

# The & Letter

Funds & Strategy

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## SUMMARY

|  |     |
|--|-----|
| <b>Editorial</b> .....                                 | 1   |
| <b>Web site</b> .....                                  | 2   |
| <b>Economic environment</b> .....                      | 3   |
| Warning signs of a recession                           |     |
| <b>Core management</b> .....                           | 4-6 |
| Money-market management .....                          | 4   |
| Sovereign crisis: Waiting on political decisions       |     |
| Rate management .....                                  | 5   |
| Deadlines crucial for the future of Europe             |     |
| Equities management .....                              | 6   |
| Hope in the eurozone, worries about corporate earnings |     |
| <b>Diversified management</b> .....                    | 7   |
| Political authorities regain control                   |     |
| <b>In the blink of an eye</b> .....                    | 8   |

Completed in October 24<sup>th</sup> 2011

## EDITORIAL



### The price of credibility

The ten-year rate spread between France and Germany has just hit 120 basis points. It now exceeds its high of the last sixteen years—i.e., 1995, when the feasibility of the move towards the euro was still strongly disputed by the financial markets. Recall the famous '5-4-3' budget deficit reduction plan, which from 1995 to 1997 aimed to ensure France's qualification. Meanwhile, the German government has, without hesitation, just aligned its growth forecast for 2012 with that of the consensus (1.9% to 1%). France, for now, is maintaining its own: 1.75% against 0.9% for the same consensus. The market provides a useful measure of the price of credibility, patiently built, in the management of public finances.

**Antoine de Salins,**  
*Chief Investment Officer*  
*Groupama Asset Management*

## The Actively Responsible Asset Manager

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## United States

### RISK OF A CONTRACTION IN EMPLOYMENT

Corporate morale seems to be holding up well for now. The one-point rise in the ISM manufacturing index, to 51.6, is apparently down to a catch-up effect in the transport sector which was impacted by supply problems stemming from Japan. However, the ISM's decline isn't over, because the overly fast pace of restocking needs correction. More significantly, the order book index—i.e., orders remaining to be filled—is at its lowest level since early 2009 and would justify a substantial contraction in employment in the coming months. This would reinforce the pessimism of consumers, already affected by a deterioration in their wage purchasing power, and then cause a drop in consumption and activity, all the more so in that their savings rate of 4.5% is a point and a half below its fundamental level. Data on the labour market will be crucial in the coming weeks.

## Euro zone

### THE CRISIS OF CONFIDENCE SHOULD TRIGGER A RECESSION IN Q4

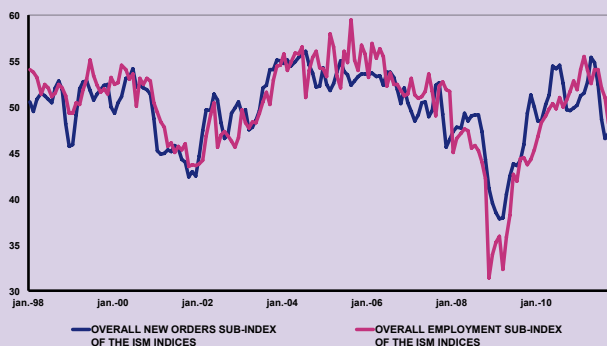
GDP growth is expected to remain around 0.2% in the third quarter, thanks to a rebound in consumption in France and Germany, after their sharp decline last quarter. The contribution of foreign trade should also remain positive, with exports growing faster still in France and Germany and imports falling in the peripheral countries, in line with domestic demand. Leading indicators, however, point to a contraction in GDP in the fourth quarter, brought on by the crisis of confidence not only in European governance, but also in the robustness of the European banking sector which is already tightening lending conditions, particularly for businesses. Capital expenditures are thus expected to contract and the inventory cycle to reverse course. Consumption—already hurt by austerity plans—is likely to suffer from the worsening jobs market: households anticipate a worsening of the labour market, including in Germany. However, in the next few weeks, important decisions by the Europeans—on eurozone governance, on the strengthening of bank capital, and on increasing the leverage of the EFSF—should restore confidence and allow for a short-lived recession (two quarters of GDP contraction).

