



2012 SCENARIO BETWEEN RECOVERY AND RELAPSE



15 JANUARY 2012

Gestionnaire Activement Responsable

Les informations contenues dans ce document sont uniquement transmises à titre d'information et n'engagent en conséquence que leur auteur. Les équipes commerciales de Groupama Asset Management et ses filiales sont à votre disposition afin de vous permettre d'obtenir une recommandation personnalisée. Ce document est strictement confidentiel et établi à l'intention exclusive de ses destinataires. Toute utilisation ou diffusion non autorisée, en tout ou partie et de quelque manière que ce soit, est interdite et passible de sanction. Groupama Asset Management et ses filiales déclinent toute responsabilité en cas d'altération, déformation ou falsification dont ce document pourrait faire l'objet.



SUMMARY OF THE 2012 SCENARIO

1 – The past year has confirmed Groupama AM's long-held conviction regarding the structural nature of this “globalised crisis” and, consequently, its belief that overcoming it will be a long and painful process. Our aim is to provide a few elements to illustrate our outlook and act as “markers” to track trends within the economy and financial markets in 2012, and provide a context for our forecasts.

The Economic and Monetary Union will not be revolutionised or radically reformed. The strategy adopted – that of Germany - involves taking small steps towards a political union whose form is still somewhat symbolic. We will therefore continue to experience high levels of volatility, especially in the first six months of the year, and without any tangible guarantees to validate the level of mutualisation and trust of investors in the stability of the euro. The motivation of S&P's latest wave of downgrading clearly conveys the medium-term perspective of the market: namely, that governance in the euro zone and the concrete instruments implemented to deal with liquidity stresses are too weak to be convincing. Today, the only reassuring element is the feeling that being on the brink will induce the ECB to ‘do its duty’ and fulfil its mandate in a more dynamic manner to provide reassurance that the zone will not break-up.

As regards **Greece**, the country has made very little progress during the last year in its structural adjustment programme, in relation to which the political classes and public opinion only pay lip service. The risk of a country leaving the euro zone has increased significantly (with Portugal's situation not being fundamentally different). Our failure to take this risk into account in our central scenario is precisely due to the lack of progress of the ECB's actions as a lender of last-resort for the States. Only an action of this nature would protect other countries on the brink from the immediate and sudden contagion that Greece leaving the euro zone would trigger. **This means that a laborious agreement must be reached regarding the restructuring of the sovereign debt with private-sector involvement (PSI).** It is clear that any such agreement must be accompanied by extra effort from official creditors to provide the “overall package” with a little more credibility. Close attention should also be paid to any progress made by politicians in the euro zone regarding growth consolidation, which is currently far too absent from their strategies, as such moves would bring public opinion onboard to a far greater extent - an essential element for strengthening European integration.

The structural consequence of this crisis of confidence (further accelerated by the regrettable sovereign debt rating decisions taken in mid-2011 by the European Banking Authority) means: investors are rediscovering the joy of closely following the financing plans of the various States, as well as the sale of treasury bills, and investment flows from various parties. On the bond markets, non-European investors have withdrawn and a “home-bias” is back. The European financial area is undergoing another fragmentation.

The American economy demonstrated a certain resilience in the second half of 2011, which somewhat surprised the most pessimistic of us.

However, our central scenario is based on a diagnosis of structural fragility and an economy undergoing an extremely slow recovery. Despite a real jolt to confidence in the second and third quarters, American consumers drew on their savings to fund consumption. Certainly, the job situation improved somewhat and private debt reduction is progressing; however, the thorny issue of controlling public debt was deferred to 2013 due to the new political configuration that has paralysed the decision-making process. The property “millstone” is still weighing heavily.

China has entered into the second year of its 12th five-year plan, and the aim is to “rebalance” a growth model driven by foreign trade and investments deemed by the authorities to be “unsustainable and unstable”. Beyond strictly economic aspects, we believe that this desire for rebalancing will be progressively implemented and translate into lower growth levels (6-8% rather than 8-10%) where internal consumption will play a greater role and the use of human and natural resources will become more sustainable.

After the “rescue” from-the-brink phase followed by a rebound and attempts to return to “business as usual”, the global economy is now entering into a new post-crisis phase during which each major geographic area will focus itself on and endeavour to heal its wounds, especially those involved in the refinancing of public debt and the inevitable conflicts the distribution of the burden will trigger. In short, this should result in weaker but potentially more sustainable world growth if the protectionist trends are suppressed.

2 - The global economy is set to significantly slow down in 2012, with growth rates declining from 3.8% to 2.0%, with a fairly defined outline: mild recession in the euro zone and weak growth in the United States in the first half of the year, followed by a rebound in the second six months due, in particular, to greater European stability after the upheavals of the summer of 2011. However, now more than ever before, the economic and financial forecasts have never been so closely linked to political events such as upcoming elections and the decisions taken as a result of these polls.

