

# The & Letter

Funds & Strategy

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

## EDITORIAL



### Antidote

U.S. money market funds have sharply cut back their exposures to French banks in recent months. Major British banks have just done the same thing with their contemporaries of the southern eurozone. European banks will likely be forced to reduce their funding via loans to emerging markets, of which they now account for 75% (BIS data).

The Lehman bankruptcy gave the international financial system a heart attack. The cardiac massages by the political and monetary authorities saved the patient. The sovereign debt crisis is acting differently, like a poison spreading gradually into all the veins of the financial system. An antidote of renewed confidence is needed. Time is short.

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

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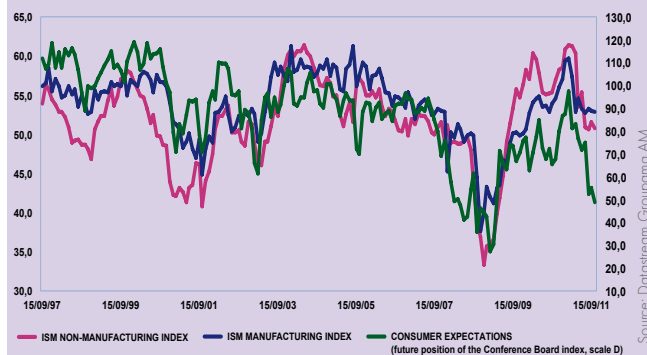


## United States

### CONSUMERS EVER MORE PESSIMISTIC

Coming in at 2.0%, up from 0.7%, growth perked up again in the third quarter thanks to investment and consumption, which benefited from the decline in long rates. But mortgage refinancings, whose sharp rise is behind the fall in the household savings rate to 3.5%, have reached their peak. Faced with nominal incomes that have stagnated over the past three to four months and a credit market that remains essentially closed to a large segment of households, their consumption is expected to contract by the start of next year. Growing consumer pessimism could be validated by three possible factors. Firstly, the unemployment rate should rise significantly due to weakening job creation, from 100,000 down to 50,000 per month, the result of tighter credit conditions for SMEs and the normal productivity cycle for large companies. Secondly, newly rising oil prices (up 30% in one month) should make a major dent in purchasing power. Lastly, the lack of a budget agreement between Democrats and Republicans casts another shadow over American governance and fuels consumer pessimism. Leading indicators are thus expected to deteriorate, especially as the European economy will worsen and set in motion another, mild, recession.

### United States: Consumers still very pessimistic; big business confidence holding steady



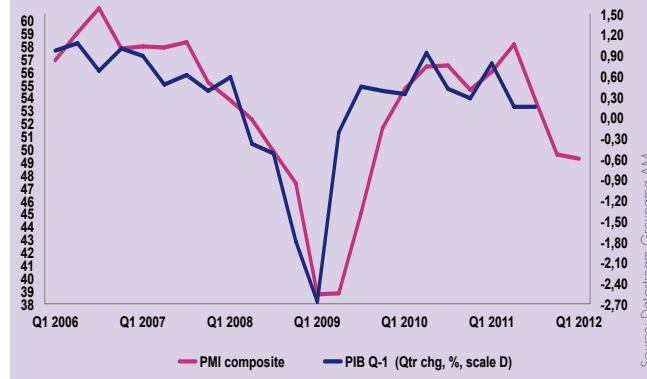
## Euro zone

### ENTRY INTO RECESSION

Growth held steady at 0.2% in the third quarter, thanks to France (up 0.4%) and Germany (up 0.5%) which benefited, respectively, from buoyant consumption and investment. In contrast, despite external support, Spain's activity was flat and GDP contracted in the small countries, as it probably did in Italy, which entered into recession.

Domestic demand throughout the eurozone is acutely affected by the wait-and-see attitude of operators gripped by too much uncertainty over the resolution of the European governance crisis. We now anticipate a mild recession, confirmed by the ECB's new president, Mario Draghi. Starting in the fourth quarter, the eurozone is thus expected to post a contraction in its activity which should continue into the first half of 2012, as suggested by leading indicators. France will not escape it. Germany should be affected one quarter later. Unless tensions calm on the public debt market, a credit crunch will then be all the more likely as the banking system is forced to reduce balance sheets in order to shore up solvency: in this case, the recession will be substantially more severe.

