

The & Letter

Funds & Strategy

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Completed in November 20th 2010

EDITORIAL



Only the rich get loans (anymore)

The Fed has taken centre stage with a new round of monetary policy easing, dubbed 'Quantitative Easing 2', or, 'printing money'. This unprecedented action, ostensibly to address the debt overhang exposed by the crisis, is raising many questions about its side effects. The resulting liquidity threatens to flood spheres that have already regained significant fluidity, such as emerging markets or lending to major international firms. Reluctance persists, however, when it comes to financing, say, a first-time home buyer in California, or a manufacturer in Detroit. This disparity in treatment is behind a growing wealth gap between households—particularly those of 'communist' China, companies and even governments. Indeed, with 'QE2' underway, the refinancing difficulties of debtor nations Greece, Portugal and Ireland are getting worse!

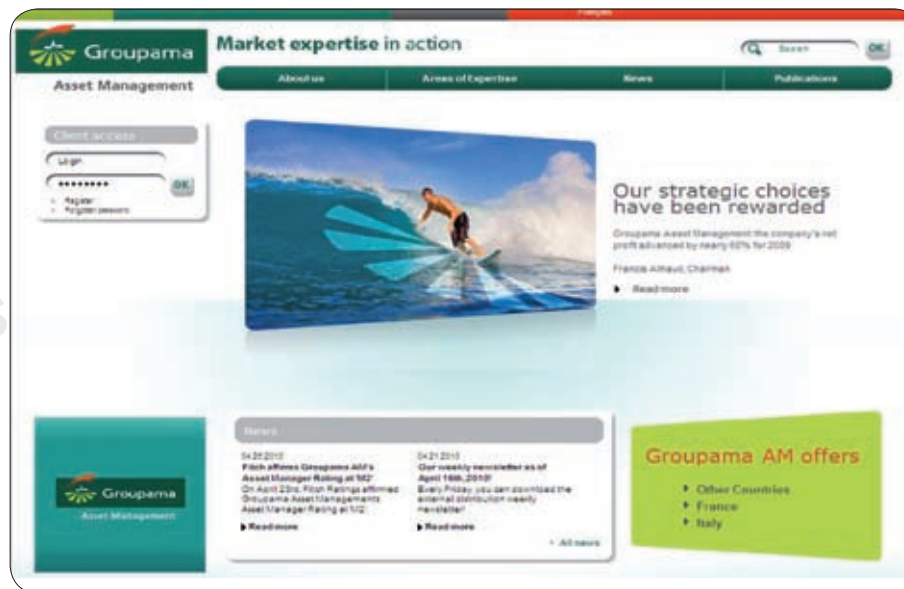
Romain Boscher,
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The Actively Responsible Asset Manager

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ECONOMIC ENVIRONMENT

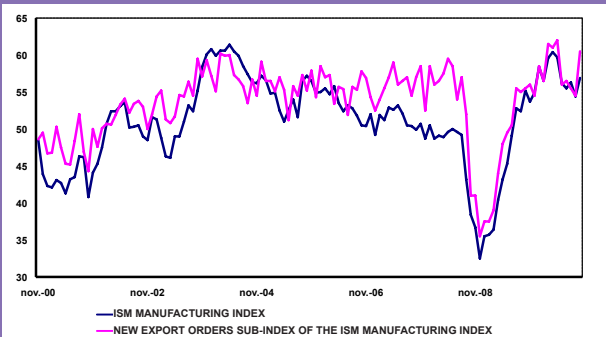
United States

ANOTHER RECESSION AVERTED FOR NOW

The ISM manufacturing index failed to confirm last month's recessionary message. It rose 2.5 points to 56.9, led by a sharp rebound in new export orders, which are beginning to benefit from the dollar's decline. The strong negative contribution of exports (another -2 points) should thus soon be neutralised. But the inventory cycle continued in its upward phase: its reversal (which will be all the more brutal the later it occurs) will trigger a fall in the ISM manufacturing index. That's because restocking has significantly accelerated, accounting for most of the third quarter's 2% growth: on an annual basis, it totalled \$115 billion, exceeding \$100 million for the first time since 1998.

