



2010 Investment Outlook

December 2009

Financial Markets Department
Asset Management and Research



Table of Content

1. Introduction
2. Economic Outlook
3. Market and Risk Environment
4. Equities Developed
5. Equities Emerging
6. Fixed Income and Rates
7. Currencies
8. Commodity
9. Alternatives

1. Introduction

IT WAS the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way- in short, the period was so far like the present period, that some of its noisiest authorities insisted on its being received, for good or for evil, in the superlative degree of comparison only.
Charles Dickens

These opening lines to a Tale of Two Cities written in 1859 describe the period leading up to and including the early years of the French revolution. These words have a strange resonance with our own situation today and echo the complexity and conflicting factors that challenge us as investors when we look through to the second decade of the 21st Century.

Today markets and the economy are delicately balanced between conflicting outcomes. These lead in very different directions and involve a variety of good and bad risks with significant implications for wealth and society at large.

The global economy skirted with depression in the latter stages of 2008 and early 2009. But as this year passes we have a dramatically different backdrop which is currently characterised by a sweet spot for risky assets.

Low interest rates, accommodative monetary policy, improving growth and news flow coupled with abundance of liquidity and under owned risk are a powerful cocktail.

However this cocktail was purchased at a high and as yet unknown cost which includes increased government involvement in society, markets and economies and a huge debt burden that will be challenging to manage.

Increasingly markets will focus on these costs and the implications for funding the stimulus we have all enjoyed, and doubts over this will eventually lead to a reassessment of risks and investment positioning.

Taking the right path will be more important than ever with the possibilities for either outsized rewards or significant losses acting to focus our efforts.

Our task in Asset Management and Research is to try and understand the economic outlook, the risks associated with this and then to see if this presents investment opportunities. It does not automatically follow that a good outlook means a great investment opportunity, nor does a bad outlook necessarily mean a poor investment opportunity.

This can only be determined by considering what is already implied in asset prices and calibrating a margin of error to accommodate the undoubted instability and uncertainty we face. If the outcome we expect is already implied by asset prices then to prosper we need to be either wrong, understating the positive outcome or benefit from a secondary influence for example irrational liquidity and exuberance.

For this reason studying the market and risk environment is critical since this creates the conditions that dominate asset price performance in the short term and drive risk aversion. Today more than ever this must not be underestimated since the medicated nature of markets and economies is a function of one dominate influence, the government.

Government motives are not always economic and its ability to understand the complexity and interrelationships within the economy is poor. Coupled with a politicisation of economic policy this creates uncertainty and risk.

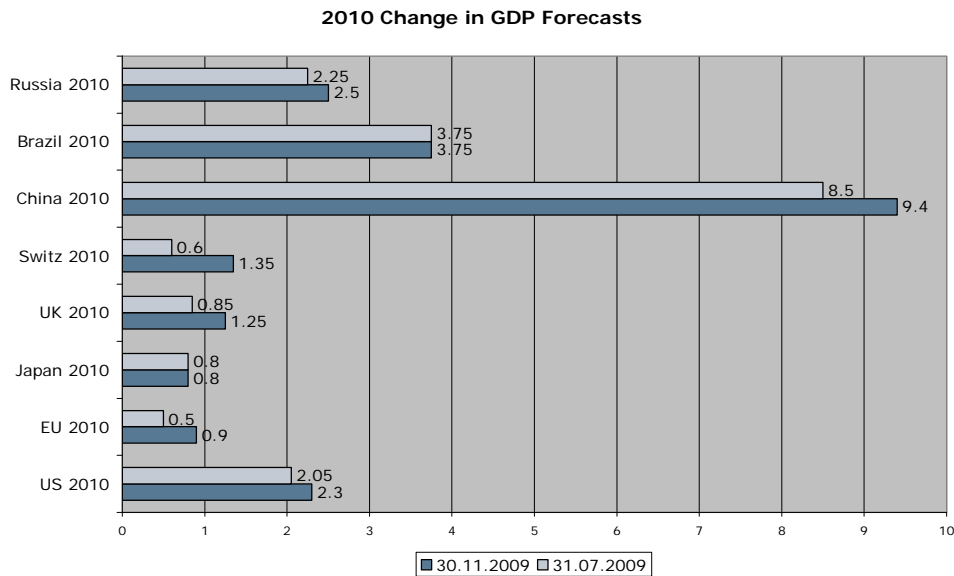
Dickens was a social commentator with a strong sense of justice and champion of the underdog but above all in this Novel he was concerned about a potential repetition of French stupidity in England and of the possibility of a destructive spiral emanating from imbalances in society.

Today rebalancing of the global economy and within economies is likely to be the single biggest factor we need to watch since it produces fantastic opportunities and helps highlight obvious risks.

Returning to the words of Dickens, they are full of equal measures of optimism and pessimism and as in all things we can decide which of these we wish to focus on.

2. Economic Outlook

The economic recovery continues as the global economy has emerged from recession in the third quarter. The low inventory level bodes well for a continuation of the economic momentum as it lowers the risk of a manufacturing setback and increases the probability of good GDP figures in the following quarters.

