

# Investment strategy



Quarterly bulletin  
January 2010



## Editorial

Please accept our very best wishes for this new year.

In 2009, for the first time in 60 years, global economic activity contracted. The recession was very severe for the three major developed countries, while the emerging world delivered growth overall thanks to China and India. Paradoxically, the global recession accelerated the migration of these emerging economies towards more domestic consumption. In 2010, the global economy, given the ongoing stimulus packages, will return to its long-term growth trend. The growth rate differential between developed and emerging countries will remain pronounced. This inequality in terms of growth and inflation will accentuate divergences in monetary policy. While the major challenge in 2009, since achieved, was to exit from recession that of 2010 will be to progressively unwind western monetary policies with the gradual increase in official interest rates. This is unlikely to happen without setbacks in the financial markets. The exchange rate equation will also be complex. Legitimate concerns (health of the banking system, deterioration in public finances) will remain very much to the fore. Emerging countries and companies proved the major success stories of 2009, the former demonstrating their reactive ability and the latter drastically reducing their costs and paying down debt. This is why the investment strategy for the start of this new year recommends significant exposure to the corporate sector through equities and corporate and convertible bonds. 2010 will also mark the return of earnings growth. Without dreaming of returns in line with those of 2009, equities still have upside potential. There will thus be many opportunities this year but also a number of unexpected events.

**Dominique Netter**  
Chairman of the Strategic  
Asset Allocation Committee

This document is the ninth 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.

## 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 EUR 83,075,920, registered with the Paris Register of Commerce, under registration number 572 037 026  
47, rue du Faubourg Saint-Honoré – 75401 Paris Cedex 08  
Tel.: +33 (0)1 40 17 25 25 – E-mail: info@lcf.fr  
NON-CONTRACTUAL DOCUMENT – Written 24 December 2009  
EDITORIAL: DOMINIQUE NETTER – NILOUPHAR VOSSOUGH

[www.edmond-de-rothschild.fr](http://www.edmond-de-rothschild.fr)

## A return to global economic growth

The economic environment remains visible and positively oriented in the USA for the coming months. US growth will outpace that of Europe which has been hit by divergences between member states. The positive surprise would be a faster-than-expected fall in US unemployment.

See p. 2

## Diverging monetary policies

Differences in economic growth rates and inflation will be reflected in interest rate increases of very different magnitudes.

See p. 3

## A significant weighting in the corporate sector through equities and corporate bonds

Equities still have upside potential. A return to earnings growth.

See p. 4

## Focus: Japan

The collapse in international trade followed by its recovery largely explains the fluctuation in Japanese economic activity, which has been penalised by yen strength and spiraling deflation. While the Bank of Japan is beginning to recognise the need to change its policy stance, bold solutions would be needed to reverse these trends. A fall in the yen would be greeted with a major 'hats off' from the Nikkei.

See p. 5



LA COMPAGNIE FINANCIÈRE  
EDMOND DE ROTHSCHILD  
BANQUE

Red turned out to be the prevailing colour for 2009. Red since the growth came from China, red given that global economic activity contracted for the first time since the end of the Second World War and red again with the explosion in budget deficits. The emerging countries will have seen overall growth thanks to China and India, whereas the G3 countries experienced a very severe downturn in their economies. The global recession encouraged the emerging countries to accelerate the transition of their economic models towards domestic consumption, hence their growth (the Chinese automobile market, for example, overtook that of the US). The challenge for 2009, which was the return to global economic growth, has been achieved since the third quarter on the back of industrial production, driven by the recovery in car sales. This economic recovery is set to continue in coming months, underpinned by ongoing budgetary stimulus (around 1% of global GDP) and the abundance of liquidity. As for 2010, the challenge will be the gradual unwinding of these ultra-accommodative policies.