Excluding inventories, growth weakened, slipping from 1.0% to 0.6%. The credit crunch continues to affect households, as shown by the nearly 8% fall in residential investment. This heightened deflationary pressure, as the unemployment rate held steady at a very high 9.6%. As a result, underlying inflation was negative for the month of September. Faced with the substantial risk of deflation and fearing another recession, the Fed opted for a new round of quantitative easing: it will inject \$600 billion of fresh liquidity into the economy over the next eight months. The result—the dollar's precipitous decline vis-à-vis the euro and the yen—reveals the lack of international cooperation in resolving this crisis.

United-States : exports sustain industrial activity



Sources: Datastream, Groupama AM

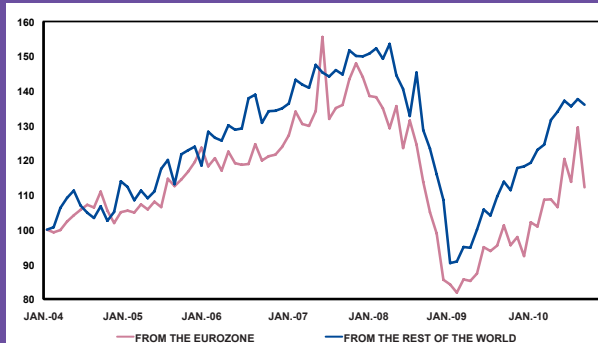
Euro zone

SLOWDOWN IN DOMESTIC DEMAND IS THEN ECHOED BY FOREIGN DEMAND

Growth deteriorated from 1% in the second quarter to 0.4% in the third. Although the breakdown is not yet available, there is little doubt that domestic demand is driving this very substantial slowdown. According to surveys, the inventory cycle is reversing course: the contribution of inventories to growth is probably close to nil. Production indices show a general decline in construction activity, after a 5.2% increase in the last quarter. Finally, according to surveys and retail sales figures, consumer spending is slowing under the impact of peripheral countries hit by austerity measures and, for some, a scarcity of credit. Growth has also slowed in Germany, despite improvements in the jobs market. France, in contrast, showed significantly higher consumer spending.

Only export activity remained dynamic in the Eurozone, thanks to Germany. However, foreign orders for German manufactured goods slowed considerably in the last two months: beginning in the fourth quarter, German exports will suffer from the slowdown of world trade and the weakening of the European countries, its main trading partners, which will be hurt by the euro's rise. This is likely to steepen the decline in GDP.

Eurozone: Industrial export orders (base 100 start of period)



Sources: Datastream, Groupama AM

China

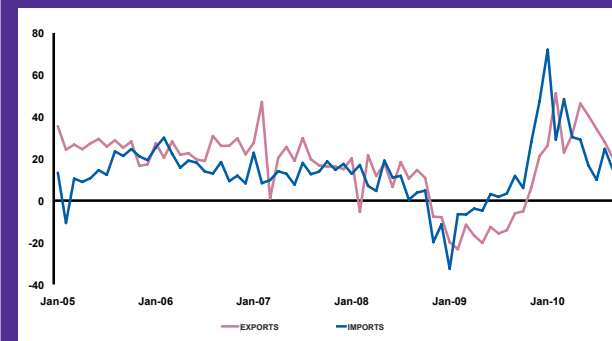
TIGHTER MONETARY POLICY, LONG-TERM CHANGE IN GROWTH STRATEGY

Activity is heating up again under the influence of consumer demand. This necessary rebalancing of growth towards domestic demand requires wages to rise as a share of GDP: they currently represent less than 40%. This is one of the priorities of the government's 12th five-year plan. Meanwhile, the current uptick in activity is doing little to help resolve global trade imbalances, benefiting domestic production greatly, but imports hardly at all. As a result, the Chinese trade surplus is widening. In addition, the resumption of sales on the property market continues to worry the monetary authorities. Deposit rates, particularly on long-term savings, have been raised for the first time since 2006: the goal is to redirect Chinese savings from real estate towards deposits, and to penalise the profitability of long-term credit and mortgage lending. The rising yuan is only a consequence of this rise in rates, though not the sought-after goal. Finally, the rise in inflation to 4.4% is no cause for alarm: underlying inflation remains low and higher food prices—the main cause of inflation—will help to redistribute wealth between urban and rural households.



