

The & Letter

Funds & Strategy

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Completed in June 21st 2011

EDITORIAL



Contrasting situation

At a time when the Europeans are getting ready to find a solution to the Greek problem, the latest American economic indicators indicate that despite the exceptionally large monetary and budgetary resources deployed over the last two years, the rebound of growth has been the lowest ever recorded following the most significant crises in the country's history (contrary to the rebound posted by equity markets, which has been the highest).

The contrast is striking: the economic policy tools of the United States do not seem to be quite as effective as could be reasonably expected from such a unified action, which is characteristic of the political system, and the margins for manoeuvring are ever decreasing. On the other hand, the European Union, which is often the source of never-ending discussions and rifts, seems able to resolve some of its issues. The pressure of the markets is somewhat forcing the situation, and some believe that this pressure should have an even greater influence on the world's leading power.

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United States

DETERIORATION OF FIRMS' DOMESTIC PROFITABILITY

The ISM manufacturing index lost 7 points to 53.5, posting its biggest monthly drop since the early 1980's. Over the last two months, all leading indicators have sharply reversed course, confirming the sudden deceleration that we've been expecting in growth and which should persist until autumn. The recent deterioration in domestic profitability resulted in a tightening of credit conditions for SMEs, forcing them to significantly slow the pace of investments in new information technology and cut job creation, which fell overall from 180,000 to 80,000 in one month. The continued rise in inflation—to 3.6 % in May—should be accompanied by a decline in purchasing power, depressing consumer spending for several more months. The fresh acceleration in activity that we had been expecting for the summer has been pushed back, but should take place under the combined impact of lower long rates and oil prices. In the coming months, the environment should nevertheless remain highly uncertain for the markets, owing to the fragility of the banking system which continues to suffer from inadequate reserves vis-a-vis outstanding doubtful loans, and which could harden consumer credit terms following the new uptick in unemployment.

Eurozone

THE REVERSAL OF LEADING INDICATORS JUST BEGUN COULD BE BRUTAL

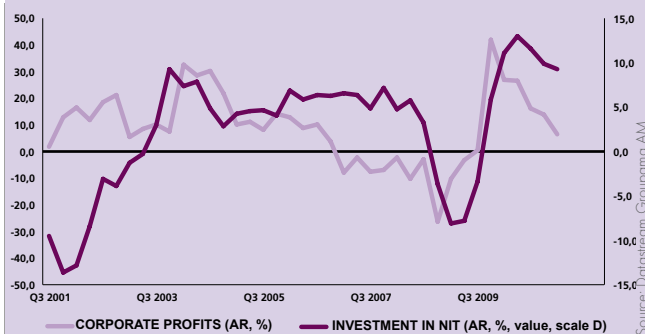
Growth was buoyant in the first quarter (+0.8 % quarter-on-quarter, after +0.3 %), led by Germany (1.5 %) and France (1 %), but penalised by Italy (+0.1 %) and the peripheral countries. Exports remained an engine of growth, but the strong increase in imports reduced their net contribution to nil. Capital investment rebounded, mainly owing to the normalisation of construction activity in Germany after the harsh weather conditions of late 2010. Consumption benefitted from the final phase of the car scrapping incentive in France and from the sharp rise in contractual salaries in Italy. After this peak in growth, activity is expected to slow sharply, hurt by domestic demand. With the remedial works now complete, construction expenditure should fall. Business investment in new information technology (NIT) will likely be affected by the deterioration in corporate profitability due to lower productivity gains. Consumption is expected to contract under the impact of the continued rise in inflation (expected to peak at 3% in August), the end of the car scrapping incentive in France and the austerity policies and structural reforms in the peripheral countries.

Japan

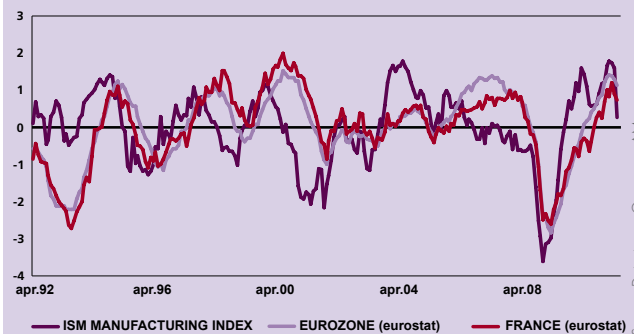
GDP EXPECTED TO CONTRACT BY 1.5 % IN 2011