Within the euro zone, GDP is set to contract by 0.7% in 2012, after a 1.4% rise in 2011; however, a greater geographic disparity will be observed. Italy is forecast to record a 1.7% downturn in its GDP; in Germany, however, growth should remain positive (+0.3%). Growth in France should be around -0.5%, far below the official forecast (1%). Throughout the euro zone, even though domestic demand is contributing to lowering business levels, investments (-2%) will be the most affected by the crisis in confidence that is paralysing long-term spending decisions. Consumption will be closely related to the consequences of a major downturn in the job market and is set to decrease by 0.5%.

American growth will remain extremely fragile due to the weak purchasing power of households as a result of debt reduction, down from 1.7% in 2011 to 1.1% in 2012, though without slipping back into a new recession. Business activities will suffer from the downturn in global trade and the marked slowdown in household consumption during the first half of the year, as their purchasing power is not set to increase. The upturn seen since the end of the summer mainly resulted from temporary factors (drop in savings rates and mortgage refinancing) and the absence of any increases in purchasing

power will subdue consumption over the coming months. Growth is still occurring within the context of forced structural debt reduction for households, as the slump in the home property market is continuing, particularly due to repossessions whose numbers are set to rise for at least two years and which should lead to a drop in prices. On the other hand, the market for joint-housing and apartments has picked up.

Emerging countries have been affected by a drop in the price of commodities, decreased foreign demand for raw materials, and a marked decline in external financing from European banks which are scaling down their activities and the size of their commitments in emerging countries in order to improve their solvency. Furthermore, they must also deal with a slowdown in domestic demand. In China, for example, the previous monetary tightening policy has led to a correction in the real-estate market, which the authorities had been seeking, as well as a significant drop in inflation whose levels had been a major source of concern for the population. Chinese growth should be in the order of 8% this year, compared to 9.3% in 2011.

The table below shows the main indicators used for our forecasts.

Central Scenario	World	US	Euro	Japan	China
Anticipated growth in 2012	+2%	+1.1%	-0.7%	+0.7%	+8%
Inflation	ns	+1.9%	1.4%	-0.6%	+3.5%

In this context, how should the situation of European banks and companies be analysed?

European banks, currently in the process of recovery, have had to confront the sovereign debt crisis, which has highlighted their structural difficulties. Liquidity and solvency crises are again looming on the horizon, and only the unconventional measures taken by the ECB avoided the worst at the end of the year, and pushed back somewhat the threat of a credit crunch. In 2012, the major challenge remains resolving the European crisis, and in the near future signing a private sector involvement (PSI) plan with Greece. Additional regulations will continue to be enforced, which clearly emphasise the major changes made to “business models”. From this perspective, the points made by the Vickers report in Great Britain regarding the separation of different business areas are starting to gain ground in Europe.

However, the fundamentals of companies remain satisfactory. Due to the debt reduction policies implemented over the last few years, the solvency of major European companies is now excellent. The net debts to equity ratio is at a historically low level. Problems in obtaining finance have driven them to maintaining high levels of liquidity. However, the situation of SMEs is different and seems to indicate a rise in the level of defaults in 2012 for the lowest rated categories. Finally, the economic slowdown can be seen, in particular, by a growing number of profit warnings and concerns about this year’s results.

3 – Major risks of the central scenario and margins for manoeuvre of the economic policy.

The first risk is the **lack of available credit in Europe**. In order to improve their creditworthiness and comply with the solvency requirements imposed by the European

regulatory authorities, European banks may seek to reduce the assets they hold in the European private sector: if this is the case, credit will dry up and companies and households will find it hard to obtain credit, which will have a negative impact on investment spending and the economy will contract even further. The conditions imposed on corporate credit have tightened considerably; however, medium-term credit is standing up well and there is no suggestion of any widespread squeeze of credit overall.

The second risk is the **stalemate in the political governance crisis** due to a lack of European political consensus, or even due to a change of government which would require a renegotiation of the settlements that have been agreed (Greek PSI and budgetary golden rule). If this were the case, the continued pressure on public debt spreads would prolong the recession and maintain the strain on the financial system and credit conditions. A credit crunch would therefore be unavoidable, with major consequences for public accounts. Conversely, an easing of European tensions (agreement in relation to Greece and a new draft European Treaty on schedule, positive bank stress tests next June and a positive impact on the monetary market of the measures taken by the ECB and public debt issues for weaker countries via the banks, etc.) should help the market renew its appetite for risk at the start of this year, especially in relation to finances.

The margins for manoeuvre for economic policies is limited where the budget is concerned. Support from fiscal policies should no longer be expected. This situation will have a negative impact on business activities in all European countries, and will have a neutral impact, at best, in the United States, if Congress and the Obama administration reach an agreement about extending tax concessions this year to support employment. However, some emerging countries such as China could use budgetary policy, if need be, to boost consumption.

