

The & Letter

Funds & Strategy

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Completed in December 23rd 2011

EDITORIAL



A need for consistency

One doesn't need to be a genius to predict that the coming year will also be marked by major political uncertainty and extreme risk. To calm the resulting volatility, public decision-makers must demonstrate greater consistency. Consistency over time, to prevent what's decided at one point (Deauville in October 2010) being contradicted later on (Brussels, November 2011) when it comes to choosing between the prevention of moral hazard (default of a eurozone country) and the automatic nature of the rules of fiscal discipline. Consistency in using the various instruments of regulation, between the heads of state who insist on the unshakeable nature of the Economic and Monetary Union, and the European Banking Authority which "marks to market" sovereign bonds and accelerates implementation of Basel III capital requirements with potentially strong consequences on how credit is distributed in the economy. Consistency, finally, in the strategy deployed: monetary stability and fiscal discipline are essential, but without a clear and common growth strategy, the euro will remain a flawed construction.

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The Actively Responsible Asset Manager

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United States

A MAJOR SLOWDOWN EARLY NEXT YEAR

Growth seems to be holding up due to the current momentum in durable goods consumption. Meanwhile, consumer confidence is rebounding concurrently with a marked decline in the unemployment rate to 8.6%. However, the steep drop in the savings rate, which funded the recent rise in consumption despite stagnant wages, is expected to end, as already indicated by its rise in October: Mortgage refinancings are sharply off and household balance sheets are under pressure, as revealed by the slowdown in the consumption of non-durable goods, the stagnation of consumer services and the large gap between the savings rate (3.6%) and its fundamental level of 5% to 6%. Wage income is even expected to slow due to a substantial weakening in job creation at the start of next year, as presaged by the ISM's employment sub-index, and another rise in the unemployment rate would harm consumer confidence. Household consumption is thus expected to stagnate in the first half of next year, leading to sluggish growth, which will also be impacted by the marked slowdown in global trade. Growth will perk up in the second half of 2012.

Euro zone

CONTRACTION OF GDP UNTIL THE END OF THE FIRST HALF

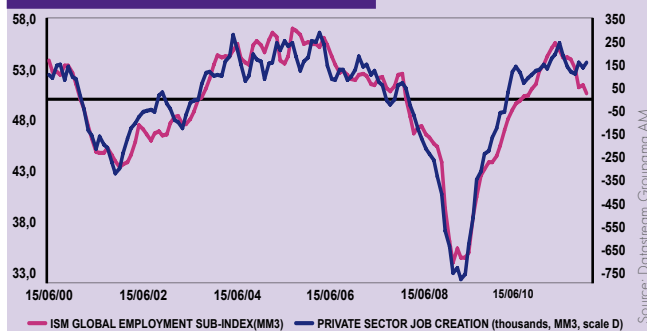
Growth held steady at 0.2% in the third quarter, boosted by still-dynamic exports throughout the eurozone and a catch-up in consumption (+0.3% Q/Q vs. -0.4%) in France and Germany. In contrast, consumption and investment fell in most other countries. After declining in September, industrial production levelled off in October: The massive shock on activity in September will lead to a contraction in the fourth quarter of about 0.4% for the entire eurozone. This recession, which will be widespread but especially acute in Italy, is expected to worsen in the first quarter, particularly in Spain where the plunge in the services activity index is disquieting. Beyond the uncertainty over the European crisis, businesses will have to adapt to weaker activity by cutting investment spending and payrolls. France could be particularly affected due to the fragile balance sheets of businesses and the severe tightening of their credit conditions. Consumption is thus expected to fall as the job market worsens, following a fourth quarter that was satisfactory in France and Germany but negative in other countries. Growth will return with the right decisions on European governance which will restore the confidence of European economic actors, the lack of which led to this recession.