### Euro Zone: Entry into recession

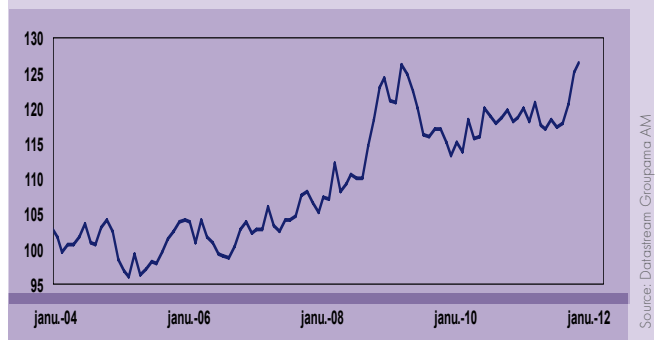


## China

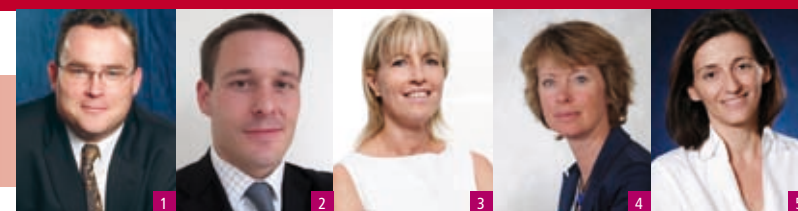
### HALTING THE YUAN'S RISE AGAINST THE DOLLAR

Activity is trending toward a soft landing. The weakening components of demand are foreign trade and real estate; however, the risks of a sharp decline in property prices are overblown given that overall demand remains strong, despite the difficulties facing some developers. Consumption remains the strong point of demand, especially as wages are rising steadily and inflation is expected to fall. SMEs, however, are still a point of major concern: Their activity has slowed significantly and their access to bank credit is increasingly restricted. For these reasons the government has decided to raise the limits on bank credit to such borrowers, even if monetary policy is in a wait-and-see phase due to uncertainties about the extent of the downturn in inflation, and the impending slowdown in activity. It is likely, however, that China will halt the rise of its currency against the dollar given the sharp increase in its real exchange rate stemming from the fall of emerging market currencies.

### China: Sharp increase in real effective exchange rate



# CORE MANAGEMENT



## Money Market Management

### A multitude of ill-defined layers

The first hazy layer stems from the Politicians. The markets were hanging on their every word at the summits of 21/07 and 26/10 but evidently, with their laborious implementations, it is risk premiums, volatility and uncertainty that are reaching their own summits. The banking sector is also contributing heavily to poor visibility in several areas, whether as to their capital needs, their future ability to finance the economy, or even their positions in the markets which are reducing liquidity to nil. Lastly, fundamentals are an added source of opacity, with an economic future that ranges from mild to severe recession and all the attendant consequences for the real world and for businesses. For good measure, one could top it off with a layer of uncertainty originating from the rating agencies. The overall diagnosis has not really worsened compared to our previous reports, but visibility has deteriorated and argues for a particularly cautious stance.

P-H.B

### CENTRAL BANKS

In the United States, while the economic news is somewhat better than expected, Bernanke says the Fed is ready to do more if necessary, especially on the mortgage front. Europe is sinking deeper into the sovereign debt crisis, and risks taking the rest of the world with it. The Greek tribulations over a referendum—which thankfully never materialised—hurt the agreement of 26 October which nonetheless signalled real progress on the eurozone’s governance. As for the ECB, Mario Draghi pleasantly surprised the markets by announcing a rate cut of 25 basis points, voted unanimously at his first meeting. On the whole, he delivered a message of continuity of his predecessor’s policies. He justified his actions by a deterioration of growth forecasts seen as significantly down for 2012, and confirmed an approach that differentiates between interest rate decisions and unconventional measures. However, despite the rate decision and the acceleration of purchases under the SMP, European sovereign spreads rose massively, with the Germany-France spread reaching 200 basis points. Overall, despite their political will, European leaders have been unable to calm the markets and the year-end promises to be turbulent.

### A WORD ABOUT THE INVESTMENT STRATEGY

#### Investment strategy:

With the market having largely digested the rate cut, we continue to favour floating rates to fixed rates. Prudent in our investment choices, we are keeping to short maturities.

