HDF

OUR MARKET VIEWS

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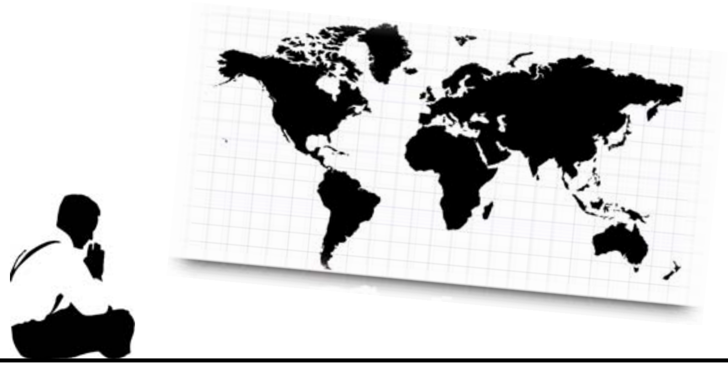

THE ECONOMIST'S OUTLOOK

Where are we headed?

A very mixed recovery

Globalisation does not mean that growth rates are converging. This is evident once again from the growth forecasts for 2010 following a recession in the most developed countries in 2009. The US economy is likely to expand by around 3% this year, China by 10%, India by 9%. All told, world GDP is expected to grow by just over 4%, compared with a 0.6% contraction last year. The figures for Europe are unfortunately well below that figure, with forecasts of around 1% on average.

If the growth differential persists into 2011 and beyond, there is a real risk that Europe will fall behind in terms of economic activity and employment. This prospect is unacceptable from an economic and geopolitical standpoint but also socially (i.e. the ability to absorb accumulated joblessness).

To continue playing in the first division, European countries will have to devise common strategies to overcome the crisis. To tackle the global crisis it was necessary to implement Keynesian policies, starting in 2007 and particularly following the Lehman Brothers bankruptcy in September 2008. This involved significant monetary easing and an equally impressive expansion of government deficits and debt. The financial and economic crises and the accompanying social fragility have certainly not gone away, but it is already time to shift to a Schumpeterian policy aimed at cultivating the competitiveness of companies and their products, a policy built around factors such as R&D, innovation, the quality of higher education and small business growth. In this tricky stage, with the European crisis now compounding the still-smouldering global crisis, the authorities need to advance on two fronts: on the one hand, start reducing deficits and debt in 2011, and on the other hand, pursue supply-side competitiveness policies. These two goals are not contradictory, even if fiscal austerity could crimp growth in the short term. The key issue is to shift the emphasis within the overall public spending budget, trimming certain current expenditures to invest in the future and offer investment incentives such as a research tax credits.

Pressure on the euro and the euro zone

It is true that Europe took too long to react to the challenges posed by the Greek crisis and the spillover to Portugal, Spain and other countries on the euro zone periphery. The Greek problem surfaced in December 2009 but it was not until May 2010 that the European authorities, finally unified and united, pragmatically decided to create a €750 billion emergency fund (funded two-thirds by Europe and one-third by the IMF) to assist troubled member countries and reassure markets. However, actually creating the fund will not be without difficulty, as persistent disagreements between Germany and some of its partners are bound to surface.

Interestingly, there are two similarities between the European response in October 2008 to the banking crisis and the response in May 2010 to the euro zone crisis. First, both responses relied on the creation of mechanisms not specified in Europe's founding instruments but compatible with them, thus avoiding a constitutional debate. Second, they involved liberal use of guarantees, which reassure markets and thus allow troubled member countries to draw amounts much lower than the total potential figure.

Under the Maastricht treaty, the ECB is not allowed to directly assist troubled member states. But the Brussels agreement authorises the central bank to purchase, in particular, Greek debt held by banks. By adding this indirect assistance for member states to earlier measures, the authorities are arming themselves to regain the upper hand from markets after weeks of being bullied. For how long? That will depend primarily on Europe's ability to effectively improve its economic and political governance, for the euro zone in particular. The ECB will not emerge from this tempest unscathed, since it will have to walk a fine line between the direct (unauthorised) and indirect (authorised) assistance it is able to provide.

There is something to the argument that there is too little uniformity within the euro zone. But there are also significant disparities – growth, inflation and so on – within each member country and within the USA. So where does the problem lie? In the fact that the euro zone does not yet have the economic, fiscal and political tools to deal with such diversity.