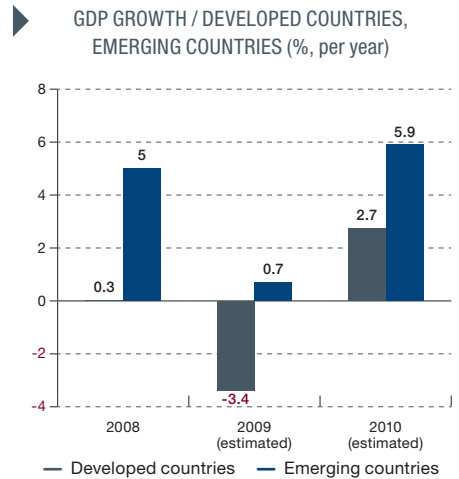
**EMERGING COUNTRIES STILL LEADING GLOBAL GROWTH**

The long-term global growth rate will be between 3% and 3.5% but this growth will be bumpy and unevenly-distributed: whereas, for the emerging countries, the crisis has been an accelerator, the G3 countries are licking their wounds. The emerging countries will again be the backbone of global economic activity in 2010. Economic growth will accelerate in Asia ex Japan, driven by China whose growth rate could exceed 9%, underpinned by the increase in retail sales and public and private investment. India will also be another driver for the region. In Latin America, a number of countries such as Brazil and Mexico will also return to growth.

The G3 countries will see very different growth rates: the USA will lead the pack with Japan a laggard.

The USA should see growth of between 2.5% and 3%, which is relatively modest given the severity of the recession. Supporting factors will include the balance of the stimulus package (around \$350bn), restocking and a modest pick-up in investment by large companies which have returned to health. Residential real estate will be a modest contributor. Having partly reconstituted their savings, consumer behaviour is less skittish. The eventual stabilisation in house prices following the ending of tax credits would be very good news. The main concern, however, remains the level of unemployment. Were it to fall more rapidly than expected, this would be a catalyst for a significant improvement in consumer confidence and, ultimately, private consumption. The virtuous circle for confidence would thus be established. This scenario cannot be dismissed but supposes that the health of small and medium-sized companies improves, an issue which President Obama wants to address.

For Europe, 2010 will be a year of transition and its growth rate should be well below that of the USA. Restocking and global trade should be the main supporting factors since consumer spending is unlikely to accelerate. The growth differentials will again be significant: France and, particularly, Germany will lead the recovery, while a number of countries such as Italy and the Netherlands will see only barely positive growth. The German stimulus package (1.4% of GDP), oriented towards tax cuts for companies and households and the extension of partial unemployment, will indirectly benefit the whole region. However, the restrictive fiscal policies implemented by the most fragile countries (United Kingdom, Spain, Ireland, Greece) will act as brakes on the region's growth.



Source: Thomson Financial Datastream



Source: Thomson Financial Datastream

*“Global growth rate will be about 3.5% in 2010.”*

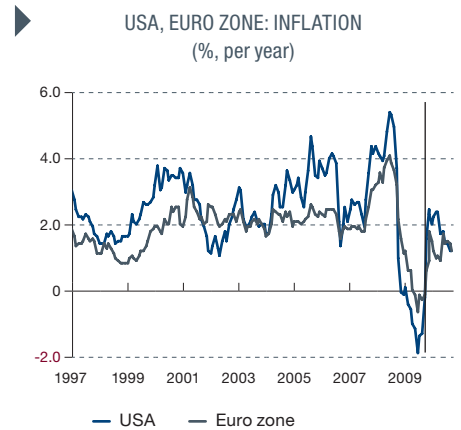
The attitude of the banks will be an important factor in embedding the global recovery. In 2009, credit contracted markedly for both households and companies due to lower demand and more restrictive lending conditions. For 2010, a degree of nervousness is still to be feared given the balance sheet fragility of a number of banks and new regulations in terms of capital adequacy and balance sheet liquidity. This behaviour would penalise SMEs on both sides of the Atlantic and the European economy, which is more dependent on bank lending.