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

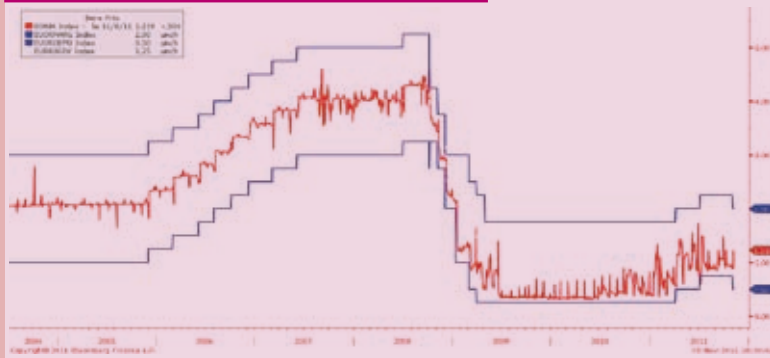
#### 4- Claire Chaves d'Oliveira

Head of Equity Management

#### 5- Claire Bourgeois

Head of Equity & Fixed Income ALM

Corridor, refinancing Rate & EONIA  
Average EONIA in October: 0.9835 %;  
from the beginning of the year: 0.904 %



### History of peripheral debt purchases by the ECB



Summary

## Fixed Income Management

### LONG RATES

■ **The markets pinned their hopes on the European authorities** and got a fairly favourable response at the summit of 26 October, even if the practical measures of this new agreement have yet to be drawn up.

The question of the Greek referendum at the start of the month highlighted the possibility of the country's exit from the eurozone, notwithstanding the agreement that had just been approved. The markets' defiance regained the upper hand, leading to a new phase of risk aversion. The contagion spread to all eurozone debt, with the exception of Germany. Italy suffered the most, with its interest rates exploding to above 7%, which drove Silvio Berlusconi to cede his post to Mario Monti.

The abandonment of the referendum idea in Greece was accompanied by a new government led by Lucas Papademos. These political changes, instead of calming, only fuelled the crisis in confidence. France, in turn, was weakened, with the new growth forecast of 1% deemed overly optimistic and the French spread over Germany widening to historic levels.

What's more, eurozone fundamentals declined again, driving risk premiums higher.

In this context, volatility and risk aversion are expected to persist and caution is called for, especially vis-à-vis the most fragile countries.

For France, its 3-month rate should trend upward as the review of its credit rating and the start of the electoral season approach.

Germany, for its part, has been protected by this defiance, although the flight-to-quality movement in its favour is losing steam.

In the U.S., the positive effects on rates of "Operation Twist" and the year-end decline of inflation are likely to be counterbalanced by upwardly revised growth and fiscal issues. Ten-year rates should remain stable in the short term.

### CREDIT

■ **The credit market also hailed the accord of 26 October**, with a marked narrowing of risk premiums. But this bright interval was short-lived. From a fundamental viewpoint, the persistent tension in the markets and especially in the banking system threatens to trigger a credit crunch and to worsen corporate financing conditions. From a more technical perspective, the absence of liquidity leads to erratic and abrupt movements. The dichotomy is widening between corporate and financial credit. In the short term, the lack of visibility and still-high volatility again urge caution on the asset class.

### INFLATION-INDEXED

■ **The change in sovereign risk premiums was the main factor** driving the market for inflation-indexed assets in recent weeks. Inflation break-even rates widened in the wake of newly rising oil prices, while the negative carry-trade offset the positive effect of the rise in break-even levels. While some negative factors persist (risk aversion and a deteriorating economy), supporting factors (attractive valuations, a more pragmatic ECB policy and the carry trade which is again strongly positive on European inflation) should prevail, favouring Germany.

### A WORD ABOUT THE INVESTMENT STRATEGY

■ **The watchword is once again "Caution".**

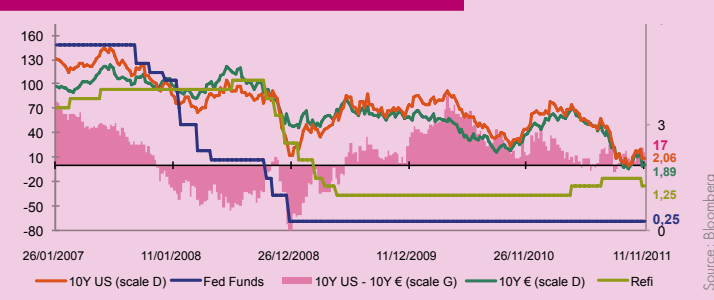
Given this unimproved climate, we are maintaining a neutral directional bias to rates. We are underweighting fragile countries (all peripheral countries) and remaining neutral on France. Within the core countries, we are lowering our overweight on Austria and favouring Finland, the Netherlands and Germany.

