



FORECASTS FOR THE FIXED INCOME MARKET

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Asset Management

Short rates:

The stage is set and the play will be comprised of four acts.

Act 1, consisting of draining – gradually and nimbly – the excess liquidity off the market, has already started in the Euro area. The message has been made loud and clear on both sides of the Atlantic. It will undoubtedly be an easier task for the ECB than the FED given the nature of the measures that have been implemented.

Act II will require adept communication skills: prepare the market for a rate increase while not setting off tension in the bond markets and heightened anticipations of inflation. We are of a mind that there is still time before the curtain rises on this act as bankers have been sending messages of prudence and are not buying into runaway euphoria.

Act III will feature the Federal Reserve as it starts to act on interest rates. It will probably begin with lending rates before raising its Fed Funds rate and will represent a return to normalcy and not indicate the beginning of a series of rate hikes. The timing of its intervention will depend on the real improvement of the US economy and the inflation situation. We are not subscribing to the current thinking that seems a touch optimistic and see an initial move happening at the end of the year rather than at summer's end. The hike in the ECB's refinancing rate, above its current 1%, like its US counterpart will not, for us, take place in 2010. Moreover, the very fact of not dropping its rate below 1% provides the ECB with a measure of flexibility as to when it must raise its rate, which we believe will happen early next year. The disconnect in the economic climate between the two regions is real and is a reason to believe that interest rates will not be raised simultaneously.

Therefore, we maintain a refinancing rate of 1% for the year and 0.75% for the Fed Funds rate for the 12 months ahead.

Long rates:

Strong tensions in the bond markets have come as a result of encouraging economic data in the beginning of this year, inflation numbers creeping higher and a return of risk appetite.

Moreover, Central Banks have extolled messages of prudence resulting in relative stability in short-term rates.

Steepening curves are still relevant and continue to be maintained at record levels. We believe this situation can continue for some time despite our monthly rate hike targets having been attained at a weekly pace. We do not expect a drop, at least in the short term, of any of the aforementioned drivers, which are: improving growth,

forecasts for increases in global inflation and risk appetite. However, we are not changing our 12-month targets, because in the long term these same drivers are likely to slow.

In a climate where long rates are under pressure and short rates are unlikely to change before the 3 parts of the aforementioned Act II, we are positioning our portfolios as under-sensitive to rates and in a steepening position.

We continue to prefer European rates over American rates given the advance the latter has with regard to the current cycle.

In the Euro area, we continue to prefer the peripheral States over Germany, notably. The lone exception is Ireland where we are lightening our positions for profit-taking reasons and because we are expecting sizeable issues from Dublin.

Credit:

2009 was exceptional for credit both in terms of the size of the performance (credit indices outperformed its governmental counterparts by more than 12% and certain sub-indices by more than 50%) and issuance levels (nearly €300 billion in corporate debt). 2010 is off to a similar start under the auspices of the following three factors: an undeniable fundamental improvement in the economic climate (including, notably, lower default rates), sustained risk appetite and liquidity that strives to find investors in search of a return in the early part of the year. There are, however, numerous factors to watch that tarnish this idyllic assessment. The subordinated debt situation is one such example. We are however acting on this very favourable environment for the asset class and maintain our portfolios full invested. We remain ultra-vigilant and maintain a high level of selectivity.

Inflation-indexed:

2008 was a dark year for the asset class. 2009, however, was a vintage year with indices that outperformed their nominal counterparts worldwide. The top of the podium belonged to the US indexed that outperformed the market by more than 15. This strong performance should carry into this beginning part of the year for three reasons. The recent rise in inflation data and lurking inflation worries is the first. The second is the nature of these instruments, considered as risky, which benefit from the current environment of risk appetite. Finally, primary issuance volumes are expected to be sizeable, which will inject life into the asset class. As a result, we maintain our favourable opinion on indices at the beginning of the year.