

Investment Strategy

3rd February 2010

Preliminary Remarks	P.2
Recommendations	P.4
Asset classes	P.5
Economies	P.9



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A difficult transition

Highlights

- Global growth should remain strong in 1H10.
- The emerging countries are expected to be the frontrunners, led by China.
- The under-utilisation of capacity remains significant, particularly in the industrialized countries.
- The withdrawal of stimulus packages is happening around the world, but the process will be gradual and variable, depending on the country.
- In light of the risk of a relapse, policymakers will have to be careful to avoid a premature withdrawal. Don't expect the Fed or the ECB to raise rates before 2011.
- The markets are responding nervously to announcements—of financial regulation (United States), monetary tightening (China) and, above all, the fragility of some Eurozone countries (Greece).
- Even if, in the short term, the last throes of turbulence call for greater caution, the environment remains promising for risky assets over the medium term.
- Risk premiums on equities and corporate bonds remain attractive, but a good deal of the correction for undervaluation is already factored in. In general, expect performances that are less impressive than in 2009.
- It will soon be time to become more selective in terms of all asset classes. Exposure to quality growth will provide an excellent source of performance.
- One trap to avoid is excessive complacency in the face of a too consensual vision of the future.

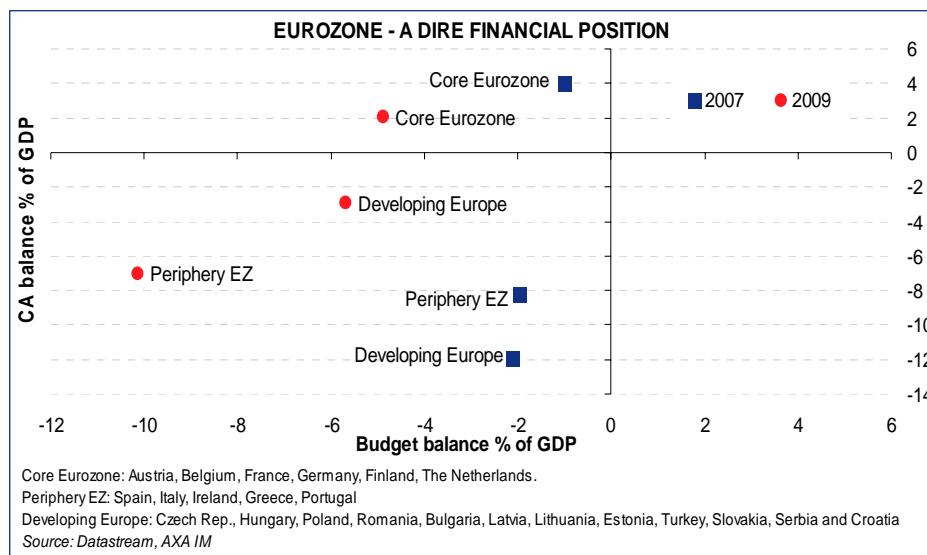
Bad news! January ended poorly for the world's stock markets, wiping out the strong gains seen during the first week of the year. However, there is at least one piece of good news, which should somewhat reassure the worry-warts and

statistics buffs. Since 1950, a rise in the S&P500 over the first five trading days of the year has resulted in an annual gain 89% of the time. At the same time, the signal for the year given by the performance in the month of January has panned out 88% of the time. In a word, we will apparently not be able to rely on number fetishism to help us predict the future. So let's focus instead on fundamentals.

This first month has brought us prematurely up against a number of problems that we knew could unsettle markets in 2010. What might the market reaction be to a reduction in the abundance of liquidities that were injected into the financial system? The news from China concerning the need to put the brakes on credit expansion, in a country that is leading the cycle and whose public stimulus effort was surely the most massive, has undoubtedly had an adverse impact on the markets in early 2010. In addition, after multiple discussions in the course of recent months, we were expecting to see new regulations put in place. But what will they look like? There again, the surprise announcement made by President Obama, inspired by the recommendations of former Fed chief Paul Volker, to limit banking activities (by eliminating proprietary trading activities, for example, as well as internal hedge funds and private equity), was like a cold

shower for the markets that has created a climate of uncertainty about the future of banking. Accordingly, banking sector stocks and bonds came in for a severe correction. Finally, while the crisis and the stimulus policies put in place leave the public finances of a number of countries—especially the industrialized ones—in a deplorable state, we expected that once the crisis was over public finance improvement paths would be defined for the medium term. How credible would they be? Greece, with its huge twin deficits (public and external trade around 13% of GDP in 2009!), has not just sown the seed of doubt on its ability to finance these imbalances, but also on the possibility of a split in the Eurozone. Obviously, the catastrophic scenari that the market entertained have hurt confidence and reduced the appetite for risk.

All of the major issues that recent events have brought to the fore are crucial for the future; at the same time, it is important at this stage not to give them more negative stature than is warranted, as some have done. Yes, liquidity will be reduced; but it is not likely in the majority of countries that this process will be abrupt and violent. Economic policymakers share a tacit consensus that it is necessary to withdraw the stimulus effort gradually. Indeed, even if activity is rebounding today, there is more risk involved in going too fast during the





policy withdrawal phase than in going too slowly. Similarly, when it comes to regulation, it would surely be a mistake to take President Obama's proposals lightly; but it would also be premature to conclude from his proposals that he seeks to weaken the banking system, when it has just been saved and there are so many questions unanswered as to its ability to offer adequate financing for future economic growth. As for the Greek tragedy, it is obvious that Greece is in for some severe correction, but it is really hard to imagine that this will happen outside the Eurozone. In parallel, it is hard to imagine Greece undergoing the same type of adjustment as fellow EU member Estonia (slashing the wages of civil servants by more than 20%). Europe will have to offer financial assistance (or eventually the IMF, with all the political cost attached) in order to reduce the cost of the effort. The Greek problem represents a genuine challenge to the cohesion of Europe. It is so critical for the Eurozone that everything that can be done to appease current tensions will be done.

It would be wrong to be too complacent and it is understandable to be more prudent when facing this type of events. However, we still believe that the environment remains promising for risky asset classes over the medium term. Accordingly, we maintain our recommended overweight to equities and corporate bonds.

Solid growth

An important factor behind this position is the currently healthy state of global growth. Indeed, the economic recovery remains very robust, and is even stronger than was expected in some regions. The latest surveys for the manufacturing sector, for the month of January, suggest that the situation remains very dynamic. For example, the manufacturing ISM for the United States has returned to its highest level since 2004. Similarly, Europe's biggest economies—France, Germany, Italy and the United Kingdom—are seeing a strong rebound in manufacturing activity.

At the same time, those countries most affected by the crisis remain behind, and continue to see contraction. This is the case for Spain, Greece and Ireland. The good news we see coming from the large industrialized countries is also visible in emerging countries, most of which are already ahead in the business recovery cycle. This is particularly true in Asia, as we can see from PMI surveys: the Indian indicator is the highest it has been since the summer of 2008.

These data support our scenario for world growth, which we see as remaining strong during 1H10. However, the idea of less homogenized rates of growth in 2H10 remains relevant. Indeed, the emerging countries will probably maintain a good deal of their dynamism, while we still see a slowdown in growth for the industrialized countries, due in particular to the gradual decline in the impact of stimulus plans, combined with the limitations placed on private demand by the employment picture and the need to deleverage further. At the same time, at this stage and taking disappointment over German growth for 4Q09 into account (0%qoq) as well as the adjustments for peripheral countries, the Eurozone will probably remain behind the rest of the world. In addition, a risk factor has appeared with the return of inflationary pressure in Asia, which could lead to a more rapid than expected tightening of economic policy, which would in turn lead to less growth than anticipated.

