

Fixed Income Management

LONG RATES

■ **After many twists and turns in Greece over the parliamentary vote on the new austerity plan, it was finally passed,** allowing the fifth tranche of the initial bailout plan to be released. This offered a glimmer of hope to the market, reinforced by France's proposal on the private sector's involvement in outlining a new financing plan.

This new optimism lasted just a short time, however, crushed by the actions of the rating agencies. Standard & Poor's deemed the French proposal a 'selective default' on Greek debt and Moody's downgraded Portuguese and Irish debt to junk status. The contagion reached Italy and all debts saw their risk premiums widen against the German Bund.

The discordance that currently prevails in the eurozone amongst the political authorities is fuelling the extreme volatility that we have seen in recent days.

If reaching an agreement still seems hard to imagine—such is the level of disagreement between the states—the spreading of the crisis to Italy reinforces the need for a lasting solution for the markets. We remain convinced that a political solution will emerge in the coming weeks, calming the extreme risk present in the markets.

Fundamentals are deteriorating on both sides of the Atlantic; inflation figures remain high, and are not expected to slow until

autumn. Current rate levels, however, seem to us to assume much more than a weakening of fundamentals, and have been driven by the flight to quality which has benefited German and American obligations.

We are maintaining our 3-month target at 3.3% for the U.S. 10-year rate, and at 3.5% for the 10-year French rate.

CREDIT

■ **The climate of extreme risk aversion is driving risk premiums higher in a very illiquid market.**

Widening spreads are mainly affecting BBB-rated debt, subordinated financial debt and utilities (highly correlated with sovereign risk).

After a small issuance window in early July, the primary market quickly closed due to the actions of rating agencies, and is expected to remain sluggish over the summer.

The recent widening of risk premiums makes valuations attractive on certain sectors and issuers, pending a favourable political solution in the coming weeks.

We will take advantage, with great discretion, of valuation levels that are considered attractive to begin adding some credit exposure (beta), especially to core countries.

INFLATION-INDEXED

■ **Recent performances of inflation-indexed assets are highly disparate between the geographical regions.** Outperformance is notable in the United Kingdom and the United States. In the eurozone, their performance is in line with that of nominal bonds. The summer's unfavourable carry trade and the risk aversion driving the markets are negative factors for euro-indexed assets, to which we prefer those that are U.S.-indexed.

A WORD ABOUT THE INVESTMENT STRATEGY

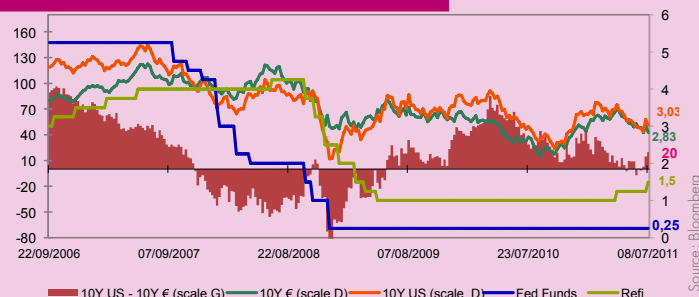
■ **The uncertainty and volatility driving the markets in the very short term militates for maintaining a neutral stance on exposure to interest rates.**

The flattening of the 2-10 year segment is still likely, given the level of the 2-year German rate below that of the Refi rate.

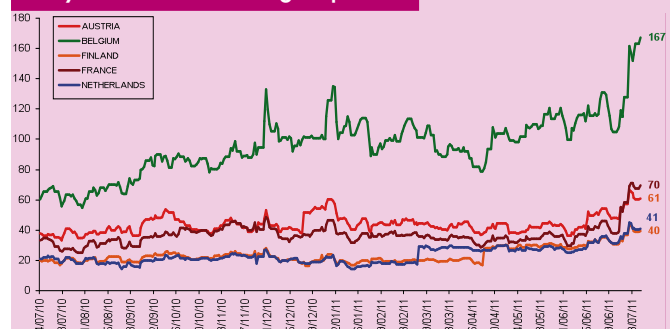
We are maintaining our bias for core countries, pending the announcement of a political resolution. Our country allocation continues to exclude the three countries which called for European assistance and maintains a neutral positioning on Italy and Spain. We are maintaining credit exposure at 100%, and asset allocation at 95%. In the medium term, we will increase the portfolios' beta in order to take advantage of valuation levels that are considered attractive.

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



10 year Core Sovereign Spreads



10 year Peripheral Sovereign Spreads