China

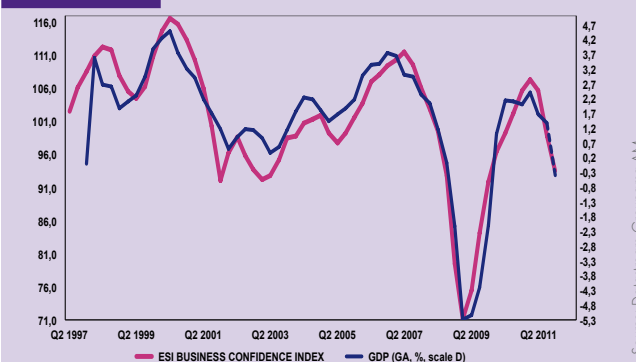
MONETARY LOOSENING TO CONTEND WITH THE WORSENING ECONOMY

The slowdown in activity is intensifying in the industrial sector, impacted by sluggish foreign demand, especially from the eurozone. The ballooning of manufacturers' inventories raises fears of a further deterioration in manufacturing activity indicators. Domestic demand is also slowing, impacted by the downturn in residential property which is expected to persist in view of housing starts, but at this point remains gradual. Despite still-dynamic household consumption due to the significant drop in inflation, from 5.5% to 4.2%, the monetary authorities decided to reduce the mandatory reserve ratio by 50 points, a move that could be renewed to avoid a liquidity crisis which would affect SMEs. A fiscal stimulus for households may be decided in the case of a sharp weakening of the jobs market next year, to reassure consumers worried about the economy. The yuan's appreciation against the dollar should slow significantly.

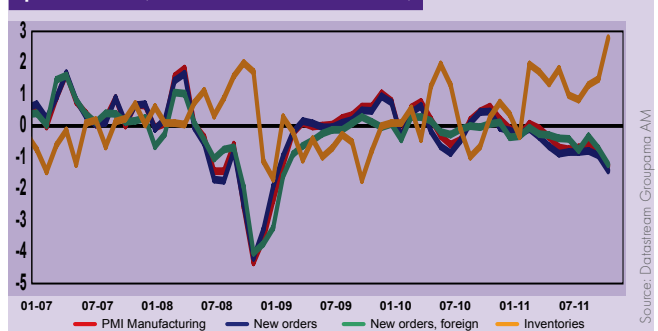
United States: the ISM employment sub-index announces a sharp slowdown in private sector job creation, which should not exceed 50,000



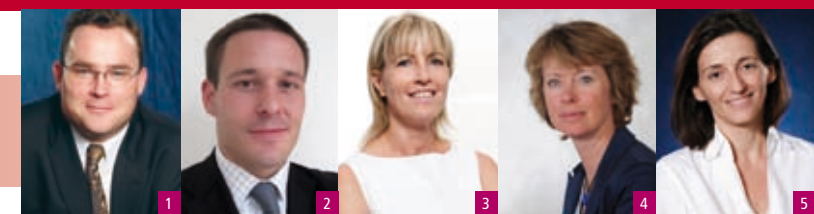
Euro Zone: GDP expected to contract by 0.4% in 4th quarter



China: the deterioration of new orders led to a sudden restocking, the resorption of which will weigh on future production (indices, centred, normed)



CORE MANAGEMENT



Money Market Management

From despair to hope

The road will be long, and hard to navigate, but our 2012 scenario does not include an unexpected detour. This stance in the current gloom entails three hopes, in order: political, economic and technical. We maintain our political hope that, in one way or another, with the ECB as a last resort if necessary, and in a way that is socially acceptable, treaties will evolve towards greater federalism and that we move towards the mutualisation of debt. We have hope for a soft economic contraction only, without a credit crunch taking hold and transforming it into a real recession. Lastly, we rely on the hope of technical fundamental reasoning, whether for equity valuations—even following a sharp drop in profits—or for corporate default rates in terms of risk premiums on bonds. This hope for 2012 does not exclude high volatility in the coming months, therefore, for now, we are maintaining a cautious stance in our portfolios.

P-H.B

CENTRAL BANKS

Christmas on 21 December

Whilst the Fed soliloquizes about more transparent communication and plans to be more specific about its long-term goals, political turmoil is raging in Europe over totally dislocated markets. Finally, the Europeans have given painful birth to a “pre-agreement” of 26 members to amend the treaties in favour of greater fiscal discipline. Despite the defection of the United Kingdom, this agreement was enough to reassure the ECB, which then opened wide the floodgates of liquidity. On the menu: cash loans for up to three years for an unlimited amount; the easing of eligibility criteria for assets accepted as collateral for these loans; the halving of the amount of reserves banks must hold; all topped off with a small reduction in the key interest rate of 25 basis points. Add to this the easing of conditions for obtaining dollars, and no longer does any European bank have an excuse for liquidity problems in the eurozone. This cash will likely be funnelled to SMEs, especially owing to the all-new eligibility of small-business loans for the ECB’s refinancing operations; conversely, nothing is less sure in respect

of government securities. Banks may prefer to cover their refinancing needs at first until they know how they will ultimately be treated in 2012 (EBA, Basel, etc.); the 3-year liquidity operation planned for February 2012 leaves them plenty of leeway. In short, we’ll all be watching on 21 December for the results of the ECB’s first 3-year operation, and let’s hope that 2012 will quickly be the year of a new and credible European treaty.