Laurent Berrebi,
Chief Economist

China: Foreign Trade (Volume, AG, %)



Sources: Datastream, Groupama AM

FIXED INCOME MANAGEMENT

Short rates

The dichotomy in the central banks' conduct—which we noted in this report last month—is increasingly pronounced.

UNITED-STATES

In the U.S., the tone is dominated by fear of the spectre of deflation and the battle to avoid a double-dip recession. Thus, as highly-anticipated by the market, the Federal Reserve announced a second round of quantitative easing. It was somewhat larger than expected—\$600 billion instead of \$500 billion—but over a slightly longer period, whilst leaving the door open to extension if needed. The markets welcomed this news, but with rather feeble movement since much of it had already been anticipated, as we described last month. What's new is the significant deferral of expectations of Fed Funds rate increases: these have been pushed back by nearly six months, to the second half of 2012.

EUROZONE

In Europe, the message is altogether different: interest rate levels are appropriate, risks are measured, and refinancing transactions continue to go smoothly. Thus, in contrast to the U.S., what has changed is that expectations of an increase in the refi rate moved up sharply, to about a 12-month horizon—i.e., by the end of next year. We are also seeing repeated and sustained tightening of the EONIA rate during the reserve maintenance period. Add to that a collapse in the spread between EONIA and Euribor swaps—which we had regularly made note of here at the height of the crisis. In sum, we are beginning to see a timid movement towards monetary normalisation. But, even though all the factors are effectively present, it seems premature to confirm this, given the potential difficulties still present in the financial sphere, and the still very fragile economic climate which could push the ECB to take further action.

At the 3-month and 12-month horizons, we are not changing our targets for Fed Funds or refi rates, but maintaining them at their current levels. Underlying this apparent uniformity, it is clear that there are now two very different stories being written.

Long rates

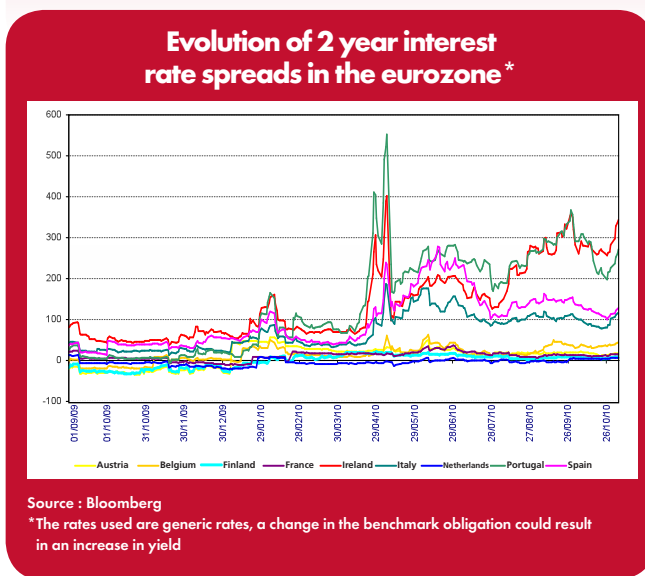
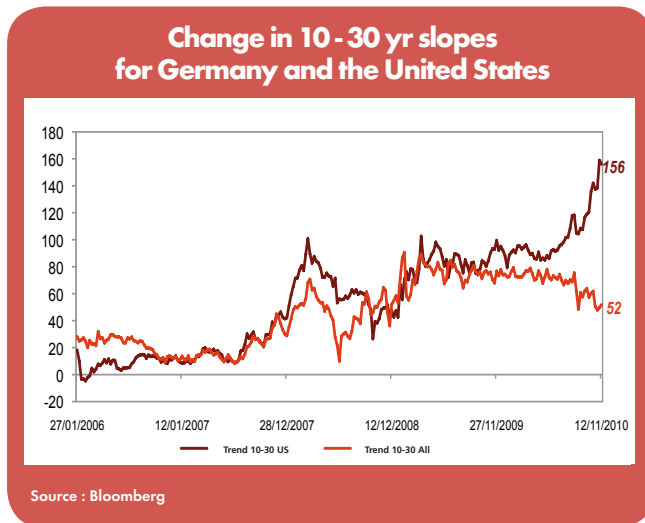
UNITED-STATES