On credit, we are paring back some positions when opportunity allows and managing volatility.

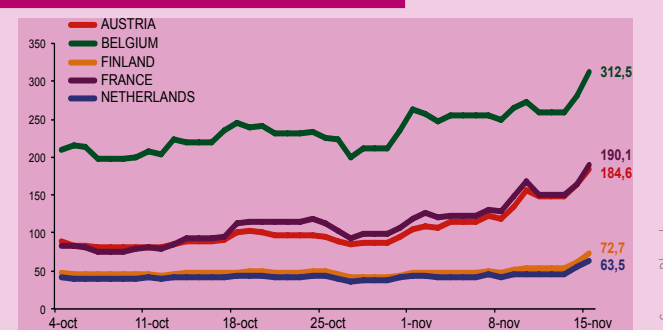
Regarding inflation-indexed assets, we are initiating an allocation in our aggregate portfolios on Germany only, after reducing holdings in German nominal debt.

G.M

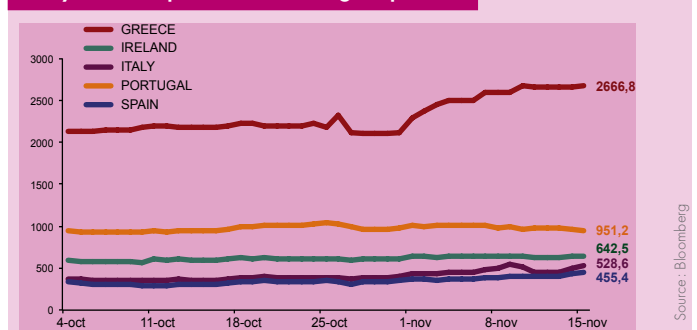
Change in the short and long rates in the United States and the Eurozone



10 year Core Sovereign Spreads



10 year Peripheral Sovereign Spreads



## Equity Management

### PROJECTED RESULTS AND VALUATIONS

#### Earnings forecasts: Further downward revisions

- Over the past month, downward revisions of 2011 and 2012 profits continued in all regions, and particularly in the eurozone.
- We are maintaining our 2012 forecasts unchanged, still below consensus expectations.

#### Equity market valuations are rising. Extremely low levels must be seen in context

- Europe, like the United States, has implicitly weak growth over the long term, at a level below the valuations of 2003-2007.

### OTHER FACTORS

#### Cash and banks: Withdrawals slow from U.S. and European equity funds

- Sharp slowdown in financial transactions, few mergers & acquisitions (Sony Corp / Sony Ericsson Mobile). British group G4S pulled out of the deal to buy ISS.

### Chart analysis: Markets are resilient, but worries persist for 2012

- The markets are resilient and are re-joining the long-term moving averages, though they will struggle to break through them.
- Meanwhile, the long-term momentum is worsening and confirms that we are still in a bear market.

### OUTLOOK

#### Outlook: A long, hard road ahead

- The financial markets had glimpsed a possible solution to the European debt crisis, until the hesitations of local governments reminded the markets of the hard political reality—and its corollary, uncertainty. For European governance, the road ahead will be long and hard, and the resolution of the crisis now depends on the peoples' acceptance of the solutions (from austerity policies to greater European integration).
- At the same time, the economic outlook isn't getting better. From confidence shock to austerity policies and tighter credit, all are risk factors for our 2012 earnings forecasts. These are partially offset by still strong demand from emerging markets, especially for consumer goods, and by a strong balance sheet position for

most European companies. We still anticipate 2012 earnings for the eurozone far below market forecasts, as well as zero growth in profits for the United States.

- Risk aversion indicators, in extreme positions last month, recovered somewhat and point to a relative reprieve.
- Just like our unchanged earnings forecasts, our 12-month market targets are unaltered. We have slightly reduced our 3-month expectations, in anticipation of slightly more chaotic circumstances in the coming weeks, and disappointments ahead for year-end corporate earnings.
- Our forecasts thus remain very modest, favouring Asia and the United States over Europe.

### A WORD ABOUT THE INVESTMENT STRATEGY

- We are maintaining a defensive profile for our portfolios, with an emphasis on energy and technology. Our emerging markets exposures are oriented more towards consumption (luxury) than investment (less industry and basic materials). Lastly, we are adopting greater caution vis-à-vis the financial sector.