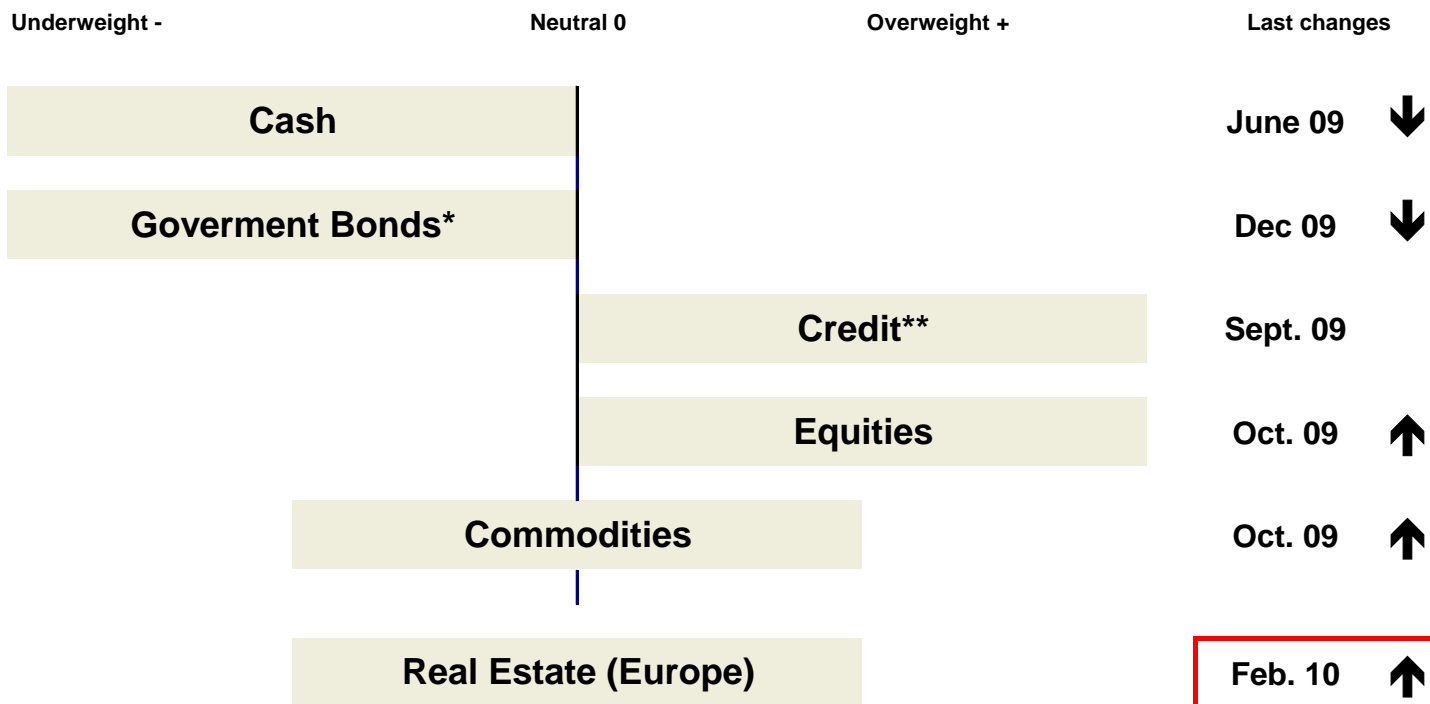
Gradual withdrawal of stimulus effort

While in Asia the worry is that more restrictive policy will have to be rolled out more quickly than expected, we continue to think that in industrialized countries the extreme under-utilisation of production capacities left behind by the crisis will cause policymakers to be very cautious in their withdrawal of stimulus. So even though we expect the ECB and the Fed to begin to unwind the extraordinary injections of liquidity into their

economies, we don't see them raising interest rates before early 2011. Conversely, in the United Kingdom a more rapid awakening of inflationary pressures should encourage the BoE to raise its rates starting in 4Q10.

Be selective in the markets

The complexity of this exit from the crisis, with sharp differences in terms of economic performance, variable speeds when it comes to policy tightening, industries and businesses more or less weakened by the past shocks—all factors that should naturally lead investors to become more selective in their bets. As we have indicated in the past, it is no longer a good idea to play the reverse systemic-risk-trade as was the case for much of 2009. At the same time, we still think that the environment remains positive for risky assets. It is true that much of the undervaluation of these assets has been corrected, but we believe that risk premia—for both equities and credit—remain fairly high, enough to justify our positive bias. In order to get the most out of this exposure to risk, we continue to insist on certain themes that should bring reward this year in the equity universe. Identifying the strong growth regions and sectors will be a priority, which is why we recommend giving preference to stocks that are oriented towards the expansion of the emerging countries. Using this same logic, and in light of current trends, we recommend giving preference to the United States over the Eurozone. In addition, looking at bonds we still prefer corporate issues. Even if over the medium term a rise in long-term yields is ineluctable in the main industrialized countries (already factored into futures), we maintain our view that, in the short term, given the distance that separates us from the first key rate hikes, long yields should fluctuate within a fairly narrow band. Finally, it is certain that the sovereign risk will be with us for a few years. Nonetheless, we believe that playing a convergence of spreads in the Eurozone at the first indication of a resolution to the Greek problem by Europe is a good bet.



* 10Y Government bonds

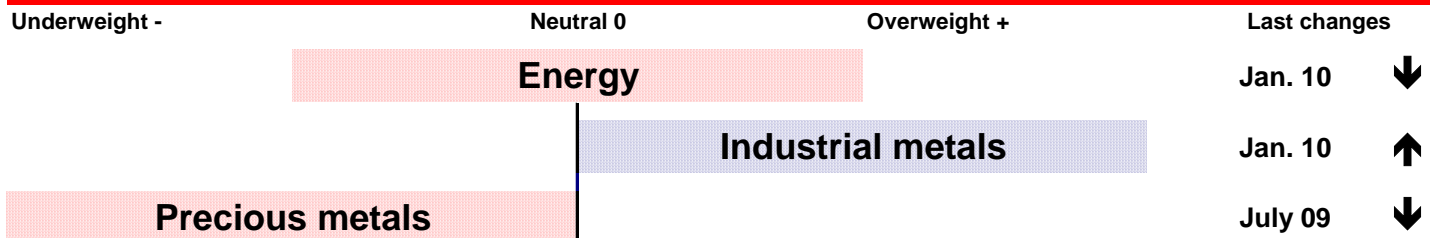
** Investment Grade credit

Equities

Preference for
Large Caps | Small Caps



Commodities





Adapting to a changing environment

Highlights

- Economic settings continue to support equities.
- The liquidity boost will fade in the course of the year as numerous central banks reel in the liquidity life lines.
- Earnings recovery is on track for a 25% jump, resulting in still appealing valuations.
- A more balanced stance is warranted in terms of sectors and countries.

The combination of a V-shaped economic recovery and ample liquidity propelled equities significantly higher last year as well as at the very beginning of 2010. Since then, global equity markets have declined as they try and digest various setbacks, be it monetary tightening in China or statements by President Obama concerning the regulation of the US banking system.

In transition: from recovery to sustainable growth

The recent economic data confirm that economic momentum is strong and broad-based, with leading indicators for the service sector clearly crossing the line between contraction and expansion. Furthermore, leading emerging economies are showing rather strong momentum, putting them in the driving seat. Moreover, ample liquidity propelled equity multiples.

Going forward, however, we think that the drivers for equities will shift. The first two boosters, restructuring combined with excess liquidity, have mostly burned out. Indeed, the latter in particular will make headlines as central banks prepare to withdraw the huge liquidity injections they made to help the ailing economy recover. Such a transition is usually accompanied by greater uncertainty. Despite the specifics of this recession, things will not be different this time, even if we strongly believe that monetary policy will remain rather accommodating in the G3 for longer

than usual. At the same time, even greater uncertainty about the monetary policy outlook will come from emerging markets, where tightening may be required more rapidly and indeed has already started.

As a result, the third engine, genuine growth—actual improvement in sales prospects—will have to take over to lift equities higher. This transition will not be a smooth one. Indeed, the horizon remains somewhat blurred and corporates are not yet ready or willing to give clear guidance for the coming year. Hence, company remarks will be under scrutiny.

Despite greater uncertainty, various leading indicators suggest that top-line growth will kick in during 1H10, allowing companies to take full advantage of the aggressive cost-cutting of the past year. This is particularly true with regard to the US. Currently, analyst expectations imply a business sales jump of around 8% —a reading we agree with even though it looks somewhat stretched by historical standards. Hence our conviction that our US earnings forecast of around 30% growth this year is on track. Against this backdrop, a forward valuation of 15x looks still fine to us.

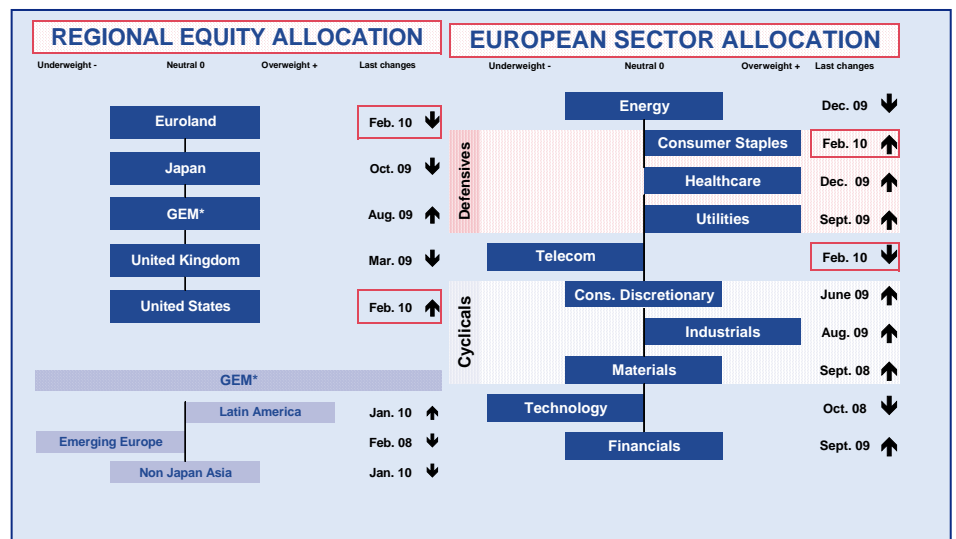
The situation is somewhat different in Europe, where a lot of doubts concerning volume growth remain. But, with a forward multiple of around 12.5x forward, this seems priced in.

