

Upgrading European Equities

Update – Global Markets Strategy Report

August 2010

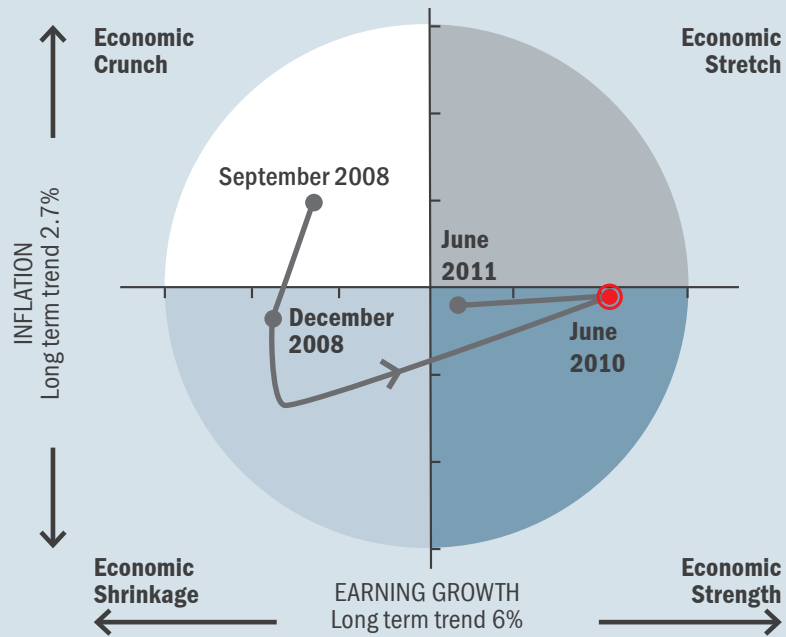
Rank: From weakest to strongest in ascending order:

Strong Underweight Underweight Slight Underweight Neutral Slight Overweight Overweight Strong Overweight

Please note that the rank is indicative and may not balance when summed.

Restoring the Base Case Scenario of Economic Strength

- As indicated in our latest Global Markets Strategy Report, we are closing our underweight in global equity markets, which was established in early May. European equities account for most of this risk-containment trade, moving to neutral on a global scale.
- The volatility related to the euro government debt crisis appears to be settling on several fronts. The recovering euro exchange rate, as well as falling sovereign and corporate credit spreads, suggest a possible change of climate, and with it a renewed case for risky assets.
- Healthy corporate data account for most of this change and the corporate reporting season is helping confidence. Better-than-expected earnings were released by firms operating in economically-sensitive sectors, also thanks to increased sales revenues. Such evidence should allay lingering concerns about a slow macroeconomic recovery in developed regions.
- Our risk-containment strategy helped us to deal with the market turbulence of the last few months, but it can hardly be extended without incurring the risk of losing selective buying opportunities. Valuations may be short of compelling but are back to attractive levels after major stock markets sold off in the second quarter. Many investors have increased their cash holdings to hedge against volatility, and reliable polls report that these have not been so high since the autumn of 2008 (at the height of the recession). This leaves some upside in spite of the recent rally or may limit any downside.
- As the flow of corporate earnings confirms the early good indications from the US, we are ready to restore our global equity allocation to neutral, starting by upgrading European equities. Indeed our long-term indicators have been calling for an overweight in risky assets (equities, corporate bonds) even in the midst of the euro debt crisis, amid evidence of strong growth in corporate earnings and low inflation. We can make our allocation consistent with this view, thanks to more stable market conditions. The safe-haven appeal of core government bond markets looks poised to diminish in this scenario and we are downgrading this asset class to underweight as a result.



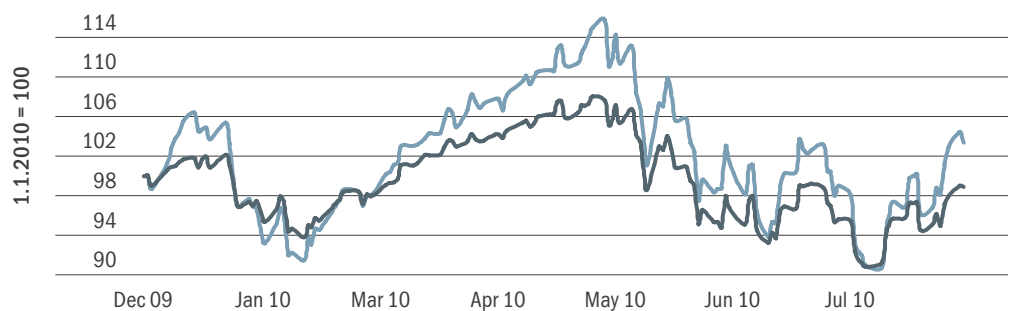
Data on US Earnings Growth and US Inflation are analysed by a proprietary statistical model to get four different economic phases. Source: Pioneer Investments Asset Allocation Research as of 30 June 2010