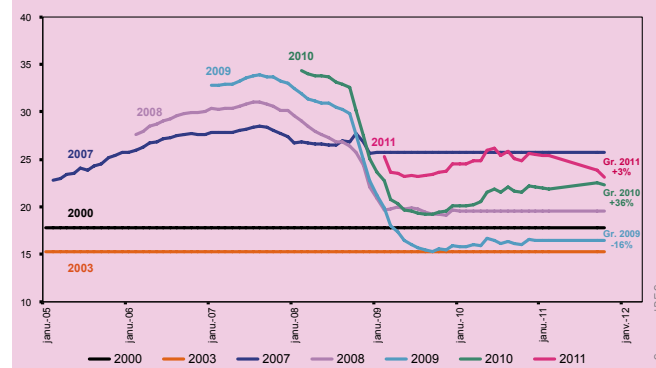
C.CO

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

	15/11/11	Var. 2011 en euros
DJ Euro Stoxx 50	2254	-19,29 %
SBF 250	2271	-18,89 %
CAC 40	3049	-19,86 %
FTSE 100 (UK)	5517	-6,26 %
S&P 500	1258	-0,78 %
Nasdaq	2686	0,45 %
Topix (Japan)	731	-14,97 %

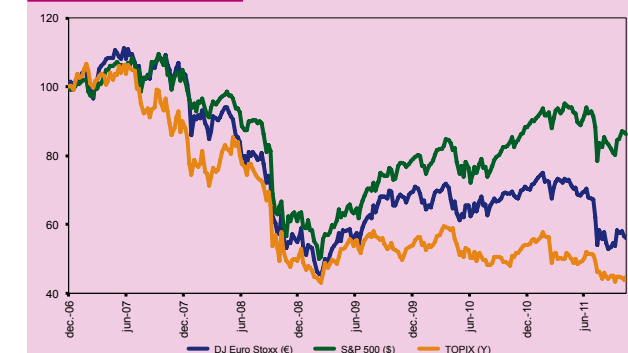
Source: Datastream

### Profits forecast by the consensus on Euro Stoxx



Source: BEB

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



Source: Datastream

# GLOBAL BALANCED PORTFOLIO MANAGEMENT

Jean-Louis Autant,  
Head of Global Balanced Management



## Trend

### A tough test of nerves!

Discouragement is a sentiment increasingly shared by investors on both sides of the Atlantic. Indeed, it seems that as soon as progress is seen on the political front, as with Europe and the replacement of worn-out governments (Greece, Italy and Spain), it's the economy that raises fears and, conversely, when the economy shows encouraging resilience, as in the U.S., it's the political sphere that throws up a roadblock. For operators, it's a tough test of nerves!

In the eurozone, the recent political changes are being digested rather favourably by market participants, although it's common knowledge that the task will be complex to rectify the fiscal circumstances that are seriously weakened everywhere. There is one caveat, however: The harmony on display in recent weeks by the Franco-German duo Angela Merkel-Nicolas Sarkozy is (already) starting to fray. The French president's position now appears weakened by the initial pronouncements of ECB head Mario Draghi, who is clearly of the same mind as the German Chancellor on the role (and credibility) of the ECB: He thus rejects any idea of transforming the ECB into a lender of last resort and has policy makers returning to the rapid development of what

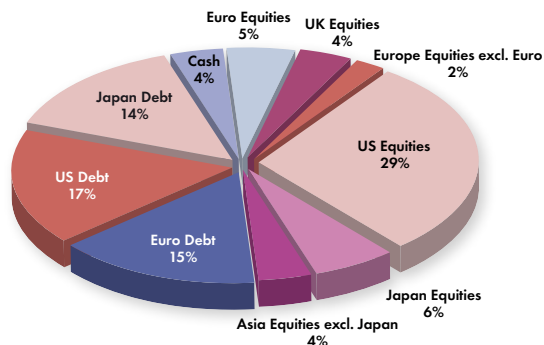
everyone is talking about but no one has seen: an expanded EFSF worthy of the challenge at hand. Meanwhile, seeing at last a chance to prove its existence, the European Commission took the opportunity to again trot out the well-worn subject of the euro bond... one can only wish it good look.