## China

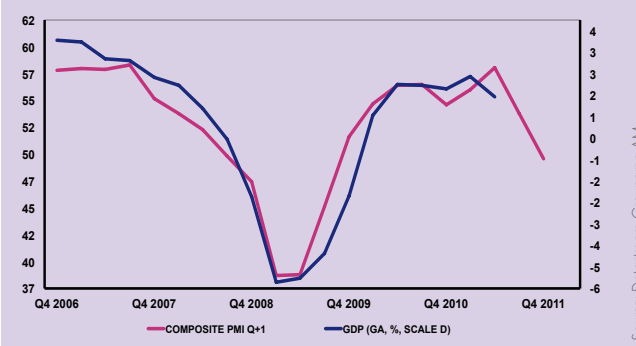
### THE COUNTRY HAS THE MEANS TO WITHSTAND A POTENTIAL CRISIS OF CONFIDENCE

Activity is expected to slow under the impact of weakening world trade and investment, excluding public real estate. Consumption should, however, keep the same pace of growth, thanks to preserved purchasing power which should benefit from lower inflation, leading to a soft landing for the economy. Monetary policy is in a wait-and-see phase faced with uncertainties about the extent of the turnaround in inflation, which will depend on movements in real estate prices—the main challenge for the authorities: These latter will have to decelerate to reduce inflation, whilst avoiding a decline which would contribute to social tensions and systemic risks. Certain elements raise fears of a Chinese crisis of confidence in their economy, such as the difficulties of some real estate developers, the significant contraction of real estate sales during the national 'Golden Week' holiday, and the deteriorating financial position of SMEs. Aside from a real estate demand that is structurally solid, China has the means to withstand such a crisis, through a counter-cyclical fiscal policy and a loosening of monetary policy.

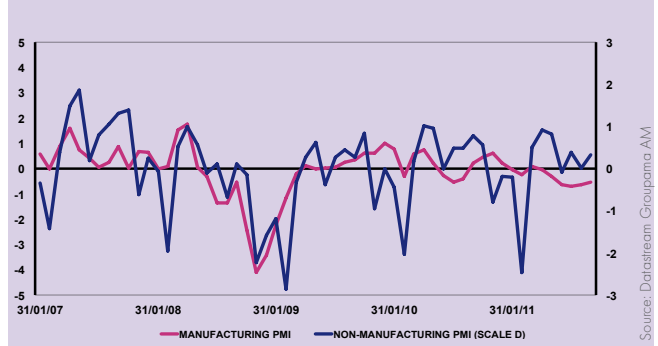
**United States: The employment sub-index of the ISM indices points to upcoming layoffs**



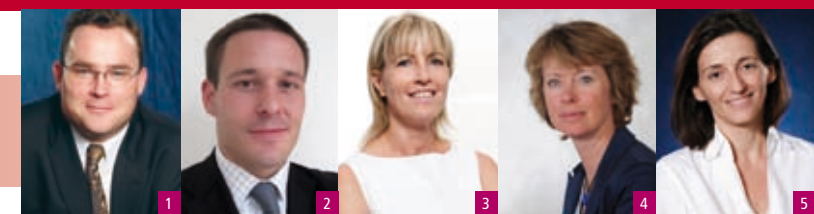
**Euro Zone: Contraction of Activity in Q4**



**China: Growth driven by the non-manufacturing sector (PMI indices, normed)**



# CORE MANAGEMENT



## Money Market Management

### **In trouble, don't double!**

No doubt the likelihood of a forthcoming agreement during the summits of late October and early November is significant for the EFSF, Greece and the recapitalisation of the banks.

The fundamental equilibrium-restoring forces are there, exemplified by the levels of credit risk premiums in respect of default rates, and those of equity valuations.

All of this bodes well, but nevertheless shouldn't make us forget, firstly, the looming economic contraction, the scope of which is still unknown, and its impact on companies' health; and, secondly, the likely insufficiency of the coming political package, especially regarding the high-risk banking sphere and progress toward a more responsible European federalism.

Uncertainty and volatility are thus likely to remain at the fore and justify prudent strategies tinged with optimism.