A WORD ABOUT THE INVESTMENT STRATEGY

Investment strategy:

In this environment, we are extending our investment horizon and seizing opportunities, particularly on the spreads of bank issuers.

T. P.

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Core Management CIO

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Head of Money Market Management

3- Gaëlle Malléjac

Head of Fixed Income Management

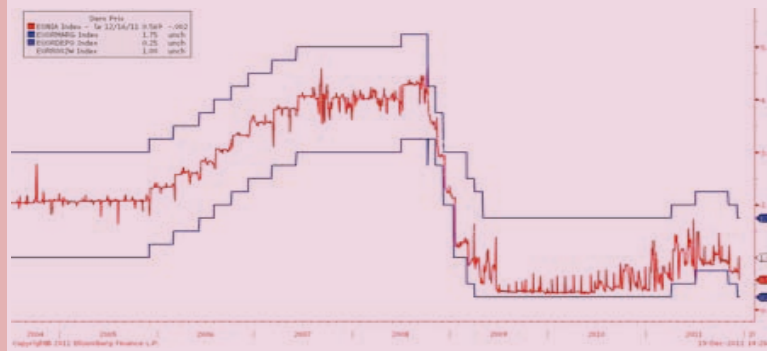
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Head of Equity Management

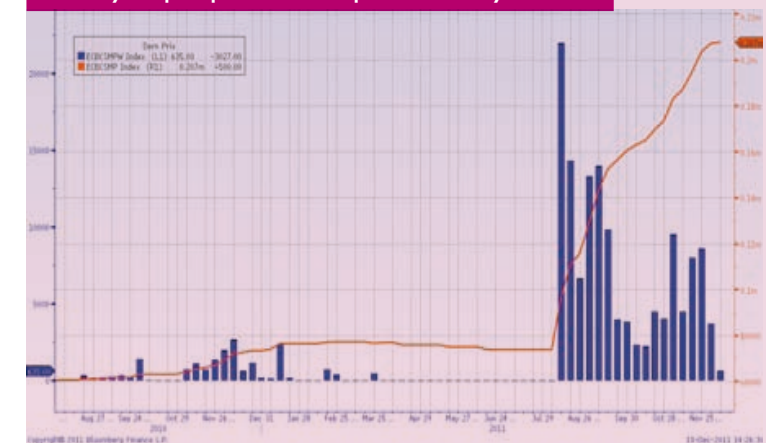
5- Claire Bourgeois

Head of Equity & Fixed Income ALM

Corridor, refinancing Rate & EONIA
Average EONIA in november: 0.78471%;
from the beginning of the year: 0.89692%



History of peripheral debt purchases by the ECB



Fixed Income Management

LONG RATES

■ **Once again, the European calendar has set the pace for the markets in recent weeks.** The summit of 9 December, by progressing on the political issue of greater fiscal integration, highlighted the willingness of member states to address the region's underlying problems in order to provide a structural response to the crisis. The signed agreement, however, remains incomplete as to the issues of growth and solidarity within the eurozone.

This progress on fiscal integration was not sufficient to allay the distrust of investors, or rating agencies. The lack of a global solution to the crisis continues to fuel market volatility.

The eurozone debt crisis will remain the main focus of attention in the coming months. Our central scenario is based on the slow and gradual improvement of governance in the eurozone and on a step-by-step strengthening of economic and fiscal integration. That won't happen without conflict or volatility, and the risks are still present.

From an economic standpoint, as the year ends, the eurozone is entering into a moderate recession, with a rebound expected in the second half of 2012.

In this environment, we anticipate in the next 3 months stability "core" (German) rates. The impact of the weakening economy will offset the gradual reduction of the liquidity premium enjoyed by Germany and the risk of a general downgrading of eurozone

governments by the rating agencies. By the end of 2012, strong European integration coupled with the return of moderate growth should push interest rates higher.

Concerning France, due to political uncertainty fuelled by the country's upcoming elections, the risk of the country missing one of its fiscal targets, and the risks weighing on its credit rating, the risk premium against Germany is likely to be pushed higher during the first months of the year (target of 160 bp with a likelihood of a return to 200 bp). By the end of 2012, political uncertainty should be allayed and global governance improved in the eurozone. These factors argue for a tightening of the risk premium in the second half of 2012, though with a spread that remains higher than historical levels (around 100 bp).