Country and sector allocation

As mentioned above, the equity drivers will change and investors will shift their focus more to fundamentals. This should be reflected in the country but even more in the sector allocation. Consequently, at this stage, we find hard to really discriminate between the different regions, even though among the major markets we have a preference for the US vis-à-vis Europe.

Meanwhile, both macro and valuation settings argue in favour of European small caps, which we suggest continuing to overweight in a diversified portfolio.

The exposure to emerging markets of European stocks should be one of the key investment themes of 2010. For this reason, we suggest to increase our exposure to **Consumer Staples** to overweight, since it is the most exposed defensive sector to emerging markets, which are expected to grow at a much faster pace than developed ones this year and next. With regard to **Telecoms**, we believe worries that some of its leading players could embark on a major spending spree are justified and should continue to weigh on the sector. Telecoms are amongst last year's most active industries, with close to USD40bn in deals.





The sovereign hangover

Highlights

- Pressure on sovereign credits and financials trigger a flight-to-quality
- Inflation-linked underperforms but breakevens still rich
- Maintain carry trades despite risks to high yield valuations and contagion in emerging world.

Lopsided markets

It is quite difficult to make sense of the pricing of risk in fixed income markets during the first few weeks of 2010. There seems to be gross misalignment of security prices with time-tested risk hierarchy. For example, the ITX IG12 corporate index is trading barely above the newly launched sovereign CDS benchmark. In CDS markets, the spreads on Vietnamese and Romanian debt (respectively 230bps and 255bps at 5-year maturities as of February 1st) are far lower than that of Greece (just shy of 400bps). In credit markets, new issue concessions turned negative recently, and spreads on high yield indices no longer compensate investors if default rates revert to their long-term average of 4.5% over the next twelve months. Maybe the world has changed, maybe not.

Concern about the sustainability of public debt in developed countries is the main reason for this misalignment. Greece, lacking a credible plan to rein in its deficit, which is worth 13% of its GDP, is being sanctioned in bond markets. The 10-year GGB spread over German bunds now exceeds 350bps, surpassing the highs since its Euro debut. The next shoes to drop may be Portugal and Spain, as both the rating agencies and the IMF have warned against the consequences of runaway deficits.

Likewise, the need for fiscal consolidation will surely be at the top of the agenda for the upcoming parliamentary elections in the UK and the US. It could therefore be

increasingly difficult for the market to absorb a large bond issuance without a credible commitment to reducing deficits at a time when central banks will no longer be the marginal buyer of government debt. The ultimate direction of yields is thus highly uncertain at this stage. Supply risk may contribute to pushing yields higher, whilst low rates and the risk of a double-dip could offer support for bonds. On balance, we anticipate a rise in yields in 2H10 and keep an underweight stance on government bonds. In relative value terms, we prefer US bonds to German bunds after the sharp underperformance of Treasuries around year-end.

Inflation

Markets expect inflation to be above target in the medium run, but as always index-linked bonds have underperformed in the latest rally. The 5-year forward 5-year breakeven in the OATi market is down nearly 50bps, to 2.40%, from a month ago. We are keeping a neutral stance on inflation-linkers.

Credit

The outlook for credit is a little less supportive despite positive news on the earnings front and spreads still wide enough to warrant a constructive stance. In particular, US banks will surely have to undergo tighter regulation after President Obama introduced the *Financial Crisis Responsibility Fee* and other measures aimed at limiting the scope and size of bank

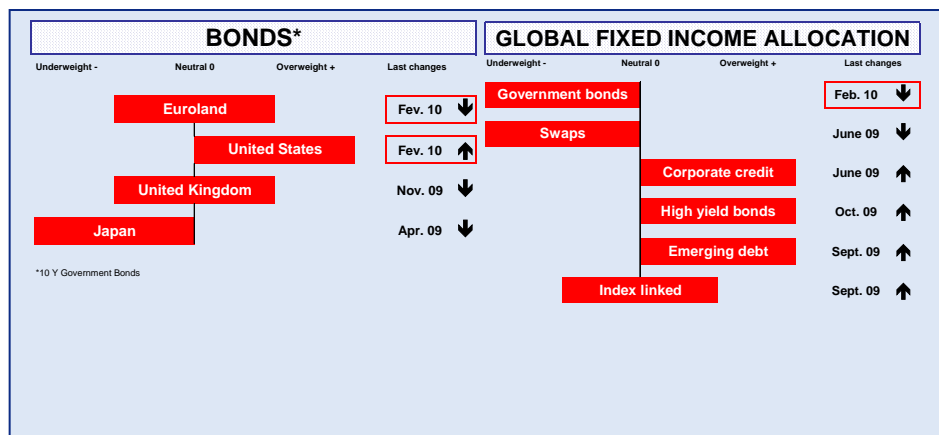
activities. The Administration is taking the moral hazard problem tied to too-big-too-fail institutions very seriously indeed. Whilst not dismissing the negative impact on spreads in the short run, we think that valuations favour financials over the more cyclical sectors of the credit market. Accordingly, we anticipate that a margin between financial and non-financial spreads will be restored.

Conversely, it is fair to say that support for the high yield segment of the market is gradually fading. Flows invested in HY mutual funds have slowed considerably and CDS spreads at a one-year horizon are consistent with sub-par default rates. Default rates are now past their peak though, and the chase after carry may not be over. Thus we maintain this long position on high yield.

Emerging Debt

Emerging debt could be subject to contagion from increased developed sovereign risk in 2010, despite the better economic backdrop and lower debt levels. The JPM EMBI+ spread thus widened from its October low of 264bps to 308bps currently. The risk-reward at these levels remains favourable in our view.

As for the swap spread term structure, we see opportunities in the short end of the Euro curve (up to two years) and expect the back end to return to positive territory.





A brighter future

Highlights

- Yields now falling in the UK.
- Stability or early falls in yields in most other European markets.
- Tentative signs of stabilizing occupational demand.
- We've upgraded the European property sector to neutral.

Capital market outlook

Despite seasonal cyclicalities, the volume transacted in European property rose from EUR14.6bn in Q3 to EUR19.5bn in Q4 according to DTZ, a rise of 32% over the quarter. However, this was only the third quarterly rise in the market recovery. DTZ have estimated that there is USD315bn of capital available for investment in direct real estate globally in 2010, and historical trends suggest that around 40% to 50% of this total will be targeting Europe.

Prime initial yields peaked at the beginning of 2009 in Central London and, since then, investment demand has caused prime London yields to fall significantly – by 2% points in the City – a phenomenon that has widened to encompass prime properties in other sectors and other countries.

While still highly risk averse, investors are getting their appetite back, encouraged by price rises in the other asset classes, and have been moving some capital from their money market funds and deposit accounts. This, together with the limited stock available in the property market, has moved the boundary such that most secure long-lease income-producing properties have become part of their investible universe.

Occupational market outlook

According to DTZ, the rental values of prime offices have fallen by 22% from their peaks but, for grade B or secondary space, the falls have been much greater. Void rates are continuing to grow in almost every European office market, except for

a few cities which have started to show signs of stability – although this might be only temporary.

For grade A space, an overhang, primarily from developments, has enabled some long-standing tenant requirements to be met at attractive rents and incentive levels. Generally, much of that demand has now been met, and with little new demand arising in the current market, completing developments may find it more difficult to achieve lettings over the current year.

According to DTZ, European prime capital city office rental values are now falling at a lower rate than previously. London, Paris CBD, and Berlin are starting to show signs of stabilisation, although this should be regarded as very tentative at this stage.

In the retail sector, the ability to successfully take advantage of, price competition is what is defining the winning and losing retailers. Those entities that have large amounts of debt to service are often left with no choice but to maintain prices in an attempt to hang onto margins. Those retailers, able to reduce price and thereby increase revenue, are gaining market share at the expense of the former, and some of them (in most cases international retailers) are in a position to expand.

The shopping centre development pipeline, in southern and central/eastern Europe, is now less

of a concern than previously estimated. However, shopping centre developments are generally having difficulty securing a sufficient number of tenants – particularly the national/international ones, and will almost all need to resort to rent concessions.

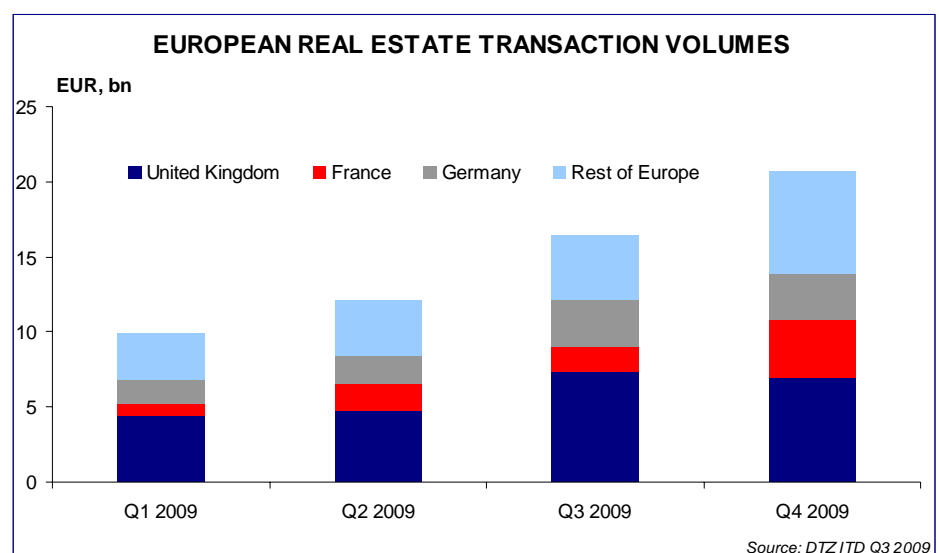
The logistic sector is characterised by a concentration of demand into larger modern distribution facilities. The older facilities are increasingly obsolete and are seeing little or no effective occupier demand.