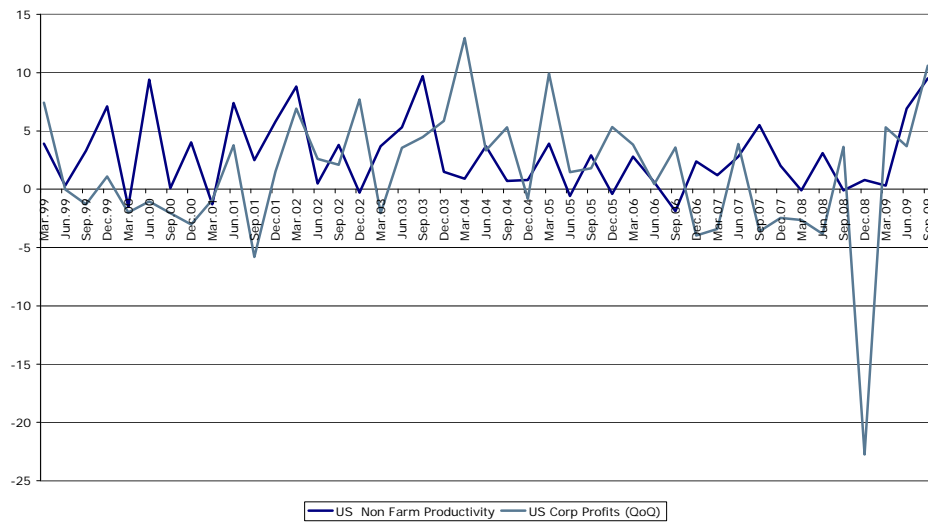


Since last summer, economists have upgraded their forecasts for the 2010 global GDP.

The employment situation should improve which will support the view that the recovery is sustainable. Some of the very intense cost-cutting measures will probably be reversed as the global economy has gone from free-fall to positive growth. The stabilisation of the financial system lowers the need for restructuring. We remain more bullish than the consensus on the job market.

Indeed, we believe that the next surprise in the global economy will come from an improvement in the US job market. We expect it to occur in the first quarter of next year. This is an out-of-consensus view and we base our thinking on the correlation between job creation and earnings. As earnings have been much better than expected, we think the need to reduce cost will also diminish. The big jump in productivity that was witnessed in Q3 set the stage for a better job market. We think unemployment rates will very soon peak and this could surprise the market.

US Non-Farm Productivity & Profits



Emerging economies should continue to expect to witness growth as the developed economies recover. We do not believe in a de-coupling theme where emerging markets are immune to mature economies' potential woes. In China, the government fiscal and spending stimulus has been extraordinary and is leading to a sharp rebound in economic growth and industrial production. The need to withdraw the stimulus is probably more acute in China where the surge in loan growth is raising some concerns on the quality of the loan book and on the formation of a Real Estate and Financial Market bubble.

A lot of debate is taking place on the outlook for inflation. The world was not so long ago concerned about deflation as a result of the worst financial crisis of the past 70 years.

The near collapse of the global financial system could have led to a deflationary spiral. Finally unprecedented government intervention ended the recession but at the expense of surging public debt. We see inflation as a longer term risk for the global economy. Governments' fiscal situation and the lack of growth engine will lead them to take the inflation risks vs. tightening too early. We therefore think that inflation should start to pick up in 2011.

Overall while we are positive on the cyclical recovery, we remain worried about the longer term outlook. Both China and the US are buying time instead of starting to reform their economies. The US should move out from their reliance on consumption and China should start revaluating its currency in order to redirect its economy towards internal demand and not to mainly rely on exports. This rebalancing of the global economy is what is needed for a more sustainable, balanced and ultimately less risky global growth.

3. Market and Risk environment

Markets have recovered from the unprecedented dislocation of 2008. However the functioning of some parts of the market continue to be poor and to say we are back to normal would be going too far.

Volatility

During 2009 volatility fell in all major asset classes. This was largely driven by the stabilising influence of central banks and constructive government rhetoric. A cleverly orchestrated rally in risky assets supported by various un-orthodox monetary devices served to increase investor confidence, dispel belief in the end of the world and mobilise liquidity. As liquidity expanded some market intermediation activities commenced again and capital slowly but only partially returned.

Volatility predominately arises from unexpected events and risks that have not already been discounted by asset prices. It follows that if a risk is known it's incorporated in the price and not a concern or potential cause of volatility.

Since we now face an uncertain future and there appears to be little margin for error built into many asset prices there are good grounds to expect the decline in volatility to stop in 2010. The key drivers of this view are:

- Uncertainty over the method and timing of liquidity withdrawal.
- Politicisation of the crisis and its implications mean that we now have to contend with a decision making process that's political and not necessarily economically rational. Scope for surprise under such a regime is high.
- Lower transparency by design and due to complexity.
- Possibilities of policy errors and contagion are not currently accommodated in asset pricing.
- The cost of capital will continue to rise forcing liquidity providers to demand more for the risk they take.
- Funding and solvency issues potentially present binary outcomes.

In what will be a lower nominal return environment, higher volatility means lower risk adjusted returns. A low interest rate environment also means investors will need to be cautious with respect to what cyclical risks they hold and how they resolve the apparent paradox of lower expected returns vs. low interest rates (opportunity cost) and higher risks.

Whilst we expect volatility to pick up over 2010 we do not foresee a dramatic increase and markets are expected to be range-bound but volatile with that range. Higher volatility and range-bound markets open up a number of investment opportunities which we are currently investigating.

We expect volatility to increase across all asset classes in 2010.

Correlations

Correlations declined slowly in 2009 from the elevated levels of 2008 but remained high by historic standards. The major feature of markets in 2009 was a high level of asset class correlation. This can be explained by the impact of Quantitative Easing (QE) and the abundant, indiscriminate and highly motivated impact of excess liquidity coupled with a low opportunity cost in the form of zero interest rates.