On the economic front, no surprises in the eurozone: The combined impact of widespread fiscal austerity and credit rationing naturally leads investors to expect a recession, characterised as "mild" (for now).

Meanwhile, in the U.S., the game seems to be up on the political front: The Super Commission will end in a super fiasco, overshadowing the evidence of surprising resilience in the U.S. economy. In a highly negative climate, the confirmation of the stunning strength of U.S. consumption is welcome news: The legendary American consumer seems more willing than ever to tap into his savings as shown by the rise in consumption coinciding with a decline in the savings rate. Let's hope it lasts!

In this tense environment the riskiest asset classes are naturally under pressure, but the theoretically more protected assets (except for the bund and artificially supported G.B. and U.S. debt) are also suffering from the widespread stress: for now, "cash is king".

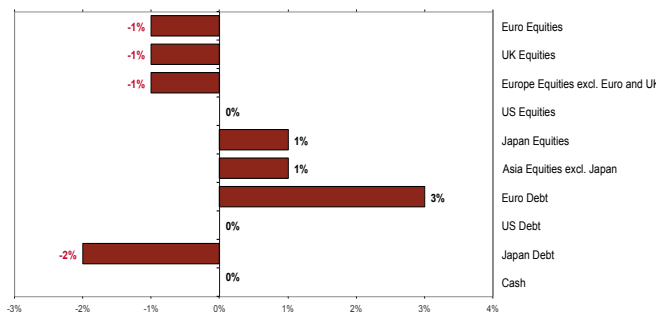
## Model portfolio



Portfolio closed on 13/11/2011. Benchmark composed of 50% JPM global hedged + 50% MSCI world. Source: Groupama AM

## % difference

### BETWEEN BENCHMARK AND MODEL PORTFOLIO



## Allocation

### GLOBAL ALLOCATION

**Equities 50% / Rates 46% / Cash 4%**

The return of pressure leads us to take a neutral stance on equity weighting; we are increasing our cash and maintaining an underexposed rates portfolio since there are currently few secure guarantees.

### EQUITY MARKETS (50)

■ **USA (+2):** We favour the U.S. markets and have increased the allocation. This is because U.S. economic circumstances have better visibility than the eurozone's, although the impact of the risks of a political roadblock are obviously unknown over the short term.

■ **Europe (-3):** The procrastination of the political and monetary authorities and the apparently well-founded fears of the eurozone's imminent entry into recession lead us to significantly reduce the weighting of euro equities. On the other hand, we are choosing to maintain the current weights of our portfolios of Europe excl. eurozone equities likely to better withstand any continued pressure.

■ **Asia/Japan (-1):** We are paring back Japan but maintaining our exposure to Asia excl. Japan, a region that outperformed its counterparts in the previous rebound phase.

### INTEREST RATE MARKETS (46)

■ **USA (=):** Triple A or not, the current stress is holding 10-year rates under the 2% bar, or at quasi-parity with German rates. The U.S. politicians of the Super Commission have apparently failed to find 1.2 trillion dollars in savings over the next decade; in this context, pressure is naturally rising, creating a classic "flight-to-quality" movement that favours T-bonds.

■ **Europe (-1):** The flight-to-quality phenomenon mainly benefits German bonds. The supposedly "core" sovereign bonds and those of the peripheral countries are also caught up in the storm. We are paring back the overexposure.

■ **Japan (=):** We are conserving the slight underexposure to Japanese rates: The Japanese bond market does not seem especially promising in this phase of flight-to-quality.

### CASH (+3)

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 15/11/11	Short-term tarjet	1 year tarjet
United States	Fed Funds	0,25	😊	😊
	10 yr T - bill	2,03	😊	😞
Eurozone	Refi rate	1,25	😊	😊
	10 yr OAT	3,42	😞	😞
Japan	BOJ rate	0,10	😊	😊
	10 yr JGB	0,97	😞	😞

Sources : Groupama AM, Bloomberg

## Our model portfolio in € 15/11/11

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 15/11/11

	Indices 15/11/2011	Forecasts	
		Groupama Asset Management	
		short term (< 3 months)	at 1 yr
France (CAC 40)	3149	😊	😊😊
Euroland (DJ)	228	😊	😊
United-Kingdom (FTSE 100)	5545	😊	😊
United-States (S&P 500)	1264	😊	😊
Japan (Topix)	736	😊	😊😊
MSCI Asia free ex-japan	480	😊	😊😊

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

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The Letter Funds and Strategy - N°109

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