I do not foresee Greece leaving the euro zone or the euro zone imploding. Who would gain from such a scenario? No one, in my opinion. But the euro system needs strengthening, and this will take several forms.

To begin with, there is a need to lay a foundation for real economic governance of the euro zone. We know what the components are: reliable statistics (a clear lesson from the Greek crisis), effective multilateral oversight mechanisms, the ability to impose real sanctions on delinquent countries, etc. All these measures concern the overhaul of the stability pact.

The guidance system established by the Lisbon treaty is not yet up to speed, but it is time to move on to the next stage quickly.

Furthermore the global crisis has shown that the pace of euro zone expansion needs to be slowed for the benefit not only of candidate countries but of current members too. Now is the time to deepen, not widen.

Whither the markets?

Let's look first at currency markets. A few months back I was expecting the dollar to weaken as a result of the US budget deficit and China's increasing questioning of the US currency. These threats to the dollar have not disappeared and may resurface sooner than some might think – provided of course that Europe is able to overcome its internal divisions. For the coming months, the euro could fluctuate between $1.18 and $1.30. These levels are favourable to euro zone competitiveness and export growth compared with recent levels in the region of $1.50 and even $1.60, but are not low enough to entail much risk of imported inflation. The euro has a storm to weather, but the dollar remains structurally weak.

The events in Europe have postponed any hint of an interest rate hike not only by the ECB but also by the Fed. We will now have to wait until 2011, which is good news in a way. As for long yields, they remain under threat of a sharp rise in 2011 under the weight of government debts and competition between public and private financing. As a result, investors would do well to factor in this risk when managing their fixed income assets and to protect themselves against a potential upswing in long yields a few quarters from now.

Despite the recent corrections and the continual ups and downs, I cannot bring myself to be bearish about equity markets between now and the end of the year. Ample liquidity and the possibility of making up the ground lost by equity indices in recent months are reasons for guarded optimism.

As for other asset classes, I am not confident in gold over the medium term, because inflation (in the usual sense) will remain manageable for at least the next two to three years. In the real estate market, price corrections are not yet finished in several countries (USA, Spain, etc.), so investors need to be careful. Emerging financial markets remain an appealing source of diversification. It is only natural to go after growth at its source, particularly in the emerging countries. But investors need to pick the right financial vehicle because emerging market liquidity remains tight.

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(sent to press on Friday, 4 June 2010)

OUR ASSET MANAGER'S OUTLOOK

Since mid-April, financial markets have entered a period of extreme volatility: the VIX index, often used to gauge market risk, has risen from 15% to 48% in a period of six weeks. Investors are concerned with the risk of the euro zone imploding and the warning that the Greek crisis represents for the long list of heavily indebted developed countries.
The plan adopted on 10 May by European governments and measures carried out by the European Central Bank show that Europe is committed to closer fiscal integration among all its members. Moving from the political decision to making greater integration a reality will take some time, though, and financial markets will very likely use that period to test European political leaders' resolve.
Investors are now demanding higher yields on the government bonds of the most heavily indebted countries. As a result, countries are being forced into fiscal tightening and debt reduction ahead of schedule. Under these conditions, such events could choke off the long-awaited signs of growth that have begun to appear in recent quarters.

The various government economic support plans have done their work and the global economy appears to be back on track. For the past several quarters, growth forecasts have been regularly revised upward, and 2010 growth could reach 3.5% in the USA, 11% in China, 8% in India and 1.5% in Europe. Global PMI leading indicators are still rising, indicating continued growth and a knock-on effect on the services sector, which until now has lagged somewhat.
Another illustration of the global recovery is the resurgence in world trade. Despite a historic drop in trade flows – more than 16% from the high point in 2008 – the risk of protectionism failed to materialise. Volumes are again rising and have already made up half of the drop.

The key factors if the recovery is to last are employment and household incomes, which support end-demand. It is hard to imagine a strong recovery without a significant improvement in these two factors. The latest data show encouraging signs, but uncertainties persist.
Employment figures are improving in the USA. Job creation has surged forward since December, with 573,000 new jobs created over the period, although unemployment remains high at 9.9%. It will take at least 150,000 new jobs per month to stabilise the US unemployment rate.
Despite the uncertainty regarding employment and the fact that joblessness is likely to come down only gradually, the US consumer is still spending. During the crisis, consumers only marginally increased their saving rate, remaining confident that they would eventually find work. The overall amount of household debt has stabilised, and even though the debt burden (principal and interest) as a percentage of disposable income is very reasonable at around 13% (and down 1% over the past 18 months), but growth can no longer be supported by an increase in leverage in the future.
Another factor easing investor concerns is the recent stabilisation of the US housing market, although we can expect a few turbulent months due to the end of home-buying incentives and various measures aimed at preventing foreclosures and forced sales.
Bank balance sheets are still too large and the future promises a stricter regulatory environment, requiring banks to hold more and better-quality capital in order to operate. The IMF recently estimated that banks – especially in Europe – still need to set aside provisions for one-third of the losses on toxic assets (total revised downward to USD2.3 trillion).