### DIFFERENT INFLATION RATES

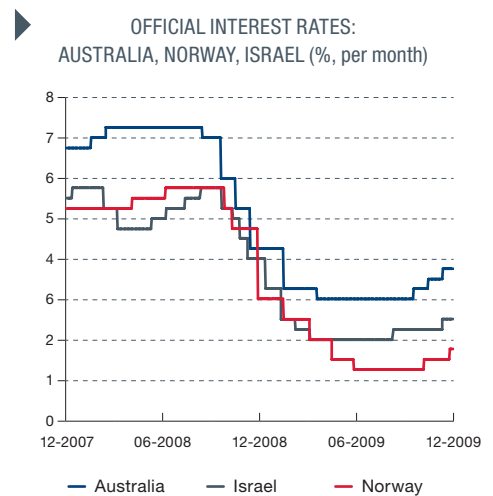
In the USA and Europe, headline inflation has just mechanically moved into positive territory and could exceed the 2% threshold in coming months. This is not a cause for concern however: it is just a temporary mechanical rebound linked to the disappearance of the favourable base effect for commodity, energy and food prices. Underlying inflation continues to see a gradual fall due to surplus production capacity, pressure on salaries and the reduction in rents in the USA. Furthermore, the velocity of money circulation remains low. Neither do excessive debt levels argue in favour of a return of inflation. The US and European central banks have also downgraded their expectations for 2010 and 2010 (below 1.5% annually). The only risks could be a rise in commodity prices, something which is not our scenario. The situation is different for a number of emerging countries, where inflationary pressures are discernable.

### INCREASINGLY DIVERGENT MONETARY POLICIES

Divergences in economic growth rates, inflation and real estate price rises have already prompted some developed countries – like Australia, Norway and Israel – to raise their official interest rates and they will continue on this course. Korea and Canada could follow suit. A number of emerging countries are going to do likewise, either due to inflationary pressures as is the case for India, a return to capacity utilisation rates at pre-financial crisis levels as in Brazil or concerns about a real estate bubble like in China. But these countries are facing a dilemma since interest rate increases would accentuate the upwards pressure on their currencies in attracting more capital. Furthermore, they are not used to initiating policy shifts ahead of the US. They are thus going to act gradually, something which could lead to an appreciation in some Asian currencies. Changes in policy stance by the Federal Reserve and European Central Bank will be key to the direction in financial markets. It is not just official interest rates which are at stake here but long-term interest rates given the need for Government financing. It will be a delicate balance between acting too soon and too late, which would be dangerous. Having drained liquidity, the western banks should start to increase official rates modestly as of the second half in order to defend their credibility and very gradually align them with trend growth. This would head off an escalation in long-term interest rates and facilitate the work of the western authorities in terms of reversing fiscal policy. This scenario seems the most likely but there could be significant indecisiveness between the three scenarios.



Source: Thomson Financial Datastream



Source: Thomson Financial Datastream

*“The western central banks should reverse their fiscal policy during the second semester.”*

How is the economic and financial environment looking as we build the investment strategy for the new year?

The global economy is returning to its long-term growth trend, with continued significant differences between growth rates in the G3 and emerging countries. The progressive unwinding of monetary policies with the very gradual increase in short-term interest rates will be difficult to achieve seamlessly. The exchange rate equation will be particularly complex – dollar rebound, appreciation of the Asian currencies? Without forgetting areas of significant fragility such as the stability of the banking sector and the very marked deterioration in the public finances of certain countries. Such legitimate concerns will remain prevalent and continue to hit the headlines as the year unfolds. They reduce visibility and could encourage a very cautious stance. Wrongly, however, since they leave aside 2009’s major success stories: the emerging countries and western and emerging companies. The former have re-oriented their growth models thanks to the crisis and the latter have aggressively reduced their costs and paid down debt. Companies can thus start to invest, make acquisitions or increase dividends.