The Catalyst of Corporate Earnings

This year's turmoil in the financial markets was marked by several mood changes, and the latest revival of confidence in the economy is likely to be no exception. However, improving fundamentals have also been supportive. The corporate reporting season is proving much better than expected for the second quarter. Admittedly, this is a recurring pattern especially after a sharp market decline, if only because of low consensus expectations. Nonetheless, investors are encouraged by two points.

First of all, the announcement of higher-than-expected earnings came from companies, which are highly sensitive to the economic cycle (industrial metals, freight, consumer electronics), allaying concerns that regional disturbances such as the euro debt crisis may curb global growth or, in the worst case, bring back recession. Moreover, earnings rose, not only because of cost cutting, but also on increased revenues. Top-line growth marks the return to a mature stage of the recovery.

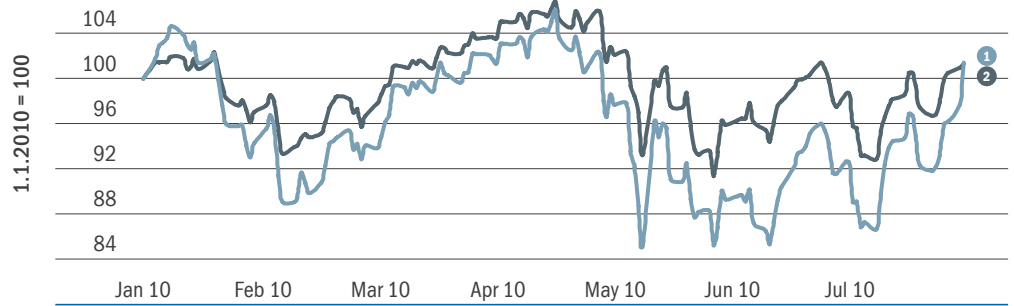
US Cyclical Stocks Outperforming Again



1 MORGAN STAN. CYCLICAL IX 2 S&P 500 INDEX

Source Bloomberg as of 27 July 2010

European Bank Stocks Erasing Springtime Losses



1 MSCI EUR/FINANCE 2 MSCI EUROPE

Source Bloomberg as of 27 July 2010

European Banks' Stress Test

The euro debt crisis is now getting less attention. In the weeks before the release of the stress test on European banks on 23 July, bank stocks had already recouped a substantial part of the losses incurred during the first part of the year, despite a widespread skepticism about the stringency of the criteria set by the Committee of European Bank Supervisors (CEBS). Last year the same test on US banks changed the mood, and this may have triggered some short covering.

The actual results met the expectations on several counts. In the end, only seven of the 91 banks tested were found to be short of capital in the worst scenario and these names were the most rumoured before the release: Germany's Hypo Real Estate, Greece's ATE Bank and five Spanish regional banks. What made the percentage of banks failing the test so low was indeed the significant capital-raising that had already occurred. European banks have raised more than €220 billion in capital during the recession and most of it was bailout money from the government. Nevertheless, a number of banks could pass the test thanks to a low bar for the key ratio of core capital (Tier One) to (risk-weighted) assets.

According to some skeptic commentators, including our own analysts, the threshold for this key ratio was set at 6% (rather than 8%) in order to avoid an undesirable outcome. Nevertheless, this lack of stringency is unlikely to regain the confidence of markets in the long term, although we should wait for a new bout of market volatility to prove this point.

