

Investment Update

Outlook

UPDATE STRATEGY INSTITUTIONAL CLIENTS



March 2008

The investment strategy proposed below is intended for a specific investment profile, i.e. that of an investor with a dynamic profile interested in a highly diversified portfolio. Depending on the customer's risk profile and investment preferences, KBC can recommend a different composition of his or her portfolio.

- Testing the bottom
- Brief, mild recession
- Earnings recession
- Stock markets the first harbingers of spring
- Bond portfolio: longer maturities
- Cautious increase in financial institutions' bonds
- Europe preferred to the US
- Neutral sector allocation

TESTING THE BOTTOM

The S&P500 lost more than 16% between the peak reached on 9 October 2007 and the low registered on 22 January. In the EMU, the bond rate fell during this period from 4.35% to 3.85%. Over the past fifty years, there have been about ten serious stock market corrections of this kind (where prices have fallen by over 15%). At least six of these have coincided with a recession, and at least three can be

associated with fears that the financial system would collapse. In addition, there have been any number of mini-crashes where the dreaded 'R-word' has cropped up, but where the fear of recession ebbed away after a while. Since the end of January, good days have alternated with bad on the stock markets, and prices have continued to fluctuate more or less around these levels. Has the market found a bottom?

In their third- and fourth-quarter earnings, the big merchant banks owned up to enormous loan losses, which took the form of write-downs on mortgage loans and impairment losses on ABS. Total loan losses have now risen to 135 billion USD and resulted in a 30% drop in earnings for the US financial sector for financial year 2007. Initially, the market was only concerned about the solvency of the big merchant banks,



but this concern spread subsequently to encompass the entire banking industry and ultimately a number of specialised bond insurance companies as well.

In the meantime, the subprime crisis has entered its fourth and final phase. This is the phase in which a good many structured credit formulas will reach maturity. Since the market has lost its appetite for this kind of investment instrument, refinancing them promises to pose a major challenge. This could well stir up some anxiety in the weeks ahead. It is also the phase in which the financial institutions in question will be raising fresh capital by issuing shares, convertible bonds and/or subordinated loans, etc. They are finding this a fairly easy exercise at the moment. Institutions have already raised more than 50 billion USD, the equivalent of nearly half the loan losses. Moreover, investors seem to be ignoring the fact that the provisions set aside and impairment recorded only actually turn into losses when the portfolio is wound up and if recovery on the subprime mortgages proves impossible. If the investment vehicles can be held to maturity, the provisions can be reversed. This is equally valid as a way of freeing up the capital base.

A brief and mild recession

Given the considerable worsening of the economic data in the US, we assume the recession got under way in January. We still believe that the recession will be short-lived and mild. There were - except in the housing market - no excesses during the 2002-2007 economic boom. Consequently, there is no need for drastic cost-cutting and/or restructuring. The inflationary effects of the high oil and food prices will gradually fade away over the course of the year. The weak dollar and the strong growth in Asia will ensure that exports make a major, positive contribution to growth.

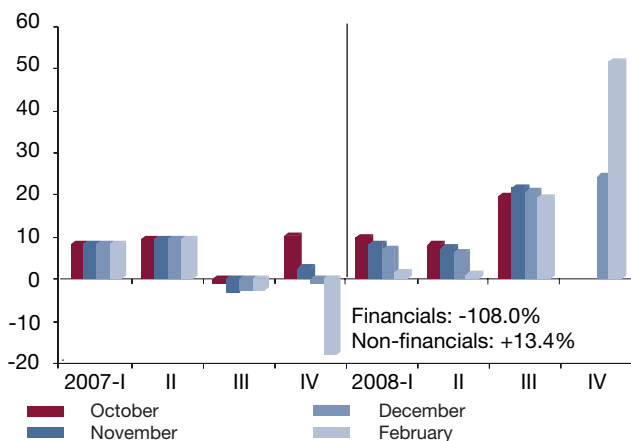
Additional monetary impulses from the US central bank (the Fed) are in the pipeline. Since the middle of September, the Fed has cut its key rate by 225 basis points from 5.25% to 3.00%. Given the widening interest-rate spreads, these rate cuts are filtering through more slowly than usual, but it is time these effects start to have an impact on the real economy. Bush's package of fiscal stimuli has come too late to avert a recession, but it will have a positive effect on growth starting from the beginning of the third

quarter. Growth is likely to be close to zero in the first two quarters of 2008, but we are anticipating a cautious recovery from the second half of 2008 onwards.

