

# Investment View

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## Investment Views HOVING & Partners S.A.

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### Summary

- We expect moderate real world economic growth in 2010.
- Chinese economic growth may disappoint with negative impact on global cyclical stocks.
- Momentum of growth of world industrial production is slowing.
- We expect a modest recovery in employment growth in the US.
- We expect a modest recovery in US house prices.
- Exit of Central Bank support programs, lower demand for “safe” havens in addition to quality concerns may put upward pressures on long-term government bond interest rates.
- Global earnings growth of companies may surprise on the upside and may reach 25% in 2010.
- Equities are expected to outperform bonds and cash.
- US equities may be the best region for equities, outperforming Emerging markets.

### 2010 Road Map Asset allocation for a balanced portfolio

Cash & deposits	Underweight (Q1) – Buy (Q2-Q3)
Government bonds	Underweight
Inflation linked bonds	Underweight – Buy (Q2-Q3)
Credits	Neutral
Convertible bonds	Neutral
High yield	Sell (Q1)
Equities developed markets	Overweight
Equities Emerging markets	Underweight – Buy (Q3-Q4)
Hard commodities	Sell (Q1)
Soft commodities	Buy (Q1)
Property	Underweight – Buy (Q2)

### Economy

Looking back, we can now say that the global economy started to stabilize in Q3 2009 due to massive policy easing by governments and central banks worldwide. Financial markets have normalized and 2009 was the year of the Great Recovery. In 2010, it is expected that financial markets will increasingly focus on the US consumer with regard to the housing and employment markets and the level of the US savings rate. Furthermore, markets will focus on the health of the financial sector and the capability of governments and Central Banks to address debt levels and budget shortfalls. Last but not least, markets are eager to see to what degree the world economy has entered a new growth phase or if a “double dip” scenario (W scenario) will occur.

Consensus forecasts for economic growth almost always underestimate the recovery coming out of a recession, or end up revising higher. In April 2009, consensus was looking for a weak economic recovery in 2010 of only 0-2% growth in the major economies. In November, the consensus was revised upwards by 0.5-1.0 percentage points.

The most recent IMF forecast expects a 3.0% real GDP world growth in 2010. This would correspond to the world's long term historic growth. Goldman Sachs, Morgan Stanley and Merrill Lynch see an even higher global growth rate of 4-4.5% in 2010. We also believe the recovery may be stronger than IMF's forecast, keeping in mind that it should be much weaker than a normal recovery after a severe recession. We have three reasons for this:

1. Economists and investors tend to underestimate the power of the business cycle. During recessions many sectors of the economy overshoot to the downside such that any improvement in confidence prompts a big bounce. Korean data provides a good example. GDP fell 18.8% at an annual rate in Q4 2008. In the spring the forecast from the IMF was that GDP would contract 4.0% in 2009 and grow just 1.5% in 2010, implying virtually no cyclical bounce. In fact, Korean GDP has advanced close to an 8% annual rate over the first three quarters of 2009.
2. Coming out of a major recession, any view that sounds even a bit optimistic is usually greeted with much scepticism. The only thing economists and investors seem to be looking for is the next "black swan". Forecasting is unusually difficult at turning points of the cycle. We believe Q3 of 2009 may have been such as turning point.
3. Capital markets are often compared to a "five cylinder" engine. After the Lehman collapse in September 2008, none of the cylinders worked any more and policy makers around the world quickly had to adopt a full scale of measures never seen before. Today, the money markets, credit markets and the stock market are recovering, but most of the banks remain in consolidation mode and the housing market in the USA is barely moving. A "three cylinder" engine cannot move at the same speed, which is the main reason the world economic recovery should be slow.

### Economic indicators

To track the global economic recovery, we follow, among others, six indicators. They are the following:

- Copper price	Positive, makes new highs
- AUD/USD	Positive, rising again
- Kospi (Korea) share price Index	Positive
- EM & G3 leading indicators	Positive, but some look to roll over
- Shanghai real estate	Side ways to negative
- US housing	Starting to be positive

The majority of our indicators have turned positive for some time. World industrial production on the other hand seems to lose momentum. China, the world's main growth engine, has seen its industrial production peaking already in July 2009. In the US, we have seen a peak in September and in Europe in December 2009.

This could indicate that the restocking phase of the cycle is almost complete and that demand and capital expenditures should be the main driver for future production growth.