For the beginning of the year, portfolios should be weighted towards equities and corporate/convertible bonds. It is the yield pick-up on corporate bonds which remains attractive since the tightening in yield spreads has mostly been achieved, particularly for high-grade bonds.

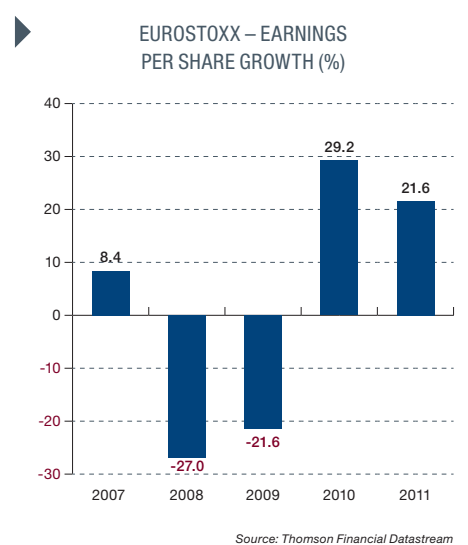
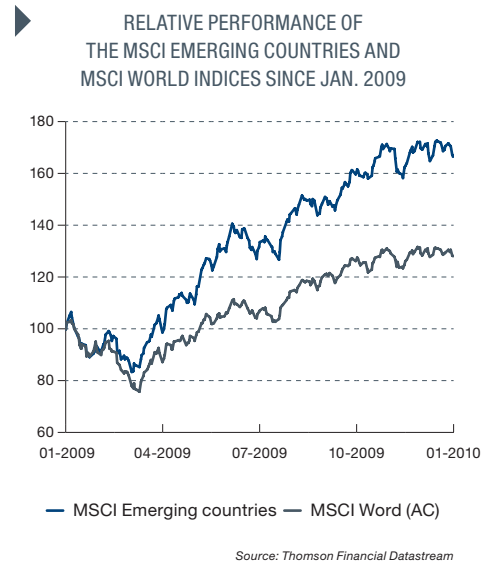
**EQUITIES STILL HAVE SOME UPSIDE POTENTIAL**

This second upswing should correspond more with a normalisation consistent with economic growth at cruising speed. The multiple expansion phase is also behind us and under-valuations have disappeared. From now on, the driver will be corporate earnings. Expectations are high for 2010 (25% to 30% for all the regions) and 2011. However, for non-financial companies, median growth is expected to be 15%, which looks attainable...The risk premium remains well above its long-term average. The positive surprise could be the return of individual investors who were absent in 2009. For the European and US markets, the upside potential could thus be around 12% to 15%. Will this target be reached very rapidly or at the year end? Difficult to say. The comparables are very helpful during the first half and concerns about the second half are widely shared by the consensus. The year will not be smooth sailing...

The performance differentials between sectors should reduce in 2010. A number of sectors still look attractive, in our view, such as health/biotechnology, technology, energy and a number of commodity, agrochemical and especially private consumption names in emerging countries. However, it is the trend in corporate earnings which will be key to the direction in share prices. A number of companies are going to capitalise on market shares gained in 2009. Our preference is for high-quality companies with visible growth and high dividends, be they small or large cap. In terms of long-term geographical asset allocation, emerging countries must be very present in portfolios, although some short-term caution is required due to their spectacular performance and the optimism in their regard. Some differentiation between countries is needed.

**GOVERNMENT DEBT: NOT VERY ATTRACTIVE**

Sovereign credit risk will regularly return to the fore since the debt of some developed countries will be downgraded while there will be upgrades for a number of emerging countries. Hence the preference for the debt of these countries. Furthermore, we see some 50 to 75 basis points of upside in long-dated government bond yields due to higher economic growth, the plethora of issuance and the ending of securities purchases by the central banks.

