



The Investment outlook and convictions for 2012

- **Recessionary forces are clearly at work in the Eurozone. Over the medium term, falling public deficits will be reinforced by the capacity of European countries to pursue vital structural reforms which will help accelerate growth.**
- **The global economy will inevitably be hit by Europe's faltering economy in 2012 but Europe's direct impact has waned. US growth is proving very resilient. Emerging countries, meanwhile, are slowing but falling inflation is giving them more room to manoeuvre.**
- **Other dynamics are on a positive trend: in both the developed and emerging zones, most companies are still looking to expand and invest.**
- **The unprecedented nature of the government debt crisis in developed countries has thrown investors off course. Markets will probably remain turbulent at the beginning of 2012; investors should be cautious and focus on defensives given the current slowdown in global growth. Nevertheless, widespread pessimism is already creating opportunities in certain heavily oversold assets.**

THE LIKELY EXIT TO THE EUROPEAN SOVEREIGN DEBT CRISIS

Apart from the central bank, Europe's institutions were not designed to deal with emergencies. The agreements reached in July, October and December are a significant advance but they will need to be convincingly rolled out. The European treaties set debt and deficit targets but they are not binding. A complicated web of clauses, and unanimous decision-making in particular, has prevented strong action being taken. Basel II regulators meant well but encouraging banks to buy sovereign debt has turned out to be a costly mistake which has pushed rates higher in peripheral Eurozone countries.

True, there are rescue plans like the European Financial Stability fund and ECB intervention on bond markets -and at some stage Eurobonds or some similar asset class might come into existence- but they are not sufficient. Germany's position in a nutshell is that financial solidarity must necessarily be accompanied by budgetary responsibility and closer surveillance of budgetary policy. The various European summits have made slow progress towards improved coordination of budgetary policy and created better-adapted financial aid tools like the European Stability Mechanism. In the meantime, ECB action will be decisive and the operational link between it and the EFSF is highly significant.

IS EUROPE IN POOR SHAPE?

We can rule out an exact repetition of 2008 because today's financial situation is different. The link between a sovereign debt crisis and banking woes has become systemic but today's proactive stance from the ECB means the current banking crisis is not as serious. The extent of economic and budgetary difficulties varies between each country. Intra-European trade means that the entire zone has been hit by falling demand from austerity drives but to differing degrees. GDP in the Eurozone's weakest countries only represents 17% of the total compared to 45% for the most financially robust members.

As far as solvency is concerned, regulatory constraints are weighing on capital ratios for Europe's banks. This has made borrowing more difficult and dearer but reinforcing these ratios can be done in several ways so there is not an automatic impact on credit distribution. As for liquidity, the ECB has shown its determination to deal with stress on the interbank market by resorting to all the instruments at its disposal. This has reduced bond yields and made it easier for the weakest Eurozone countries to issue new debt. Lastly, the ECB has reduced its benchmark rate from 1.25% to 1%.

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MORE RESILIENCE IN THE US

US consumers are determined to maintain spending levels even if they are keen to pay down debt. Although the unemployment rate is still high, more jobs are being created, the cost of debt servicing has fallen and household net worth has risen. At the same time, the worst effects of the property correction are now a thing of the past.

Short term rates will stay low until 2013 and the Federal Reserve has not ruled out further monetary easing. Budgetary policy is, however, a trickier area. In a presidential election year, it is impossible to repair imbalances in public finances. The automatic cuts stipulated in August's agreement will start in 2013 and stretch over the next 10 years. The biggest concern is that taxes which are currently suspended will come into force on January 1st 2012 unless Congress manages to find a solution. The stand-off will also mean that aid to the long-term unemployed will cease from the end of 2011.

EMERGING ECONOMIES: CHINA'S CONTRIBUTION IN 2012

China's inflation seems to have reached an inflection point. Even so, the government's determination to rein in lending and property prices will probably remain unchanged. The transition in political leadership scheduled for the autumn of 2012 should ensure moderate policies. In a new development, accelerating trade with other emerging countries is reducing the direct influence of the developed zone. The US economy weighs as much as Europe but investment flows between emerging countries are now an integral part of their relationship and this is curbing the impact of European flows. Inflation is falling due to base effects in commodity prices and governments now have more room to manoeuvre. For example, central banks in Indonesia, Brazil, Israel, Turkey and China have started to ease monetary policy.

ASSET ALLOCATION STRATEGY

Equities

For the moment, we remain cautious on equities. We expect markets to remain uncertain at least for the first half of 2012. Although recent US economic data has been brighter, the outlook for growth is merely moderate, a striking contrast with the brisk recoveries the country is used to seeing. In the Eurozone, companies are in better health and positioned to cope with a recession in 2012, but the worsening economic picture suggests investors should be prudent.

We prefer emerging equity markets, especially in the Asian zone, as governments there have the leeway to deploy counter-cyclical monetary and budgetary policies. Markets in this zone fell sharply in 2011 despite robust earnings growth. We believe that macroeconomic fundamentals warrant higher valuations.