We are revising our positive view on **China's economy** to a more neutral stance which is contrary to the general bullish view on China's economic prospects. We also believe that there is a risk that securities markets may lose momentum on reports of economic slowdown in China. After all, China was the economy which came out first of the recession to lead the world economy out of its slump. There are three main reasons why we change our views on China:

1. China's expansion cycle has surpassed all others in history. It is widely believed that China is still in an early development phase and therefore in a position to expand capital spending for years to come. However, both in its duration and intensity, China's capital spending boom is now outstripping previous great transformation periods. We believe the potential for expansion in China is restricted by slower export growth and its underdeveloped internal market.
2. Policy actions (China has spent nearly as much stimulus money as the USA to support its economy) are not sustainable into 2010. This year's burst in economic activity has been inflated by a front-loaded stimulus package and a surge in credit growth. Given their exceptional and forced nature, we believe growth rates in government-driven lending and capital spending could be much lower in 2010.
3. China has built an overcapacity and sees its marginal returns on investments falling. Analysis of industrial capacity, urbanization and infrastructure development shows that China's industrialization and structural modernization are largely complete. Combined with falling returns on investment, there is evidence that China's long-term investment needs are overestimated.

### Inflation

Some economists think that the threat of future inflation has increased following the unprecedented injections of liquidities in the financial system by Central Banks. The potential return of inflation is a concern and a dilemma for Central Bankers. On the one hand the recovery of the world economy may not be sustainable with the withdrawal of the various support programs; on the other hand a wrong timing of the "exit" of these programs leading to "over" stimulus may enhance inflation.

We believe that inflation should remain low in the developed economies in 2010 with an expected core inflation of 0.3% in the US in 4Q 2010, fading to around zero in 2011. In the European Union we expect core inflation to fall to 0.6% by 4Q 2010.

The world is still in a deflationary cycle. **Wage** growth is the lowest in fifty years and no real change is expected for this year. Another factor is the sizeable **overcapacity** built up in the last few years. It will take some time to eliminate this output gap. While this is true in a world with free global trade, protectionism may have a negative influence on the inflation outlook.

The world's financial system has been financed (and saved) by massive issuance of government bonds and various buy-back programs (accompanied by ballooning balance sheets of Central Banks). This extra cash has been mostly used by the financial system to repair balance sheets of commercial and mortgage banks and to increase capital ratios. The demand for "safe" assets such as government bonds by private investors and institutions has taken the other part. Moreover demand for loans was low and banks have become overly prudent to lend money to individuals or corporations. The fact that the Fed and other Central Banks took over part of the credit system is not necessarily causing inflation.

In a low growth environment, the price of **oil** should remain stable. The price hike of oil in 2007 and 2008 happened at the peak of the economic cycle while there was limited spare capacity. Thanks to the high oil price, tremendous efforts were made by the industry to discover new oil fields with success (Mexico and Brazil). This year, Iraq's oil fields will start to produce more oil, making Iraq one of the largest oil producers jointly with Saudi Arabia and Russia. With this additional capacity, the demand and supply curve of oil will be more balanced. It is in the interest of Western and Emerging economies (China and India) that the price of oil remains stable. Raising oil prices would hinder the already weak world economic recovery and would enhance the current power base of Iran. We anticipate oil prices to remain at around current levels.

### Interest rates

With the benign inflation outlook, we expect no changes to Fed funds rates through to end 2010. The ECB traditionally has a more inflation "hawk" attitude and inflation in Europe is higher than in the US. We may see an interest rate hike by the ECB of 25 bp in 4Q 2010.

We expect that improved employment numbers will trigger the first interest rate hikes in the Western economies.

### Exit strategies

There has been much published and talked about the "exit" strategies by the Central Banks. Stopping support is the first stage to "normalize" the financial system, with the aim to let the economies stand on their own feet. Economists are discussing the "how and when" of the exit but not the principle. No matter the timing, the exit by the Central Banks will have the

indirect effect that long real interest rates will raise. We already see this phenomenon with 10-year US Treasuries which steepened from 3.3% to 3.8% in December 2009.

We see the “exit” strategy envelop in basically three stages:

1. Central Banks will stop or wind down life support programs for banks (US in December 2009, the EU have limited its programs except the UK that has even increased its programs).
2. Central Banks will stop buying mortgages, government bonds or other securities directly in the market (US expected in March 2010, EU has already stopped and the UK continues. Japan has decided to increase)
3. Central Banks will start raising real short term rates (Australia, Norway have started and China rose lending rates on 12 January 2010, but moves by the ECB and the Fed are expected much later).

### Basel 3 Accord

Currently, central bankers are discussing a new Basel 3 accord with the aim to make the world financial system more resistant to credit crises similar to what we have seen in the period 2007-2009. The proposal focuses on the role of banks and to limit their capacity to leverage and to increase their capital base. If all proposals are accepted, it is predicted that the new Accord will ultimately translate into generally higher costs of capital for financial institutions and into higher costs of lending. This is a strong measure while the recovery of the global economy is weak and we expect the new Accord to be put in place only when the economic growth cycle has become more sustainable.

