



## THE ECONOMIST'S OUTLOOK

### *2010 is a transitional year*

The lags between economic growth and employment are well documented. Taking unemployment as a yardstick, the global crisis is nowhere near finished, because joblessness will continue rising for most of 2010 in many countries, developed or not.

This article seeks to pinpoint exactly where we are in the crisis, and to explain why we need to start preparing now for the post-crisis period.

**Crisis still going strong**

The balance sheets of some international banks are still burdened with toxic assets left over from the banking and financial crisis. No one really knows exactly how many institutions are affected or where they are – except maybe some of the banks themselves. One can only hazard a guess: the actual figure will depend primarily on economic conditions, particularly how quickly the US housing market regains its footing. One thing that is certain is the pronounced, widespread slowdown in bank lending. Because banks are more nervous about granting loans, the supply of credit has contracted. Faced with the crisis and greater risk, banks have grown more selective, especially towards small businesses. Meanwhile, credit demand has fallen since some borrowers, burdened by excessive debt, pulled out of the market suddenly. The near-bankruptcy of Dubai is an after-shock of the international financial crisis, and surely not the last. It was foreseeable in principle, given Dubai's blatant property market bubble, but no one could have predicted the timing. The systemic impact was limited because assistance from regional partners helped contain the spread.

#### **Recession?**

The most advanced countries emerged from recession in the spring or summer of 2009 following 12 to 18 months of economic contraction. This is due both to emerging countries' resilience and to the effects of government stimulus plans. China's economy grew by around 9% in 2009 and could expand by 9.5% this year. The same resilience has been seen in India, the rest of Asia and Latin America. The developed countries' emergence from recession in the second half of 2009 can be seen as a "plateau", from which a modest rebound will be possible. The rebound is likely to be led, as mentioned, by the principal emerging countries but also by the recovery in the US, where growth this year could reach between 2% and 2.5%.

As for France, the 2009 recession was daunting. In volume terms, GDP likely contracted by some 2% on average in 2009, making the recession twice as serious as those encountered in 1975 and 1993.

We consider the most likely scenario to be a modest recovery in 2010, in which case French growth this year would be between 1% and 1.5%, just above the European average.

This scenario will not make it easy to overcome the unemployment problem. It is estimated that France, given its labour market structure, needs to grow by 1.5% for unemployment rate to stabilise. Accordingly overall unemployment will continue to rise for much of 2010, and youth unemployment will increase even faster, affecting even university graduates. Make no mistake: as we emerge from the crisis, the real enemy will be unemployment, not inflation. Even though liquidity is abundant globally, inflation in the usual sense – a rise in the price of goods and services – will remain subdued for a host of reasons that I lack the space here to discuss at length. Capital markets will continue to experience bouts of inflation (bubble formation) and deflation (bursting) as they have done over the past 15 years. In the years ahead we can expect to move from one bubble to the next.

#### **Exit strategy**

The impact of the Pittsburgh G20 summit has been mixed, depending on where you look. Probably the most lasting initiative was creating a template for a new global governance. This involves promoting the G20 as the main global economic forum and realigning the governance of large international bodies such as the IMF and World Bank in favour of the principal emerging countries. As for the rest, measures were proposed regarding traders' compensation and bonuses, but we will have to wait and see what actually happens before judging the degree of convergence between the US and Europe – or even among European countries themselves. Banking and financial regulations are in the midst of a reform, not a revolution, with respect to a certain

number of points that did not necessarily contribute to the crisis, but that came to light as a result of it. A clearer picture will not emerge until late 2010 on matters such as accounting standards, tax havens, credit rating agencies, financial derivatives, capital adequacy requirements and improvements to the Basel II system. At the same time, there is a global debate over banking-related issues: should we adopt regulations similar to the US Glass-Steagall Act of 1933 that separated deposit banks from investment banks? To prevent governments from being forced to step in and rescue institutions that are "too big to fail", should megabanks be broken up and the emphasis be placed on small and mid-sized banks? I am incredibly sceptical that a Glass-Steagall Act or efforts to restrict the "too big to fail" principle are the answer.

To ensure an orderly exit from the crisis, monetary authorities will have to gradually reconsider the support measures put in place since August 2007. But the challenge is far from insurmountable. It can be done without central banks raising interest rates. The Fed, ECB, Bank of Japan and other major institutions are likely to keep their policy rates at the current rock-bottom levels for most of 2010. The ECB is likely to stay at 1% for several months more, and the Fed in a range of 0% to 0.25%.

Managing the exit strategy will be more complicated when it comes to fiscal and budgetary policy. As with monetary policy, it would be premature to hit the brakes in 2010. Public deficits and public debt ratios will remain high in 2010. Thus, governments around the world will need to begin working to reduce them in 2011. It remains to be seen whether renewed growth and tighter control of public spending will be enough to bring about the necessary adjustments.