In the manufacturing sector, the combination of reduced output demand and poor access to debt capital continues to be the main problem for European small- and medium-sized enterprises, the main occupiers of these industrial units.

According to CBRE, industrial rental values in the EU15 fell by 0.4% qoq over Q4 (after falls of 0.3% in Q3, 1.5% in Q2 2009 and 2.2% in Q1), with the largest falls, over the quarter, occurring in Budapest (-10%) and Barcelona (-7%). Utrecht (+8%) and Geneva (+5%) were the two main risers. Nevertheless, we are very cautious about accepting evidence of rising rents at this stage in the cycle.

Conclusion

Overall, we have upgraded European real estate from underweight in previous reports to neutral, acknowledging a brighter environment.





Will the situation escape OPEC's control?

Highlights

- OPEC quotas are less and less complied with.
- Spare production capacities are high.
- Chinese metal imports are not declining.
- Cereal and grain prices suffer due to production outlook.

The rise in oil prices seems to have come to a halt

Oil prices seem to have hit a roadblock, unable to make a lasting leap above the price of USD80 a barrel. We think that it is important not to mistake the reasons for the rise in prices observed in the course of 2009. Inventories, which had increased enormously at the end of 2008 due to the magnitude and severity of the crisis, were brought down to less aberrant levels after OPEC announced its decision to reduce its production quotas by 5mn b/d. The gradual decrease in inventories resulted in higher prices, approaching their equilibrium level (USD80). But in order to clear this threshold durably, the price curve has to shift into backwardation (i.e. the expectation of a relative shortage of the product). In fact, for several months now we have been seeing an accentuation of the contango of the slope of the price curve, which is a factor that supports declining price. This happens when a certain number of OPEC members do not really comply with their quotas (Iran, Angola, Nigeria and Venezuela). Overall, the cartel is actually producing more than 1.8mn b/d above the target, with the four countries cited above responsible for 1.4mn b/d of the total. In addition, OPEC's spare production capacities remain extremely high (5.4mn b/d in December), which puts considerable limits on the upside potential over and above the equilibrium price (USD80). Two conditions could change this situation: the first would be a faster than expected acceleration in growth for the developed countries (a hypothesis that is not very likely),

while the second would be a substantial increase in speculation, comparable to what we saw in the spring of 2008.

China's currency policy constitutes the final unknown. The demand for fuel in the People's Republic is rising very rapidly, in reaction to a spectacular jump in new vehicle sales in 2009 (more than 13.6 million units, which is 2.4 times more than in 2005). Demand for fuel can only rise; if the RMB begins to appreciate again, this development could only lend further strength to Chinese imports.

Overall, we are placing our bets on an average price for the year of USD80, with a few temporary spikes reaching up to USD85.

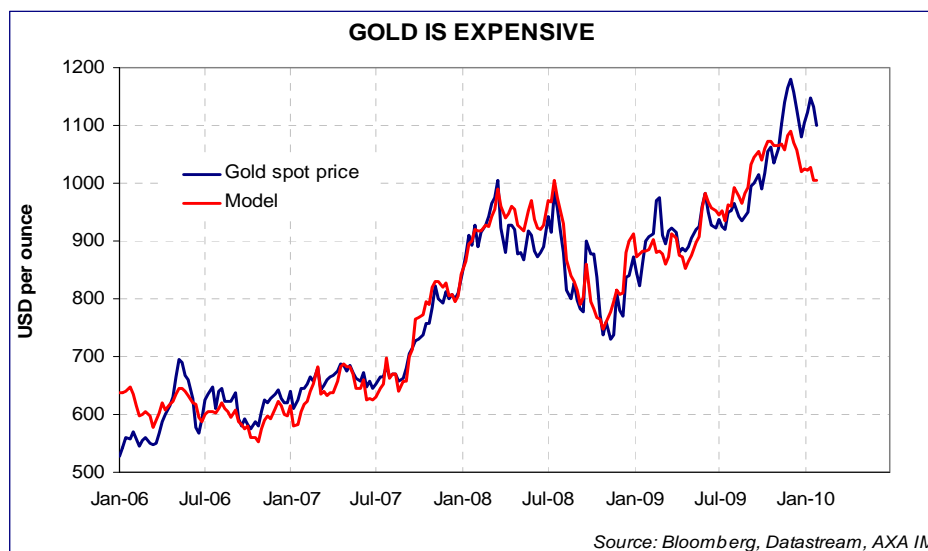
The outlook for gold is not as bright

The theme of the "remonetisation" of gold (by both investors and central banks) pushed the price to more than USD1 200 an ounce in early December. That said, it seems to us that this is an excessive price level given certain of the factors that generally impact gold prices, the first of which is the price of the dollar and the perception of risk (as measured by implied volatility in the equity markets). In addition, non-commercial positions in the United States have stagnated in recent weeks, indicating that investors are in a wait-and-see phase. Finally, over the longer term the price curve (highly correlated to Fed Funds)

should get steeper again, which will exert downward pressure on the spot price. For the time being, however, we see gold coming back to a level approaching USD1 000 to USD1 050 an ounce.

Industrial metals continue to surprise to the upside. For example, copper prices have nearly returned to their highest historical levels. China, which is by far the biggest market for all metals combined, played a key role last year and should continue to carry the market in 2010, even though the fundamentals are not supportive. Global inventories, expressed in terms of consumption weeks, have been relatively high (in particular for aluminium), but the lack of latitude in terms of supply is helping to keep the pressure on, and the lack of sloping on the price curves suggests that some of this inventory is not available on the market. Yet again, the movement of the RMB will play a decisive role. In addition, an uptick in construction starts in China argues for a rundown in local inventories.

Finally, the outlook for the major cereals and grains remains depressed amid higher production levels. Conversely, sugar prices are getting a boost from the negative outlook for India, and cocoa prices are benefiting from the price inelasticity of supply and the situation in Ivory Coast.





Political uncertainty, a new variable in the equation

Highlights

- The US economy is growing again. The policy-driven recovery will gather pace in 1H10.
- But growth will be constrained later this year by continued de-leveraging, poor employment growth and credit scarcity.
- Policy will remain accommodative for most of 2010. Fiscal stimulus will remain ample, while liquidity will be gradually taken back by the Fed. No rate hike in 2010.

The US economy is growing again. In the final quarter of 2009, GDP advanced by 5.7%qoq a.r., as consumer and corporate spending picked up. Adding to growth, inventory rebuilding played a very important role in the dynamic at the end of last year. But the current recovery is set to remain only shallow, much less pronounced than what has happened in past cycles, as heavy constraints weigh on growth. Therefore, it will take some time before activity returns to pre-recession levels.

In addition, recent defeats for the Democrats on Capitol Hill, weakening their majority, have recently become a growing source of uncertainty, which could weaken the US growth outlook. In particular, the outcome of the health and financial reforms announced by President Obama remains unclear at this point.

De-leveraging and banking sector consolidation

The recession hit consumers' balance sheets hard. The negative wealth effect from falling financial asset and real estate prices took more than USD14000bn (100% of GDP) from household net worth from 3Q07 to 2Q09. At the same time, the correction in household debt levels was rather mild during the recession, with debt to GDP falling by just 1.5 point. As a result, further de-

leveraging in the consumer sector is needed, and the legacy of excessive debt accumulated in the last decade will weigh on future spending.

In addition, although most banks have managed to significantly strengthen their capital ratios, loan losses and related provisions are still rising fast, making banks reluctant to add to their credit outstanding. This was confirmed by the last Senior Loan Officer Survey on bank lending practices, although bankers are less wary than last year. Furthermore, banks also need to de-leverage, and sizing bank balance sheets down would lead to a reduction in lending. The current uncertainty about how the White House wants to reform the financial sector is only exacerbating the tendency.

As a result, the current credit crunch reflects a combination of both demand (household de-leveraging) and supply (tight bank credit conditions) scarcity. Looking ahead, less credit means less support for a rebound in spending than in past recoveries.

Job-poor recovery

Job creation ended 2009 as it began: in negative territory, making 2009 (after 2008) one of the worst years in history. The adjustment in the labour market, which started in January 2008, cost the US economy more than 7 million jobs. As unemployment more than doubled, the average work week fell to a low 33 hours, the average duration of unemployment more than tripled, and the downward trend in wage growth, although it came late in the correction, is now firmly in place. From January 2010 onwards, we should see positive employment numbers (NFP) coming out, since the economy is growing again. But it remains an issue that the recovery may not be strong enough to create enough jobs to drive the unemployment rate significantly lower. Beyond a positive impulse coming from the census (adding up to 300k jobs to the payroll from January to April), labour market momentum is expected to remain poor, resulting in only very modest

gains in household income and therefore spending.

