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Doubts that jeopardize the future

Highlights

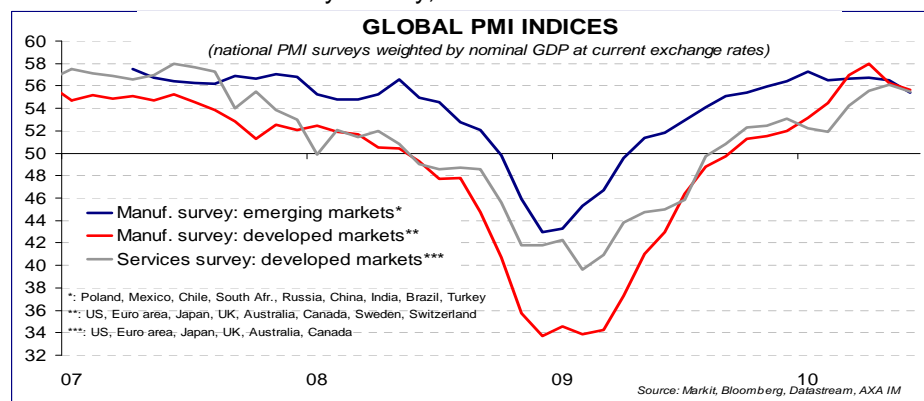
- Landing gear in place for the global economic cycle.
- The risk of a relapse into recession in 2011 is low.
- The accumulation of budget adjustment plans next year is a source of worry.
- Worries about Europe are expected to persist.
- Monetary policy should remain very accommodating to support the economic cycle.
- Caution remains the order of the day: neutrality on equities and government bonds; Investment Grade credit gets the nod.

It is often said that through exaggeration we can have the strongest impact on people's thinking when we want to advance an idea. So let's exaggerate a bit. Europe is not doing well, and its center—the Eurozone—is facing the worst crisis of its short history, feeding speculations that the monetary union will fall apart. At this stage, the prospect of disintegration is an exaggeration, but one that serves to underscore the gravity of the situation and the real possibility that the European project could go haywire in this new world, which we are having a hard time apprehending due to the magnitude of the changes in power relations. China, India, Brazil and other large emerging countries are forcefully demanding a bigger role in the world's business, supported by their dynamism and a level of confidence in the future that is clearly lacking today in Europe. As is often the case, the individuals caught up in the

ambition of a shared project, whether noble or not, have a hard time imagining the worst. Unfortunately, it is only when facing defeat that they finally realize that in their relentless focus on victory they have forgotten to envision defeat. But this critical regard is nonetheless essential for questioning the wisdom of any decision or movement. In his book *Collapse*, Jared Diamond identified (through simplification) two basic principles that could be critical to the survival of a society: its ability to think long term and its ability to question itself, which even includes calling certain values into question if necessary. The European project needs a breath of fresh air, which defends the notion of prosperity against the promise of stability alone. But this requires knowing how to change. The idea that simply revisiting the stability pact and adding a greater degree of rigor would be the panacea for reinvigorating the single currency is an illusion. We can see that the errors (budgetary) of some, the more virtuous behavior of others, have led to individual adjustment strategies and that this has undeniably threatened the integrity of the fabric of the whole. It seems obvious that Europe's ability to continue to build a unitary identity,

particularly on the economic level, depends on collective energy. Admittedly, the collective financial measures of protection taken in the course of two years of crisis, including the recent creation of a Financial Stabilization Fund for the European Union to put a halt to speculation, should be seen as strong signs of solidarity. But to create a genuinely strong dynamic, the European project—and not that which entails a multiplicity of domestic initiatives—is that which will finally put the accent on research, innovation and the ambition to set down roots in the future and not in the past, with an emphasis on fighting against the scourge of unemployment amongst the young.

In the markets, the European mess is weighing adversely. Questions about the future of the euro are very present, especially since the financial weakness of the various states and the banks continues to feed speculation. CDS (measured on the basis of 5-year maturity) remain very high, between 260 and 300bps for Spain, Ireland and Portugal. Greece is fluctuating around 1 000bps, lending credence to the idea of restructuring this country's debt in the future. In addition, due to their holdings of public



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debt, the weak public finance situation is further weighing on bank balance sheets in Europe. As a reminder, there is still around EUR200bn (IMF estimate) worth of doubtful debt to be written down by the banks. The promises to disclose the results of stress tests for Europe's major banks has not really reassured investors.