GDP contracted by 0.9 % in the first quarter, following an 0.8 % decline, penalised by consumption, external events and inventories. Despite the current rebound in industry, GDP is expected to further decline by almost 1 % in the second quarter. The industrial rebound will come from exports, which should take off sharply after falling by 9 % in March and 8 % in April due to the disruption of the supply chain following the Fukushima accident. However, consumer spending should continue its downward trend: a direct consequence of the decline in activity, salary purchasing power is deteriorating faster, as calculated by the number of hours worked and average pay. Job cuts are expected to accelerate. Households will also be penalised by the continued rise in inflation due to soaring energy prices, a consequence of the price of oil and the Fukushima accident. Companies seeing their profitability worsen are now cutting back heavily on capital expenditures, as shown by falling domestic orders for capital goods in April. Ultimately, the recovery will not take place before autumn.

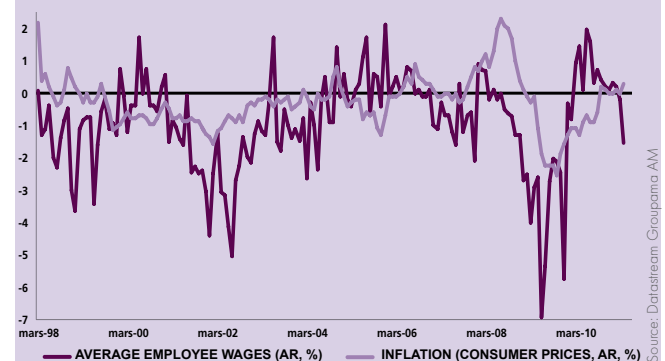
United States: The sharp slowdown in profits should lead to the same in capital investment



Eurozone: Industrial confidence has begun a sharp reversal (centred, normed, standard deviation)



Japan: consumer purchasing power is falling again.



CORE MANAGEMENT



Money Market Management

Feverishness doesn't mean fever.

Economic growth has stalled. The sovereign debt crisis is creating much agitation in the markets. The cacophony between the states—to be saved or the saviours—and the ECB is, as always, at a fever pitch ahead of the upcoming European summits. But the doctors are treating the patient, and we continue to believe that measures will be taken and accepted by all parties to avoid the worst. Nevertheless, the contours of these measures will probably still be considered too blurred by the markets. By the same token, while the risk aversion thus triggered is significant, the micro-economy (i.e., the corporate world) is still in good shape. Feverishness will thus persist and will call for caution in our investment strategies, but the fever itself should be avoided.

P-H.B

CENTRAL BANKS

■ An unsurprising ECB

During his last press conference Jean-Claude Trichet offered no surprise to the markets. By using the term “strong vigilance”, he confirmed that the ECB will indeed raise its rates in July, as he had implied last month, in keeping with its mandate to combat inflation.

This monetary hardening does not contradict the ECB's liquidity policy and unconventional measures will continue until the end of the third quarter.

The central bank's decisions clearly do not take into account the growing disparity of economic conditions in the various countries of the eurozone.

The money market is normalising and the EONIA has begun its convergence towards the refi rate.

We are assuming a rate rise of 25 basis points in July and a second increase in late 2011. Inflation is expected to decline in 2012; we therefore believe that the trend towards normalisation should stop there.