As for the peripheral countries, the cautious stance taken early in the year continues to be warranted in a context of volatility, significant flows of issues and sustained pressure from rating agencies. Longer term, the gradual resolution of the crisis should push these countries' risk premiums lower and lead to a convergence of rates towards those of the core countries.

In the United States, the economic slowdown—which will intensify at the start of the year—coupled with continuing fiscal difficulties, should keep rates close to current levels in the first half of the year. Longer term, the return to weak growth, persistent budgetary problems and the election season will lead to higher U.S. rates.

CREDIT

■ **Exiting the crisis will still be long and volatile, so caution on credit is still called for in the short-term,** reinforced by the context of a structural liquidity shortage.

Longer term, in a climate of "soft" recession and taking into account the risk premiums offered, the asset class remains attractive: rates are low and credit spreads incorporate extreme implied default rates.

INFLATION-INDEXED

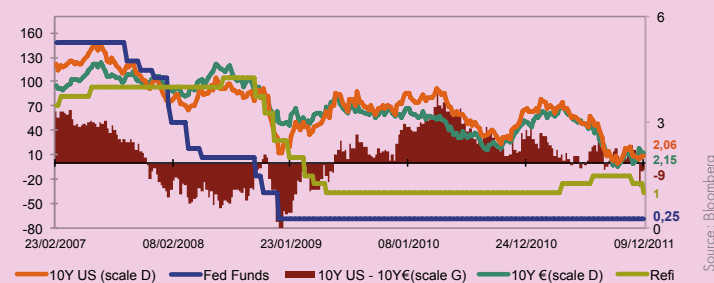
■ **The trend in sovereign risk premiums remains the main factor** behind the performance of inflation-indexed assets. Persistent volatility could still impact the asset class. Longer term, valuations of inflation expectations remain attractive, especially on short maturities.

A WORD ABOUT THE INVESTMENT STRATEGY

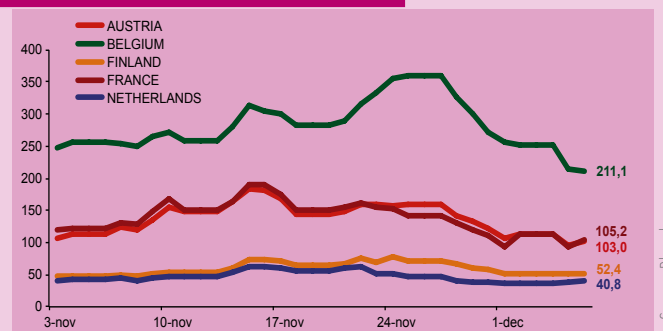
■ **We are approaching the transition from the end of this year to the start of 2012** by maintaining the overall positioning adopted in recent months in the context of the eurozone crisis: a neutral directional bias to rates, underweighting of peripheral countries, and continued underexposure to credit.

G.M

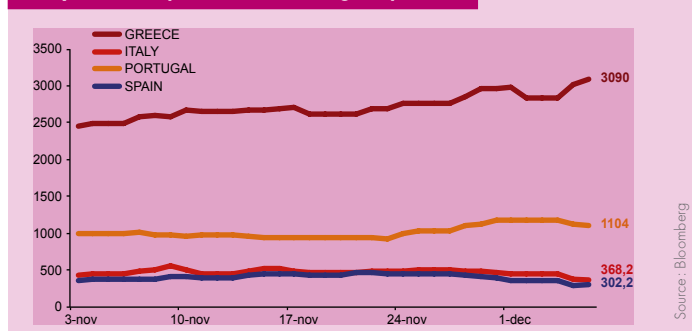
Change in the short and long rates in the United States and the Eurozone



10 year Core Sovereign Spreads



10 year Peripheral Sovereign Spreads



Equity Management

PROJECTED RESULTS AND VALUATIONS

Earnings forecasts: Further downward revisions

- The eurozone, now in recession, is leading the pack on negative EPS revisions.
- Accordingly, for 2012 we are now forecasting a 9% drop in profits in the eurozone and zero growth in the U.S.

The under-valued equity markets must be viewed in context

- The equity markets still have upside potential but in a context of lowered guidance and likely weaker long-term growth.

OTHER FACTORS

Cash and banks: Withdrawals from European equity funds are moderate, but picking up steam in U.S. equity funds

- Another major slowdown in financial transactions: predators are losing their appetite. Conversely, capital increases are planned for some banks.