Monetary policies will remain, however, an active concern both in developed and emerging countries. In the United States, the Federal Reserve will continue to replace long-term government bonds with short-term ones on its balance sheet. It may also, if necessary, take decisions to keep the long-term rates low for lengthy periods (around 2% for 10 years): it could commit to a range of long-term rates, for example, and pursue another quantitative monetary policy of a different nature, dedicated this time to the real-estate sector, for instance. Regarding short-term rates, the Fed may decide to keep them at extremely low levels beyond 2013.

The ECB is set to continue reducing its base rates (0.25% over the year, at least), buying European debt securities and operating long-term financing transactions for European banks, which could resemble "quantitative easing" by another name, if banks invest their cash in public securities.

In China, a further reduction in legal reserves is expected as inflation rates drop and the real-estate market continues to correct itself; however, a reduction in interest rates seems highly unlikely due to the potential effect on the real-estate sector, which remains under pressure.

4- Major market fluctuations.

Due to the expected high volatility levels, **risk premium movements on bonds will remain high in line with the risks involved in the refinancing of States.** The variation in rates for the "core" euro-zone countries will depend on the relationship between the expected economic figures showing an improvement (in France and in Germany mainly) and the uncertainties regarding the sovereign debt crisis, which should finally resolve itself over the medium- to long-term. The rates of these "core" countries should also fluctuate within the recent range before progressively climbing, leading to a lowering of risk premiums. Even if a greater stability is achieved in relation to the governance of the euro zone, the French-German spread will not return to its previous lowest level of between 30 and 50 base points above the Bund. It should fluctuate around an average of 160 base points over the next six months due to the forthcoming elections and the reach a level more suited to the new French rating, if the economic strategy adopted by the new authorities manages to convince the financial markets.

Our country allocation will certainly change over the course of the year, and we will start by always promoting AAA countries and underweighting the peripheral countries.

Regarding credit, the separation between the way financial debts and corporate debts are managed should continue, and this for as long as the sovereign crisis penalises the former. The policy to maximise yields will favour corporate debts from companies whose fundamentals remain excellent. We always prioritise such debts over the "core" countries, and those with a BBB rating. Regarding financial debts, the regulatory uncertainty and possible new "stress tests" will continue to encourage volatility. Selectivity remains our keyword.

For the coming period, we will maintain a slight underexposure in terms of allocation and low sensitivity to credit within our portfolios. The underweighting in relation to senior bank debts is slightly lower and we will continue to provide debt relief in favour of senior CT debts.

A macroeconomic environment is always a difficult one; moreover, austerity policies and a tightening of credit conditions are some of the elements that will have an impact on corporate profits and therefore on the **stock markets**. We have therefore lowered our 2012 growth forecasts in terms of earning per share to -9% for the euro zone, far below those of the analysts' consensus. There is still a high risk of negative surprises at the start of the year for this class of assets, as investors still do not trust this type of stock for long-term investments.

However, even when including the new earnings per share forecasts, the valuations remain attractive which has allowed us to make moderately positive one-year expectations, with a continued emphasis on Asia. These forecasts, and our expectations for the next three months, still obscure the anticipation of numerous volatility shocks during the first half of the year.

Antoine de Salins
Chief Investment Officer

Appendix: projections at 12 January 2012

12/01/201	2011	2012	
(%)	Groupama AM	Groupama AM	Consensus
United States			
Growth	1.7	1.1	2.2
Inflation	3.1	1.9	1.9
Euro zone			
Growth	1.5	- 0.7	- 0.3
Inflation	2.7	1.4	1.7
Japan			
Growth	- 0.6	0.7	1.9
Inflation	- 0.2	- 0.6	- 0.3
China			
Growth	9.2	8.0	
Inflation	5.5	3.5	

Monetary policy			
	30/12/11	12/01/2012	At 1-year
Euro zone	1.00%	1.00%	0.75%
USA	0.25%	0.25%	0.25%
Japan	0.10%	0.10%	0.10%
UK	0.50%	0.50%	0.50%
Stock market indices			
	31/12/11	12/01/12	At 1-year
France (CAC 40)	3 160	3 196	3 400
€ Zone (DJ Eurostoxx)	226	230	240
USA (S&P 500)	1 258	1 282	1 420
10-year Government Bonds			
	30/12/11	12/01/2012	At 1-year
Euro Zone (OAT)	3.15%	3.05%	3.5%
USA	1.88%	1.90%	2.5%
Japan	0.99%	0.96%	1.3%
UK	1.98%	2.00%	2.6%
Japan (Topix)	729	734	800

Les informations contenues dans ce document sont uniquement transmises à titre d'information et n'engagent en conséquence que leur auteur. Les équipes commerciales de Groupama Asset Management et ses filiales sont à votre disposition afin de vous permettre d'obtenir une recommandation personnalisée. Ce document est strictement confidentiel et établi à l'intention exclusive de ses destinataires. Toute utilisation ou diffusion non autorisée, en tout ou partie et de quelque manière que ce soit, est interdite et passible de sanction. Groupama Asset Management et ses filiales déclinent toute responsabilité en cas d'altération, déformation ou falsification dont ce document pourrait faire l'objet.