RESEARCH · MARKET OUTLOOK

Our Investment Strategy for 2010

A Family Office view of the year ahead in the markets

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> *Families can increasingly less rely on their own intuition and their common sense alone to manage their sometimes very substantial wealth. Entrusting it to a Family Office has become more than ever a necessity. The Family Officer will build for families a portfolio based on the combination of management styles and vehicles, while allowing a precise calibration of exposure to market risks. At each stage of the investment process, he will ensure that he optimises the return and risk of the managed assets according to his clients' degree of risk aversion and the structural weighting within the portfolio. He will analyse the strengths of each manager as well as the costs and expenses, and will position each one according to its return for each level of risk. To assist families in managing and preserving their financial assets, the expertise of the financial team must therefore be constantly improved. It is within this framework that we present the strategy of Fuchs & Associés Finance for the year 2010.*

The macroeconomic backdrop

The global economy is emerging from a historic recession. After a sharp contraction of nearly 5% in total for the OECD countries, activity has resumed: first in Asia, driven by the Chinese stimulus plan, then in the Western economies. The publication of the GDP figures confirmed the exit from recession of the major economic zones as early as the third quarter of 2009. The phase of falling prices ended with the return of the inflation rate to positive territory in the United States as well as in Europe. Thus, the risks of deflation are eliminated. Nevertheless, inflationary fears seem premature, insofar as the economic recovery remains weak and moderate outside Asia and the rise in commodity prices is only very gradual.

The investment strategy for 2010 must be largely guided by expectations regarding the evolution of monetary and fiscal policies, which will be decisive for the evolution of the markets. While certain central banks will begin or continue to raise their key interest rates as part of the tightening of their conventional policies (Australia, Korea, Taiwan, Norway, Switzerland), the main central banks (Fed, ECB, Bank of England, Bank of Japan, etc.) should maintain their key interest rates at their current level, that is to say close to zero, throughout the year, at least as long as the labour markets show no sign of improvement.

The real challenge of the year 2010 will lie in the ability of governments to gradually withdraw the fiscal "stimuli" without jeopardising the nascent recovery. It is indeed essential to begin reducing public spending (the budget deficit reaches 15% of GDP in the United States), failing which the drift of public finances will have damaging inflationary consequences. Long-term interest rates would risk soaring and breaking the ongoing recovery, which would bring us back to the worrying "W"-shaped economic scenario. Governments nevertheless seem to have grasped the extent of the danger, both in the United States and in Europe.

Equities

In such a context, we favour equities, which should represent 60 to 70% of a dynamic portfolio. Admittedly, the euphoric torpor of the equity markets in the last quarter of 2009 and in the first days of January 2010, characterised by a bullish "Rally" without transaction volumes, without implied volatility and without "Momentum," abruptly gave way to greater realism. Nonetheless, these markets present excellent prospects. The S&P 500 index was expected to see its earnings per share rise by at least 25% this year, after a modest increase of around 8% in 2009. The 2010 P/E is estimated at 14.5x, which is below its historical average. There will be violent discriminations and divergences between sectors rising sharply and others falling sharply, because the economic recovery will be unbalanced.

The geographic allocation of equities that we recommend is 50% in American equities, 20% in emerging markets (BRIC + Indonesia), 20% in European markets, and 10% in non-emerging Asia. But this is purely indicative: the European portion groups together industrial stocks closely linked to activity in Asia and stocks in the "basic resources" sector correlated with global activity. In the United States, we favour domestic sectors (retail, transport, energy, biotechnology, etc.) and stay away from banks, health insurers and hospital management. We are becoming cautious on technology.

Bonds

The bond markets followed bumpy and volatile trajectories in 2009. By way of example, the yield on 10-year US government bonds ended the year at 3.84% after beginning it at 2.20%, before returning to 3.63% at the beginning of January 2010. This fuels the fears of an economic slowdown that periodically emerge, given the prevailing uncertainty. It is highly likely that, despite the efforts of governments and central banks to contain the deficits, the drift of public finances will eventually have an upward effect on interest rates. This movement will, however, be only very gradual in the absence of strong inflationary expectations, but it will be sufficient to make government bonds unattractive, almost everywhere in the world. Fears about certain credit signatures such as Greece, Ireland and Portugal will do the rest to turn investors away.

"Corporate" bonds are clearly more attractive in terms of yield, as evidenced by the considerable issuance volumes on this market, although the bulk of the performance is certainly behind us. This type of bond is of interest for a defensive portfolio with a medium-term outlook (4/5 years).

Currencies

The US employment reports for the months of November and December, which were rather encouraging, constituted a turning point for the dollar exchange rate, which recovered (1.4140 EUR/USD on 25 January 2010) since the end of November 2009 after having sunk significantly (1.5134 EUR/USD on 25 November 2009) under the effect of the decline in risk aversion ("Carry Trade"). The confirmation of the economic improvement in the United States enabled the greenback to recover. The euro was weakened by the budgetary situation of certain European states. The movement of fundamental appreciation of the dollar should continue, supported by the economic improvement in the United States and in the rest of the world.

Commodities

The commodities sector remains particularly attractive, because it is linked to the economic improvement in the world and to external growth operations in the "basic resources" sector. Oil should move between $70 and $80 per barrel without any speculative surge in the immediate future. Metals should appreciate gradually. But it is the agricultural commodities sector and "agro-business" that should primarily attract the attention of long-term investors.

Gold

Gold, which some consider not to be part of financial assets, nevertheless presents itself as an indispensable multi-risk insurance, especially in a period of low interest rates: anti-inflation, anti-deflation, anti-distrust of the dollar, anti-geopolitical turmoil, anti-maintenance of key interest rates close to zero. Gold should represent between 5 and 10% of a dynamic portfolio.

In summary

To summarise, 2010 should be, overall, very bumpy financially, with unattractive interest-rate products, requiring very reactive management of risky assets (mainly equities), based on sector arbitrages and significant "stock picking." The major equity indices should mask very divergent sector performances. There is little alternative to equity investments in the immediate future, apart from "corporate" bonds or "reverse convertibles."

— Jean Fuchs, Managing Director, Fuchs & Associés Finance.

> *There is little alternative to equities in the immediate future: a year for sector arbitrage and stock picking.*