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

- The trend is fairly bullish for the year-end, and the rally could last several months.
- But the deterioration of long-term charts is stoking fears of bearish turn in 2012.

OUTLOOK

Outlook: From summit to summit, a narrow ridgeline, still not far from the precipice

- Each European summit brings a (small) step more towards the resolution of the debt crisis. But the time horizon of investors is more pressing than that of politicians and has little tolerance for the hesitations, countervailing pressures and electoral risks inherent to the world of politics. In addition, while Europe is edging slowly towards fiscal integration and the eventual repair of public finances, the issue of a "firewall" for sovereign debt remains sensitive. Lastly, there's still the matter of growth to contend with, conspicuously absent from discussions.

- The ridgeline is therefore especially tricky, and the chaotic news flows expected in the coming months portend renewed high volatility.
- Meanwhile, the macroeconomic environment remains problematic: Austerity policies and tighter credit conditions are going to weigh on corporate profits. We've thus lowered our 2012 growth forecasts for the eurozone by 9%, far below those of the analysts' consensus, reflecting a substantial risk of negative surprises.
- We've slightly corrected our 1-year expectations, which remain moderately positive, with a continued emphasis on Asia. These forecasts, and our expectations of a zero change at 3 months, still obscure the anticipation of numerous volatility shocks in 2012.

A WORD ABOUT THE INVESTMENT STRATEGY

- We've maintained our exposure to financial shares (banks and insurance), even as systemic risk is subsiding thanks to the ECB. We continue to prefer technology as well as shares exposed to consumption in emerging markets, but we have nevertheless reduced our exposure to the automobile sector.

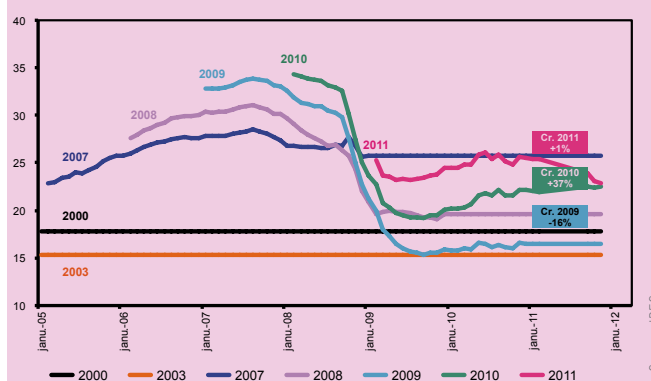
C.CO

Performance of the main indices since the start of the year

	14/12/11	Var. 2011 en euros
DJ Euro Stoxx 50	2206	-21,01 %
SBF 250	2207	-21,19 %
CAC 40	2976	-21,78 %
FTSE 100 (UK)	5367	-7,24 %
S&P 500	1212	-0,19 %
Nasdaq	2539	-0,85 %
Topix (Japan)	737	-11,81 %

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

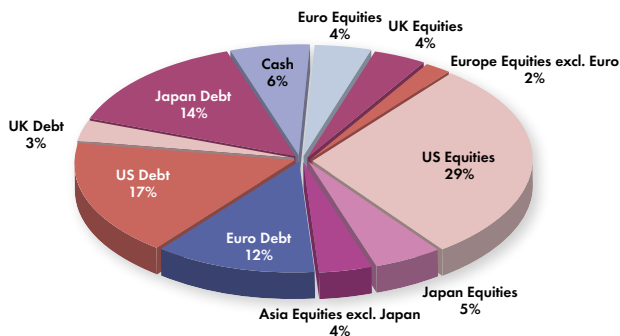
Anticipating 2012?

It's amazing how long and arduous the climb is up these European summits, when the descent is so fast! It's indeed disappointing, to say the least, to note that the "Merkosy" duo failed to re-captivate, for more than a few hours, weary investors whose dearest wish seems to be to get past this dreadful year as quickly as possible. Anticipating 2012? But the challenges for 2012 in the eurozone are so vast that to show such optimism here seems rash; one can only just bet on the non-breakup of the eurozone, but what of the rest? One could perhaps risk qualifying the severity of the coming recession: based on the opinion of experts in general, and ours in particular, the term "soft" can reasonably apply. In short, it's not especially encouraging, and in any case not sufficiently convincing to load up on risk assets when one is (so it seems) an informed European investor.