P-H.B

### CENTRAL BANKS

#### ■ Sovereign crisis: Waiting on political decisions.

In the context of a worsening sovereign debt crisis in Europe, the ECB and the Federal Reserve are confronting politicians with their responsibilities, reminding them that monetary policy will not resolve the crisis. In his speech before Congress, Bernanke admitted that the economic recovery has been much less robust than expected and indicated that he is ready to implement other measures to support the economy without launching a new QE3. The Fed Funds rate will remain low until at least mid-2013. For his last meeting, Jean-Claude Trichet confirmed the ECB's differentiated approach between key rates and inflation on the one side, and systemic bank risk and unconventional measures on the other. Thus, without touching interest rates due to inflation forecasts exceeding the 2% target, the ECB announced new 12- and 13-month liquidity operations in unlimited amounts to loosen up the interbank market. In addition, it is launching a new covered bonds purchasing programme (CBPP2) for €10 billion over one year in the hope of reviving the capital markets, which have been virtually moribund since July. Finally, purchases of sovereign debt through

the SMP are continuing at a steady pace. We are maintaining a very slight bearish bias on the key rate until the end of the year. Inflation is expected to be lower in 2012, reinforcing our expectations for it to decline over the longer term. In response to the central bankers, French and German political leaders jointly announced that a plan to recapitalise the banking system would be presented before the end of October. In the background, the fate of the EFSF weighs heavily: France is advocating its transformation into a bank, while Germany seems opposed, adding to the confusion that already exists over its validity.

### A WORD ABOUT THE INVESTMENT STRATEGY

#### ■ Investment strategy:

In this environment, we continue to make targeted investments and to remain vigilant about issuers in the portfolio. The market has already largely anticipated a decline in interest rates, making the fixed rates offered by issuers appear less attractive. We are thus favouring variable rates, especially since the spread levels are at historical highs.

T. P.

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Core Management CIO

#### 2- Thomas Prince

Head of Money Market Management

#### 3- Gaëlle Malléjac

Head of Fixed Income Management

#### 4- Claire Chaves d'Oliveira

Head of Equity Management

#### 5- Claire Bourgeois

Head of Equity & Fixed Income ALM

#### Corridor, refinancing Rate & EONIA

Average EONIA in september: 0.996%;  
from the beginning of the year: 0.895 %



#### History of peripheral debt purchases by the ECB



Summary

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## Fixed Income Management

### LONG RATES

■ **Two weeks to save the euro....** Phases of extreme risk have characterised the market in recent weeks, fuelled, among other things, by the procrastination of European states on ratifying the plan to extend the EFSF, and the postponement to a later date of payment of the sixth tranche of aid to Greece.

Statements by politicians and European authorities in recent days have revived the hope of forthcoming announcements of new measures to resolve the crisis. Any news reporting on considerations or progress of new actions is hailed with great relief by the markets, leading to a decline in risk premiums and an upturn in interest rates in the core European countries.

Confidence in the markets and in economic actors must be restored. Decisions by political authorities are awaited with bated breath. In the meantime, uncertainty will remain very strong and volatility very high.

The sustained recovery of confidence will, in our view, depend on the kind of announcements issued about the recapitalisation of European banks, the power of the EFSF to limit any future risk of contagion, and the handling of Greek debt.

The risk of disappointment is likely, however, in light of expectations and provisions for implementation.

Against this backdrop, we expect rates in the core countries to remain low at the 3-month horizon, especially since we believe that the market is underestimating the reality of the economic

downturn. Over the longer term, improvement in the situation of the banking system, progress on resolving the sovereign debt crisis and a willingness to nudge treaties toward greater economic and fiscal integration should drive core-country interest rates higher.

### CREDIT

■ **Phases of extreme risk resulted in a further rise in risk premiums in the market for private debt.** Such a widening of spreads, in the context of major distrust of the financial sector, has mainly materialised on bank debt and subordinated insurance debt.

Corporate industrial debt, on the other hand, has shown some resilience. The primary market is very gradually re-opening to corporates. However, financiers are not in a position to seek funding on the bond market.

