

# The & Letter

Funds & Strategy

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Completed in April 21<sup>st</sup> 2011

## EDITORIAL



### Quantitative Easing = Ponzi scheme?

The recent words of one of the oracles of the bond markets, Bill Gross, caused a stir on the markets. But, even if it is difficult to feel reassured by the U.S. Fed purchasing 60 per cent of U.S. Treasuries in the fourth quarter of 2010, it does not do justice to the relative effectiveness of the strategy pursued. The point was to, by all means, avoid “hitting the wall”, as a cyclist sometimes does when riding through the mountains—i.e. that state in which the body no longer responds to any solicitation, like an economy that has entered deflation. Holding down rates to stimulate the equity markets and, in so doing, increase household wealth, consumer spending and, ultimately, employment: such was the remedy to keep the U.S. economy from “hitting the wall”. The next six months will show whether the economy can go without the “quantitative easing elixir”. The results will weigh heavily on how historians judge the healing powers of “Doctor” Bernanke.

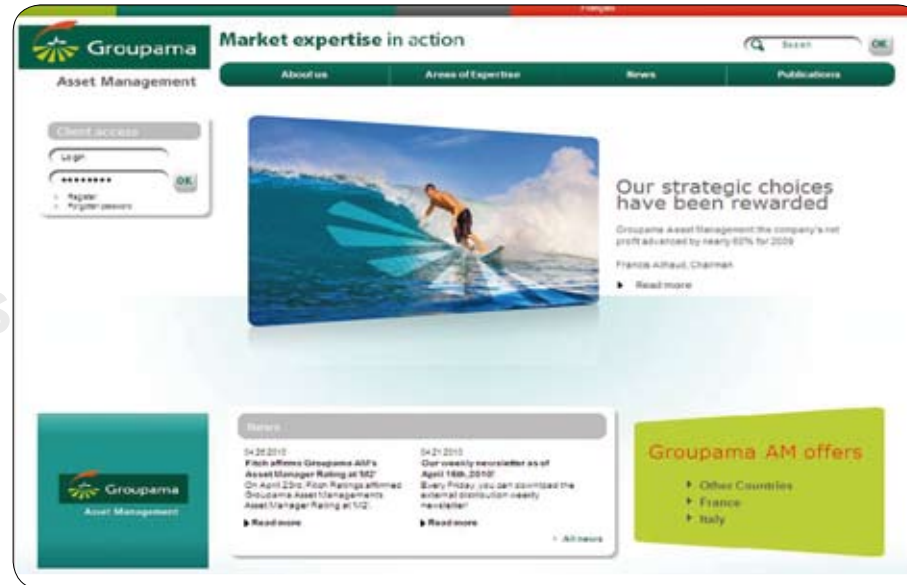
**Antoine de Salins,**  
*Chief Investment Officer*  
*Groupama Asset Management*

## The Actively Responsible Asset Manager

**Groupama Asset Management - Communication department:**  
58 bis, rue La boétie - 75008 Paris - Tel.: +33 (1) 44 56 79 18 • Fax: +33 (1) 56 59 40 93  
[www.groupama-am.fr](http://www.groupama-am.fr) • Numéro ISSN:1634-9032



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## United States

### SHARP SLOWDOWN IN FINAL DEMAND

Contrary to what was implied by the ISM indices' spectacular rise, growth will have been even weaker in the first quarter of 2011 than in the fourth quarter of 2010. Indeed, all components of final demand are slowing. Trade is penalising growth, because the significant rise in imports is more than offsetting the momentum of exports. Investment in both residential and commercial construction is falling again because of rising mortgage rates. Investment in capital equipment should continue to slow due to the deceleration of profits and substantial overcapacity. Finally, consumption, which rose 0.3% in February, is flattening, and expected to post an annualised increase of less than 2%. Without inventories, growth would be significantly lower in Q1 2011 than in Q4 2010. All these factors confirm our scenario. But the slowdown is expected to intensify in the second quarter under the dual impact inventories, which will once again penalise growth, and, especially, the surge in oil prices. The sharp decline in consumer expectations presages weak consumption, along with a marked drop in purchasing power. Inflation, now at 2.2%, is expected to be near 3% very soon. Leading indicators, like the ISM indices, are falling, and have probably peaked.