### Currencies

We expect lower volatility in world currencies which would be welcome news. The **USD** should gradually get stronger in 2010 as world trade recovers and when US economic growth proves to be stronger than in Europe. At the end of November 2009, the USD made a turning point appreciating by more than 7% against the EURO until the end of the year.

The **Chinese Remnibi** should gradually appreciate. The Chinese government has indicated their willingness to take positive steps in that direction. This measure will reduce global imbalances and stimulate the development of the internal Chinese economy (cheaper imports).

With the appointment of a new minister of Finance in Japan, the strong **Yen** policy adopted by his predecessor has been thrown out of the window. The Japanese economy is still very much dependant on exports. This situation should remain in place for a while.

The **EURO** came under pressure late December 2009 as US economic data came out stronger than expected and debt problems in Greece scared investors away.

We think that it is unlikely that the **EU block** will collapse as the economic costs would be much higher than not supporting member states. In fact, a case can be made that the EURO block will ultimately come out stronger as a result of the PIIGS crisis (Portugal, Italy, Ireland, Greece and Spain). It is expected that the weaker countries will be subject to much stricter oversight by the ECB and Brussels. Ireland has taken bold measures to reduce budget deficits and seems to be committed to the standards set by the Maastricht Treaty. We are far away to see the first issuances of European Union government bonds jointly guaranteed by all member states (no longer individual country bonds) which have been proposed by a.o. the Italian government. This would be necessary for the EURO to become a true reserve currency. Germany traditionally following a strong currency and tight budget approach is still opposed to this idea.

The currencies of **Emerging economies** should continue to appreciate long term. Short term, currency management by local Central Banks will be dominated by political considerations.

The **AUD, NOK and CAD** remain “commodity” currencies. All three economies are well managed and have profited from the tremendous run in commodity prices including oil. These are usually the first countries to raise interest rates in the early part of the economic cycle making these currencies attractive for bond investments (Australia and Norway).

The French President Sarkozy has increasingly made the point that there is a need for a new **world economic order** and that the USD should be replaced as the world’s currency standard. France being the champion protectionist country in Europe faces strong declines in their export volumes (20% below 2008) and maintains that French industry suffers greatly from the low USD (President Sarkozy’s party faces regional elections in 2010 and attacking the USA attracts votes in France). We do not believe we have arrived at a stage that the US and China would agree to discuss such a new economic order.

### Commodities

**Hard commodity** prices have risen sharply for nickel (+65%), copper (+43%), lead (+24%), zinc (+19%) and aluminium (+5%) during the past few months, driven mostly by China. Despite high inventory levels, China has continued buying. As China’s leading indicators are topping out, we think demand will fall and prices should at least stabilise or come under pressure when there is more evidence of a China slowdown.

**Gold** had a good run in 2008-2009, but we believe Gold should still be part of investors’ portfolios as it acts as a hedge against extreme events and currency depreciations. The fundamental reason behind the rise in the Gold price has been the loss of trust in Western governments and the Western banking system.

## Investment Views HOVING & Partners S.A.

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In the absence of alternatives, it seems logical for surplus countries to diversify part of their reserves into Gold (recent Gold purchases by India and China support this). With the current uncertainties with regard to the success of government policies in the US, it seems prudent to remain invested in Gold. Gold is the ultimate diversifier among various asset classes for investors looking to preserve value and avoid currency depreciations.

Long term, **oil** prices are mostly correlated with world GDP growth. In our current low growth environment, oil price movements should become less volatile and more stable. Oil producing capacity has increased with the improved exploitation of Iraqi's oilfields. Saudi Arabia now also has more spare production capacity improving the supply side of oil. We believe Saudi Arabia and the US will be reluctant to let the oil price rise much above \$80.

Over the coming years, economic growth and a demographic transition in Emerging economies will support strong growth in demand for **soft commodities** such as grains, oilseeds and meats, putting upward pressure on prices in the medium term. However, as the world expands agricultural production capacity, rising input costs (fertilizers, machinery, fuel, water) require output prices to rise from current levels. More worryingly, inventories across most agricultural products still stand at multi-decade lows. Even though expectations are for decent harvests this year, we still believe that agricultural commodities are in the early stage of a long-term bull run.

### Equities

Last year was a year of great recovery for global equity markets following the severe declines of 2008. Equities were one the best performing asset classes on a global basis with the best returns found in the Emerging markets and in the Materials and Technology sectors.