In the U.S., the two-year rate flirted briefly with the 0.30% level several days after the Federal Reserve's pronouncements, only to tighten slightly afterward on more fundamental news. The 10-year rate saw relatively little movement, fluctuating between 2.4% and 2.8% since the end of the rally of late August which was triggered by expectations of quantitative easing. The 'losers' in the story are clearly the longest rates (not targeted by the Fed's purchasing programme), such as the 30-year rate, which has risen since late August from 3.50% to 4.25%. There was also some good news about the economy, with published figures in line with or slightly beating expectations. Consequently, we are confirming both the reduced future impact of the Fed's current programme, and the temporary improvement in fundamentals, to slightly raise our 3-month target on 10-year rates to 2.4%.

EUROZONE

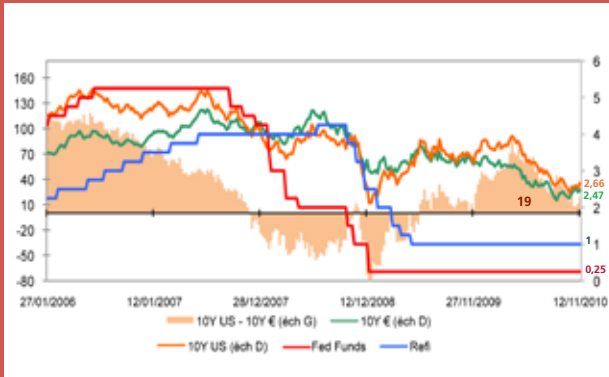
In the Eurozone, volatility between the various countries continues to be very high. On one side, we are seeing a strong return of risk aversion in respect of peripheral countries, as fears of debt restructuring mount. There is thus a quasi-permanent continuation of tightening on Ireland, whose risk premium on 10-year debt versus the German Bund now exceeds 550 basis points. Similarly, Greek debt, which had temporarily been performing well, is again climbing higher, displaying a very pronounced 'V' curve between mid-September and mid-November. The difference here is that the risk premiums on central-country debt are widening, as with France, which went from 25 bps in mid-August to 45 bps today. The only category spared for the moment is Italian debt, which is withstanding pressure and continuing to perform well.

We believe that this dynamic will continue, and are thus strictly maintaining our country allocation: remaining overweighted, for example, on Germany and Italy, and underweighted on peripheral countries. Conversely, we anticipate a latent but sustained tightening of the risk premium between France and Germany. So, though we are maintaining overexposure to interest rates in our portfolios, we are slightly raising our 3-month target for the 10-year OAT to 2.7%.



FIXED INCOME MANAGEMENT

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



Source : Bloomberg

At 12 months, however, we are retaining our targets for 10-year rates at 3% for both the U.S. and France.

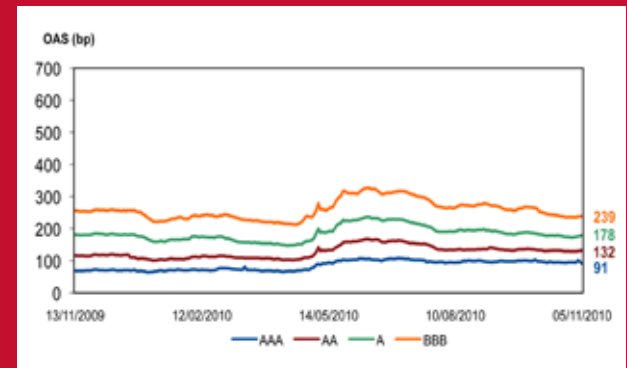
Inflation indexed

Despite an environment that favours risk assets, indexed assets have only recently, and modestly, joined the party, due to worries over possible deflation in the U.S. The second round of easing announced by the Fed will have a doubly positive effect on this asset class. First, it seeks to revive expectations of higher inflation. Second, this influx of cash should continue to favour risk assets and help indexed assets to overcome their lag in this area. Furthermore, seasonality is once again auguring well. All of these factors are pointing in the right direction, giving us a more positive view of the asset class in the U.S. and, once again, a more neutral one in the Eurozone.