## Euro zone

### GROWTH STAGNATES DUE TO DETERIORATION OF THE PERIPHERAL COUNTRIES

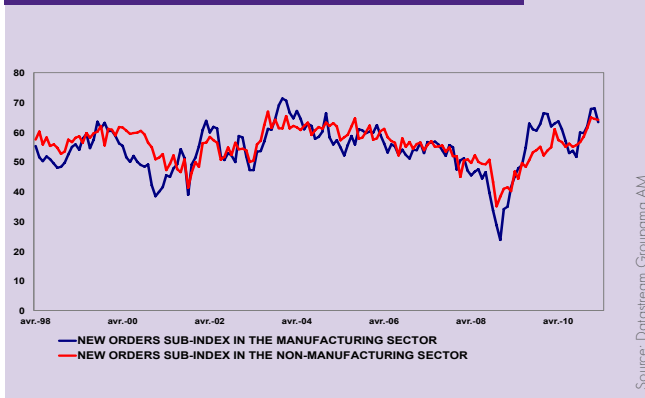
First-quarter growth likely remained at about 0.3%, unchanged from the two preceding quarters. Certainly, business in the construction sector is benefitting from the catch-up effect in France, and even more so in Germany, after the lag accumulated in the previous quarter due to the cold. But despite the momentum in exports, driven by the rebound in world trade on the back of major restocking of intermediate goods, industrial production slowed in the first quarter. Consumption is moderating throughout the eurozone, with the exception of France and Germany. In effect, it is still being penalised by the peripheral countries (Greece, Ireland, Portugal and Spain) where the sovereign debt crisis is worsening: all, except for Spain, have been downgraded several notches by rating agencies. Portugal is about to become a speculative investment for Standard & Poor's and Fitch, as will Ireland for Moody's, whereas Greece already is. Unsurprisingly, Portugal has decided to appeal to the EU for assistance. We expect €50 billion to €60 billion in support, which should be finalised within the next few weeks. Faced with this two-headed eurozone, the ECB decided to raise its key rate, while core inflation fell to 1%, despite the jump in energy prices that has pushed headline inflation to 2.6%.

## Japan

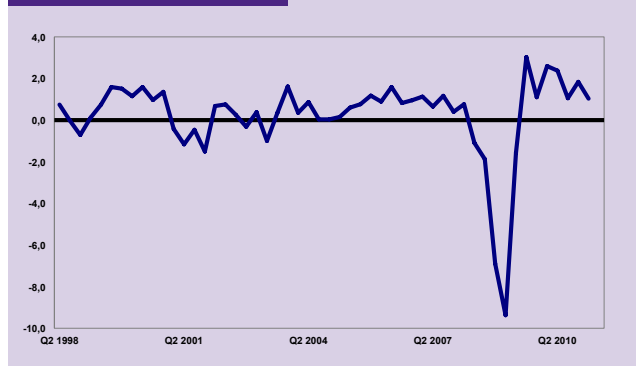
### A COLLAPSE IN ACTIVITY

Production and new orders sub-indices of the PMI manufacturing index have each lost 15 points and fallen below 40, pointing to a 10% drop in manufacturing production in the coming months. The drop should have been much steeper: results were biased upward because only 5% of businesses in affected areas responded, resulting in a 65% response rate to the survey instead of the customary 80%. In addition, the PMI reflects the manufacturing sector alone and does not include the energy and power sector where 15% of generating capacity has gone offline or can no longer be operated since the earthquake. Finally, the small business activity and confidence index shows an even more dramatic drop in services and trade – to the levels of the severe recession of 2001 or the financial crisis of 2008. We've factored in a contraction in GDP of 2% in the second quarter. Recovery from reconstruction spending is not likely to happen before the last quarter: to cope with a 20% to 30% shortfall in generation capacity, power outages will affect businesses significantly this summer and will require them to limit their production. Overall, we have factored in a 1% contraction of GDP in 2011, but it could be much higher.

United States: ISM indices reverse course



Euro zone: slowdown in industrial production (QTRLY CHG, %)



Japan: small business activity and confidence index (Economy Watcher Survey)



# CORE MANAGEMENT



## Money Market Management

### Markets under the influence of investment flows

Whether equity or credit, the markets for risk assets seem impervious to bad news. This situation reflects a major reallocation of assets toward these markets in the ever-present search for more significant returns, fuelled mainly by the rebound of M&A activity on the equity side, and of primary market issues on the credit side. While we are factoring in the importance of these supports in a medium-to-long-term perspective, we still find it crucial to maintain a cautious stance in the short term. In respect of bonds, caution is also the watchword, with Mr Trichet having begun to raise the refinancing rate, as expected, and the situation of the peripheral countries still in need of a long-term solution.

P-H.B

### CENTRAL BANKS

#### The European Central Bank sets the ball rolling

Rising inflation due to soaring commodity prices, especially for oil, is top-of-mind for central bankers.

Unsurprisingly, at its meeting of 7 April the European Central Bank raised its refi rate by 25 basis points, to 1.25 %. This sent a strong message to the markets and economic agents faced with rising inflation in the eurozone and the risk of its pervading the economy.

The ECB no doubt chose to intervene early so as to avoid more harsh action later. Nevertheless, monetary policy remains very accommodative; further increases are to be expected, but without urgency.

To cope with resurgent inflation, other central banks reacted according to their mandate.

For the BoE, growth is still too fragile to consider a rate hike.

The Fed, meanwhile, is responsible for growth and full employment, which currently excludes raising interest rates. Nevertheless, the monetary status quo is vacillating. More and more voices on the Federal Open Market Committee are demanding the normalisation of U.S. monetary policy.

We expect a rate increase of 25bp in the eurozone in June, followed by another hike by the end of the year.

In the U.S., normalisation will take place over the more or less long term. We believe that the first rate hike will happen within a year.