Exchange rates are another challenge for 2010. While the euro was rattled late in 2009 by tensions in the eurozone affecting its weakest links, Greece in particular, dollar weakness will remain a constant in 2010-11. I fear a series of competitive devaluations around the globe. The more Washington claims to want a strong dollar, the more suspect its claims appear. The greenback will remain vulnerable due to the size of US budget deficits, which could cause trade deficits to balloon again after several quarters of contraction. The Chinese will do all they can to ensure that their currency follows the dollar downwards; the Japanese want to avoid a stronger yen at all costs; and sterling will remain weak. Not all currencies can fall at the same time, so at least one of them will have to appreciate, and that could mean the euro. Thus, the euro's appreciation – apart from inevitable short-term fluctuations – could be the consequence of active exchange rate strategies pursued in other regions.

#### **Financial market outlook**

The CAC 40 gained around 22% in 2009. Will the rally continue? Apart from some volatility in the immediate future, the trend is likely to remain favourable in 2010, even though the CAC 40's gains are likely to be more in the neighbourhood of 10% to 15% this year.

Several factors point in this direction. As mentioned, there is ample liquidity worldwide, and it has to go somewhere. Diving back into the property market would be premature, since corrections are still under way in some countries. Bond markets are not unattractive but will become increasingly risky as the "indigestion" of government debt grows more apparent. Gold, which shot up in the fourth quarter of 2009, is not an especially appealing medium-term investment, given that inflation is likely to remain quiescent. Emerging financial markets? Investors will have to put their money there to tap the growth at its source, but to a reasonable extent because these markets are generally not very liquid. Commodities – energy and otherwise – considered as an asset class? Oil prices can be counted on to rise quickly and substantially, but not necessarily over the next six months. Conclusion: equity markets in developed countries remain attractive for reasons that are both negative – chiefly the risk/return profile of other investments – and positive: a recovery (albeit modest) is underway, monetary policy will remain very accommodative, and corporate profitability will often beat market expectations.

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(sent to press on Tuesday, 12 January 2010)

# OUR ASSET MANAGER'S OUTLOOK

The implicit commitment by all major global powers to support institutions presenting a systemic risk to the world economy was a historic event. Paired with massive liquidity injections by monetary authorities and governments worldwide, this support gradually calmed the fears of financial market participants. On the economic front, the strength of the economic recovery cycle surprised most forecasters. In addition, the record level of underinvestment and low returns on risk-free assets (cash and government bonds) helped drive up the prices of risky assets (equities, corporate bonds and commodities) over the course of the second, third and fourth quarters.

In 2010, we believe that the current monetary and fiscal policy will continue to bolster the prices of real and financial assets, at least in the first part of the year. We also think that a premature tightening of liquidity conditions is unlikely because governments and central banks have virtually no room for manoeuvre if growth slumps. Furthermore, stimulus plans have not yet been fully implemented in many countries, and certain support measures will be extended at least through the first quarter of 2010.

We think that the exit strategy, i.e. interest rate rises and the phasing-out of government-led support measures, when it does happen, will produce uncertain results that could potentially be devastating.

It appears that the best plan for risky assets in 2010 is to invest with a view to subsequently selling: proper timing could well be the key to 2010.

Investors put off by the risk of a correction can turn to so-called risk-free assets. But are government bonds still a good hedge against risk? Actually, the imbalances that triggered the financial crisis have not gone away, because the private sector's excessive debt has merely been transferred to the public sector. Thus, we can no longer ignore the risks of government insolvency, as events in Greece and Dubai have made plain.

As a result, in 2010 it will be tough to rely solely on traditional asset classes, as passive investment performances may be quite tumultuous.

It is these uncertainties that will give nimble managers the best opportunities for performance in 2010. Which is why the vast majority of hedge fund strategies are likely to offer the prospect of attractive returns over the coming quarters.

**Equity** valuations are currently in line with their historical average, and the potential for beta-driven performance is probably much less than in 2009. Most forecasts point to a gain of around 10% for the S&P in 2010. A marked increase in prices would come mainly from upside surprises on corporate earnings. But expected earnings growth in certain sectors is already very strong, with IT stocks in the US expected to add 57% and industrial stocks in Europe, 28%. Selling opportunities will be more numerous than in 2009. As with other asset classes, differing forecasts for the various sectors show that sector dispersion is likely to remain significant. All signs point to a favourable environment for Long/Short Equity strategies. Lastly, the number and volume of M&A transactions have been rising steadily since July 2008, and premia remain relatively high.

**Fixed income markets** probably hold the greatest potential for hedge fund managers, both for directional and for trading strategies. Volatility remains high for long-term yields, with 10-year Treasuries rates up 60bp just in December. The extent of these movements in the long yields of major currencies is, moreover, the principal source of performance for L/S Fixed Income and Global Macro managers. In fact, there is every reason to believe that volatility will remain high in 2010: government bond issuance will be abundant (for example, in 2010 Germany will issue 40% more than in 2009), quantitative easing is coming to an end, and the continuation of the recent drop in government bond prices could frighten certain investors.