Meanwhile, the secondary market has still not returned to normal. The ECB nevertheless gave a positive signal with the reactivation of purchases of covered bonds and of 12- and 13-month LTROs, easing pressure on the liquidity of the European banking system.

From a valuation perspective, current levels already incorporate a recessive scenario on credit. In the short term, the lack of visibility and still-high volatility continue to urge caution on the asset class.

### INFLATION-INDEXED

■ **Strong risk aversion and a negative carry trade continued to penalise inflation-indexed assets.** Nevertheless, it appears that inflation break-even points have bottomed and valuations are attractive on a medium-term horizon. The carry-trade outlook is favourable at 3 months. We are adopting a neutral stance on this asset class.

### A WORD ABOUT THE INVESTMENT STRATEGY

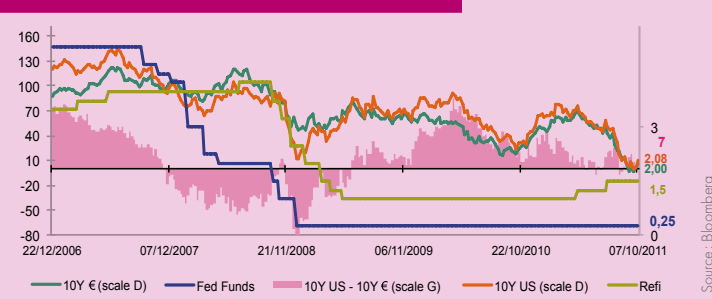
■ **The coming weeks will be crucial, and uncertainty will be the watchword in the short term.** Faced with this lack of visibility, we are maintaining a neutral position on exposure to rates and a slight bias toward the flattening of the 2-10 year segment.

In terms of country allocation, the preference for core countries is maintained, but to a lesser degree versus Italy and Spain.

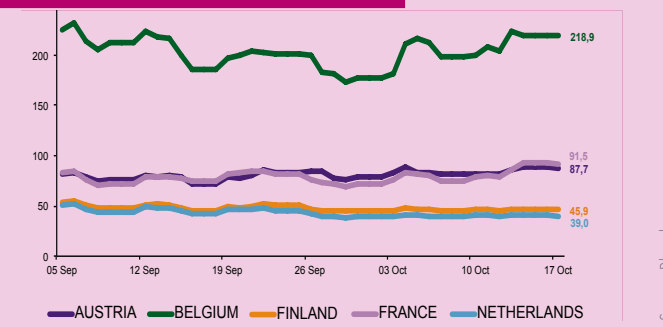
On credit, we are maintaining an asset allocation of 95%, conserving our bond positions, and managing volatility pending crucial deadlines in Europe.

G.M

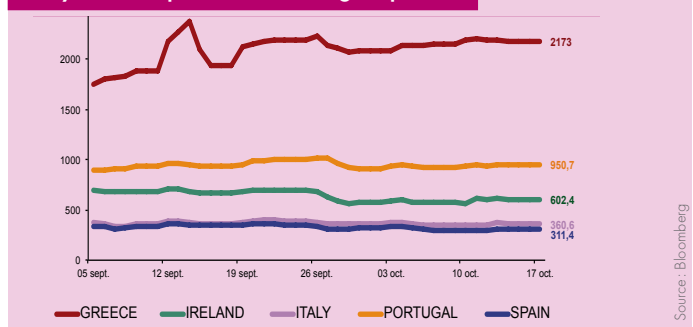
Change in the short and long rates in the United States and the Eurozone



10 year Core Sovereign Spreads



10 year Peripheral Sovereign Spreads



## Equity Management

### PROJECTED RESULTS AND VALUATIONS

#### ■ Projected earnings: 2012 profits revised downward

- In Europe, earnings guidance has been lowered. Downward revisions also started in the U.S., which was previously stable...
- The 'net up' is now at its highest level since May 2009.

#### ■ Equity market valuations are collapsing.

- The extremely low levels of the crisis have been exceeded!
- Europe, as the U.S., has entered into implicitly negative growth in the long term. A level previously unseen, and extremely distant from the valuations of 2003-2007 (growth years, to be sure...).