To add to the market's troubles, the G-20 press release showed how difficult it is to maintain international coordination in economic policy at this juncture. European zeal for budgetary adjustment has also fed worries about the sustainability of growth. And these fears have become all the more acute as the latest economic surveys suggest that the recovery dynamic is slipping away to some extent.

Given the overly abundant sources of uncertainty that are hovering over the global economy, we still think it is smart to recommend caution. Accordingly, for the major asset classes, we maintain our stance of neutrality with regard to government bonds and equities, while we continue to overweight investment grade credit (IG), on the grounds of attractive valuation. We underweight commodities given the moderation in the cycle and the glut of some raw materials (metals, oil).

The recovery catches its breath

The month of June sent out a clear message of moderation in the economic cycle at the global level. Indeed, most business surveys stagnated at best. In the manufacturing sector, this should not be considered as a big surprise. In fact, it was wholly expected that the very powerful inventory rebuild movement would lose some steam. Asia, which is surely the region that leads the pack in terms of its position in the recovery, has seen confirmation of the signs of deceleration that have appeared in the last few months. Stateside, the ISM manufacturing index came in at 56.2 for June. Even though it lost 3.5 points, this is a level that is still compatible with solid growth. In the Eurozone, we are seeing a similar phenomenon, although less pronounced (55.6 versus 55.8 the previous month). In addition, and

perhaps less anticipated, the service sector has also accompanied this slowdown in the expansion. This could be an indication that the recovery is having a hard time spilling over into the economy as a whole. However, at this stage the emerging fears of a possible relapse into recession on the part of the developed countries seem to us to be premature at best. At the same time, it is important not become complacent, especially in light of the difficulty this recovery has had in creating jobs. This is exacerbated by the ongoing, extreme weakness in the real estate sector and by the still shallow recovery in credit, as deleveraging is likely to continue. Overall, the slowdown that has been anticipated for the second half of 2010 should in fact come to pass.

The budgetary adjustment

The question that is being asked in the markets is whether the slowdown that is underway might lead us into a set of dynamics that is far worse in light of the budget tightening measures that have been announced. In fact, despite the apparent lack of coordination that was revealed by the last G-20 meeting, it seems to be widely accepted that the year 2011 will be dominated by budgetary adjustments. The negative impact on demand of the aggregation of announced adjustment and the dissipation of previous stimulus could be considerable. In Europe, consensus seems to be that the adjustment measures will amount to just over 1% of the Eurozone's GDP. In the United States, including budget restrictions at the states level, the adjustment will be just as great if not greater. And this will put the brakes on growth. However, it is still hard to tip the scales in favor of a gloom and doom scenario whereby economic policy errors would push a number of economies over the brink and back into recession. This is even more so considering that monetary policy is expected to remain very accommodating. In particular, key rate hikes could be further postponed, both in Europe and the United States, against a very low inflation backdrop—to late 2011 or even 2012.

Stay covered this summer

In the face of mounting uncertainties, the markets once again began brooding in the second half of the month. As a result, risky assets suffered, with some stock markets falling to their lowest levels of 2010. Once again, it was the systemic risk—associated mainly with the sovereign debt crisis in Europe—that dominated. This was reflected in the substantial underperformance of financial stocks. We believe that, unfortunately, the universe we'll be navigating in over the months ahead will continue to be very murky, since it is difficult to imagine investors rapidly finding sufficiently clear answers to the nagging questions that plague Europe, not to mention the future evolution of the economic cycle.

Nonetheless, and despite our call for caution in an environment that is expected to remain very volatile, we maintain our preference for growth thematics. Exposure to growth in the emerging countries should continue to pay off, and should continue to be visible in strong earnings growth. In passing, we note it is likely that our forecast calling for a 30% increase in earnings in 2010 (in Europe and the US), which looked pretty optimistic compared with analyst estimates at the beginning of the year, could well be exceeded by reality. In fact, this is one of the factors that is pushing us to go no further than neutral on equities, since valuations remain quite reasonable. Moreover, in spite of fragile financing dynamics, we continue to defend the mergers and acquisitions thematic that is typical of exits from recession.

It appears to us difficult to be overly pessimistic with regard to government bonds (at least Treasuries and Bunds), which should continue to play their traditional role of safe haven, while also getting support from very accommodating monetary policy stances. At the same time, we maintain a healthy exposure to credit, with a preference for IGs (Investment Grade credit), as the recent increase in implied default rates to 11% 5 years out (with a 40% recovery rate)—in other words, nearly three times the worst case historically—seems excessive to us.

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