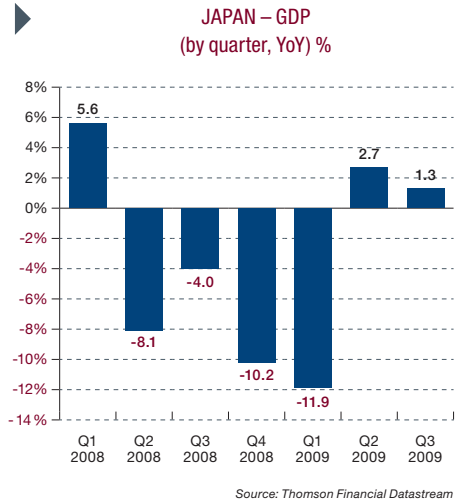


*“The yield pick-up on corporate bonds remains attractive.”*

# JAPAN

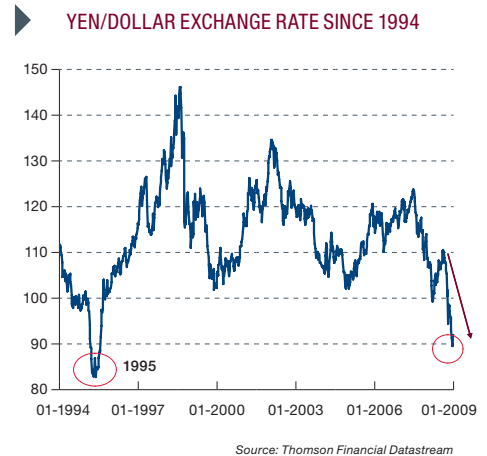
## AN ECONOMY VERY DEPENDENT ON EXPORTS...

After no nominal growth since 1995 (0.3% on average), Japan has been the G3 country most severely impacted by the downturn in global economic activity. In 2009, activity contracted by more than 5% due to an 11% collapse in first quarter GDP, driven by the fall-off in international trade. The stimulus package launched early in the year enabled a return to positive economic growth. Japan was, thus, a logical beneficiary of the recovery in international trade, notably within the Asian region. While consumption has seen a modest pick-up due to government support, households remain very nervous due to the stagnation in their revenues and a mediocre employment outlook. Furthermore, companies, and particularly SMEs, are still reducing investment in order to make up for a marked deterioration in their financial situation. This is why the new government has decided to launch a second fiscal stimulus package during the 2010 first quarter (1.4% of GDP). While additional spending will only represent half this package, it should enable the growth rate to be consolidated at around 2%. Domestic demand could thus recover during the second half. Exports will remain the main growth driver, particularly those bound for Asia.



## PENALISED BY YEN STRENGTH...

Whereas all the economic factors warranting a depreciation were in place, the yen has recently returned to its 1995 highs against the dollar! The strength of the yen is partly explained by the incentive for Japanese companies to repatriate foreign earnings and the unwinding of carry trades. It has risen by more than 20% relative to the dollar and the euro since late 2007, stifling exporters and reinforcing deflation. However, it has appreciated particularly strongly against the Asian currencies. In two years, the Korean won has depreciated by 36% against the yen. Massive yen selling is the only tool the Bank of Japan has at its disposal to force down the currency and, for the moment, no major programme is underway. A policy reversal from the Bank of Japan and the Fed could prompt a fall in the yen which would replace the dollar as the currency used to finance carry trades.



## AND PERSISTENT DEFLATION

Headline inflation has been mostly slightly negative since 1995. Deflation has, of late, become more severe at -2.5% year-on-year, due to the low production capacity utilisation rate. Given the concerns and pressure from the government, the Bank of Japan opted for a significant liquidity injection which had a positive, albeit short-term, impact on the currency and equity markets. The interest of increased liquidity injections is, however, clear in order to contain the increase in the exchange rate and avoid the embedding of deflationary expectations. This is why the Bank of Japan has just taken a major step in explicitly stating that it would no longer tolerate negative inflation and that its inflation target was between 0% and 2% with a mid-point at 1%. This should be reflected in increased use of the central bank's balance sheet in order to inject more liquidity into the economy.