### OTHER FACTORS

#### ■ Flows: Significant withdrawals from equity funds

- In June and July withdrawals reached their highest level since October 2008.
- Reduced appetite: Several IPOs delayed.... M&A activity is mainly involving cash-rich sectors.

#### ■ Chart analysis: A year-end rally? In a bear market...

- Early autumn could be a buy zone for equity markets - meaning any downturn would be a time to buy with a medium-term perspective (end 2011/early 2012). However, the long-term momentum remains negative and confirms that we are still in a bear market.

### OUTLOOK

#### ■ Outlook: Hope in the Eurozone, worries about corporate earnings

- The equity markets are operating under the dual pressure of a recessionary threat and eurozone difficulties. The sovereign debt crisis has spread to such a degree that the supposed 'U.S.' recession could originate in the eurozone, with the contagion spreading to the rest of the planet, including emerging countries: at least that's why the markets panicked.
- We have not changed our earnings expectations for the eurozone, which are still far behind those of the market, and we now expect zero growth in the United States. But even with our very conservative figures, current market levels imply a highly attractive

valuation (10x 2012 for the eurozone). Similarly, indicators of risk aversion are in a position of extreme panic, far below the levels reached in March 2009.

- Beyond the possibility of a temporary resolution of the debt crisis (in the coming weeks?) or a more integrated fiscal governance (in the coming years?), it can be said that equity markets are already anticipating the worst and that current levels are points of entry.
- But uncertainties remain, both at the macro- and micro-economic levels. Both our 3-month and 12-month forecasts therefore remain very modest. We are maintaining our bias for Asia and Japan, whose growth prospects—even as they slow—are still better than those of Western countries.

### A WORD ABOUT THE INVESTMENT STRATEGY

#### ■ We continue to favour companies benefiting from emerging market consumption (luxury goods, automobile).

We are more cautious about capital expenditures (capital goods, raw materials). Lastly, we are closing our short bet on financial securities, which should be helped by decisions taken in the coming weeks.

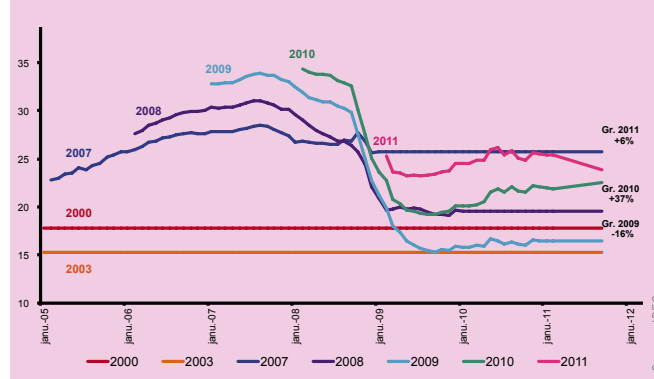
C.CO

### Performance of the main indices since the start of the year

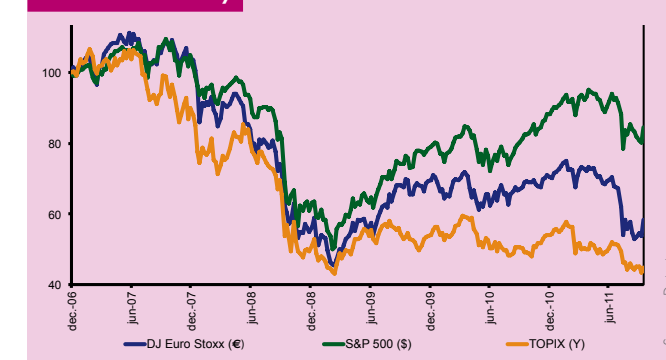
|                  | 13/10/11 | Var. 2011 in euros |
|------------------|----------|--------------------|
| DJ Euro Stoxx 50 | 2333     | -16,48 %           |
| SBF 250          | 2374     | -15,24 %           |
| CAC 40           | 3187     | -16,24 %           |
| FTSE 100 (UK)    | 5403     | -9,94 %            |
| S&P 500          | 1204     | -6,32 %            |
| Nasdaq           | 2620     | -3,32 %            |
| Topix (Japan)    | 759      | -12,76 %           |