But economic policy to remain supportive

Fiscal policy will make a large contribution to GDP growth in 2010 (1.1% of GDP). The bulk of the government spending program (American Re-investment and Recovery Act) enacted last year remains to be spent this year. In addition, the extension of various tax cuts or benefits was agreed at the very end of last year. Additional stimulus, which the White House wants (according to the State of the Union speech on Jan 28, 2010), could prove more difficult to bring about following recent electoral defeats for the Democrats on Capitol Hill.

Monetary policy remained extraordinarily accommodative during the recession, in order to both fix the banking system and prevent a collapse in private spending. Now that the economy is growing again, and the financial system has normalized, the question of unwinding the conventional and unconventional measures taken so far is on the table. The Fed confirmed at the last FOMC that liquidity facilities and the MBS buying program will expire, as planned, by February 1st and March 31st respectively. The Fed has also already begun talking about exit strategies, like reverse repo operations and asset sales. We still think a policy rate hike will be the last stage of the process, with ZIRP remaining in place as insurance against a double-dip scenario. When the economy has sufficient growth to generate a significant deceleration in the unemployment rate, by early 2011, Fed Funds will be raised.



Brazil 1, Mexico 0

Highlights

- The recovery continues, boosted by global trade and restocking in the manufacturing sector.
- Mexico suffers from weakness in its domestic economy. Conversely, Brazil's robust internal demand is buoyant, fuelled by public expenditure and the subsistence of the household credit cycle.
- Everywhere else, consumer confidence is on the rebound, although the contraction in real credit and the impending return of inflation will weigh adversely on spending power.
- The cyclical recovery and the rebound in commodity prices will force gradual monetary tightening as of Q2.

The V of industry

The economic recovery continues apace, with a strong contribution from the industrial cycle still on display. Brazil and Argentina have experienced the strongest rebounds in industrial production (4.0% and 6.6%yoy, respectively, in the month of December). Peru, Chile and Mexico are still in negative territory yoy, but both the recovery and the restocking trend are well in place. Advanced indicators for the manufacturing sector (new orders) for Brazil (PMI at 60.7 in January) and Mexico (IMEF at 57.3) suggest the pursuit of strong expansion in Q1.

However, the strength of the continent's industrial recovery hides some underlying dynamics that are quite different. In Chile, the recovery in manufacturing is a little slower off the mark due to the strength of its currency (which has moved in line with copper prices towards records last seen in 2006, despite quasi-zero short rates), strikes in the mining sector, and the salmon industry crisis. The situation is saved by the strength of Chile's internal demand. The situation in

Mexico is the exact opposite, with the industrial rebound (+23%qoq a.r. in Q4) driven by the peso's weakness and exports to the US, particularly by the automotive sector, where production was up by 2%yoy in Q4, after having fallen by 42%yoy in the first three quarters of 2009. Domestic demand in Mexico is still on the mend, as attested by sluggish retail sales (-1,5%yoy in November). Conversely, retail sales have rebounded sharply in Brazil (10%yoy), Chile (7%yoy), and Argentina (9%yoy). Colombia falls somewhere in the middle (0%yoy), but a rebound seems imminent given the recent strong rise in consumer confidence. Indeed, consumer confidence is improving across the board, with the exception of Mexico. In Brazil, this indicator has even beaten its pre-crisis peak (April 2008) since October 2009. In the other countries, consumer confidence has barely made up a third of the ground lost during the crisis, which suggests that sentiment needs to be consolidated in order to renew with the levels of growth seen during the "decoupling" years (2006-2007).

Waiting for the consumer

During the glorious 2005-7 years, consumption was boosted by the unprecedented vigour of the domestic credit cycle, a première in Latin American history. This cycle was abruptly interrupted in late 2008 by the subprime crisis. Brazil was effective in staving off the spectre of the credit crunch by enjoining the public banks to take some of the load off the private banks. These managed credits, which amounted to 3% of GDP, kept the credit market from collapsing altogether, although its real growth was halved (from 20 to 10%yoy). Mortgage lending saved the real estate cycle, and the construction sector actually continues to create jobs (5%yoy in December). In the other countries, domestic credit is contracting in real terms (-1%yoy in Colombia, -3% in Chile, -8% in Mexico), despite the good health of the banking systems.

Mexico is experiencing the most intense credit crunch on the continent, despite the politically-motivated rise in lending by public banks (1.5% of GDP in 2009) and rock-bottom real rates (3.4%). The contraction in credit goes hand in hand with stagnation in Mexico's construction industry, as well as Argentina's. The construction sector is slowly recovering in Chile.

The strength of private consumption therefore appears to be dependent on a recovery in confidence. On the side of credit conditions, historically low real rates were not enough to revive supply (banks more skittish) or demand (lack of visibility regarding future income). Internal debt is thus not likely to start rising again in the short term, especially considering that monetary conditions will probably tighten as of Q2 in every country. In addition, improvement in the labour market (wages and unemployment) will only be felt long after activity has actually recovered. Finally, the resurgence of inflation (in particular the 10% rise in energy-related inflation as of H1) will eat into real income and dampen consumer enthusiasm for spending.

As this economic panorama indicates, Brazil—once strangled by its external constraint—has completed its metamorphosis and now enjoys an autonomous, domestically-driven growth. It may be too early to speak of a new locomotive for the Western hemisphere, a role that has historically been played by the United States. Indeed, the exports from Latin America ex-Brazil to its big neighbour represent less than 1% of aggregate GDP, compared with 10% for exports to the United States. The glorious achievements of the "Lula years" nonetheless constitute an economic and political example for the entire continent.



Bringing up the rear

Highlights

- The economic recovery is certainly visible, but remains subdued by deleveraging in the private sphere...
- ...masking significant divergences from one country to the next.
- Inflation remains under control, allowing the ECB to maintain its rates unchanged.

The Eurozone emerged from the recession in 3Q09, and the most recent data confirm that growth is still on track as we move into 2010. However, with labour market adjustments and deleveraging in the private sphere weighing adversely on demand, the rebound will hit a ceiling. In addition, the heterogeneity of the Eurozone is accentuating, as Germany benefits from the recovery in global trade while countries such as Spain and Ireland, on the contrary, face a drastic adjustment in their construction sectors and accordingly remain stuck in recession. Once again, the Eurozone is lagging the global recovery. In this context, the ECB is expected to maintain its accommodative policy stance with regard to key rates, while gradually withdrawing the liquidities it has made available to the banks since the beginning of the crisis.

Economic surveys for the early part of the year confirm that the rebound is in place, with most indicators continuing to climb in January (PMI, IFO, INSEE). However, some survey data from the end of last year show signs of fatigue. In addition, the publication of 2009 GDP data for Germany, showing a contraction of 5%, suggests that the recovery was more modest in 4Q09, which in turn suggests an unexpected slowdown in activity.

Above and beyond cycle-related trend differences, the financial crisis and the recession it triggered have also underscored some of the key structural differences within the Eurozone. Our forecasts reflect these differences. Accordingly, this

year GDP is expected to grow by 1.4% in both Germany and France, while the Spanish and Irish economies will continue to feel the adverse effects of their real estate sector adjustments. Between these two extremes, Italy—capitalizing less on the recovery in global trade—will only see 1% GDP growth this year, while domestic demand is limited by rising unemployment, a phenomenon it shares with other countries.

For the Eurozone as a whole, GDP is expected to increase by 1.2% in 2010, limited by a number of obstacles: economies that do the bulk of their business with one another, competitive strength is being eroded due to the weak EUR; the need for households and/or businesses to pay down debt and a rising saving rate; deteriorating labour markets and the impact on wages—just as inflation moves back into positive territory.

The slow rise in inflation

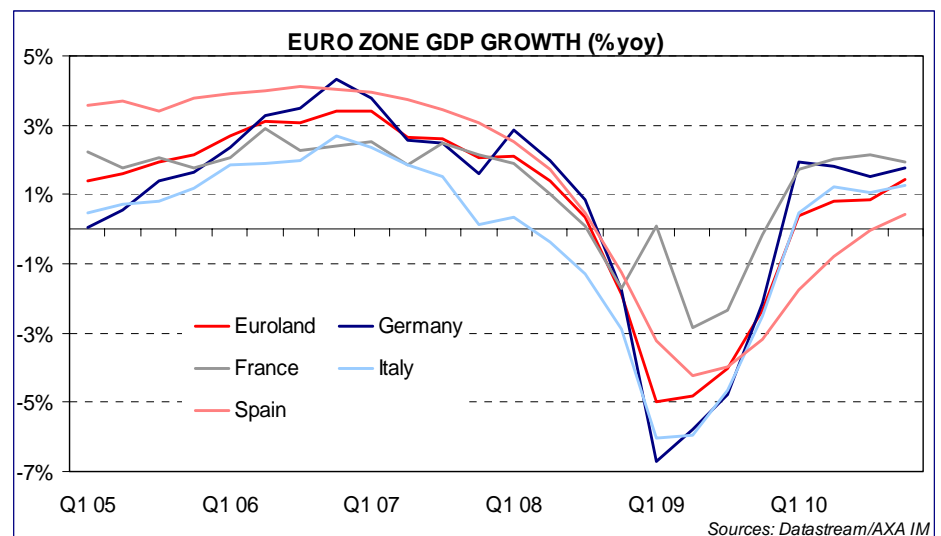
Inflation has been building little by little since last fall, as the base effects from past energy prices dissipate. From being in negative territory last summer, inflation had moved back into positive territory by November and reached 1.2%yoy last December.