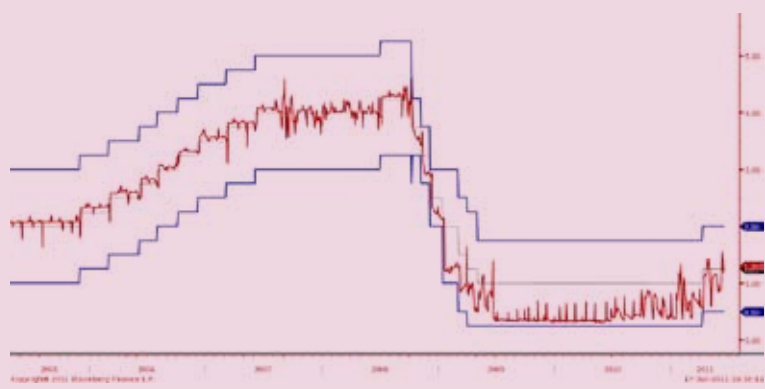
A WORD ABOUT THE INVESTMENT STRATEGY

■ Management policy

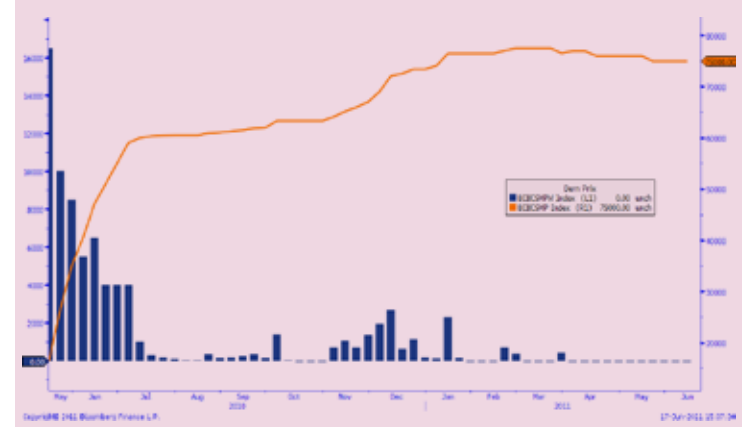
We have maintained our fixed- and variable-rate positions on money market portfolios in anticipation of rate increases..

D.B

Corridor, refinancing Rate & EONIA
Average EONIA from 01/01/11 to 30/05/11 : 1.023 %



History of peripheral debt purchases by the ECB



1- Philippe-Henri Burlisson

Core Management CIO

2- Diana Breton

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

Fixed Income Management

LONG RATES

■ **The Greek situation is still fuelling the news cycle**, once again raising worries and increasing risk aversion and volatility in the markets. Greece is unable to seek refinancing from the markets in 2012, as provided in the initial rescue plan in 2010. It therefore now needs a new financing plan for the next two years.

Discussions on the arrangements of the new plan have been initiated and the private sector's participation has been mentioned. At present, it appears that the states are struggling to reach an agreement on the terms of the private sector's involvement. All of this should still take a few weeks, which will sustain a high degree of uncertainty. However, the IMF is ultimately expected to agree to pay out the fifth tranche of the 12 billion package against assurances that new austerity measures will be voted in before the end of June to avoid triggering the country's default during the summer.

Persistent worries about Greece and pressure from rating agencies on eurozone countries have fuelled the flight to quality, favouring lower interest rates in the core European countries and the United States. The fall in rates was also guided by economic fundamentals which recorded a sudden deceleration of U.S. activity.

The slowdown in the U.S. economy caused us to revise our

expectation for the 3-month rate in the U.S. and the eurozone (France). Factors favouring higher interest rates, including rising inflation in the coming months, the end of QE2 (reduced flows from U.S. debt buyers), and difficulties in reaching an agreement to raise the statutory ceiling for U.S. public debt, will be tempered by the slowdown under way in the U.S. and continuing risk aversion. We are revising our 3-month target to 3.3% for the U.S. 10-year rate, and to 3.5% for the 10-year French rate.

CREDIT

■ **The escalation of risk aversion has reached the credit market**, which up to now had shown good resistance. Spreads are widening, particularly on subordinated debt and "high beta" debt which have posted the best performances year-to-date. Despite the context of widening risk premiums, the primary market stayed very active until the beginning of June, albeit against a backdrop of significant redemptions.

Some technical and fundamental factors remain positive for the credit market; nevertheless, the pressure on states from rating agencies, European difficulties in finding a short-term resolution to Greece's problems and the sudden slowdown of the U.S. economy are weighing on spreads. We are returning to a neutral stance on this asset class.

INFLATION-INDEXED

■ **Inflation-indexed bonds are underperforming nominal bonds.** The context of risk aversion, the recent decline in oil prices and a less favourable carry trade for the coming months is weighing on indexed assets. Current valuations nevertheless reveal low expectations (1.8%) in terms of inflation rates. We are maintaining our neutral position on the eurozone.

A WORD ABOUT THE INVESTMENT STRATEGY

■ **The climate of risk aversion and a slowing U.S. economy have led us to re-establish a neutral exposure** to interest rates in the portfolios.

