 1996 plunged the economy back into recession.

The debate on the normalisation of monetary policy can only intensify over time, and will be reignited by the emergence of concrete signs of an economic recovery. This will make the communication from central banks more difficult and less predictable and should lead to volatility in forecasts.



The rally in the stock markets exceeded our expectations. Investors ready to be opportunistic and take on more risk were rewarded as shown by the stellar performance of the emerging markets, commodities and high-yield bonds. The easy part of the rebound in risky assets is now behind us following the correction in the extreme undervaluation. This is why it seems important to constitute a highly-diversified, actively-managed portfolio to reflect the increased volatility in terms of both economic forecasts and interest rate and currency expectations. Given the fragility of the environment and the many questions regarding the policies for the exit from recession, it seems sensible to continue to hold onto some insurance policies in the form of gold and government bonds. Ten-year government bond yields have moved markedly higher in recent weeks driven by a scenario that suggests economies have now passed their cyclical lows and the deluge of bond issues from governments. The absence of inflation combined with the continued intervention from central banks leads us to believe that the highs have probably been seen for the year.

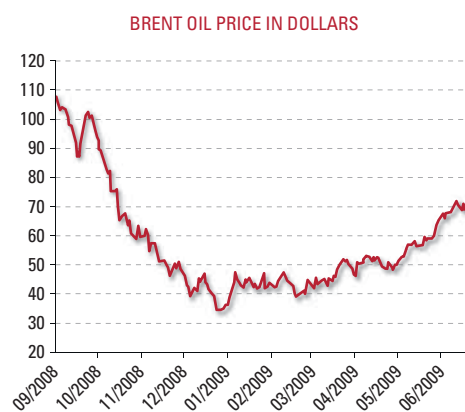
A CONTINUED PREFERENCE FOR CORPORATE BONDS

Our recommendation remains unchanged in this area. Yield spreads have continued to fall but the yield to maturity still looks very attractive. For companies rated BBB, it remains above 8% (down from 11% at the beginning of the year), which remains very worth-while and, given the modest volatility, the risk/reward profile looks compelling. Selectivity is still needed since, besides an unprecedented level of issuance enabling companies to increase their resilience in a difficult environment, the rating agencies are pointing to the deterioration in the fundamentals of certain issuers and will not hesitate to downgrade them. It is a very similar story for convertible bonds whose potential is not yet exhausted.

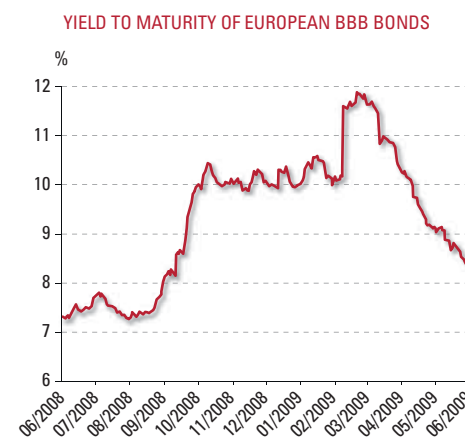
LITTLE EXUBERANCE ON THE EQUITY SIDE

For the past few weeks, the stock market indices have stagnated as they look for new catalysts after a spectacular three-month rally. Will the next move be a continued pause/correction or a continuation of the bull run? It is difficult to predict the sequence of events. A pause for breath looks logical in the event of any disappointment on the economic reality, the second quarter earnings reports or difficulty digesting capital increases. However, the markets are not always logical or reasonable and they could thus return to an upwards trend but with a greater degree of volatility. This last phase could propel the stock market indices to levels close to those of end-September 2008, which leaves upside potential of 10/15% for the developed markets but less for the emerging markets. This move would be driven by a change in the earnings trend, the reallocation of assets and the ongoing effects of stimulus policies. At these levels, however, equity valuations would be high and discount earnings growth scenarios for 2010 which could prove overly optimistic.

In this environment, maintaining a near-neutral position seems reasonable, with a preference for the developed rather than the emerging markets. European equities, which have recouped part of their lag, still look attractive, in our view, as do US and Japanese export plays. At a sector level, the performance differential should close in favour of defensives which have been overly neglected but it is still too early to switch out of cyclicals and oil stocks which would be the most sensitive to any positive economic surprise.