In 2008 high cross asset correlations meant that naive diversification did not work and to some extent this was also a feature of 2009. However in 2009 this flattered returns and the danger now is to assume that this is a 'normal' outcome, which it certainly is not.

In 2010 we expect correlations across and within asset classes to decline which could upset some portfolios in unexpected fashions. We particularly expect the correlations between bonds and equities and with the USD to change course. The requirement is therefore to identify hidden portfolio exposures and unplanned accumulations of risk.

In addition we anticipate that the dispersion of returns in asset classes will increase, providing an opportunity for stock and sector players to prosper. Indeed the risk based rally of 2009 will shift to a more value or skill based environment in 2010.



Since we anticipate range-bound markets this shift to greater dispersion encourages us to focus on more relative value and stock picking funds. The ability to exploit differentiation will be important as the market increasingly rewards companies and sectors able to deliver sustainable growth. In particular the current lack of discrimination provides good opportunities for specialist long short managers.

We expect correlations to weaken across and within asset classes in 2010.

Liquidity

We see markets driven by valuation, risk aversion and liquidity. Liquidity is the most important of these in the short term and has had a dramatic impact on markets in 2009.

Indeed in many parts of the market, especially spread assets, liquidity driven and technical factors may account for up to 75% of this year's performance.

The dominant impact of liquidity frustrates the market's ability to incorporate future risks and valuation factors in prices. This leads to distortions and the possibility that when liquidity moderates that mispricing unwinds and markets more effectively and dramatically discount future risks. Clearly this is an opportunity but also a major risk. Understanding the drivers of liquidity and the potential methods of its withdrawal are therefore central to our thinking at this time.

We feel it is very important to emphasise that liquidity has retarded the ability of the price discounting mechanism to differentiate and properly incorporate long term risks. As a result risks are higher than normal as we enter into 2010.

The creation of liquidity and its immobilisation in the financial system along with the constructed incentive structure explains much of 2009. 2010 will be a year where this may be removed and the time and method of this will have an impact on risky assets. The timing and scope of this are obviously unknown, hence the risk. We will monitor for early signs of this and its potential impact on risk aversion before repositioning our own risks.

We expect liquidity to remain supportive in the near term but be progressively withdrawn as the year progresses.

4. Equities Developed

We remain positive on major equity markets for the first part of 2010. We believe that the economic recovery is likely to gain momentum, leading to strong earnings data at the beginning of the year. A combination of continued positive economic news flow, upward earnings revisions, undemanding valuation, a high level of liquidity in the economy, and a still cautious investors positioning should drive global major equity markets higher. We also expect fund flows towards major equity markets, which have been negative in 2009, to reverse at the beginning of 2010, supporting the markets.

Though the flow of economic data is expected to remain globally supportive, positive surprises are now more difficult to achieve. Also, towards the end of 2009, the focus has already shifted to the structural imbalances in the major economies with the recent resurgence of debt issues in Dubai, Greece and Spain weighing on market sentiment.

We are less optimistic on major equities on a 12-month time horizon. On the positive side, we expect global economies to continue their recovery in 2010, albeit at a slower pace than in previous economic recoveries, which will allow equity earnings to continue to show significant growth in the next two years. In fact, operating leverage will drive corporate profitability higher, aided by the positive effects of cost cutting measures combined with an improvement in revenues. We also foresee a higher level of M&A activity from depressed levels and the fast growing emerging economies should be positive elements for developed market equities.

However, we also see some adverse factors developing for equities later in 2010. Firstly, the combined front-loaded impact on growth from the unprecedented policy stimulus as well as the supportive inventory cycle are expected to fade at some point in 2010. Secondly, the major central banks and governments of the industrialised world will have to deal with the so-called exit strategies. As they are confronted with large budget deficit and a rising level of indebtedness, central banks will have to start tightening monetary policies to prevent inflation expectations develop from developing, potentially leading to higher interest rates or renewed pressure on the US dollar to materialise. Before hiking key rates, central banks should put an end to their quantitative easing policies, stopping their large scale programs of asset purchases. Thirdly, we also expect discussions to emerge about governments cutting spending or raising taxes to balance their budgets for 2011. As major equity markets have enjoyed a significant multiple expansion in 2009, we expect some multiple compression to take place once the anticipation of these "exit strategies" materialises, which should negatively impact equity returns. As a matter of fact, periods around the start of the Fed tightening cycles have usually led to near-term corrections in equities. Given the uncertainties surrounding the exit strategies, we also anticipate the equity risk premium to stay higher than usual in a phase of economic recovery.

Regional strategy within developed markets

In terms of regional allocation, we continue to recommend overweight Euroland and the UK, neutral rating for the US, Japan, Canada, and Australia and underweight Switzerland. As the year progresses, we will progressively adapt our regional allocation to the market conditions.

Currently we prefer the Eurozone on a relative basis, as it appears to be better placed than other developed markets and though economic recovery is not uniform throughout the region we are confident recovery is underway even with a strong Euro. The overall market offers a compelling valuation and the index is more geared to global GDP growth with a higher weighting to both cyclical financial sectors.

We also like the UK, as we expect the sector allocation within the UK market to be supportive whilst earnings are boosted by the high level of international exposure and the weakness of the sterling. Attractive valuations and a supportive dividend yield are also positive. Macro risks remain but we are focused on the attraction of the UK market and remain overweight.