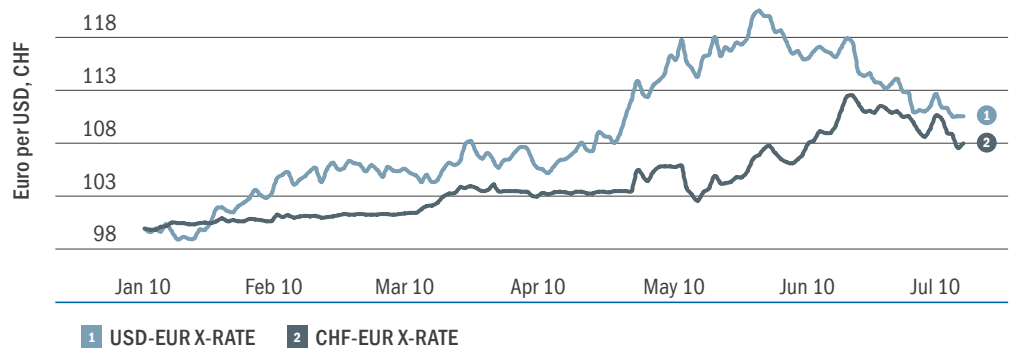
Another problem comes from the discretionary approach of single countries about what kind of information to disclose in order for the test to be conducted. Some German banks did not disclose, for instance, what government bonds they hold. In this regard the Bank of Spain has done better than many of its peers, by forcing banks to release detailed information on all of their holdings in European government debt.

The stress tests on European banks were not as stringent as those conducted in the US last year but appear to convince investors that the region's banking system is fundamentally sound. Speculation that the new rules on capital and liquidity (from the Basel Committee) would be softer is lending further support to bank stocks, which on average (the benchmark being the MSCI World Financials Index) have regained mid-April levels, as if the worst of the crisis never happened. At the same time the euro regained ground against both the US dollar (also on evidence of softer US growth) and, more remarkably, against the Swiss franc (whose safe-haven appeal was particularly felt

at the height of the debt crisis). Against this backdrop, the credit risk of bonds issued by peripheral European governments and most banks is declining sharply.

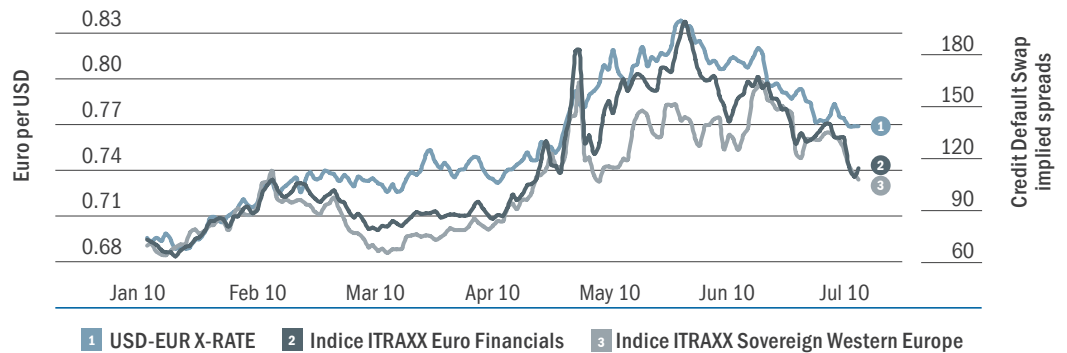
If the threat of a double dip is less perceived, the base case of global growth is strengthened again. We have often argued that countries like China and other giants of the emerging area have driven the global economy out of recession and have not slowed down in spite of the euro's debt crisis. Our long-term indicator of the economic "phase" has never substantially deviated from a path of economic strength. Our strategic asset allocation has contained risk in a turbulent market environment, but this call should not be overly extended under the current more settled conditions. Valuations have become attractive again and investors' cash holdings are reportedly high, so that an upside margin exists for global equity markets, particularly in Europe. As early indications of second-quarter corporate earnings in Europe mirror the improvement already seen in the US, we are therefore ready to add to our equity allocation by moving to neutral on a global scale and by tempering our aggressive underexposure to European equities. Indeed, Europe's macroeconomic outlook remains downbeat as fiscal policies tighten, but a number of companies are less reliant on domestic demand than on global growth.

Receding Fears: The Euro Regains Ground



Source Bloomberg as of 28 July 2010

Receding Fears: Credit Risk Declining in Europe



Source Bloomberg as of 27 July 2010

Tactical Asset Allocation Summary

Global Equities: Neutral

The case for cyclical assets is strengthened, as buoyant corporate data make the euro debt crisis less of a threat to the global economy. Although we have often argued that the euro debt crisis posed no significant challenge, this view needed more settled market conditions to be confirmed and form the basis of our asset allocation.

USA: Overweight

The recovery in consumer spending helped GDP regain a normal growth trend although there are reasons to believe that the second half of the year will be less supportive, as most stimulus measures have expired and the labour market is showing less visible signs of improvement. However, the latest market downturn brought most valuations back to attractive levels, notably for the most cyclical sectors. For its part, the Federal Reserve should feel inclined to maintain very low interest rates for the foreseeable future, with core inflation held in check by subdued wage growth.