Source: Datastream

### Profits forecast by the consensus on Euro Stoxx



### Performances of international stock market indices in local currency



# GLOBAL BALANCED PORTFOLIO MANAGEMENT

Jean-Louis Autant,  
Head of Global Balanced Management



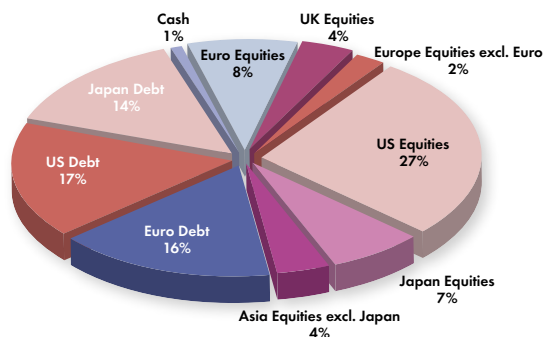
## Trend

The refrain heard non-stop over the summer, that “the markets’ timing is not the same as politicians”, suddenly no longer seems relevant: These same politicians, led as usual by a Franco-German couple spurred on, for once, by senior European authorities, have regained the upper hand, and the markets are now heeding their call. Operators at last appear receptive to new ideas aimed at organising the rescue of the eurozone; and it will take more than the recent skirmishes coming from one or another (small) member of the zone, it seems, to curb the new-found optimism. Market participants, who are somewhat binary on the subject, are thus switching directly from “risk-off” to “risk-on” mode. They are even showing a certain propensity to buy the rumour because, for now, the only truly tangible element is in Mr Barroso’s proposal to recapitalise European banks to bring their Tier 1 ratio to 9%. The way to achieve this is still under debate, even though the sequence of private shareholders > States > and the EFSF (whose future status remains undecided) as a last resort, appears to be endorsed. Obviously, the first proposal, that of calling on

private capital, must be favoured, but only a sustained recovery of confidence could guarantee its success.

While investors remain focused on the procrastination of eurozone leaders, a substantial slowdown (a recession?) is undeniably in the works. Widespread fiscal austerity, a credit crunch and high unemployment can clearly make a truly poisonous cocktail for growth in the region. Politicians are evidently in denial, as is often the case, and the ECB’s inaction due to persistent inflationary pressures does little to reassure. In this environment, the IMF’s shadow is looming larger each day, with its corollary of pressures from emerging nations seeking to increase their circle of influence. In short, the situation is far from being resolved.

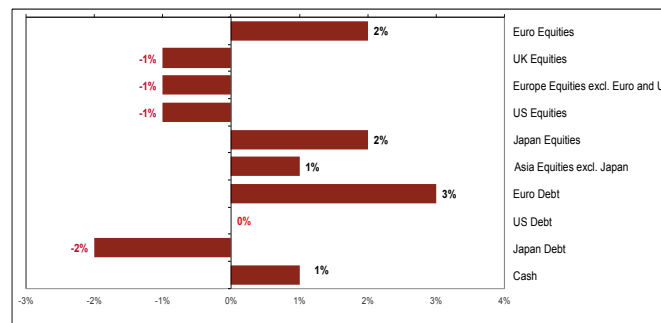
## Model portfolio



Portfolio closed on 13/10/2011. Benchmark composed of 50% JPM global hedged + 50% MSCI world. Source: Groupama AM

## % difference

### BETWEEN BENCHMARK AND MODEL PORTFOLIO



## Allocation

### GLOBAL ALLOCATION

**Equities 52% / Rates 47% / Cash 1%**

Our reweighting of the portfolios last month allowed us to participate in the rally of the equity markets. We are maintaining our slight bias toward overexposure in equities, and are reinforcing the rates portfolio, which was distorted by the market effect, to benefit from the impact of the correction.

### EQUITY MARKETS (52=)

■ **USA (+1):** Initial quarterly earnings reports coming in one by one are fairly encouraging for Wall Street; otherwise, the U.S. stock markets tended to underperform their counterparts in the eurozone. This is leading us to moderately strengthen our positions.

■ **Europe (-1):** We are slightly upping the weight of eurozone stock markets—which have rebounded significantly—in the hopes of a resolution to the debt crisis. This is leading us toward a neutral stance vis-à-vis the benchmark.