Investment Strategy

We remain neutral to the US as we favour other developed markets which are more geared to recovery due to their sector exposure and valuation. The US acts as an important barometer for investor sentiment, and therefore we remain neutral as this helps balance risks elsewhere.

The Japanese market has underperformed in 2009, as foreign investors have shunned the market reflected in negative funds flows. Also, the strength of the Yen has weighed on the all important exporters within the

index whilst risks including Government policy and capital raising have added to the negative sentiment. We retain a neutral exposure reflecting recent underperformance.

The Canadian market has been very resilient, outperforming during the market downturn and subsequent rally supported by a high weighting to the Financials, Energy and Materials sectors. This could lead to further outperformance though we view the market as being fair value whilst earnings were less depressed and are therefore unlikely to surprise on the upside.

The view on Australia is very similar to Canada with the market composition of the two markets being skewed towards Financials and Materials. The market has outperformed this year but with little upside in terms of valuation, negative earnings revisions and tightening monetary policy, we remain neutral.

The Swiss market is dominated by defensive sectors such as Healthcare and Consumer Staples and therefore we would expect the market performance to lag in a global GDP recovery scenario. The defensive nature and low beta of the market can be attractive but at this time we remain underweight this specific market.

Sector strategy for developed markets

For the first part of 2010, we reiterate our positive view on cyclical sectors such as Materials, Industrials, Consumer Discretionary and IT taking into consideration that the continued improvement in the macro environment will translate into higher-than-expected earnings for companies in those sectors. At the same time, we remain cautious on defensive sectors such as Health care, Consumer Staples, Telecoms and Utilities. We are Neutral on Financials.

Since March 2009, cyclical and value stocks have largely outperformed defensives. Unprecedented cost cutting measures have led to significant improvements in margins, driving cyclical stocks higher. Later in 2010, as our economic scenario forecasts a muted economic recovery in developed countries and uncertainties surrounding the exit strategies, we will progressively adopt a more pro-growth stance. Early cyclical sectors which have performed strongly in 2009 such as Consumer Discretionary and Materials will be first on our downgrade list.

However, we believe that some cyclical sectors such as Industrials and IT should continue to be favoured by the expected upturn in capex as well as from their large exposure to faster growing emerging markets. IT also specifically also benefits from a positive product cycle (netbooks, smartphones, virtualisation, cloud computing), as well as from the emergence of a PC replacement cycle.

We believe that in 2010, more stable growth sectors such as Consumer Staples, which are largely exposed to emerging markets, should progressively re-rate. Utilities and Telecom Services, which have been the weakest sectors in 2009, could also start to become more attractive at some point next year, as high dividend yield combined with stable growth and reasonable valuations are features that will attract more investors.

EQUITY	Rating
MAJOR MARKETS	OW
US	N
EUROPE	OW
JAPAN	N
UK	OW
Swiss	UW
Canada	N
Australia	N

SECTORS	Rating
MAJOR MARKETS	
IT	+
INDUSTRIALS	+
UTILITIES	-
TELECOM	-

5. Equities Emerging

Following the dreadful 54% loss in 2008, emerging market (EM) stocks have rebounded very strongly since March 2009 on the back of abundant global liquidity and improving macro- and micro-economic news flow. Better than expected corporate results and economic growth acceleration coupled with low inflation and accommodative monetary policies across the world have created a favourable environment for riskier assets including EM equities this year. Moreover, investors have acknowledged and rewarded the sound fundamentals of many emerging economies. Indeed, their stable financial systems largely clean from toxic US-subprime mortgage assets, as well as their relatively low sovereign, corporate and household indebtedness levels, high foreign exchange reserves and large room for counter-cyclical policy measures were strikingly in contrast with some more developed parts of the world. As a result, the MSCI Emerging Markets index has gained some 70% in USD since the beginning of 2009 and recovered the bulk of the past year's decline from its peak reached in October 2007, as investors adopted a much more upbeat stance toward EM stocks over the last couple of quarters. EM stocks have significantly outperformed the MSCI World index this year and now stand close to an all-time high versus developed markets.

The December fund manager survey sponsored by BAS-Merrill Lynch shows that EM remains the favoured region for asset allocators. A net 45% of global investors are overweight EM equities, which is near the all-time high readings seen over the past few months. EM investors have a preference for high-beta markets such as Russia, Brazil and Turkey and are very underweight low-beta markets such as Malaysia and Chile.

However, we believe that the sustainability of the EM rally is likely to be questioned in the near future amid rising market valuations, decelerating corporate earnings upgrades and the increasingly lacking marginal buyer for EM stocks. Although inflation is still not a major near-term risk in the EM world as a whole, the first "baby" steps in the lengthy monetary tightening phase taken by some emerging countries should increase investors' cautiousness. Hence, in our view, we should see ups and downs within a trading range (seen at 860-1000 for the MSCI EM index) leading to a close-to-flat final result over the next three months compared with the current levels. We downgraded our stance on EM stock markets on a 3-month basis to neutral on the 1st of October and we stick with our neutral rating over the next 3 months. EM currencies' returns should remain reasonably strong though and are likely to be a sizeable contributor to the performance in USD terms of several major EM equity markets. Key risks to our neutral view include (1) possible re-emergence of the EM decoupling theme, which could incite large flows of non-dedicated money into EM assets driving prices much higher; (2) policy mistakes (such as no action or excessive action on the monetary side, capital control measures, etc) and (3) a sudden surge in global risk aversion leading to "flight to quality" and profit-taking in risky assets.