Highly cyclical and low quality stocks were the best performers. The year was characterized by increasing risk appetite and falling equity price volatility built on evidence of an economic recovery allowing those stocks most leveraged to falling discount rates and economic recovery to perform best. The Emerging markets were the best performing region in 2009, benefiting from both developed world recovery as well as fiscal stimulus programs that helped buoy domestic demand.

We think the drivers of the equity market in 2010 will mark a clear change from the high risk appetite for cyclicals that characterized 2009. Since 2<sup>nd</sup> half 2009, we have been shifting our investments to **sustainable growth** companies, with **high dividends** and **BRIC exposure**. We believe this trend will be more significant in 2010.

We expect that **net earnings** growth will take over from valuation or P/E expansion as the key driver of returns.

## Investment Views HOVING & Partners S.A.

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Current market valuations look fair on consensus 2010 net global earnings with a 2010E P/E of 11.4x and 2011E P/E of 8.9x in Europe and respectively 15.6x and 13.7x in the US. These figures are based on a growth of net global earnings of 25% (32% in Europe) in 2010.

We expect higher valuations of stock prices in the coming months as the markets may be surprised by stronger than consensus earnings growth in 2010 or 2011. With economic growth expected at 3% for 2010 (BRIC 8-9%), revenue growth of companies may reach 6-8%. We believe this revenue growth is possible (and may even be too conservative), which combined with higher capacity utilization, will strongly boost margins and net earnings.

After all, companies have cut production by 20% in Q4 2008 and 2009 while GDP declined only by 4.4% over the same period. Also, companies have made deep cuts in their expenses. With a much lower cost base, the operational leverage is high with an immediate impact on the bottom lines.

The Expected Risk Premium (ERP) on European equities is now 5.5% (from a peak of 7%). This compares favourably to the 20-year average of 2.9%.

We expect the first quarter to be strong for equities based on surprisingly good 4Q 2009 earnings. As the markets have rebounded in practically one straight line since March 2009, we should anticipate corrections in the stock markets this year. When and how much will be the result of sentiment and “unexpected” events. The accelerator for such a correction may for instance come from a “growth scare” out of China or a mismanaged “exit” by Central Banks.

With global economic growth of around 3-4% in 2010 and 2011 and still relatively low interest rates, the case for equities remains very attractive and we expect to finish this year on a positive note.

**Regionally**, we think that developed equity markets will attract more money flows this year than Emerging markets as valuations look more attractive. We recognize that economic and earning growth of Emerging markets is superior to the developed world, but as real yields will rise this high growth will face a higher discount rate. Moreover, we expect some slowdown from China, which could scare BRIC investors in the short term. Strong stock price declines would obviously be an attractive moment to go back into Emerging markets.

### Fixed Income

We expect global **government bond** rates to move slightly higher in 2010, caused by the pressure of heavy new government bond supplies and increased risks of sovereign debt downgrading. We would avoid US Treasuries and UK Gilts and prefer German Bunds and Dutch government debt for quality reasons. Long dated Bunds are the best hedge for investors concerned about the sustainability of the recovery and the fragility of financial

institutions and deflation. Otherwise, EURO government bonds have become less attractive because of too low yields.

Another risk scenario that is worth keeping an eye on is the possibility of a sizeable rally in the long-end of the yield curves, should the economic recovery stall in 2010. This “double dip” scenario should not be excluded and large portfolios should retain a position in long dated Bunds or Dutch government bonds as a hedge.

**Corporate bonds** had a strong performance in 2009 (IBOXX: +13%) driven by high demand and shrinking spreads. Investment Grade Corporates now have an Expected Risk Premium (ERP) of 1.1% (0.6% is the 20-year average) and start to look fairly valued.

At best, IG Corporates will return the coupon yield this year. We would recommend to Hold on to existing positions.

European and US **High yield** bonds are no longer attractive and we would sell all positions as the ERP is now only 0.6% compared to a historic ERP 1.6% on a 20-year average.

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Table 1: Performance of various indices in the year 2009

Copper in \$ per Lb.	+231.3%
MSCI Latin America in \$	+98.1%
Barrel of Oil in \$	+74.6%
MSCI Emerging Markets in \$	+74.5%
MSCI China Free in \$	+58.0%
High Yield in \$	+44.5%
Rogers Int'l Commodity Index in \$	+25.6%
MSCI Europe	+27.1%
Gold \$ per Ounce	+27.2%
CV Bonds in €	+26.7%
MSCI USA in \$	+24.2%
MSCI World in €	+23.1%
Credits in €	+13.2%
HFRX Global Hedge Fund Index \$	+13.4%
MSCI Japan in JPY	+7.4%
JP Morgan Gvt. Bonds in €	+3.5%
JPMorgan Cash index 1M in €	+1.1%
Barclays CTA Index	+1.4%