Companies are reporting that business conditions are improving. Margins are holding at historically high levels and volumes are beginning to recover. They are carrying reasonable amounts of debt and some have cash on their balance sheets, meaning they can contemplate acquisitions.

Lastly, the picture of financial conditions painted by short-term borrowing rates is still favourable and is likely to remain so for some time to come. The inflation outlook in developed countries remains very moderate, especially because growth in private credit is still sluggish (and currently negative in Europe and the USA). Furthermore, in a context of very high indebtedness, the most dangerous and least manageable situation is deflation. To avoid that scenario, monetary policy will remain (too?) accommodative, with the risk that inflation could inch up in future.

In terms of directional strategies, we still prefer equities over corporate bonds and we continue to steer clear of government bonds. In our view, European equities and emerging equities, with P/E ratios of 12, are more attractive, with a potential performance over the long term of 7-9% per annum, but with high volatility.
Now more than ever, we think it is vital to have a broad array of "tools" for navigating this highly uncertain environment. As a result, we are highly diversified in terms of strategies and managers. We still favour managers who are quick to react, who manage portfolio risks well and have a good understanding of macroeconomic analysis.

Please feel free to contact us for more information. We thank you for the trust you place in us.

Christophe Jaubert - Eric Debonnet - David Gilleron - Thierry de Rycke
HDF Finance – Sent to press on 4 June 2010

	PERFORMANCES AS OF MAY 14, 2010 IN EURO	Target	Rating S&P	2010 YTD	5 YEARS	10 YEARS
MULTI STRATEGY	HDF Multi Strategies Part A EUR(ex HDF Multi Alternatives)	Absolute gain	AA	2.42%	21.58%	53.25%
	HDF Multi Reactive Part A (ex HDF Trading) *	Absolute gain	AA	1.75%	33.67%	(1)
	HDF Xiphias Investissement **	Absolute gain		2.35%	32.49%	90.78%
	HDF Capital Appreciation Class A	Absolute gain		0.01%	16.31%	45.50%
	MSCI World Index [a]			12.04%	13.16%	-27.32%
MULTI STRATEGY LOW VOLATILITY	HDF Arbitrage Low Vol Class A	Absolute gain		2.72%	15.29%	42.89%
	HDF Global Arbitrage	Absolute gain		3.15%	15.22%	(1)
	HDF Fixed Income Alternative Class A EUR *	Absolute gain		2.71%	14.27%	50.08%
	EONIA Index			0.13%	13.79%	33.43%
FIXED INCOME LONG-SHORT	HDF Optimix Class A *	Absolute gain		4.71%	7.79%	(1)
	Avg. of the Morningstar "International Bonds" category			5.20%	13.34%	-
LONG-SHORT EQUITY	HDF Global Opportunities Class A EUR	Absolute gain	AA	-0.08%	17.91%	50.63%
	HDF Xiphias International Class A EUR *	Absolute gain		2.21%	18.58%	63.39%
	HDF Europe Long/Short *	Absolute gain		0.51%	19.76%	(1)
	HDF Eurovest Class A EUR *	Absolute gain	AA	1.12%	19.39%	68.32%
EQUITY	HDF Global Equity Class A EUR	Relative gain	AA	7.41%	33.58%	41.41%
	MSCI World Index [a]			12.04%	13.16%	-27.32%
	HDF Europe Equity Class A	Relative gain		-2.48%	25.98%	23.77%
	MSCI Europe Index [a]			-0.96%	8.35%	-19.39%
	HDF Emerging Markets Equity Class A EUR	Relative gain		8.31%	77.82%	106.46%
	MSCI Emerging Markets Index [a]			11.84%	108.91%	169.05%

* Estimated performance. Monthly NAV. [a] With dividends. (1) Track record too short for the period. ** As of 30-Apr-10
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