In terms of the trailing Price-to-Book ratio (which in our view is one of the most relevant valuation indicators for the EM equity universe as a whole at the current stage of the cycle), EM equities now trade at a 2% premium to their own 6-year average and 11% premium to their long-term average. We believe that no further expansion of the P/Book multiple is likely in the short-term. At the same time, a major correction in EM stock markets is not warranted at this stage and therefore, we will use major spikes in risk aversion and any sharp decline in equity markets to accumulate EM shares, as the latter remain attractive for long-term investors.

Our 12-month (November 30, 2010) target for the MSCI EM index stands at 1040, implying a 9% price appreciation gain and a total return of around 11%. This target reflects normalization of corporate earnings in 2010 and anticipation of a double-digit (+19%) earnings per share growth in 2011, as private consumption should progressively take over fiscal stimuli measures as a major driver of global economic expansion. The broadening out of the recovery in 2010 should benefit both EM exports and domestic demand, providing an overall favourable backdrop for EM equity markets over the next 12 months.

We favour diversified exposure to large EM economies capable of generating high rates of growth internally. We overweight emerging Asia versus Latin America and EMEA and keep our major country bets (China, India, Taiwan, Indonesia and Brazil) intact.

6. Fixed Income and Rates

2010 is expected to be a year of change in volatility, correlation and liquidity.

As we end 2009 Government Bond markets are in the limelight once again. The process of transferring private debt to public hands has raised the concentration of risk and the vulnerability of the financial system and global economy to policy mistakes.

While fundamentals have been distorted by massive liquidity injections, some investors fear that the removal of these excesses will have a dramatic negative impact on bond prices. This view is challenged by other investors who think that the removal of extraordinary liquidity conditions will be widely counterbalanced by fundamental factors. These include continued de-leveraging, tightening of bank reserve regulation, US consumer savings, all of which are supportive of bond markets.

If one accepts this view it becomes necessary to also believe that these factors will be enough to maintain bond markets in the current, unstable and medicated equilibrium.

The existence of such a dramatic bipolar view is not unusual at time like this but it does present a major challenge to investors. We see the management of this is as a risk management exercise and not a simple case of opting for either one of these views.

The high level of uncertainty with respect to the nominal level of the "risk free rate" is therefore elevated. This has two major consequences :

1. Forecasting economic outcomes or asset class performances becomes even more difficult than normal, especially since the discounting of risk in current assets is distorted by the dominant impact of government activity.
Professional forecasters from major Investment Banks are split almost 50/50 between bond bears and bond bulls, dispersed between benign and dramatic scenarios and the outliers at extreme levels. This dichotomy implies extreme uncertainty which equals risk for the repricing of all assets and risks and for which investors need reward. Our challenge is to see what is actually implied in asset prices.
2. As liquidity will be removed, fundamentals will increasingly dominate and dispersion across and within asset classes should increase. The feed back loop effects of any Central Bank will be paramount.

Under such premises, investors must expect a more volatile environment and be prepared to use this as an opportunity.

As a consequence, we foresee several themes for Fixed Income markets in the year to come. These range from tactical and thematic to long term fundamentally driven ones:

1. Issuance patterns are expected to diverge between the private and public sector, this should benefit Investment Grade debt relative to Government debt, with the exception of US TIPS (Treasury Inflation Protected Securities), which continue to be supported by low issuance relative to nominal US Treasuries.
Any change in fiscal policy or in Quantitative Easing (QE) programs could challenge this view. However we would not see this changing the long term outlook and expect investors to continue to focus on real yields and not only nominal ones. This is driven by the idea that long term headline inflation will be structurally elevated due to growing competition for natural resources.
2. Expectations of Central Banks policies are likely to be volatile. First, rate hikes have already been delivered in a few countries, and it is not yet clear if this signals the beginning of a new rate cycle or the removal of extraordinary loose policies. This, in turn, tends to blur the position of the 3 major central banks.
 - The Bank of Japan has again moved to a deflation fighting stance
 - The ECB is currently focused on a gradual removal on QE but could soon shift its attention to the deteriorating position of weaker European countries. Many of these are having difficulty in financing their debt burden from public and domestic banks)
 - The US Federal Reserve is probably leaning secretly toward generating inflation to escape its own funding difficulties.

Investors must therefore expect less synchronisation in interest rate cycles than we have seen of late.

For the time being we maintain our view that policy rates should remain low for a long time, but positioning around this conviction will be harder in 2010 than it was this year. As a second consequence, we expect FX volatility to rise.

- 3 The path of fiscal policies will diverge between different countries, as Central Bankers concerned about their independence will attempt to distance their activities from the political motivations of governments. The politicisation of monetary policy has been a feature of 2008-2009 and we expect this to shift back in 2010.

Such a theme could develop quickly in countries where no election is due in 2010. For the more politically involved Central Banks, the possibility that governments remain irresponsibly loose in their budget is sadly high. This will continue to impact sovereign credits, we expect this to be a big theme in 2010.

While this is a serious issue for developed countries, it is much less so for emerging nations, and this will translate into a more attractive relative valuation of EM debt compared to Developed country debt. This supports our long term stance that local currency Emerging Markets debt is one of the best Fixed Income assets to hold for the long run.

- 4 As a long term consequence of fiscal imbalances, the current steep shape of yield curves in the developed world should remain steeper than history would suggest. Ways to position for such a long term trend are many, one of our favourites is through the structured product market, though implied volatilities remain dear.

With so much uncertainty, reducing duration can expose investors to deflation risks and much lower carry. A long duration position combined with protection in the form of options offers more flexibility in the management of assets and better protection relative to different interest rate environments.

