

FIXED INCOME MANAGEMENT

■ ■ ■ ■ ■ Eurozone: a blurring of the horizon!

The multiple austerity plans announced for the euro zone will puncture the future growth of both economies and businesses. The absence of political federalism in the zone and the cacophony of unilateral announcements significantly limit the impact of the rescue and stability plan announced in early May. Moreover, the lack of upstream precision in the volumes and targets for debt purchases is seen as a weakness and treated as such by the markets. Thus, risk aversion continues to prevail for all classes of assets, and the resulting lack of visibility is increasingly evident. In this environment, we are adopting a prudent position in most of our portfolios.

Inter-bank tensions: change in rate variances between IBOR and OIS



Source : Bloomberg

Evolution of 2 year interest rate spreads in the eurozone*



Source : Bloomberg

* The rates used are generic rates, a change in the benchmark obligation could result in an increase in yield

■ ■ ■ ■ ■ Short rates

Mr. Trichet's most recent speech on 10 June was not particularly surprising, and reinforces his solid reputation as the protector of price stability, indifferent to other macroeconomic parameters, unlike his trans-Atlantic counterpart. In this regard, he again clarified the neutralisation of the debt purchases of neighbouring countries by draining cash to prevent a hypothetical inflationary skid that could boost debt balances. Tensions in the inter-bank market, specifically the yield gap between the various "iBor" rates, such as the Euribor in the eurozone, and swaps of the same maturity at the overnight rate, such as the Eonia in the eurozone (see graph opposite) are certain to return, but at levels largely less worrisome than we have been seeing over these past three years. It is therefore normal for the ECB to maintain its strategy of gradually drawing down cash, and suspending the one-year facility, which it is replacing with 3-month and 6-month facilities. As for rate refinancing, this is nothing new, and the 1% Refi rate is certainly in place for the foreseeable future.

■ ■ ■ ■ ■ Long rates

Rates in the eurozone have followed three distinct trends: first, a continuing rally of German debt in an unbridled flight towards safety. Unlike American rates, which have benefited from the same trend, German rates have completely surpassed their previous historic lows, reaching new records of 0.43% for the two-year rate and 2.50% for the ten-year rate. The second is a moderate but continuous increase in the yield gaps with neighbouring countries, whose debt has been the object of direct purchases within the framework of the support plan. The third, as may be clearly seen in the graph opposite, is a continued increase in the yield gaps with other neighbouring countries that are not yet directly benefiting from the support plan, but which nevertheless are moving beyond their previous high points. Even if the latter appears to be a bit extreme, and we are undoubtedly witnessing a ballooning of a bubble on the German Bund, the lack of visibility, particularly in the political sphere, does not allow us at this stage to determine when these movements will be reversed. Thus, we are tactically reverting to positions close to neutrality on our rate sensitivity, and becoming more prudent in our allocations in neighbouring countries, which we are lightening in favour of so-called core countries.

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Inflation indexed

The recent environment has been particularly negative for this class of assets, with declining prices for black gold, lower inflation figures, and risk aversion overall. Thus, the indices are underperforming their nominal counterparts in all countries. With seasonality becoming less and less attractive, and inflation projections remaining particularly low, we are lightening our positions in this class of assets, or eliminating them completely for certain portfolios, in which indexed assets merely serve the purpose of increasing diversification.

United-States

SHORT RATES

The Fed chairman's latest speech gave evidence of a rather optimistic view of the state of the US economy. Similarly, his messages on unemployment and potential rate increases resulted in an anticipated increase in the Fed Funds rate, without, however, an actual increase. Finally, dissension has begun to appear within the Fed as to the timing and responsiveness with which it might have begun increasing rates. All of that is heading in the direction of monetary normalisation and gives us confidence in our projections of a slight increase in the Fed Funds rate next winter.

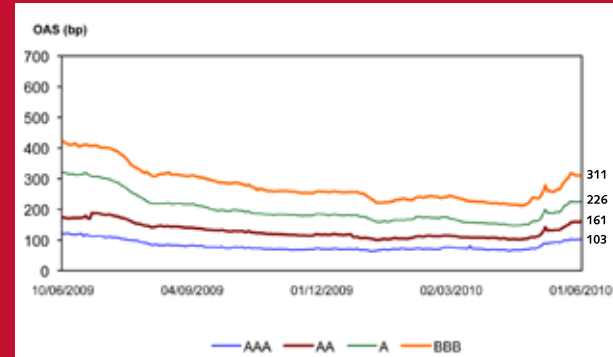
LONG RATES

The overall risk aversion has benefited US rates. Thus, between 10 May and 10 June, the entire rate curve flattened, particularly for long rates, with, for example, ten-year yields declining from 3.60% to 3.20%, while short rates remained relatively stable, reflecting the two-year rates that fluctuated between 0.70% and 0.85% over the period. We have thus reached the lowest points from the end of last year. By contrast, we are quite far from the lowest points at the end of 2008, when the US ten-year approached 2%. Continuing concerns surrounding budget deficits and the future flows of debt issuances they assume, as well as the improving US economy, give us confidence in our projection of a moderate recovery in bond tensions, as we noted in the first quarter.

Crédit

From a global standpoint, the assets class has moved relatively little over the month, as reflected in the Barclays Capital Euro Aggregate Crédit Corp global index, which saw stable performance between 10 May and 10 June. By contrast, a detailed analysis of this market shows that the risk-averse environment caused a sharp widening in the risk premiums on highly subordinated debt and the debt of corporate and financial issuers in neighbouring countries. Similarly, the primary markets have been virtually non-existent, with the exception of covered bonds, which saw a turnaround at period-end. Potential positive elements remain the volumes of cash ready to be invested among investors still seeking returns, default rate statistics that show a net improvement and positive results for certain companies, even if these optimistic trends must undoubtedly be revised downwards. In this uncertain environment, we have slightly reduced our credit allocations while seeking visibility, particularly on the political front.

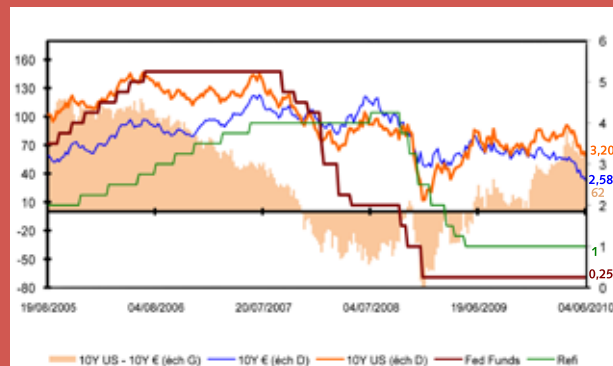
Change in risk premiums by rating



Source: Barclays Capital

Past performance is not a reliable indicator of future performance.

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



Source: Bloomberg



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