Source: Thomson Financial Datastream



Source: Thomson Financial Datastream



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» GERMANY BADLY AFFECTED

While Germany, unlike many other countries, is not suffering from the bursting of a property and credit bubble, it should see the worst GDP contraction of the euro zone members (-6.0% in 2009 versus -4.8% for the euro zone). GDP is currently 7% down on the peak of the cycle in early 2008, the most severe decline since the Second World War, and a return to its 2005 level. Exports collapsed by 9.7% in the first quarter. The exposure to the downturn in external demand is even more marked than for the other European economies since exports represent nearly 50% of GDP, having grown steadily since 1990. The fall-off in global demand has led to massive cuts in corporate investment. Given the low utilisation rate of production capacity and the surveys of business leader intentions, investment plans will be pushed back until next year. The significant exposure of German companies and the banks to Eastern Europe, currently in severe recession, has only increased this trend.

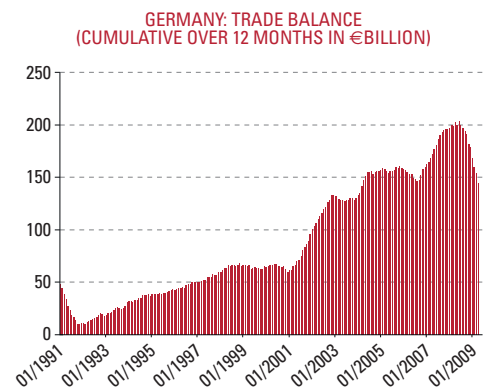
GRADUAL EMERGENCE OF GROWTH RELAYS

Consumer spending rebounded by 0.5% during the first quarter thanks to the incentive measures in the automobile sector. Inflation, having turned negative in May and likely to remain so for several months, will support the purchasing power of German households, especially since they are not constrained by the need to deleverage like in many developed countries and have not seen the erosion in their property values. Their revenues will, however, continue to suffer the consequences of the sharp deterioration in the employment market (with unemployment expected to reach 10.8% in 2010), the increase in part-time workers (+3.4 million since September 2008) and the explosion in company bankruptcy which is still to come. Internal demand should thus see a gradual recovery during 2010. Furthermore, while Germany remains significantly dependent on a more sustained recovery in global trade, its exports which are, for the most part, oriented to higher-growth regions like South-East Asia, offer a safety net in the event of a prolonged absence of a recovery in demand in the developed countries.

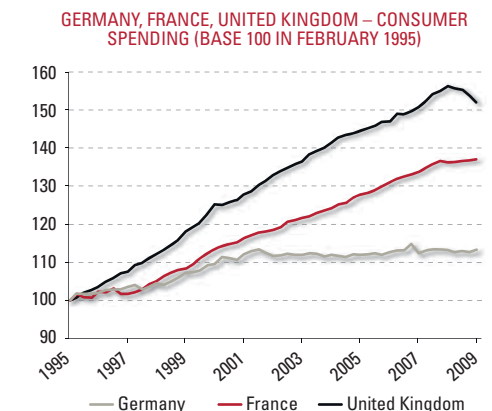
A FRAGILIZED BANKING SYSTEM

The banking system has been fragilized by the recession given its significant real estate exposure (US, Spain) and its role as the primary lender to Eastern Europe. The balance sheets of the German banks saw relatively limited growth but the lending was to low-quality regions and borrowers. The magnitude of the German recession constitutes an additional handicap as shown by the collapse of Arcandor (retail and tourism), as do the too many small banks with poor profitability. The German banks still hold €800 billion of toxic assets which are likely to generate additional losses of around €200 billion. The Landesbanks hold most of these toxic assets, whose cost will have to be borne by the State and the regions. Their restructuring looks complicated to achieve but their recapitalisation seems a priority since, without it, the financing of small and medium-sized businesses could suffer. The government has set up a Financial Markets Stabilisation Fund (SoFFin) to bail out institutions in difficulty. It is through this fund that Hypo Real Estate was nationalised. The government is also planning a scheme to guarantee toxic assets for banks requiring this which should be approved in the next few days.

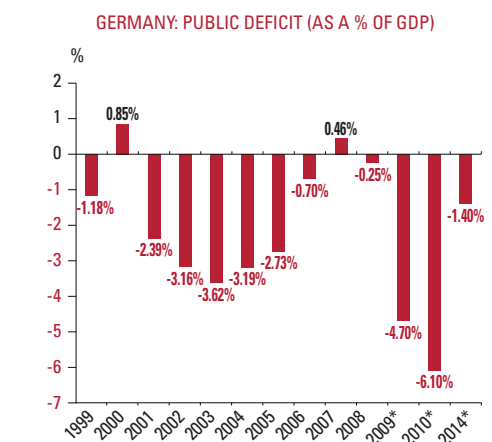
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Source: Thomson Financial Datastream



Source: Thomson Financial Datastream



Source: Thomson Financial Datastream

*Estimates

THE ELECTIONS: A CATALYST FOR REFORM?