Lending

It was yet another strong month for lending, which hailed both the expectation and the announcement of the Federal Reserve's plan. Financial issues continued their strong performance, led by subordinated bonds. The primary market also performed well, with recent issues mostly recording strong results in its wake. The environment remains buoyant in the short term, given the still very prevalent search for returns and high levels of cash reserves. But worries about the longer term are mounting up, both in respect of regulatory risk and the fundamental environment—whether sovereign, financial, or economic—given the recessionary nature of the announced austerity measures. We are therefore gradually reducing our position in this asset class through the end of the year with the aim of ending with an underweight position in terms of allocation and a neutral one in terms of sensitivity.

Change in risk premiums by rating



Source : Barclays Capital

Past performance is not a reliable indicator of future performance.



Philippe-Henri Burlisson
Core Management Director

Earnings outlook and market assessment

PROFITS OUTLOOK

More positive surprises in earnings announcements, but upward revisions are waning.

- Third-quarter earnings season went well and was once again dominated by positive surprises. However, this did not lead to substantial revisions of profit estimates.
- We are slightly raising our estimates of EPS growth in the U.S. for 2010 and 2011, though our 2011 forecast remains below the consensus.

Valuations in European and American markets are still attractive:

- Equity markets continued to rebound.
- The US and Europe are still lagging behind the historic valuation levels of 2003-2007, and hovering near their 2009 lows.

OTHER FACTORS

Flow funds.

- Continued withdrawals from U.S. equities funds, but steady subscriptions in Europe.
- Financial transactions (mergers and acquisitions, capital increases, reclassifications and securities buybacks) continued apace, particularly in Asia. Amongst other transactions, LVMH's increased stake in Hermès was especially noteworthy. Since January, Asian stock markets have welcomed an influx of \$132 billion into the region's businesses.

Small Caps: more attractive than ever.

Several reasons:

- The Mergers & Acquisitions cycle focuses primarily on this asset class
- Stronger earnings growth
- Major source of discounted issues

Chart analysis: Markets are tense in the short term but the trend remains positive in the medium term.

- U.S. and European indices have returned to their 'highs' of the year (in April 2010) which may trigger some profit-taking in the short term. The correction should not be severe and, in light of improved medium-term indicators, the bull trend may persist for several months.

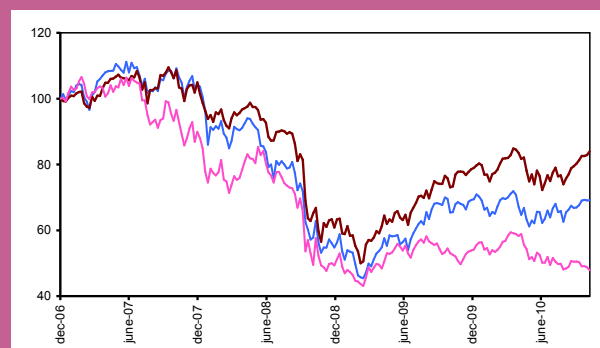
EQUITY MANAGEMENT

Performance of the main indices since the start of the year

	09/11/10	Var. 2010 in euros
DJ Euro Stoxx 50	2891	-2,5 %
SBF 250	2878	3,2 %
CAC 40	3946	0,2 %
FTSE 100 (UK)	5875	11,7 %
S&P 500	1213	12,2 %
Nasdaq	2563	16,5 %
Topix (Japon)	840	9,9 %