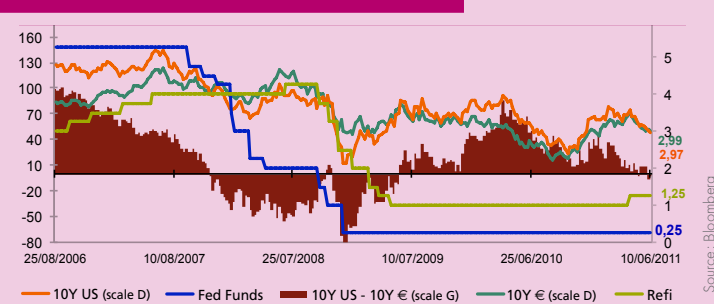
The position on the flattening of the 2-to-10 year segment has been strengthened. Short maturities remain underweighted in anticipation of the upcoming rate hike by the ECB in July and the 10-year zone has been raised to a slight overweight.

Our country allocation continues to underweight the three countries that have called on European aid. In order to limit expected volatility in the coming weeks, we are returning to neutral on Italy and Spain.

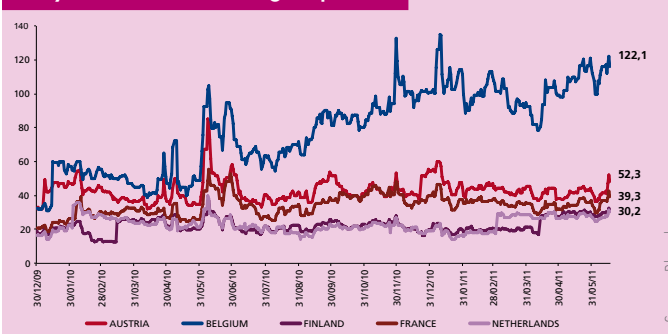
On credit, we are reducing our sensitivity to 100% due to the environment.

G.M

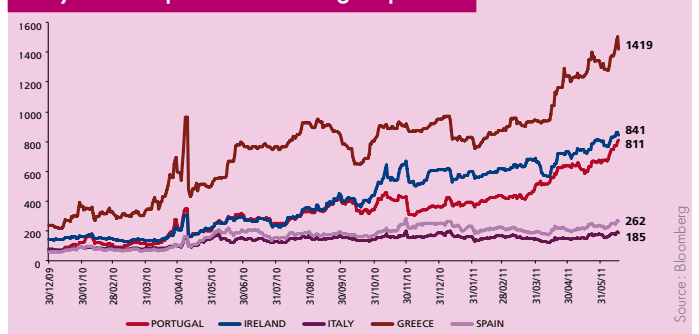
Change in the short and long rates in the United States and the Eurozone



10-year Core Sovereign Spreads



10-year Peripheral Sovereign Spreads



Equity Management

EARNINGS FORECASTS

- **The upward revisions** of the analysts' consensus mainly concern 2010 and are less rosy for 2011.
- We are not changing our profit expectations and remain more cautious than the consensus.

VALUATIONS

- **Valuations are falling**, due to the retreat of the equity markets and the decline in long rates, and are once again very attractive.
- Is the persistence of valuations at these levels down to a lack of visibility in the markets or a paradigm shift?

OTHER FACTORS

- **Small caps return to favour:** few financial issuers, but many industrial in this asset class.
- The performance of small caps is expected to continue in 2011, favoured by M&A activity and higher earnings growth.
- **Flows: return of subscriptions in equity funds on both sides of the Atlantic.** Return of IPOs (Verallia, Moncler, Ferragamo), but declining M&As.

■ **Chart analysis: the markets take a break.** In the very short-term, the markets are at an oversold level and could rebound. The current configuration of the indices suggests a trend within a broad corridor. This trend could continue during the summer and thus form the expected interim top.

OUTLOOK

■ Markets caught between macro and micro...

- After striking the top of the channel observed for many months, the markets are reversing course under the dual threat of the debt crisis and the economic slowdown in the United States, thus conforming to the "risk-on, risk-off" pattern.
- On the macroeconomic side, the environment is tense, but not disastrous: conditions in the United States are deteriorating as expected; in Europe, we anticipate a resolution—albeit an overdue and painful one—to the Greek debt crisis. The question, however, is still open as to the consequences of the conclusion of QE2 and the effects of the end of the cash infusion into the financial markets.
- As regards microeconomics, while analysts expect upcoming earnings releases to be solid, the focus will be on the corporate outlook. Nevertheless, valuations are once again attractive, even

according to the sharply lower "post-crisis" standards. This is demonstrated by the companies themselves, which aren't hesitating to offer a substantial premium when pursuing a takeover target.