In addition, uncertainty about the timing of the increase in short-term interest rates in the G20 countries – Australia and Norway have already hiked – will undoubtedly create opportunities on money markets.

The inflation theme is also a source of current and future performance for managers, with a likely increase early in the year (due to y/y comparison effects) followed by another dip, and even possibly a return to deflation if the economic recovery does not materialise.

Lastly, arbitrage strategies may benefit from, among other factors, the significant steepening of yield curves (roll down), divergences between the monetary policies of the major central banks, or even the end of quantitative easing. Arbitrage between countries will also be a source of potential profits. For example, within Europe trends in the differences in spreads are volatile, and trading opportunities may be very profitable in certain cases.

**Currency market** volatility is also high and likely to remain so. Currencies are now the only avenue for adjustment in the event of an economic slowdown because governments have exhausted their options on the fiscal and monetary fronts. Growth rate volatility in the G20 is now twice its historical average, as shown by the trend in exchange rates. Will the US dollar be left behind in the event of a premature monetary tightening? What will be the next carry trade financing currency? There is presently no clear answer to these questions.

**Emerging country debt and currencies** will probably continue to benefit from good fiscal orthodoxy, with an average debt/GDP ratio of 35% compared with 114% for the developed countries. Their substantially higher growth rates will continue to attract investments from the developed world, a theme advanced by many managers. However, long-only positions are risky, as witnessed by the events surrounding Dubai's debt.

**In conclusion**, in our view most of the performance to be had from beta exposure is behind us. By contrast, there will clearly be numerous opportunities to generate alpha in most asset classes in 2010. Thus, we are confident in the ability of the managers HDF has chosen to profit from expected market volatility, both in relative terms and as a result of very dynamic management of their directional exposure.

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HDF Finance – Sent to press on 15 January 2010

## PERFORMANCES AS OF DECEMBER 31, 2009 IN EURO

			2009 YTD	5 YEARS	10 YEARS
MULTI STRATEGY	<b>HDF Multi Strategies Part A EUR (ex HDF Multi Alternatives)</b>	<i>Absolute gain</i>	9.86%	18.53%	55.16%
	<b>HDF Multi Reactive Part A (ex HDF Trading) *</b>	<i>Absolute gain</i>	7.89%	31.97%	(1)
	<b>HDF Xiphias Investissement *</b>	<i>Absolute gain</i>	13.21%	30.72%	95.65%
	<b>HDF Capital Appreciation Class A</b>	<i>Absolute gain</i>	8.95%	16.97%	52.28%
	<i>MSCI World Index <sup>(a)</sup></i>		31.18%	4.65%	-31.82%
MULTI STRATEGY LOW VOLATILITY	<b>HDF Arbitrage Low Vol Class A</b>	<i>Absolute gain</i>	5.72%	11.89%	41.89%
	<b>HDF Global Arbitrage</b>	<i>Absolute gain</i>	6.24%	12.04%	(1)
	<b>HDF Fixed Income Alternative Class A EUR *</b>	<i>Absolute gain</i>	7.99%	9.29%	50.13%
	<i>EO尼亚 Index</i>		0.77%	14.52%	34.96%
FIXED INCOME LONG-SHORT	<b>HDF Optimix Class A *</b>	<i>Absolute gain</i>	8.02%	4.13%	(1)
LONG-SHORT EQUITY	<b>HDF Global Opportunities Class A EUR</b>	<i>Absolute gain</i>	8.10%	19.06%	60.53%
	<b>HDF Global Long/Short *</b>	<i>Absolute gain</i>	9.25%	18.43%	(1)
	<b>HDF Xiphias International Class A EUR *</b>	<i>Absolute gain</i>	7.78%	16.45%	61.71%
	<b>HDF Europe Long/Short *</b>	<i>Absolute gain</i>	11.42%	21.85%	(1)
	<b>HDF Eurovest Class A EUR *</b>	<i>Absolute gain</i>	14.43%	19.51%	89.31%
EQUITY	<b>HDF Global Equity Class A EUR</b>	<i>Relative gain</i>	28.95%	28.72%	35.07%
	<i>MSCI World Index <sup>(a)</sup></i>		31.18%	4.65%	-31.82%
	<b>HDF Europe Equity Class A</b>	<i>Relative gain</i>	28.81%	33.90%	42.99%
	<i>MSCI Europe Index <sup>(a)</sup></i>		35.97%	14.86%	-15.04%
	<b>HDF Emerging Markets Equity Class A EUR</b>	<i>Relative gain</i>	46.54%	71.99%	84.98%
	<i>MSCI Emerging Markets Index <sup>(a)</sup></i>		72.95%	94.84%	77.66%

\* Estimated performance. Monthly NAV.

<sup>(a)</sup> With dividends.

<sup>(1)</sup> Track record too short for the period.

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