■ **Asia/Japan (11=):** We are maintaining our positions in a geographical region whose performance has disappointed: Fears of a hard landing in China and the dashed hopes of a V-shaped recovery in Japan have been a dampener overall for investors.

### INTEREST RATE MARKETS (47 +1)

■ **USA (+2):** The twist effect was inadequate to stem the correction of the long portion of the yield curves; we consider the correction excessive and are reestablishing our positions.

■ **Europe (=):** Rate levels of 1.80% on the Bund did not survive for long, overwhelmed by the market’s return to “risk-on” mode; we feel that the correction should only be temporary.

■ **Japan (-1):** Japanese bonds were the month’s best class of obligations; we are using this opportunity to continue paring back our holdings, which we began last month.

### CASH (-1)

We are maintaining a defensive cash portfolio. We are holding a rather low residual amount of 1%.

# IN THE BLINK OF AN EYE

## Our strategy

|               |                | Current level<br>13/09/11 | Short-term<br>tarjet | 1 year<br>tarjet |
|---------------|----------------|---------------------------|----------------------|------------------|
| United States | Fed Funds      | 0,25                      | 😊                    | 😊                |
|               | 10 yr T - bill | 2,21                      | 😊                    | 😞                |
| Eurozone      | Refi rate      | 1,50                      | 😊                    | 😊                |
|               | 10 yr OAT      | 2,95                      | 😊                    | 😞                |
| Japan         | BOJ rate       | 0,10                      | 😊                    | 😊                |
|               | 10 yr JGB      | 1,00                      | 😞                    | 😞                |

Sources : Groupama AM, Bloomberg

## Our model portfolio in € 12/10/11

| BENCHMARK                    | EURO MTS GLOBAL |
|------------------------------|-----------------|
| Sensitivity                  | 😊               |
| Inflation indexed allocation | 😊               |
| Curve choice                 |                 |
| 1 - 3 yr                     | 😞               |
| 3 - 5 yr                     | 😊               |
| 5 - 7 yr                     | 😊               |
| 7 - 10 yr                    | 😊               |
| 10 - 15 yr                   | 😊               |
| 15 yr +                      | 😊               |

Sources : Groupama AM, Bloomberg

## Conclusions of the equity markets committee 13/10/11

|                           | Indices<br>13/10/2011 | Forecasts                  |         |
|---------------------------|-----------------------|----------------------------|---------|
|                           |                       | short term<br>(< 3 months) | at 1 yr |
| France (CAC 40)           | 3230                  | 😊                          | 😊       |
| Euroland (DJ)             | 231                   | 😊                          | 😊       |
| United-Kingdom (FTSE 100) | 5442                  | 😊                          | 😊       |
| United-States (S&P 500)   | 1207                  | 😊                          | 😊😊      |
| Japan (Topix)             | 759                   | 😊                          | 😊😊      |
| MSCI Asia free ex-japan   | 463                   | 😊                          | 😊😊      |

Sources : Groupama AM, Bloomberg

## Sector Outlook

|                                    |   |                               |   |
|------------------------------------|---|-------------------------------|---|
| Energy                             | 😊 | Consumer Products - Cosmetics | 😞 |
| Basic Materials                    | 😞 | Health Care Equipment         | 😊 |
| Capital Goods                      | 😞 | Pharmacy & Biotech            | 😊 |
| Industrial and Commercial Services | 😊 | Banks                         | 😊 |
| Transportation                     | 😞 | Diversified Financials        | 😊 |
| Automobile                         | 😊 | Insurance                     | 😊 |
| Consumer Durables                  | 😊 | Real Estate                   | 😊 |
| Hospitality & Leisure              | 😊 | Software & Computer Services  | 😊 |
| Media                              | 😊 | Technological Equipment       | 😊 |
| Non-Food Retail                    | 😞 | Semiconductors                | 😞 |
| Food Retail                        | 😞 | Telecoms Operators            | 😊 |
| Food Processing                    | 😊 | Utilities                     | 😊 |

Sources : Groupama AM

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📄 Summary

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8

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