- 5 As damaged balance sheets on public sectors will weigh on government bond valuations, the Corporate sector, and particularly large, solvent, and sound Investment Grade companies should benefit on a relative basis. We remain positive on credit market performance relative to government markets, though higher uncertainty and the unwinding of "moral hazard" supportive public policies may increase idiosyncratic risk. More than ever, selection of the most skilled bond selectors among the credit fund universe is the way to play this sub-asset class. This means a greater focus on manager skill and flexibility in fund selection.
- 6 More tactically, our economic outlook predicts positive surprises on employment, this in turn is also supportive to High Yield markets as it benefits small corporates most. Furthermore, the current technical factors and momentum are also supportive.

The economic crisis the world now emerges from was a consequence of a financial crisis triggered by insolvent US consumers who were over-leveraged in an over supplied housing market. These factors were magnified by loose regulations and the illusion of risk control given by spurious securitisation.

We ask ourselves what of these issues have been solved? The answer is sadly none.

The risk of a return of these problems will be increased by the unwinding of public support. We suspect the cautious approach toward exiting extraordinary policies adopted so far by authorities in the US, UK, Euro and Japan may signal a different situation than formally depicted in the official statistics.

The big structural theme for 2010 will be about the willingness and ability to reform and control the financial system.

Related to this is the issue of sovereign credit risk. Several nations are currently on negative watch and we expect this number to increase in 2010.

Investors can gain little comfort from CDS markets in hedging this risk. Corporate CDS markets did not perform their hedging function in the fall of 2008 and in a similar vain the Sovereign CDS market is unlikely to protect investors in the event that the public debt market is, as we expect, the next bubble to pop.

Finally the risk just mentioned casts into doubt the ability of many Government debt markets to protect portfolios.

Government debt is increasingly a no return risk asset rather than a low return riskless one.

7. Currencies

The US dollar has been globally weak over the past few months. Dovish comments from the US Federal Reserve have fuelled expectations that US interest rates would remain low for some time to come. FX reserve managers' accumulation of USD reserves by emerging market central banks and subsequent diversification toward non-US dollar currencies also undermined the greenback. Eventually, finance officials and central bank governors of the Group of Seven rich nations condemned excessive currency volatility in principle but did not send any strong signal to markets that the G7 wanted to prevent further dollar weakness.

We believe that a moderate appreciation of the US currency can now be expected in the months to come. Indeed, the recent overall US dollar's downtrend is now seen as vulnerable. The heavy short speculative positioning is starting to make investors hesitate to sell the US dollar further, creating conditions for a pullback. This is particularly true as there are increasing uncertainties about both the pace of the economic recovery and the leading central banks' stance on currencies and interest rates. A round of capital controls being implemented or envisaged by emerging countries' policymakers to curb massive speculative capital flows could prevent further US dollar weakness.

The market has also begun to focus on exit strategies. Although the US Federal Reserve is unlikely to raise interest rates anytime soon, speculation of an upcoming FOMC statement language change as an early step toward future monetary tightening might boost the US currency. Our expectation of an improvement in US unemployment data supports this view. The US central bank will likely start to prepare the market when it moves towards eventual policy normalization. The aim is to avoid a situation in which it might be forced to move quickly from forecasting an "extended period" of rates held near zero to raising rates, as that would disrupt markets and damage credibility.

In the Eurozone, policy stimulus has been more modest, suggesting that the economy in the region will be slower to recover. Rising unemployment, overvaluation of the housing market, concerns regarding the debt position and possible downgrades of some countries, could all drift the single currency lower in the coming months. Indeed, public debt has risen to unsustainable levels in EMU's peripheral countries and sovereign credit default spreads have started to blow out again. This increase in uncertainty will likely start weighing on the euro.

Sterling is expected to struggle going forward due to signals from the Bank of England of a far looser stance on monetary policy than market participants had expected. Britain has undergone its longest recorded economic contraction and is now likely to be the last major country to return to growth. A weaker pound seems to be the only way for the UK to see any stable economic recovery as its consumer is stretched and national balance sheet impaired. Public debt has reached a level where rating agencies are threatening to remove the UK's triple A rating. This suggests that the government will have to implement a massive fiscal tightening programme, thus depressing further economic conditions.

The upward potential for the Swiss franc is seen as limited, due to the Swiss National Bank's commitment to fight any rise of the currency.