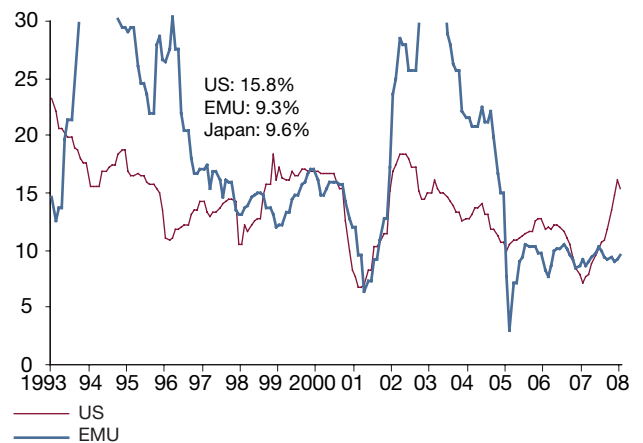
Recession = earnings recession

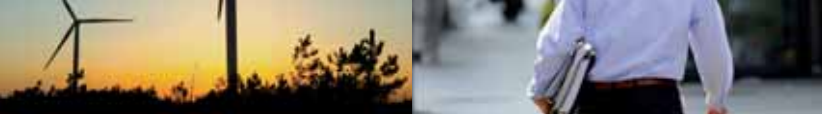
The earnings cycle is traditionally in sync with the economic cycle. Each of the recessions of the past fifty years has been accompanied by an earnings recession. In previous recessions, 15% of the most recent annual earnings have been lost on average. The third quarter of 2007 was the first in the present downward earnings cycle. In the third and fourth quarters of 2007 combined, 5.8% of earnings were already lost. Consequently, the current earnings recession preceded the 2008 recession by two quarters. One or two quarters after the end of a recession, company earnings start to pick up. The fourth quarter of 2008 could be the first showing a positive year-on-year increase in earnings per share. Analysts, however, are sticking to unrealistic earnings forecasts: For the four quarters of 2008, earnings growth of 1.6%, 1.0%, 19.3% and 51.7% is expected. Thanks to the strong fourth-quarter figure, the annual increase for 2008 can be put at 15.8%. For financial institutions, a 30% incre-

Earnings growth
(S&P500, in %)



Earnings forecasts
(in %)





ase in earnings per share is expected. After the 30% drop in earnings recorded for 2007, this boils down to a return to the earnings level achieved in 2006, a record year. For non-financial companies, analysts still expect earnings to go up by 10% this year. This is unrealistic, because an (albeit mild) economic slump will also entail a (likewise mild) earnings recession.

The first harbinger of spring

A typical pattern seems to be repeating itself: first there is a sharp stock-market correction, followed by an economic downturn, then a steep drop in corporate earnings, then a further stock-market correction, and so on. When the recession is at its worst, when economic figures only seem to be deteriorating, when analysts are busy lowering their earnings forecasts, when the central banks keep cutting interest rates, the first to recover and anticipate a new phase in the cycle are the stock markets. In the past, this has happened around six months before the end of a recession. The timing is not easy to predict, but that turning point should be somewhere in April-May. Investors should not forget that the first year of a stock market recovery is the

best investment year of the cycle.

Shortly after the stock markets, bond markets too will start anticipating a new cycle. By mid-2008, bond rates will have bottomed out. They cannot go much lower than they are today, because the market has already discounted a good many rate cuts. Indeed, the central banks have no choice: policy rates can only go down. A Fed funds rate of 2% is possible in the US by mid-2008. The ECB also seems to be revving up for a first rate cut. In the longer run, this easing of monetary policy may well sow the seeds for renewed (inflation) anxiety. Although the current increase in inflation is temporary and can be put down to transitory factors (i.e. the high price of oil and mounting food prices), it has lasted for a long time now and core inflation is starting to pick up. Inflation expectations are also unquestionably starting to mount. This does not necessarily have to result in higher bond rates in the short term. In this phase of the cycle of monetary easing, it is normal for bond rates to fall further, and they will not go up substantially before the last rate cut has taken place.

ASSET ALLOCATION

The next few weeks are set to be a difficult time for the stock markets. However, investors should realise that the first phase of the market rally will be the most vigorous. It's impossible to predict exactly when it will happen, but stock markets in the past have bottomed out and started picking up around six months before the end of a recession. According to our scenario, the turning point may occur in April or May. Equities are currently given a neutral weighting in the overall asset allocation. The market could still receive a good deal of negative news until the publication season for the 2008 Q1 results (i.e. the latter half of April).