At the same time, these inflationary pressures remain contained, with core inflation trending downward due to a significant output gap and its

repercussions on both employment and wages. The unemployment rate has been rising since last year and should continue to do so until around the middle of this year. Under these conditions, nominal wages should continue to stagnate, accentuating the downward pressure on core inflation.

Gradual exit for the ECB

As expected, the ECB left its key rates unchanged in January (the repo stayed at 1%). Given the modest growth and gradual recovery, not to mention the absence of inflation expectations, we think that key rates will stay at their current level throughout 2010. As for the withdrawal of the exceptional measures that were rolled out to cope with the financial crisis, the ECB gave some partial details on its upcoming refinancing plans last December. The last 12-month LTRO, in December, supplied an additional EUR96bn to the banks; the last 6-month LTRO will take place at the end of 1Q10; the 3-month MROs for 1Q10 will be offered at fixed rate and will meet all expressed demand. Thereafter, the ECB is leaving the door wide open for other MROs, with features as yet unknown. Given the natural expiry of the 12-month LTRO of June 2009, we know that liquidity will gradually be withdrawn starting in mid-2010, as various past operations expire.





Without fanfare

Highlights

- Laborious exit from recession in 4Q09 followed by a strong uptick in 1H10 thanks to inventory rebuild.
- Falling unemployment and a real estate recovery will boost consumer optimism in 1H10, despite the ongoing consumer credit crunch.
- The strong backdrop of recovery and inflationary pressures suggest the end of quant easing in February, though the first hikes are probably not due until 2 H.

Light at the end of the tunnel

After six quarters of recession, the United Kingdom finally rediscovered positive growth in Q4, but it wasn't glorious: the first GDP estimate predicted 0.1%qoq growth, as opposed to the market's more optimistic +0.4%. For 2009 as a whole, real GDP will finally have shrunk by 4.9%. This poor GDP performance contrasts with the very strong rebound in leading indicators and business surveys. The manufacturing sector was still in recession in Q4, showing contraction of 0.2%qoq, while the PMI manufacturing index showed an average of 53.1 for the quarter. The UK's cash-for-clunkers (scrappage) programme was not enough to get the manufacturing sector back on track, despite a 20%qoq rise in car sales for Q4. In the service sector, the recession was still present from September through November (-0.2%qoq), the most recent period for which data are available. There again, the contrast with the performance of the PMI index is flagrant, 56.8 on average over the period. Retail trade activity rose by 0.8%qoq for the three months to November, while business and financial services remained distressed (-0.6%qoq). This dichotomy illustrates the rebound in consumer spending, while key sectors of the UK's specialization, i.e. tradable services, remain in the doldrums. The

construction PMI, on the contrary, remains in recession (at 47 since July 2009); but the rise in housing starts in England over the last three quarters (including +18%qoq for Q3) seems to bode well for a rebound in the sector soon.

Inventory and cement

We remain confident in the ability of the economy to undergo a vigorous rebound in early 2010. Consumer spending should stay on the right track. Retail sales have grown since September (by 0.2%mom). The BoE survey, which is a leading indicator by 4 months, suggests that retail sales will grow by 0.5%qoq in Q1. The rise in the VAT sales tax in January (+1.5 points) will probably cool consumption to some degree; but the rise in disposable income for households should preserve the underlying trend. Real disposable income for households was up by 5%yoy in 3Q09, thanks to higher social transfers and the strong decrease in the debt servicing charge (a fall in short rates in an economy where most loans are indexed to short rates). In 1H10, the fall in unemployment should help to maintain this positive thrust: the unemployment rate fell to 7.8% in December, and the number of jobseekers receiving unemployment benefits has been falling since November (-26 000 for November-December). The new jobseekers curve is highly correlated to household confidence, and its collapse (of +137k/months in February and -15k in December) explains the rebound in consumer confidence (despite the recent pullback due to political uncertainties). In addition, the aggressive monetary policy stance taken by the BoE has revived the UK property market. In a country that is still suffering from a housing shortage, the decline in short-term rates has provoked a renewed interest on the part of buyers. The housing price index (the Halifax) rebounded by 9.4% in 2009, and is now only 15% from its peak in 2008. Mortgage approvals (+123%yoy in November) are a six-month leading indicator for

prices, and still indicate further gains to come. Only the first-time homebuyer component of the RICS survey has taken turn for the worse, but it is a nine-month leading indicator for prices. The positive wealth effect of real estate should contribute to revive consumer confidence. Lower rates have also paved the way for a rebound in the commercial property sector, where prices were up by 5% in H2, after having fallen by nearly 45% since the peak.

Corporate investment should, on the contrary, have a hard time getting back on track in 2010. The BoE's survey of investment intentions has rebounded since it bottomed out in 1Q09, but, at -2, it is still far from the low point it reached during the last recessionary episode for business investment (-0.7 in 2001). The inventory component will save capital formation, with an exceptional contribution in the neighbourhood of 1 point of GDP in H1, after eight consecutive quarters of massive decline in its GDP contribution.

Overall, we expect GDP growth to reach 1.4% in 2010, with a half-yearly profile that shows a moderation in the second half of the year (2.5% a.r. in H1, 1.5% in H2). Behind this weakening, due to technical and political factors (inventories, public expenditures), we expect an acceleration in private final demand (from 1.1% to 1.9%), which will gain strength in 2011. The vigour of demand will keep inflation at an uncomfortably high level for the BoE, which will probably end its quant easing policy in February and begin raising rates as of 2H10. Coordination with fiscal policy will be key to ensure a smooth exit from quant easing. The next government will have to present an ambitious plan of medium-term fiscal adjustment in order to retain investors' confidence, notably foreigners, in the Gilt market, as the visible hand of the BoE disappears.



Another year of contrasts

Highlights

- Uneven recovery continues in the region.
- Czech Republic to be driven by exports, Poland by domestic demand.
- Hungary to begin easing fiscal policy modestly.
- Poland will be the first to hike rates, probably in 2H10.

Central Europe: Poland to lead, Hungary to lag

2009 was a year where growth dynamics in CEE3 diverged dramatically, depending on the ability to implement countercyclical policies (in turn conditioned by each country's initial external constraint) and the degree to which economies were exposed to inter-European trade. Less open economies with a strong domestic demand basis fared better. These trends will continue in 2010, with an additional complication given by the need to retighten fiscal and monetary policy.

Poland was by far the regional outperformer. Not only did its economy not experience a formal recession in 2009 (preliminary estimates point to 1.7% annual growth), but indicators are pointing to a much more robust recovery in 2010 than in the rest of the region. Retail sales are running 7%yoy, boosted by a rebound in wages and a slowdown in the employment contraction. In Hungary and the Czech Republic, on the other hand, retail sales are still contracting (by 7.8% and 4.9%yoy, respectively).

By contrast, 2009 was a year of sharp economic contraction in Hungary (its GDP shrunk by 7.1%yoy in Q3), due to a combination of low external demand and very tight fiscal policy, imposed by the IMF SBA. In spite of the impressive progress made on the fiscal front so far (budget deficit down from 10% in 2006 to 3.5% last year), slippages are still being very closely monitored by the market. Indeed, the debt ratio is by far the

highest in the region (almost 80% of GDP). Hungary is facing parliamentary elections (in April), with Fidesz, the opposition party, most likely to win on what unfortunately looks to be a rather populist agenda of considerable fiscal easing. However, in the real world policy makers will have to strike a very delicate balance between giving some stimulus to the battered domestic economy and assuring markets that public debt is not on an explosive path. Failure to do the latter would certainly trigger currency depreciation and a second leg down in the recession.

Poland, on the other hand, is supported by the broad-based momentum of its domestic economy and the contra-cyclical policies implemented last year (rates cut by 250bps to 3.5% and 1.2% fiscal stimulus in 2009). The only risk to the Polish outlook would also come from further deterioration in public finances, since public debt is dangerously approaching the 55% of GDP threshold that would trigger automatic tightening and, most importantly, could alert rating agencies and adversely impact investor sentiment. However, the government deficit target is based on a very pessimistic growth assumption (1.2%), which we believe will be overshot, meaning positive surprises on the fiscal front. The comparatively healthy growth that distinguishes Poland from the rest of the region (GDP should accelerate to 2.5% in 2010) will probably mean the government's privatization programme will go ahead swiftly, helping to replenish public accounts. Moreover, Poland's access to the IMF Flexible Credit line, a financing facility with no strings attached but which is only open to countries with sound fundamentals, shelters it from the risk of a reversal in external capital flows and will help the PLN to continue to remain strong.