- Lastly, the contrarian reading of sentiment indicators is rather encouraging, with the "Bull / Bear" balance returning to its lowest levels of the past 18 months.
- As such, we haven't changed our target levels, anticipating a very slight rise at 3 months, with no geographical bias, and a somewhat more sustained increase at 12 months.

A WORD ABOUT THE INVESTMENT STRATEGY

- **We are adopting a more cautious outlook** on financial shares, fearing that a solution to the Greek crisis will come a bit later than expected and will probably offer only momentary relief.
- **We continue to favour companies capable of preserving their margins:** strong brands, oligopolistic situations, i.e. automobiles, chemicals, healthcare and industrials.

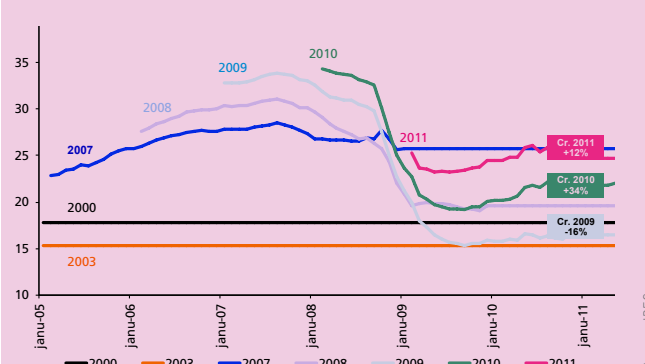
C.CO

Performance of the main indices since the start of the year

	15/06/11	Var. 2011 in euros
DJ Euro Stoxx 50	2731	-2,20%
SBF 250	2824	0,82%
CAC 40	3807	0,05%
FTSE 100 (UK)	5743	-5,14%
S&P 500	1265	-5,55%
Nasdaq	2631	-6,88%
Topix (Japan)	825	-13,36%

Source: Datastream

Profits forecast by the consensus on Euro Stoxx



Source: IBES

Performances of international stock market indices in local currency



Source: Datastream

GLOBAL BALANCED PORTFOLIO MANAGEMENT

Jean-Louis Autant,
Head of Global Balanced Management



Trend

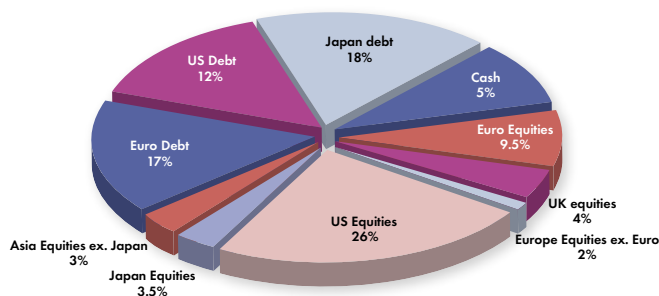
Last month, we remarked in these columns on the markets' performance within a trading range, and one month later it is obvious that it's now the lower bounds—and thus the support levels—of this fluctuation channel that are increasingly being tested. Some of these chart levels could almost become legendary by virtue of being tested and retested: for example, the S&P 500's now-famous level of 1250 points continues to provide resistance, but the reasons for crossing it have been on an unfortunate uptrend. Indeed, on both sides of the Atlantic the horizon is darkening and the markets are increasingly feverish. In this context, it's no surprise that risk aversion is finally taking off and driving up the volatility indices (VIX back up to 23, its highest level this year within the 29-and-under range established post-Fukushima).

In Europe, the subject having been widely documented elsewhere, we will not dwell unduly on the impact of the never-ending Greek crisis and Franco-German procrastination regarding the second rescue plan. However, although we can assume that an agreement will eventually be found in extremis, the damage will be felt by both

the sovereign rate markets, through the higher cost of financing peripheral issuers' bonds, and by the many players in the financial system which will not emerge unscathed from this crisis due to heightened monitoring and downgrades by rating agencies.