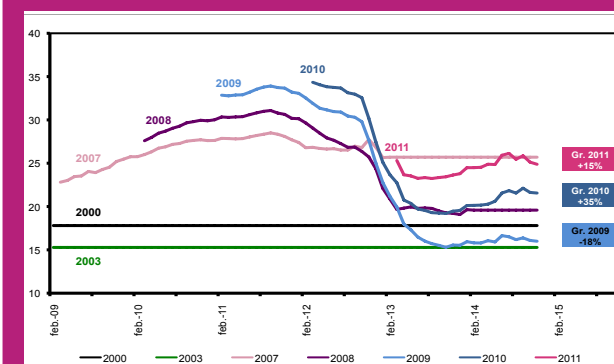
Source : Datastream

Performances of international stock market indices in local currency



Source : Datastream

Profits forecast by the consensus on Euro Stoxx



Source : IBES

good news for producers (mining, oil).

- Despite rising markets, valuations remain very attractive, well below the norms of recent years.
- These discounted valuations—in a context of low interest rates that makes other asset classes seem unattractive—should encourage the transfer of investments to risk assets, including equities. Such a transfer is already underway in emerging markets, which are seeing a record influx of capital and IPOs, with the former aiding the latter's success.
- Companies themselves are sending a positive signal, with the resumption of M&A activity and share buybacks.
- Only one cloud on the horizon: this optimism is a bit too consensual, with the proportion of bulls versus bears returning to its highest level since the crisis began (but still far off the peaks of the 2000's). Technical indicators for risk aversion, however, remain benignly neutral.
- We've thus only slightly modified our 3-month expectations, but have raised our 1-year targets, with a preference for emerging markets.

Market outlook

Outlook: An upturn in risk assets (Thank you, QE2)

- Third-quarter earnings on both sides of the Atlantic beat expectations in the vast majority of cases—as anticipated by investors. Domestic demand remained sluggish, with results driven by emerging markets. While higher commodities prices threaten the margins of intermediate goods manufacturers, this is primarily



Claire Chaves d'Oliveira
Head of Equity Management

GLOBAL BALANCED PORTFOLIO MANAGEMENT

Trend

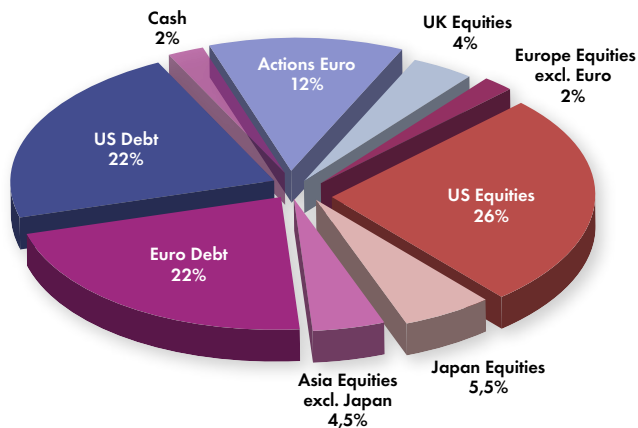
A page has been turned in the saga of 'Helicopter Ben' (Bernanke), off to flood the U.S. economy with a deluge of \$600 billion. That hasn't kept aircraft out of the headlines, though. This time, market participants had their eyes trained on the movements of a gleaming Air Force One as it landed in Seoul for a G20 meeting that was going to put an end, once and for all, to the currency war. It came as little surprise to us that it will rage on for some time, which-as an aside-will give the next G20 organiser the historical opportunity to eradicate it, forever....

For now, though, currencies continue to swing: the dollar—once considered to be on its last legs under the presumed effects of QE2-has grown healthier, at the euro's expense. For the peripheral sovereign states of the Eurozone, the time for an armistice has not yet come-far from it, in fact.

Under speculative attacks, the spreads on their debt have hit their worst historical levels (for Ireland and Portugal) or returned to them (for Greece).