The German stimulus package is currently one of the most substantial in the euro zone and much of it is focused on 2010. The budget deficit should reach 3.7% this year and 6.2% in 2010. To finance this, Germany will need to borrow €86 billion in the markets, twice as much as this year. The forthcoming elections complicate the situation, although victory for Angela Merkel looks likely. The coalition wanted to reduce taxes, which will be difficult given the size of the budget deficit but the betting is that it won't increase them either like in 2007. The return to budgetary and monetary orthodoxy is, nonetheless, a key consideration for Germany.

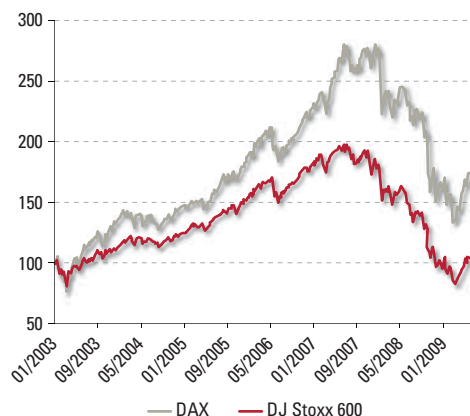
AND THE GERMAN STOCK MARKET?

While the German economy is the largest in the European zone, its weight in the DJ Stoxx 600 index is only 12% compared with 17% for France and nearly 27% for the United Kingdom. According to the thematic breakdown of this index, the weight of cyclical stocks is 53% for Germany, with 26.4% for defensives and 20.6% for financials, of which more than half are insurance companies. This breakdown is very close to that of France, although the DAX does not contain any oil stocks. Over three and five years, the DAX has significantly outperformed the CAC 40 and DJStoxx 600 indices.

Between the high and the low of last March, the DAX fell 55% before regaining 40%. It is still some 36% off its high, trading at 13.6 times estimated current year earnings and 1.2 times book, multiples well below their long-term averages. DAX 30 company earnings should only fall by 15% this year, after a decline of around 40% in 2008. This is more than the CAC 40 companies given the bigger losses in the banking sector and the absence of oil companies. Overall, between the peak and trough, the earnings contraction should reach around 50/55% as for all the indices. The net dividend yield is 4% higher than the 10-year bond yield. Non-financial companies have solid balance sheets.

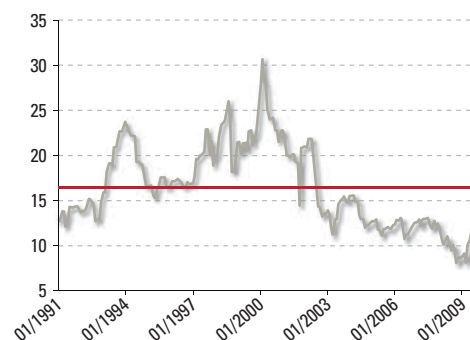
The weight of cyclicals and industrials makes this market attractive for the next few quarters. It is a good way to gain exposure to the recovery in international trade which should take place in coming quarters. Companies such as Thyssen Krupp, BASF and BMW are very attractive on this basis. The German stock market also has a large number of alternative energy stocks like Solarworld and Wacker Chimie, an area in which global demand has been revised up, particularly coming from the USA and China. This sector should benefit from budgetary subsidies from a number of governments to encourage the development of 'green or clean technology'. The probable victory of Angela Merkel in the forthcoming elections should also be welcomed by the market.

EUROPE: RELATIVE PERFORMANCE: DAX, DJ STOXX 600



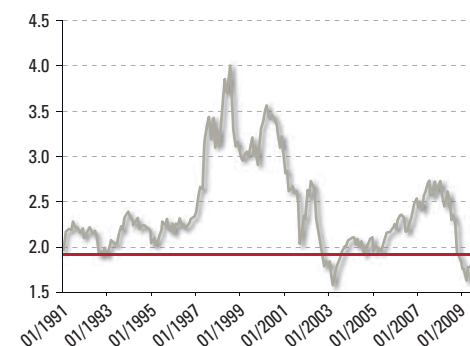
Source: Thomson Financial Datastream

MSCI GERMANY: PE FOR THE CURRENT YEAR



Source: Thomson Financial Datastream

GERMANY: PRICE TO BOOK



Source: Thomson Financial Datastream

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