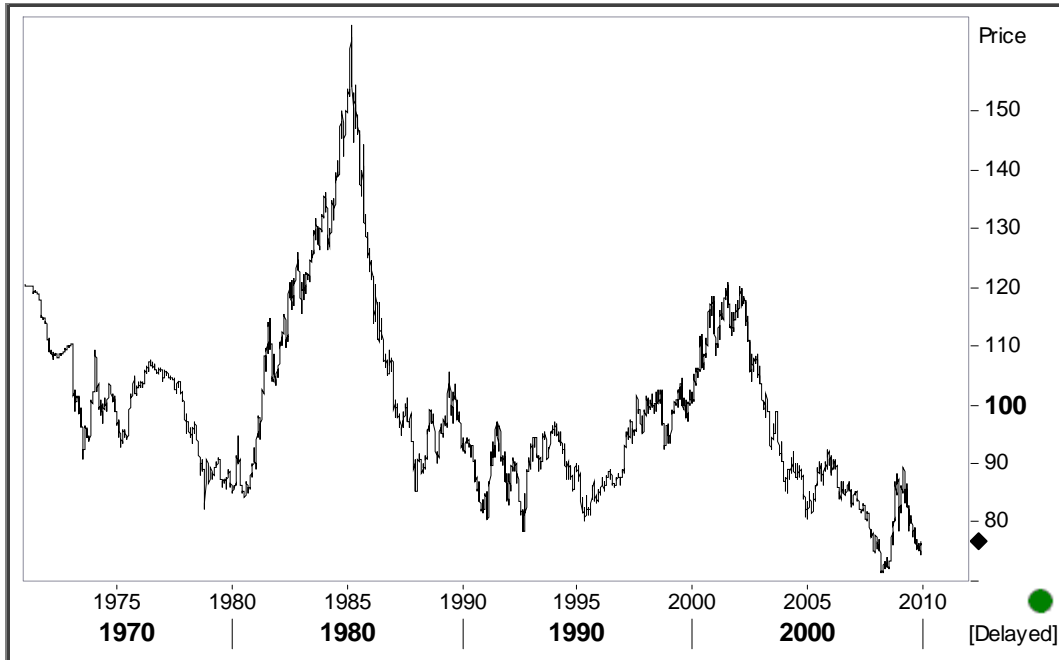
Japan's fiscal position is negative for the Japanese yen. With public sector debt exceeding 200% of GDP, interest rate payments represent more than 25% of tax revenues. This explains why Japan's Finance Minister is very sensitive to yield increases. As 93% of all bonds are issued domestically, domestic savings are very important. But for Japan to maintain its high savings ratio, the Japanese economy will have to remain in deflation. This implies that the yen will weaken across the board once inflation picks up and bonds yields outside of Japan start rising.

On the longer term, the level of uncertainty is very high. Prospects for the US dollar will mainly depend on the ability of both the Federal Reserve and the US administration to remove quantitative easing in a timely manner and reduce the fiscal deficit to a more manageable level. Our expectations of weak US and global economic growth prospects should lead to renewed concerns about deficits and the debt situation. While the US will not be alone in trying to bring public finances under control, the size of the challenge facing the US appears to be still much greater. Barring a surprisingly strong and lasting recovery of the US economy, the US dollar will probably succumb to the gravity of US fiscal concerns. The debate surrounding the US dollar's reserve currency status will likely intensify, weighing on the US currency.

Speculation about a China's yuan revaluation could, however, potentially provide the US currency with some support. Indeed, to stem the rise of their currencies against the yuan and the dollar, both being pegged at present, central banks around Asia have in recent months been purchasing billions of US currencies and building their foreign reserves. These flows have then required large reserve manager purchases of non-US dollar currency, particularly the euro, to maintain portfolio shares. Any slowdown in reserve accumulation

could reduce diversification into non-USD currencies and thus reduce the downward pressure on the dollar versus other G10 currencies. In turn, structural advantages for developing countries, including factors such as lower levels of public and private debt, demographics and powerful effects from urbanisation, infrastructure build-up and increasing purchasing power of a big share of global population, are likely to boost most emerging currencies.

US dollar Index



8. Commodities

Despite the most rapid contraction in global growth for many decades, commodity prices have benefited in 2009 from an improvement in leading indicators, strong demand imports from China, rapid supply-side adjustments, a weaker US dollar and a strong rebound in investors' flows into the complex. But the price appreciation at the front end of many commodity curves has slowed or even reversed of late, suggesting that commodities, after starting an earlier-than-usual recovery in the economic cycle, have priced in all the good news and are now peaking earlier as well.

Despite the rise in prices, it is important to remember that commodity markets have not yet reached equilibrium. There are still massive supply surpluses and very large inventories to be eroded, especially in the energy and base metals sectors. The key concern is related to the extent and timing of any slowdown in China's commodity imports and whether or not demand improvement in the OECD will come through quickly and strongly enough to offset it. In China, the easy bank credit has found its way into popular asset classes, such as the domestic equity markets, and likely into global commodities markets as well via inventory accumulation. If credit is tightened, as it is widely expected, China's apparent commodity demand will slow. A recovery in OECD demand could help to offset some of this weakness. But in our views, re-stocking would likely be much more muted than in previous up-cycles, as fabricators operate cautiously given the lack of visibility in orders and partly due to continued credit constraints. The economic environment remains uncertain, and there are good reasons to believe that the coming world GDP rebound will be constrained. The various fiscal stimulus packages and accommodative monetary policies could lose their efficiency in the coming months, as governments have started to progressively withdraw the various incentives. Once the positive news has been fully absorbed and the policy stimulus in the US, Europe and elsewhere is gone, a renewed patch of economic weakness might be in store for the global economy. In addition, with higher commodity prices, supply growth can also be expected to accelerate. All this could contribute to undermining prices in the coming months.

Oil prices, for instance, look vulnerable. Energy demand is soft, particularly in distillate products. Non-OPEC production is holding up very well, while OPEC quotas are being exceeded with impunity as shown by the fact that crude oil inventories are still relatively high. Following the rise of prices in 2009, the temptation to increase production is high for many OPEC countries. The resulting increase in supply and lack of demand growth, with many countries holding surpluses, could weigh on prices. On a longer term, however, structural factors could likely underpin prices. Funding and development costs in the oil industry will continue to rise at a time when oil majors are spending less in terms of capex spending to find new oil fields. This is problematic in an environment where depletion rates on exiting oil wells have been rising steadily over the past five years.