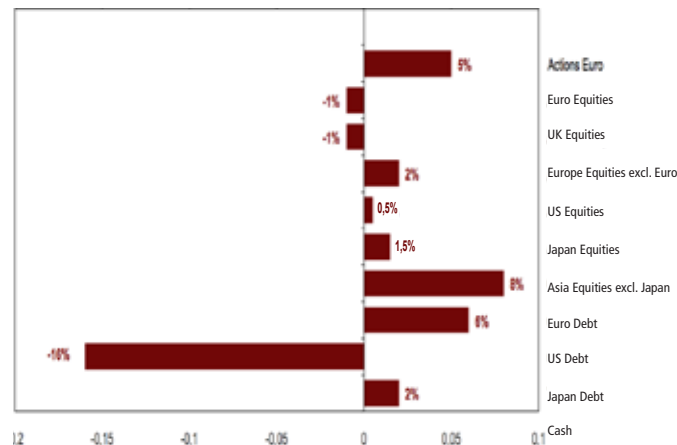
Hereafter, the risk of Ireland tapping into the European bailout fund appears increasingly likely. These fears, compounded by uncertainties over the extent of inevitable Chinese money tightening, are disrupting a trend that had up till now been very positive, and pushing the markets to consolidate. Beyond this retracing phase, it seems reasonable-in light of rather encouraging news on macro and micro economic indicators-that the year's end should still augur well for holders of risk assets.

Model portfolio



% difference

BETWEEN BENCHMARK AND MODEL PORTFOLIO



Portfolio closed on 13/11/2010. Benchmark composed of 50% JPM global hedged + 50% MSCI world. Source: Groupama AM

Allocation

GLOBAL ALLOCATION

Equities 54% / fixed income 44% / money market 2%

Overall, the environment remains favourable for equities: economic indicators are still flashing green and positive earnings surprises for publicly-traded companies are multiplying. We are nonetheless shaving one point off our equities weighting in the portfolio (actually closer to 2 points given the market effect) and re-establishing a cash position.

EQUITY MARKETS (54%) -1

■ **USA (-1)**: with the U.S. stock exchange approaching its highest levels of the year, we are taking partial profits; this puts us slightly below the benchmark's weight.

■ **Europe (-1)**: the turmoil caused by Ireland's troubles (and, to a lesser extent, Portugal's) is clouding visibility. As a corollary, the euro's slide is a positive factor for European stock exchanges; we are thus paring back at the margin.

■ **Asia (+1)**: we are slightly reinforcing both Japan (+0.5), an especially decorrelated asset class, and Asia (+0.5) whose economic dynamism is more relevant than ever.

BOND MARKETS (44%) -1

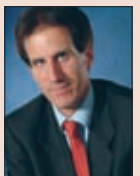
■ **USA (+2)**: U.S. bonds remain buoyed by Quantitative Easing 2: the visibility of this asset class is thus quite good, and we think that justifies its reinforcement.

■ **Europe (-3)**: we are reducing our weighting on the zone as the sovereign debt woes of its most fragile countries will continue to weigh, leading to uncertainty that is hardly conducive to outperformance.

■ **Japan (=)**: no interest.

MONEY MARKET (2) +2

We've re-established a cash position.



Jean-Louis Autant,
Head of Global Balanced Management

IN THE BLINK OF AN EYE

Our strategy

		Current level 09/11/2010	Short-term objective	1 year objective
United States	Fed Funds	0,25	😊	😊
	10 yr T - bill	2,53	😊	😞
Eurozone	Refi rate	1,00	😊	😊
	10 yr OAT	2,83	😊	😞
Japan	BOJ rate	0,10	😊	😊
	10 yr JGB	0,98	😞	😞

Sources : Groupama AM, Bloomberg

Our model portfolio in € 09/11/10

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 09/11/10

Indices 09/11/2010	Forecasts Groupama Asset Management short term (< 3 months)		a 1 yr	
	France (CAC 40)	3 914	😊	😊
Euroland (DJ)	276	😊	😊	😊
United-Kingdom (FTSE 100)	5 850	😊	😊	😊
United-States (S&P 500)	1 222	😊	😊	😊
Japan (Topix)	842	😊	😊	😊
MSCI Asia free ex-japan	576	😊	😊😊	😊😊

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

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

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