### A RECORD LEVEL OF GOVERNMENT DEBT

While the average OECD public debt to GNI ratio will approach 100% in 2010, that of Japan will reach twice this! This record level is explained by the collapse in tax revenues over the current year and the absence of any economic growth, together with the structural budget deficit and the increase in social security spending linked to an ageing population. Bond issuance is going to reach a record level next year but will be absorbed by a continued high level of domestic saving. Japan is generating a current account surplus and has substantial foreign exchange reserves. Issues surrounding the sustainability of the debt will become more pressing over the next few years, since the ageing population implies a structural decline in the long-term household savings rate. The government can always monetise a debt in local currency. Currently, 93% of government bonds are held by the Japanese (public sphere or private investors). However, over the long term, if Japan does not manage to increase its potential growth and/or reverse its demographic decline, fiscal consolidation will prove a very difficult exercise: attracting international investors will then require higher interest rates.

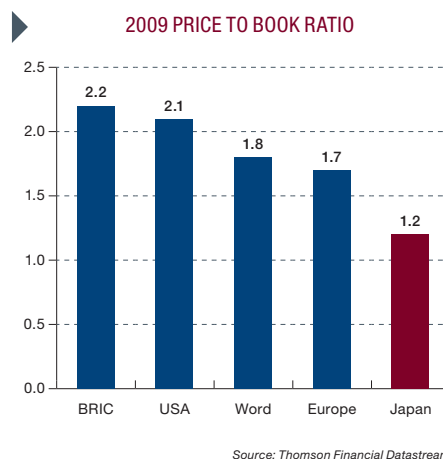
### AND THE JAPANESE STOCK MARKET

Some twenty years ago, the Nikkei reached its historic high of 38,915 and accounted for 40% of the MSCI Global index. Currently, its weighting is just 8% and it is trading around the 10,000 level. Over these past twenty years there have, however, been several 50% rallies; between 2003 and 2007, the Nikkei even rose by 130%. In 2009, the market delivered one of its worst returns, totally collapsing as of August due to the appreciation in the yen which is penalising companies. The Japanese banks, which underperformed their western counterparts, weighed on the index. They are starting to make up their lag in terms of under-capitalisation. This market has been neglected by international investors who prefer Asia ex Japan. This is also a very difficult market to trade, with sharp rises often followed by periods of great apathy.

However, on a number of valuation metrics – particularly price to book – the Japanese market now looks the cheapest in the world. Corporate earnings are going to rebound in 2010-2011. Large companies are effectively benefiting from the expansion of the Asian region and are not representative of domestic growth. Their production costs are under control and they remain the leaders in cutting edge technologies. While everyone is familiar with the major auto manufacturing, robotics and consumer electronics companies, there are many SMEs which are global leaders like Nidec (75% market shares in the manufacturing of PC hard disk drives) and Shin-Etsu Chemical (specialists in rare materials for semi-conductors). The spectacular arrival of Uniqlo in Paris (a subsidiary of Fast Retailing) highlights the international ambitions of this textile company which wants to compete with H&M and Inditex within the next few years.

While a number of elements argue in favour of this market, the weakening in the yen will be the decisive factor behind any significant bull run. The Japanese market, which may surprise in 2010, could have a role to play in tactical strategies. The yen thus needs to be watched closely. It is, however, difficult to envisage a sustainable bull market until such time as monetary and fiscal policy becomes bolder.

*“The Japanese market may surprise in 2010.”*



**Disclaimer:** The data, comments and analysis in this document reflect the opinion of the Edmond de 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 Edmond de Rothschild Group or by any of its subsidiaries. The Edmond de 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.

NON-CONTRACTUAL DOCUMENT – Written 24 December 2009 – EDITORIAL: DOMINIQUE NETTER – NILOUPHAR VOSSOUGH