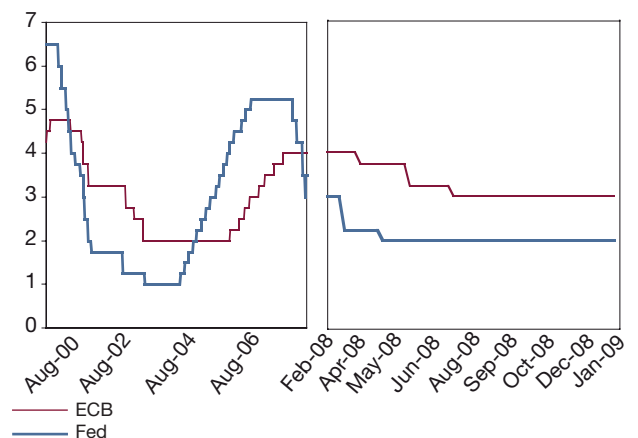
Longer maturities

In the short term, bond rates could fall again in the wake of key rates in the US and Europe. Even though scope for a further drop in interest rates is limited – because the bond market has almost completely discounted expectations of a lower policy rate – we still intend to act on this possibility. We are taking advantage of the latest correction to scale down our ample cash position some-

Valuation of MSCI EMU according to Fed model



ECB and Fed monetary policy





Financial institutions and credit spreads

The rate spreads between corporate and government bonds have become more attractive due to the subprime crisis. Nonetheless, they are still narrow, especially for this phase of the cycle, although this is warranted from a business-economic standpoint. Companies boast an ironclad asset structure and their borrowing requirements are low. However, financial institutions – even those with a prime credit rating – now have to pay rates on their issues that are well above the risk-free rate of return. This is opening up opportunities that we do not want to lose out on. We are cautiously stepping up our position in financial institutions' corporate bond issues.

what and to shift into bonds. Longer maturities are the first order of business. We are setting the modified duration of the bond portfolio at 6.7 years, which is slightly longer than the market's.

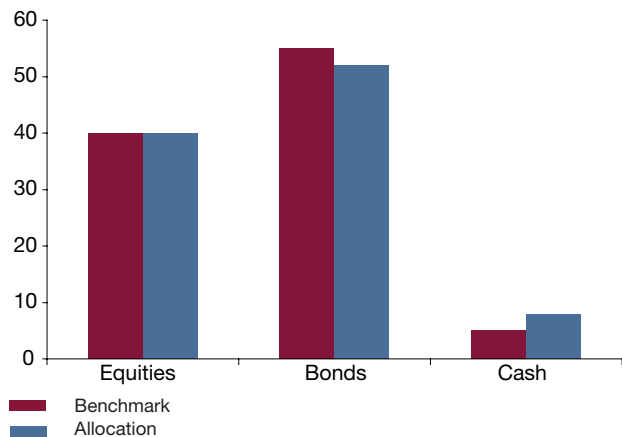
EQUITY PORTFOLIO

As far as the regional allocation is concerned, we prefer European to US equities. The valuation gap between Europe and the US remains wide. European equities traditionally trade at a PER that is 6 to 10% lower than in the US but, at around 18%, this discount is unjustifiably high at present. This relatively high discount is not warranted either by interest rates or by earnings growth. Nor can it be accounted for by the different sector make-up (financial and cyclical shares are better represented in the European benchmarks), because the valuation gap is seen in most sectors. Contrary to the entrenched consensus, we believe Europe to have more upside earnings potential than the US. There is less risk of a sharp downward revision of earnings forecasts (see above). European companies have more potential to cope with pressure on margins via restructuring measures. The dividend yield in Europe is higher. Corporate events, such as mergers and acquisitions, share buy-back programmes, dividend increases, etc., which have a positive influence on the investment climate, are more common in Europe than in the US.

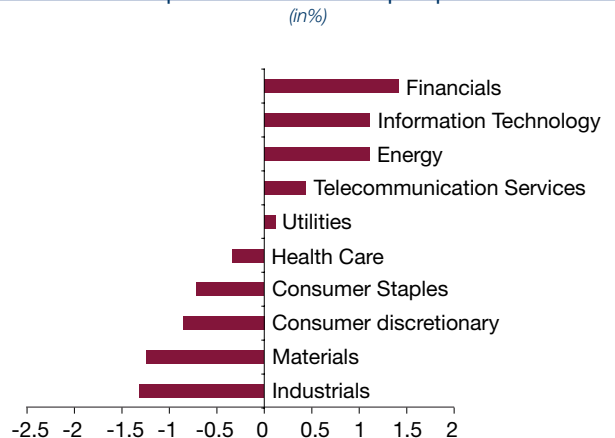
We have adopted a neutral stance where Japan is concerned. We prefer to invest in the Asian growth economies, primarily because of their attractive valuations. For instance, a PER of 14.5 for the stock markets in South Korea and Taiwan, with their strong technology bias, is certainly justified for emerging markets such as these. Economic growth there is no longer underpinned by exports alone, domestic demand is also pitching in. The economic slowdown in the West will have some impact on the region, but it has in recent years developed some degree of immunity that should help mitigate the negative effects. In addition, the region is no longer dependent on speculative, short-lived investment flows from the West. In the past few months, it has become clear that the region has become a net investor in the West.

