

## Fixed Income Management

### LONG RATES

■ **The exposure of weak economic fundamentals on both sides of the Atlantic, along with the issue of sovereign debt,** drove the markets toward extreme levels of risk.

The events of the summer reinforced the markets' concerns about the growth profile of developed countries, illustrated by the United States' revision of growth figures for the past several years. In the eurozone, the sovereign debt crisis took on a new dimension. Despite the European political will to find solutions to the Greek problem, the responses presented on 21 July were not enough to reassure the markets, given the complexity of the measures to be put in place.

The ECB then intervened in the secondary market, in the context of the SMP, by buying Italian and Spanish debt in order to contain the interest rates of these two countries.

The dissensions between the eurozone's member states and Greece's lack of rigour in implementing austerity plans revived fears of Greek default and led to expectations that Greece would exit the eurozone.

Markets are now waiting for strong political decisions towards more coordination and economic governance, and greater credibility of the eurozone countries in implementing the adopted and necessary measures of austerity plans.

In the short term, the uncertainty surrounding the fate of Greece and the contagion to other peripheral countries -with no

immediate solution in sight- is driving continued flight-to-quality, with the primary beneficiaries being U.S. and German debt and, to a lesser degree, French debt. In this environment, reinforced by the continuing global economic slowdown, we expect a further rate cut and are posting a 3-month target of 1.75 % for the U.S. 10-year rate, and 2.4 % for the 10-year French rate. In the longer term, the eurozone economy is likely to be further weakened by the succession of austerity plans, without falling into recession, and will thus maintain a low rate environment. The liquidity premium (linked to the flight-to-quality phenomenon) will be mitigated by future policy decisions and steps towards greater integration. Overall, we expect a 10-year French rate of around 2.75 %.

### CREDIT

■ **The major stress that has affected the markets for several weeks is having a very significant impact on the credit market,** which is seeing the massive widening of spreads in an illiquid market. The financial sector once again bore the brunt of the losses, particularly French shares.

The valuation levels of some sectors and companies look attractive from a fundamental point of view.

However, the lack of visibility over the short term and continued erratic movements argue for caution vis-à-vis the asset class.

### INFLATION-INDEXED

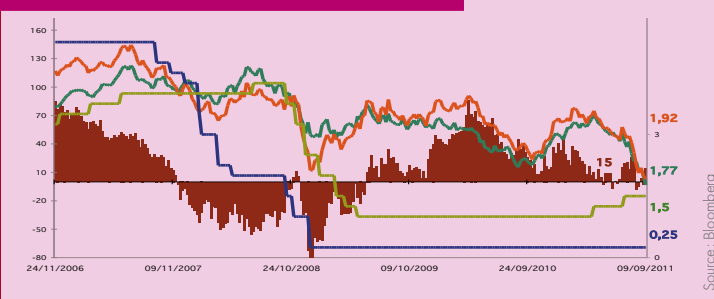
■ **The last few weeks have been very negative for inflation-indexed assets.** Inflation break-evens fell sharply and are not expected to find support levels in the short term despite very attractive valuations. Real rates have fallen to very low and even negative levels in some geographic regions. They should remain low in view of trends in the economic environment.

### A WORD ABOUT THE INVESTMENT STRATEGY

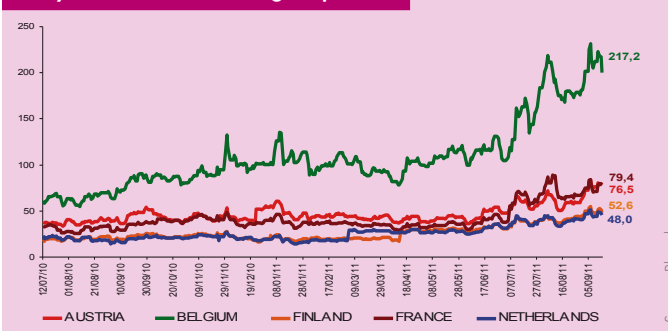
■ **The lack of visibility on a short-term solution in the eurozone calls for conserving a neutral position on exposure to rates.** The strategy of flattening on the 2-10 year segment is maintained, as the rate cut by the ECB that we are expecting has already been anticipated by the markets. The flight-to-quality movement is expected mainly on 10-year rates. We are reinforcing our bias for the core countries, and increasing our exposure to Germany at the expense of Spain and Italy, on which we are now underweight; France is now neutral, from overweight. On credit, we are maintaining an asset allocation of 95 % and are initiating several hedges to reduce the impact of high volatility on our portfolios.

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

