

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".**

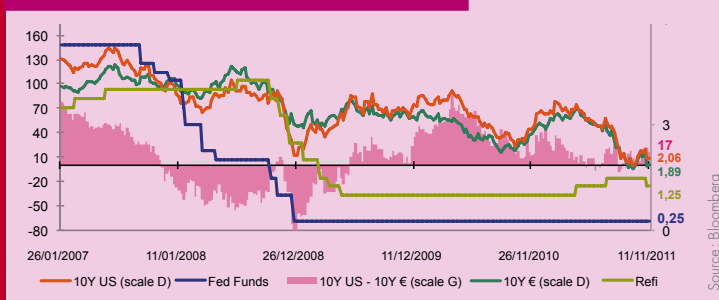
Given this unimproved climate, we are maintaining a neutral directional bias to rates. We are underweighting fragile countries (all peripheral countries) and remaining neutral on France. Within the core countries, we are lowering our overweight on Austria and favouring Finland, the Netherlands and Germany.

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

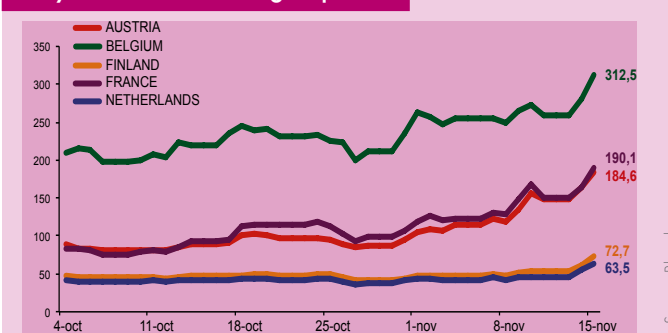
Regarding inflation-indexed assets, we are initiating an allocation in our aggregate portfolios on Germany only, after reducing holdings in German nominal debt.

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