Europe: Underweight

The outlook for Europe's economy is still fragile, as tight budget policies are looming, not only on peripheral, deficit-stricken countries. Divergences are set to widen on a country basis, with Germany seemingly better equipped because of its strong exposure to foreign demand.

Japan: Underweight

Foreign demand makes up for the weakness in domestic spending, like in most of Europe, as strained government finances call for a fiscal squeeze (a consumption tax is likely in Japan). Valuations are again in cheap territory and may remain so for a long time before attracting substantial investment flows.

Pacific ex Japan: Underweight

Markets overly reliant on China's growth may be concerned about early policy tightening aimed at keeping the economy from overheating. Moreover, commodity-related sectors play a key role in this region and their valuations look demanding at recent levels.

Emerging Markets: Overweight

Most of these regions retain a strong potential for domestic growth, with Asia in the first tier. The current turmoil over the debt crisis in the euro area is unlikely to dent those prospects, while the risk of overly restrictive policies to contain inflation is worth monitoring closely. A radical change in China's exchange rate policy would be helpful, but the recent announcement on more currency flexibility should be followed by a conservative approach.

Global Bonds: Underweight

Government bond yields in core markets, such as Germany and the US, are close to cyclical lows in spite of a global economic upturn, which makes them fundamentally unattractive. Regional crises prompted investors to look for safety in German bonds but yields have fallen to unattractive levels (even more so in the US where the budget deficit is unlikely to be reduced).

Euro Government: Underweight

Domestic household spending has rarely driven GDP growth in the euro area and the debt crisis may spur tighter fiscal policies, which will curb spending further and keep inflation at bay. If this sounds fundamentally supportive, we should also keep in mind that volatility among peripheral markets was the main reason why investors resorted to the safety of German Bunds, however, once conditions settle the investment case looks diminished.

Euro Corporate: Neutral

Most companies have cut costs in an effort to regain profitability. Compared to some profligate governments now grappling with heavy budget deficits, they have deservedly had their risk premiums lowered. However, bank names account for a large part of the euro corporate market and their holdings of government debt may put the balance sheets at risk of asset write-downs (albeit to a lesser extent than in the recession where corporate defaults could have risen dramatically).

US Government: Underweight

Evidence of softer economic growth in the second half of the year is making US Treasuries attractive again, as core inflation is held under control by subdued wage growth. Yields of about 3% for the benchmark 10-year maturity hardly look attractive, however, when the huge government deficit (which is funded mainly by overseas investors) is duly taken into account.

US Corporate: Overweight

Global risk aversion tends to rise as a result of an extended period of uncertainty in euro government bonds and may boost credit risk premiums, even for solid companies. That may provide renewed opportunities with cheaper valuations, adequately hedging the risk of a rising default rate.

Emerging Markets: Neutral

In most emerging countries economic policies have clearly improved, particularly compared to developments in Western Europe. Renewed opportunities (including in local currencies) may be provided by the recent rise in yields, although we recommend waiting for more settled market conditions, with risk aversion receding.

Tactical Asset Allocation Summary

Global Summary Table

Asset Class	Recommendation
Equity	Neutral
Government Bonds	Underweight
Corporate Bonds	Overweight
Liquidity	Overweight

Regional Summary Table

Asset Class	Recommendation
Euro Cash	Underweight
2yr Euro Corp	Overweight
Total Liquid Assets	Overweight
Euro Bond	Underweight
US Bond	Underweight
Japan Bond	Underweight
Government Bonds	Underweight
US Corporate	Overweight
US High Yield	Neutral
Euro Corporate	Neutral
Euro High Yield	Neutral
Emerging Market Bonds	Neutral
Corporate Bonds	Overweight
North America Equity	Overweight
Europe Equity	Underweight
Japan Equity	Underweight
Global Emerging Mkts	Overweight
Pacific Ex Japan	Underweight
Equity	Neutral

Foreign Currency Exposure

US Dollar	Overweight
Euro	Underweight
Yen	Underweight
Other	Neutral

FROM WEAKEST TO STRONGEST IN ASCENDING ORDER:

Strong Underweight Underweight Slight Underweight Neutral Slight Overweight Overweight Strong Overweight

Please note that the rank is indicative and may not balance when summed.

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