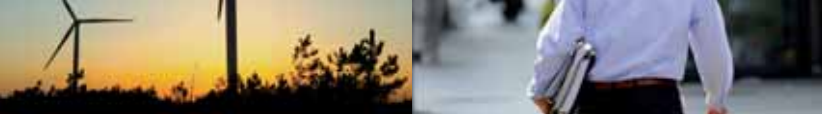
As regards the sector allocation, we refrain from taking pronounced positions. The economic outlook is too uncertain and turning points in the cycle are frequently characterised by significant sector rotation. In the European portfolios, minor, overweighted positions are being taken in diversified financials (holding companies offering an attractive

Global portfolio



Active positions in the European portfolio





discount and a portfolio with a strong technology bias), energy (diesel refining and oil services), consumer staples (companies with strong sales in Asia), and software (players in certain niches,

such as security and video-conferencing). Underweighted sectors include materials (chemicals and paper, due to pressure on margins), food & staples retailing (idem), transport (idem) and

media (structural shift from advertising to the Internet at a time when the market growth is weak).

Russia

Now that it has become clear that Putin will be keeping a tight rein on things (and that the political risk has greatly diminished), the Russian stock market has also become a good deal more attractive. It provides an interesting alternative for taking advantage of the consistently high energy prices. With a PER for 2008 of 10.3, this stock market is now one of the cheapest among the emerging markets. The Russian stock market has also significantly underperformed other emerging markets over the past year. The low valuation is to a large extent accounted for by the undervaluation of oil and gas concerns, which represent over 60% of the market and are trading at a discount of 25-30% vis-à-vis their Western counterparts. Insofar as this discount was justified by the political risk (with the Yukos debacle in mind), this argument no longer holds water.

The Russian stock market is not just oil and gas. The construction industry and capital goods manufacturers are also well represented. They are benefiting from the boom in infrastructure works aimed at speeding up the country's reindustrialisation. These projects are being financed with gas dollars. Foreign revenues from natural gas have also enabled the government to eliminate the macroeconomic imbalances, and there's a surplus on both the budget and the balance of payments.

These developments have in turn helped give the Russian rouble a fairly stable exchange rate against the EUR. The 1998 debacle is now but a distant memory.

Regional breakdown of the equities portfolio (in%)

	Bench	Allocation	Class
EMU	50	52	+1
Rest of Europe	10	12	+1
North America	30	28	-1
Pacific	10	8	-1

Water utilities

Even though we expect the recession in the US to be short-lived and mild and to have little impact on growth regions such as Asia, the implications it will have on the various business sectors are extremely unclear. Around the turning points in the cycle, sector rotation also accelerates, which argues against taking active positions of any magnitude. In any event, the water utilities sector will not be hampered much by the economic slump.

Of all the raw materials, water is the most valuable. It has no substitute, which is why it is sometimes referred to as 'blue gold'. Demand for water is not cyclically sensitive, but exhibits long-term growth of 3.5% year-on-year, double the rate of demographic growth. On a global scale, demographic growth is greatest in those areas where (fresh) water is scarcest. Even in the US, the population is growing more in the desert regions of the Southwest than in the wet Northeast. Demand is not price-dependent, either. Nonetheless, price increases are inevitable. The supply-demand imbalance is one factor that will come into play, the lack of investment over the past two decades another. Pollution and stricter quality standards are making investment in the infrastructure – which is completely obsolete technically – even more mandatory.

Consequently, this can be considered a defensive and very heterogeneous growth sector. Not only does it include utilities such as Suez, RWE and Veolia, with their strong market positions, it also includes companies specialised in infrastructure works and manufacturers of capital goods such as pumps, desalination plants and filters.

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The stated opinions and strategies are valid as per 22 February 2008.

All historic data and graphs are current up to and including 18 February 2008 (stock market data).