The U.S. investor, on the other hand, may seem privileged in comparison: firstly, he obviously avoided the major tumble taken by his colleagues throughout the financial world (i.e., the Dow Jones brilliantly posted a positive score for 2011), and secondly,

he undoubtedly has a clearer horizon based on the evidence. In effect, he can already confirm the existence (and persistence) of economic growth in his land and he also has a formidable ally in the person of his central banker. Of that he is well aware: according to a recent poll, 70% of investors approve of the policy carried out by Ben Bernanke. Certainly, doubling the size of the Fed's balance sheet for very mixed results—especially on employment—has brought him harsh criticism by lawmakers, but investors love him. They're even asking for more: At this stage, they'll be offered a new round of "twist" but they want more—a QE 3, for example, would delight them. For that, they'll have to be more patient, but should tensions mount in the eurozone... What a contrast with European investors! And though it may seem painfully trivial to focus on defensive assets in such a context, it's difficult to be a die-hard optimist!

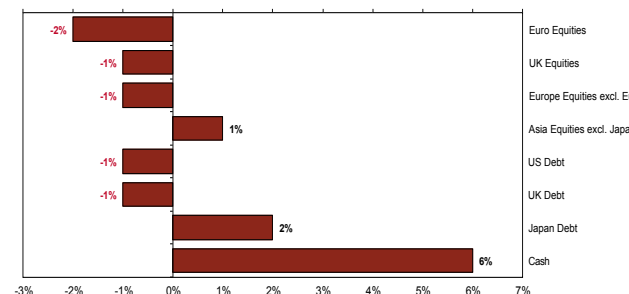
Model portfolio



Portfolio closed on 13/12/2011. 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 46% / Cash 6%

Evidently convictions are lacking when it comes to risk-taking. The prospects for "soft" growth in the U.S., a "soft" recession for the eurozone, and a "controlled" landing in China do not encourage the return of risk to the portfolio. On the contrary, a quick exit from the European crisis seems remote and the problems of European governance are still present. Accordingly, we are underweighting equities in the portfolio by two points: one on Europe, and one on Japan.

EQUITY MARKETS (48)

■ **USA (=):** We continue to favour the U.S. market, which is resilient in all circumstances. The strong growth in earnings per share (EPS) in 2011, like the performance of the U.S. stock market, are commendable. Of course, 2012 looks to be more sluggish, with EPS stabilising at best, but compared to other markets that already seems far more attractive.

■ **Europe (-1):** The crisis of governance in the Eurozone appears deep, with rating agencies now focusing their concerns on "core" countries, led by France and Italy, but Germany as well... And time is running out for our leaders. Will the ECB eventually monetize part of the problem? Nothing is less sure, which leads us to increase our underexposure to the region.

■ **Asia/Japan (-1):** We are returning to neutrality on Japan, based on a gloomy economic outlook for the coming quarters. The return of deflation in the context of continued weakening of global growth holds little promise for the cyclical market in Japan. We are maintaining our overexposure to Asia excluding Japan.

INTEREST RATE MARKETS (46)

■ **USA (=):** The current stress is still holding 10-year U.S. rates at quasi-parity with German rates. The continuation of the "twist" and the prospects of an eventual QE 3 in early 2012 indicate to us that long rates will remain at least at these levels for the short term.

■ **Europe (=):** After a brief correction, the flight to quality has again benefited German bonds. Core sovereign and peripheral bonds continue to have a tough time and their rates are stabilising at still-high levels, which makes the refinancing of governments even more problematic in early 2012.

■ **Japan (=):** We are maintaining a slight underexposure to Japanese rates, as the bond market in Japan provides little reason to favour it.

CASH (6)

Cash holdings were increased by two points.

IN THE BLINK OF AN EYE

Our strategy

		Current level 13/12/11	Short-term tarjet	1 year tarjet
United States	Fed Funds	0,25	😊	😊
	10 yr T - bill	2,03	😊	😞
Eurozone	Refi rate	1,00	😊	😊
	10 yr Bund Fr/Germ Spread	2,06 149bp	😊 😞😞	😞😞 😊😊
Japan	BOJ rate	0,10	😊	😊
	10 yr JGB	1,01	😞	😞😞

Sources : Groupama AM, Bloomberg

Our model portfolio in € 13/12/11

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 13/12/11

Indices	Forecasts	
	Groupama Asset Management	
15/11/2011	short term (< 3 months)	at 1 yr
France (CAC 40)	3090 😊	😊
Euroland (DJ)	220 😊	😊
United-Kingdom (FTSE 100)	5428 😊	😊
United-States (S&P 500)	1236 😊	😊
Japan (Topix)	741 😊	😊😊
MSCI Asia free ex-japan	464 😊	😊😊

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°110

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