Fundamentals for precious metals however, remain positive. Beyond risks on prices in case of unwinding of speculative positions, the prospect of other risks, particularly the fallout from fiscal imbalances resulting in incipient inflation and the potential for currency devaluation, together with uncertainty about exit strategies, could continue to boost prices. A low interest rate environment, together with increasing central banks' demands and limited supply capacities, should provide additional support.

CRB Index

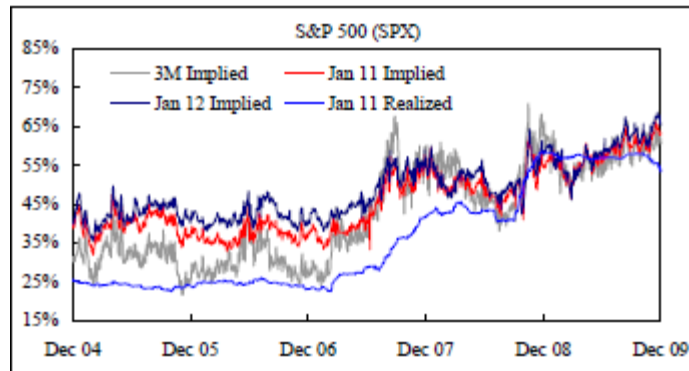


9. Alternatives

Since the 6th of March, we have experienced a tremendous rally in most risky assets. While the first part of the rally was an inevitable rebound from the extreme lows of March, the second part was driven by an improvement of micro and macro economic data. While large market reversals often go together with increased correlation between asset classes, this rally broke historical asset relationships with equities, high yield bonds, gold and euro currency going up simultaneously. After several quarters of rush for cash, investors began to chase anything but cash.



Also, intra-correlations are historically high. Concerning the equity market, the rally was characterized by a lack of discrimination between high quality and low quality companies on one side, and between high growth and low growth on the other side. In the current market, it is not rare to find a highly leveraged company with low growth expectation more expensive than a highly visible growth company.



Source: JP Morgan

Whatever the economic scenario is for next year, we think that this situation is unsustainable, and that inter and intra correlation should reach much lower levels, offering hedge fund managers plenty of opportunities for several years. This is true between strategies (asset class disconnections are very good for global macro) as well as within strategies (price dispersion is good for alpha generation in equity long/short, credit long/short and multi-strategy managers).

In terms of strategy allocation, taking account that there is a clear case for less liquid strategies after the liquidity crisis, we are concentrating our strategy allocation mainly (but not exclusively) on liquid funds to fit the liquidity profile of managed accounts. We will continue to propose less liquid investments but in a separate investment proposal. We have increased our allocation to equity long/short managers as a strategic play. There is still a real case for large cap equity traders in 2010 due to different elements: they have proven to be resilient to major liquidity crises; they are still capable of delivering good return, they generally don't have legacy issues; and, in our opinion, they will be in a market configuration where they are able to generate decent return owing to stock dispersion rather than to the direction of the market. In terms of overall risk, we are currently in a pretty normalized environment as shown by the volatility graph below.



	Nov.09 Allocation*					Bias**
	-2	-1	0	1	2	
Fixed Income Arbitrage			0			→
High Yield L/S				1		→
Credit Directional			0			↗
MBS directional				1		→
Convertible Bonds arbitrage			0			→
Distressed Securities				2		→
Equity Market Neutral				1		→
Equity Long / Short				2		→
Emerging markets				1		→
Event Driven				1		→
M&A				1		→
Global Macro			0			↗
Systematic Trend Followers			0			↗

*Refers to the cash allocation in each reference currency strategy
**Next likely move

In terms of strategy allocation for 2010, the main changes we forecast are the following:

- Fixed income arbitrage has been upgraded from -1 underweight (small arbitrages with huge leverage is too risky in crisis time) to neutral. If the interest rate curve steepens further, carry traders will find a lot of opportunities with less leverage.
- We keep our overweight +1 rating for high-yield long/short but decrease our rating on directional credit strategies as we think that the current level of spreads doesn't offer a compelling risk reward ratio. Meanwhile we are still happy to buy on dips (i.e. come back to overweight +1) should the spreads widen again.
- We have recently upgraded the MBS strategies, though carefully. We think that as the real estate market stabilizes, investors in general will be less afraid to trade their portfolios and this should provide opportunities for MBS specialists. We will be very cognizant about liquidity issues imbedded in the strategy.
- We have upgraded the distressed strategies by two notches from neutral to overweight +2. The reason is that distressed managers have now almost fully invested their portfolio while most of them were only invested 50% during 2009. The number of opportunities are there, the risk level in the market is back

to normal and the liquidity is there. The combination of those three elements is very powerful for the strategy.

- We have downgraded our equity market neutral from overweight +2 to overweight +1. We think that they have done the job during the crisis but that the next phase of the cycle will be more favorable to real stock pickers. We could even see value managers coming back into the game. This is the reason why we keep our overweight +2 in equity long/short. We also keep our overweight +1 in emerging markets (mainly equities) as they clearly remain the growth engine of the world.
- We have built a special case for global macro and CTAs. We keep our neutral rating but are ready to overweight it to +2 at any time. Those two strategies have not performed well in 2009 because we were in a decreasing volatility environment. But if we see volatility increasing in the fixed income market, the curve steepening further and government spreads starting to take off, Global macro managers will do fantastically especially as in this particular scenario, currency will also be volatile again. It might not be the most likely scenario for 2010 but if it happens, consequences in financial markets could tough and then global macros and CTAs will be our best hedge.