Meanwhile, the U.S. has seen massive publications of disappointing and even downright mediocre economic indicators. Market operators have tried hard to convince themselves that the Fed would deem the current slowdown temporary but in fact, in this environment, the bank's leeway appears very limited, with a QE3 being clearly unsuitable. Faced with these dour facts, and to avoid despairing, Wall Street continues to look positively on the still very reasonable valuations seen on the global stock markets: a 2011 P/E of 11 in Europe, 13 in the U.S. and barely higher in Japan. Meanwhile, the analysts' consensus still anticipates earnings growth for 2011 to be (too?) high, at 13% in Europe and 16% in the U.S. Add to this the recurring argument of the obvious support provided by M&A deals at generally lofty prices and operators could soon abandon Spartan regimes and the markets recover an Olympian calm.

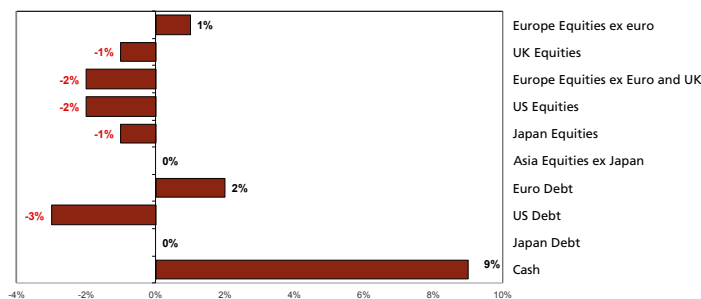
Model portfolio



Portfolio closed on 14/06/2011. Benchmark composed of 50% JPM global hedged + 50% MSCI world. Source: Groupama AM

% difference

BETWEEN BENCHMARK AND MODEL PORTFOLIO



Allocation

GLOBAL ALLOCATION

Equities 48% / Rates 47% / Cash 5%

We're taking advantage of the market correction to stake out more aggressive positions on equities, though we remain slightly underexposed. Meanwhile, the rate allocation increased mechanically and we are maintaining the weighting reached.

EQUITY MARKETS (48%)

■ **USA (=)**: The U.S. stock market, which might have seemed relatively immune to the effects of the Greek crisis, plunged like its counterparts due to a domestic slowdown. We are maintaining a slight underexposure in the model portfolio.

■ **Europe (+2.5)**: The eurozone is preferred: We're taking advantage of the pullback in its stock markets to resume an overexposed stance. Europe excluding the eurozone was reinforced due to its defensive nature in a persistently uncertain environment.

■ **Asia (+0.5)**: Japan corrected sharply in recent weeks and we decided to add new investments to reduce our underexposure. On Asia excluding Japan, we are maintaining our neutral position relative to the index.

DEBT MARKETS (47%)

■ **USA (-2)**: The spectacular rally on U.S. bonds led us to pare back the portfolio: we believe that risk aversion will decline, and that the uncertainties on U.S. sovereign debt (ceiling and end of QE2) argue in favour of some caution.

■ **Europe (+1)**: The stress on peripheral sovereign debt is not abating, which should maintain the flight-to-quality phenomenon. We have therefore slightly reinforced the portfolio, mainly, of course, on the sovereigns considered to be the safest.

■ **Japan (+2)**: We continue to trade off U.S. bonds for those of Japan because, although Japanese debt as a percentage of GDP is near an all-time high, the island nation's fragile economic situation leads us to prefer rate instruments.

MONEY MARKETS (5%)

We are using a portion of our cash to fund investments in equities.

IN THE BLINK OF AN EYE

Our strategy

		Current level 14/06/11	Short-term target	1-year target
United States	Fed Funds	0.25	😊	😞
	10 yr T - bill	3.08	😞	😞
Eurozone	Refi rate	1.25	😞	😞
	10 yr OAT	3.38	😞	😞
Japan	BOJ rate	0.10	😊	😊
	10 yr JGB	1.16	😊	😞

Sources : Groupama AM, Bloomberg

Our model portfolio in € 14/06/11

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 15/06/11

Indices 15/06/2011	Forecasts Groupama Asset Management	
	short term (< 3 months)	a 1 yr
France (CAC 40)	3808	😊😊
Euroland (DJ)	271	😊😊
United-Kingdom (FTSE 100)	5773	😊
United-States (S&P 500)	1272	😊😊
Japan (Topix)	823	😊
MSCI Asia free ex-japan	557	😊😊

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

COMMERCIAL CONTACTS

😊😊 Positive 😊 Positive neutral 😐 Neutral 😞 Negative neutral 😞😞 Negative



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The Letter Funds and Strategy - N°105

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