The Czech Republic is somewhere in the middle compared to these two extremely different economic dynamics. Healthy balance of payment fundamentals and low FX exposure of the private and public

sector have allowed for monetary and fiscal easing. Nevertheless, its dependency to global trade has clearly been a fragilizing factor. Indeed, the main expected growth engine remains the recovery in the Eurozone, especially Germany which looks to be less robust than previously thought, explaining the "soft V" profile we've seen so far in the Czech Republic. Our estimate puts GDP contraction in 2009 at 4.1%yoy. In 2010, although exports should recover, domestic demand will be constrained by fiscal tightening (measures have been adopted to bring down the budget deficit from a projected 7% to 5% of GDP) and weak private consumption. With the unemployment rate having almost doubled, from 5% to 9.7%, consumption shows few signs of reviving. GDP growth close to 1.5% is expected this year.

Central banks to change tone

While interest rates have been on hold in Poland since May of last year, Hungary continues its monetary easing, although the pace has been lowered from 50 to 25bps per meeting (rates now stand at 6.25%). The Czech National Bank made a surprise final cut in November, putting rates at an all time low of 1%. In Poland, where there is no output gap and headline inflation has been particularly sticky (near the upper band of the NBP's tolerance band of 3.5%), inflationary pressures could emerge. In Hungary, despite the economic slump, a combination of administrative price increases and currency pass through has kept inflation high (above 5%), meaning the end of the easing cycle is near. In the Czech Republic, core inflation was still negative in December yoy. All in all, only Poland will raise rates this year, while the Czech Republic will remain on hold.



Will deflation provoke a contraction in productive capital?

Highlights

- Economic recovery tied to budgetary policy.
- External trade is solid despite the yen's strength.
- The low capacity utilization rate is fuelling deflation.
- Short term, not much leeway in terms of the budget.

Not very convincing recovery

In many respects, the Japanese economic recovery seems to be robust. Industrial production has bounced back by 27% between the low point reached in February and November. However, just 54% of the ground lost after the Lehman Brothers collapse has been recouped so far. A detailed look at industrial production confirms the importance of budgetary and monetary policies, both domestic and foreign, with regard to this rebound. For example, the automotive sector, which only accounts for 8% of the index, has generated 21% of the total rise in manufacturing since February. Similarly, semi-finished goods and components, highly exposed to exports (particularly those going to China), contributed 73%, although they make up just 50% of the index. If automobiles and semi-finished goods are excluded, then the rest of the manufacturing sector rose by a mere 1.6%.

Given the level of uncertainty in the current context and its dependency on economic policies, the reluctance of businesses to invest is not too surprising. The Tankan survey for December confirmed that the priority is still to rebuild margins and that, as a result, both wage hikes (excluding the variable component) and investment plans must be postponed until the next fiscal year. Nonetheless, the improvement in the confidence level of small- and mid-sized businesses in the industrial equipment sector leaves some room for hope that 2010 will be better, which would be

all the more justified given that capital stock apparently stagnated in the course of 2H09, a phenomenon that had not been observed since the end of the war. But the effort that private business makes will be offset by the clear-cutting that the Hatoyama administration will have to make in the area of public investment, while residential investment is bound to remain depressed.

In addition, the inventory rebuilding dynamic observed in other countries is not so obvious in Japan, to the extent that in volume terms there was no prior inventory rundown at the global level in 2008 or 2009.

Once again, external trade should constitute the real pillar of the Japanese economy, reaping the full benefit of robust Chinese demand.

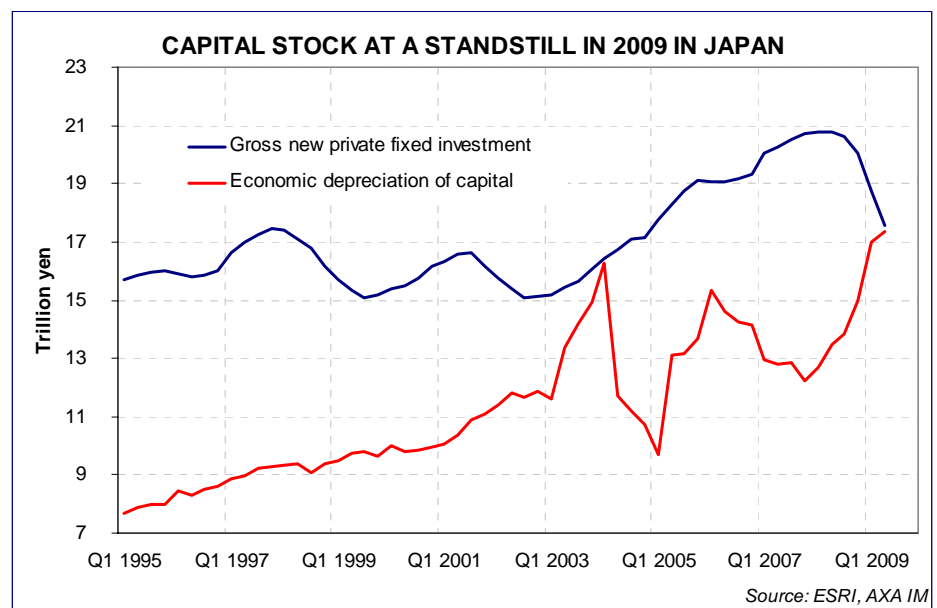
Is there reason to place hope in Japanese economic policy?

The policy that the majority elected in late August wants to implement seems to make sense in the medium and long terms, but is fraught with risk in the short term. In fact, it entails reducing direct expenditures (public works) and promoting indirect expenditures by supporting consumers. This policy bore fruit in 2009, in particular for the automotive sector, but labour

market weakness could lead to fears that some of these budget stimulus measures will benefit savings and not consumption. Moreover, budgetary projections are based on a deficit of just under 10% of GDP, versus 9% in 2009. Even if the current economic support measures are maintained, the impact on growth will be limited, while the debt will just continue to climb, automatically (this will be the case for as long as nominal GDP progresses at a pace that is lower than the debt servicing charge).

In parallel, the Bank of Japan (BoJ) has issued a reminder that its comfort zone for inflation is between 0% and 2%. To achieve this aim, the BoJ seems to be moving towards a reduction in monetary rates, but the decline in credit is more likely due to less demand than to less supply. In addition, liquidity injections remain inadequate to stimulate money supply.

In the final analysis, the growth outlook remains mixed for both 2010 and 2011, with +1.6% projected for this year and +1.3% for next year. Accordingly, the deflationary scenario cannot be ruled out before 2012.





Inflation and monetary policy: old demons rear their ugly heads

Highlights

- Strong growth of 8.7% in 2009.
- 9.5% projected in 2010.
- Extremely rapid growth in lending.
- Return of inflationary pressure.
- Monetary policy expected to reverse in 2010.

Resources poured into sustaining growth in 2009

China was able to maintain its growth rate above 8% in 2009, recording growth of 8.7%. This performance is all the more remarkable considering exports lagged domestic demand implying a flat, or even negative, contribution of exterior trade to GDP growth. Things began to change in December, however, as exports picked up.

Nevertheless, doubts persist regarding the degree of growth autonomy. More than any other country, China has used extreme stimulus measures including direct public sector spending and pumping RMB9,500bn in lending (banks are within the realm of the State) into the economy. Supposing that at least half of the stimulus plan was used in 2009 and given that an additional RMB4,500bn in new loans were granted compared to 2008, it can be estimated that RMB6,500bn, or 20% of GDP, reached the economy.

These measures had at least two consequences. China's decoupling has had a real impact on external trade as the country absorbs more and more of the rest of the world's production. On the financial side, the money supply expanded considerably and was accompanied by a resurgence in inflationary pressures.

Inflation will complicate authorities' job in 2010

Officially, Chinese monetary policy remains "relatively accommodating" but the tightening has already

started and should accelerate with the real remuneration of banking deposits becoming negative. As in 2008, the fear is that a significant portion of households' and companies' savings will be funnelled into assets that pay better than banking deposits, notably property assets, which would fuel fears of a bubble.

Given that December's inflation stood at 1.9%yoy and the benchmark rate on deposits for one year stood at 2.25%, real rates are quasi nil and should become negative in 1Q10. In and of itself, this will be a constraint as the authorities maintain a more or less constant intermediation margin of around 300bps. In other words, an increase in the lending rates will accompany a comparable increase in the remuneration of deposits: an unappetizing combination for Beijing.

As a result, interest rate hikes should be quite measured i.e. an increase of 27bps in Q2 followed by 27 additional basis points in Q3. The end result will merely be to reassure depositors.

It is likely that authorities will use other policy tools such as required reserve ratios (an initial hike occurred in January) and direct administrative controls to curb excess bank loans. In this case, however, the stated goal of RMB7,500bn in new lending in

2010 could appear inconsistent. On the one hand, this target is 20% lower than last year's actual lending but, on the other hand, it is 50% higher than in 2008.

As part of its fight against inflation, the Chinese government could reconsider its position on the Yuan - as suggested by the return of the central bank's sterilisation operations. Nevertheless, several months of export growth will be required before this option becomes politically palatable for Beijing. On the non deliverable forward market, expectations for the year ahead indicate that investors are rather dubious.