In 2012, developed market performance will be only marginally impacted by earnings which in our core scenario are expected to see modest growth in the US and a slight dip in Europe. The crucial point will be valuation or PE levels which have declined sharply in recent months due to macroeconomic uncertainty and systemic risk arising from the sovereign debt crisis. Any marked improvement here would send risk premiums down from their current record levels.

As far as investment themes are concerned, we prefer yield and flexibility over the shorter term. In our view, themes like healthcare/ageing populations and infrastructure are still attractive over the medium to long term.

Fixed income

Government bond yields in core countries like the US, the UK, Germany and Japan are very low in absolute terms and actually negative in real terms. Moreover, they offer neither yield nor protection. Government bonds in liquidity-stricken peripheral countries (Spain and Italy) are attractive as long as investors can bear mark-to-market risk.

For investors with no short term constraints – volatility is persistently high and liquidity still low - we think that yields in the high yield sector largely compensate for any default risk, especially as companies are in much better shape than in 2008. Similarly, the sell-off in emerging country debt is overdone given its fundamentals and we believe the segment now offers attractive yields.

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We recommend being overweight convertible bonds as the carry is once again attractive and they also benefit from cheaper convexity than traded options

Currencies

In forex, we are maintaining our structural positions in emerging market currencies and favour the Canadian dollar and Norwegian krone

INVESTMENT CONVICTIONS

Equities

The US market

Now that worries have spread to all global financial centres, US economic growth is no longer the focal point of investor concerns. The US market, which already seems to be factoring in the growth differential with Europe, will benefit from its safe haven status in the event of turbulence.

Amid lower risk aversion, the *Value* segment on the US equity market could benefit from some serious catching up. We own some highly discounted stocks with particularly robust finances which are trading at levels that already discount a recession. Healthcare and dividend yields remain the core themes in our portfolios.

The European market

European companies are much better equipped to deal with a recession in 2012 – gearing is very low and they depend less on the banking sector- but governments are much more fragile and unable to kick start economic growth on their own. There are probably more downward revisions in earnings to come.

Although strong cash flow in European companies makes them less dependent on banks, securing finance will be trickier due to higher interest rates and taxes.

As a result, we prefer (i) companies that have robust cash flow and the capacity to increase dividend payouts, (ii) special situation stocks which are relatively decorrelated from economic trends and (iii) companies which benefit from emerging country growth. We remain very underweight cyclicals, especially if they have high gearing and are too focused on their home market. We are still avoiding financials apart from a few non-Eurozone banks and certain robust insurance companies.

Emerging markets

At the macroeconomic level, numerous countries are expected to ease monetary policy as governments now seem to be more focused on growth. In commodities, rising tension in the Middle East combined with a supply/demand imbalance should keep oil prices high. We also expect to see sustained demand for agricultural commodities.

At the microeconomic level, companies have learnt from the past and their sound finances and high profitability mean they are well-armed for the future. Moreover, the emerging equity universe keeps on expanding as better governance, improved capital markets and more efficient institutions create fresh investment opportunities. Our favourite investment theme is still the expanding consumer base in emerging countries. Other key investment criteria are infrastructure development, expanding financial markets, and companies which stand to gain from increasing energy demand and outsourcing of IT services.

Gold equities

Year to date, gold equities have performed more or less in line with equity markets as a whole. However, thanks to margins which have increased tenfold over the last 10 years, higher dividends and a fresh wave of M&A deals, they should over time improve performance relative to the gold price.

Convertible bonds

In recent weeks, convertible bonds have been hit by sharp falls on equity markets and widening credit spreads. However, we believe the correction has gone too far for some issues. With such significant discounts, convertibles are an excellent way of tapping into any market rebound while securing protection against any further declines. In our view, a global fund is the ideal solution for investors looking for geographical diversification.

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Edmond de Rothschild Asset Management

An affiliate of La Compagnie Financière Edmond de Rothschild, Edmond de Rothschild Asset Management is specialised in managing equities, convertible bonds and asset allocation. Focusing on stock analysis and selection and asset allocation, Edmond de Rothschild Asset Management relies on unique know-how. The results testify to the firm's capacity to deliver sustainable performance.

The company has offices in Paris, Hong Kong, Santiago de Chile, Madrid and Brussels and offers investment solutions to institutional investors, banking and insurance company partners and distribution platforms throughout the world.

As of November 30 2011, Edmond de Rothschild Asset Management had EUR 12.6bn under management in investment mandates and 29 open-ended funds registered in 10 countries.

About La Compagnie Financière Edmond de Rothschild

La Compagnie Financière Edmond de Rothschild Banque is the French branch of the Edmond de Rothschild Group. For several years now, its success has stemmed from its strategy of specialising in private banking and asset management.

Its mutual asset management range has for several years been considerably enriched by a dynamic product innovation strategy. All asset classes are covered: equity, convertible and diversified funds, fixed interest and credit, structured management, direct alternative and quantitative management, multi management (alternative and traditional) as well as private equity funds (capital-development, biotechnologies, FCPI [French innovative funds], LBOs and funds of funds).

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