Monetary conditions will be, on the whole, accommodating during most of 2010 and, given the stimulus in 2009 and favourable fundamentals, economic growth should reach 9.5%. Starting in the second half, however, stimulus measures will be wound up leading to lower lending levels, notably. As such, in 2011, growth should return to a more sustainable level of 9%.





Early monetary tightening, decoupling's other side

Highlights

- Cyclical recovery ahead of that in advanced countries.
- Signs of cooling seen in Q4 for South Korea and Singapore.
- Inflationary pressures accentuate.
- Both China and India are beginning to tighten monetary policy.

Asian recovery leads advanced countries

2009 will go down as the year of decoupling, or at least as the year of greater growth autonomy for the economies of Asia. Indeed, the low point was reached immediately after the Lehman Brothers collapse, and the recovery began while the advanced economies and global trade were still on a downward spiral. The region was helped by the stabilising effect of its big economies with relatively little dependency on exports, such as India and Indonesia, as well as by the efficiency of the counter-cyclical policies run by China and South Korea, albeit on a different level altogether.

Apart from the specific case of China, the first national data for Q4 seem to suggest that normalization is occurring. For Singapore, on the basis of data for October and November, GDP probably fell by 6.8% in Q4 a.r. For South Korea, the year ended in positive territory at just 0.7%, also a.r. The case of South Korea is interesting, because the slowdown is related to the appreciation of the won and the first steps toward rebalancing public finances (public consumption fell by 11% a.r. in Q4, after very strong growth of 18%qoq a.r. on average over the previous two quarters), with a significant impact on private consumption. The exit from ultra-accommodating policies brings us back to the question of the autonomy of the private sector just when the spectre of inflation begins to rear its head again.

Rapid return of inflationary pressures

The output gaps for Asia narrowed considerably in the course of 2009, which in light of the acceleration in money supply (M1, the most liquid portion of broad money supply), could lead to fears of a return of inflationary pressures. Indeed, the situation is already worrisome in India, where food prices prevented consumer prices from easing during the crisis. For several months now, other price components of inflation are also moving upward. This is also the case in China, where the resurgence of inflation, though largely anticipated and undoubtedly caused by the sharp rise in commodity prices in the past year, is stronger than expected. The base effects should push inflation into the region of 3%-4% between now and March. Taiwan and Singapore are just about the only places in the region where prices continue to fall.

The fact that liquidity is being maintained at high levels is also fuelling fears that asset markets, such as real estate, could get out of control. In the real estate market, prices are increasing rapidly in Hong Kong and China, as well as to a lesser extent in both Singapore and South Korea. In addition, bank lending continues to rise in every country in the region, contrary to what is happening in the Eurozone or in the United States.

Inevitable monetary tightening

The central banks are taking the inflation risk quite seriously and the stance of their monetary policies is less and less accommodating. Since the beginning of the year, the Chinese and Indian central banks have already raised the level of their required reserve ratios in order to calm the credit market down and limit the rise in money supply. But this is only a first step that should be followed by key rate hikes some time during the first six months of this year. Since the advanced countries, the United States in particular, will not adjust their policy stance before H2, rate differentials will become favourable to the Asian economies, with the risk that their currencies could appreciate substantially in the event of significant rate hikes.

Overall, the uncertainty surrounding growth in 2010 is greater than it was in 2009. While there is no ambiguity as to the impact of a massive budgetary and monetary easing on the economy (the most, the best), the impact of tightening is less clear, because it requires more fine-tuning. Opting for a median scenario, growth in Asia ex-Japan could reach 7.2% in 2010 and 7.1% in 2011, with average inflation of 4% and 3.7%, respectively.




GDP, in %yoy

February 2010	2010				2011			
	Consensus*		AXA-IM		Consensus*		AXA-IM	
	last revision		last revision		last revision		last revision	
USA	2,9	↑	3,1	↑	3,1		2,6	
Japan	1,3	↓	1,6	↓	1,5		1,3	
UK	1,5	↑	3,2	↑	2,2		2,0	
Euroland	1,3	↑	1,2	↓	1,6		1,9	
Non Japan Asia	7,4		7,2	↑	7,4		7,1	

Inflation, in %yoy

February 2010	2010				2011			
	Consensus*		AXA-IM		Consensus*		AXA-IM	
	last revision		last revision		last revision		last revision	
USA	2,2	↑	2,5	↑	1,9		2,1	
Japan	-1,0	↓	-0,8		-0,3		-0,2	
UK	3,2	↑	2,1	↑	2,4		1,7	
Euroland	1,2		1,3	↑	1,5		1,7	
Non Japan Asia	4,4	↑	4,0	↑	4,0		3,7	

* Sources: Datastream as of February 3, 2010

10 Year Bond Yields

Country	3-Feb-10	Forecasts		Forward 12 Months Feb-11
		12 Months Feb-11		
USA	3,65	4,00		4,13
Japan	1,35	1,50		1,58
UK	3,91	4,25		4,35
Euro zone	3,19	3,80		3,60

Sources: Bloomberg as of February 2, 2010 - AXA IM estimates

Official Rates

Country	3-Feb-10	Forecasts					Last action	
		1Q 10	2Q 10	Q 10	4Q 10	1Q 11	Rate	Bias*
USA <i>Fed funds</i>	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	1,50	-75 (16/12/08)	+
Euro zone <i>ECB repo</i>	1,00	1,00	1,00	1,00	1,00	1,50	-25 (07/05/09)	+
UK <i>BoE base</i>	0,50	0,50	0,50	0,50	0,75	1,75	-50 (05/03/09)	+
Japan <i>JP overnight</i>	0,10	0,10	0,10	0,10	0,10	0,10	-20 (19/12/08)	+

* accomodative +, neutral 0, restrictive -

Sources: Bloomberg as of February 2, 2010 - AXA IM estimates

Currency

Currency	3-Feb-10	Forecasts 12 Months		Forward 12 Months Feb-11
		Feb-11	% Change	
USD / JPY	90,38	95,00	-5,1	90,00
EUR / USD	1,40	1,40	-0,3	1,39
EUR / JPY	126,18	142,50	-12,9	125,34
EUR/ GBP	0,87	0,80	8,5	0,87
GBP / USD	1,60	1,43	10,8	1,59

Sources: Bloomberg as of February 2, 2010 - AXA IM estimates



02/02/2010	Index	Yield 10 year Bonds	Performance		PE		EPS growth in %		PE/EPS growth	
			Equity Markets YTD, in local currency	Bond Markets	2009	2010	2009	2010	2009	2010
United States										
S&P 500	1089,2	3,65	-2,3%	1,83%	19,2	14,8	0,5	30,0	n.s.	0,5
Canada										
TSE300	11317,6	3,35	-3,6%	2,37%	18,9	14,9	-26,2	26,8	n.s.	0,6
Japan										
Topix	898,6	1,32	-1,0%	-0,29%	35,7	18,5	n.a	91,9	n.s.	n.s.
Euroland										
DJ EUROSTOXX 50	2793,3	3,18	-5,8%	1,94%	14,2	11,7	-17,8	21,3	n.s.	0,6
Germany										
DAX	5654,5	3,18	-5,1%	1,94%	19,1	13,0	-12,2	46,8	n.s.	0,3
France										
CAC40	3762,0	3,44	-4,4%	1,44%	16,1	12,5	-30,6	29,1	n.s.	0,4
The United Kingdom										
FTSE 100	5247,4	3,99	-3,1%	1,28%	17,6	13,1	-35,7	34,0	n.s.	n.s.
Italy										
MIB	22012,0	3,90	-5,3%	1,02%	16,1	13,0	-43,6	24,2	n.s.	0,5
Spain										
Madrid General	1144,9	3,92	-7,8%	0,41%	13,9	12,6	-30,3	10,4	n.s.	1,2
The Netherlands										
AEX	331,3	3,39	-1,2%	1,48%	23,4	13,5	-48,9	72,8	n.s.	0,2
Belgium										
Bel 20	2537,7	3,52	1,0%	1,72%	18,2	13,0	511,8	39,7	n.s.	0,3
Switzerland										
SMI	6496,3	1,86	-0,8%	0,40%	16,2	12,8	495,3	26,6	n.s.	0,5
Sweden										
OMX	967,8	3,18	1,7%	1,05%	20,5	15,9	-43,8	29,2	n.s.	0,5

Source: Datastream; IBES; Reuters
n.s. = not significant / n.a. = not available

ABBREVIATIONS

1Q05	first quarter of 2005	CPI	Consumer price index	BRL	Brasilian real
1H05	first half of 2005	GDP	Gross Domestic Product	EUR	euro
s/a	seasonally adjusted	IMF	International Monetary Fund	GBP	sterling pound
n.s/a	non seasonally adjusted	ISM	Institute of Supply Management	HKD	Hong Kong dollar
a.r.	annualised rate	OECD	Organisation for Economic Co-operation and Development	IDR	Indonesian rupiah
mom	month on month	OPEC	Organization of the Petroleum Exporting Countries	INR	Indian rupee
qoq	quarter on quarter	PMI	Purchasing Manager Index	JPY	yen
yoy	year on year			KRW	South Korea won
pp	percentage point			RMB	Chinese renminbi (yuan)
P/E	price/earnings			RUB	Russian ruble
[RHS]	right hand scale (graph)			USD	American dollar

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