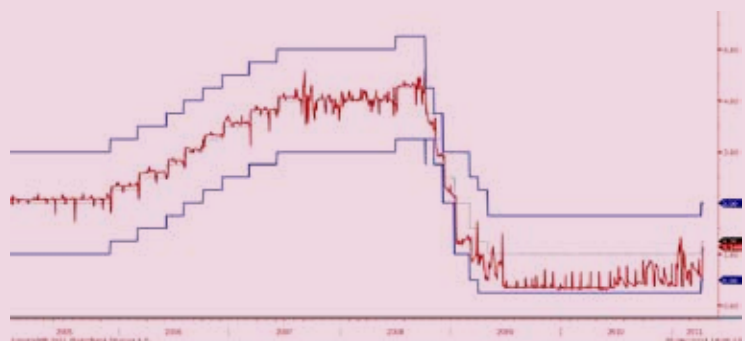
### A WORD ABOUT THE INVESTMENT STRATEGY

#### Investment policy

Expectations of an ECB rate hike sent Euribor and 3-month swap rates higher, while the Eonia remained stable. The widening of the 3-month swap spread against the Eonia is thus creating good investment opportunities at a fixed rate; for this reason, we are maintaining a share of fixed-income investments in our portfolios.

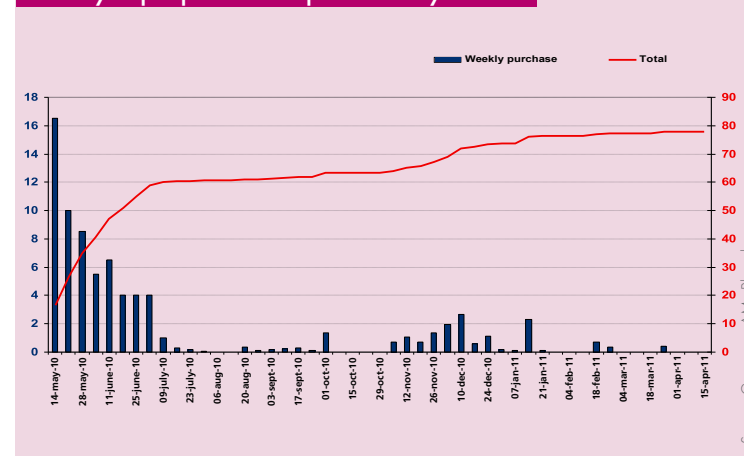
D.B

Corridor, refinancing Rate & EONIA  
Average EONIA from 01/01/11 to 31/03/11 : 0.66 %



Source: Bloomberg

History of peripheral debt purchases by the ECB



Source: Groupama AM - Bloomberg

#### 1- Philippe-Henri Burlisson

Core Management CIO

#### 2- Diana Breton

Head of Money Market Management

#### 3- Gaëlle Malléjac

Head of Fixed Income Management

#### 4- Claire Chaves d'Oliveira

Head of Equity Management

#### 5- Claire Bourgeois

Head of Equity & Fixed Income ALM

## Fixed Income Management

### LONG RATES

■ **The succession of major events which have accumulated in recent weeks**, including the Libyan crisis and the events in Japan, have, at this stage, had little impact on the so-called “risky” asset classes. If these new risks initially caused a substantial “flight to quality”, prompting a fall in U.S. and German bond yields, this effect quickly faded. Fundamentals quickly returned to centre stage with, at the fore, inflationary pressures, exacerbated by high oil prices.

This focus on the risks weighing on prices is key to the discussions of the central banks, led by the ECB. Bond yields thus resumed an upward climb on both sides of the Atlantic.

The inflationary theme pleads for the continuation of rising short-term yields; this movement will be reinforced in the U.S. by the scheduled end of QE2 at end-June.

For peripheral sovereign debt, worries persist, despite clear advances in managing the crisis. The principle of raising the effective loan capacity of the European Financial Stability Fund (EFSF) to €440bn was endorsed. Next, the European Stability Mechanism (ESM), which will take over from the EFSF in mid-2013, was adopted with an effective loan capacity of €500bn

and the possibility of intervening on the primary bond markets of countries in difficulty. In addition, the eurozone states have adopted the “Pact for the Euro” and agreed to a stricter reform of the Stability Pact. However, these resolutions do not provide immediate answers to questions about the ability of some eurozone countries to credibly propose long-term changes to their public finances. The resignation of the Portuguese Government during the month illustrates this. Accordingly, the question of solvency in respect of Greece, Ireland and Portugal remains open. We are still underweight on these countries.

### CREDIT

■ **Once again, the credit market has shown great resilience** to multiple shocks, posting a sharp outperformance in recent weeks. Though numerous risks remain, the still-buoyant fundamentals, frenetic search for performance, and pronouncements on European aid mechanisms are supporting the asset class.

### INFLATION-INDEXED ASSETS

■ **Inflationary pressures are ever present.** The coming figures are expected to show a further rise in inflation, driven by persistently high oil prices. Nevertheless, the recent strong

showing by the asset class, attainment of expected inflation levels, and the ECB’s actions to curb inflation expectations justifies a neutral position on the eurozone.

### A WORD ABOUT THE INVESTMENT STRATEGY

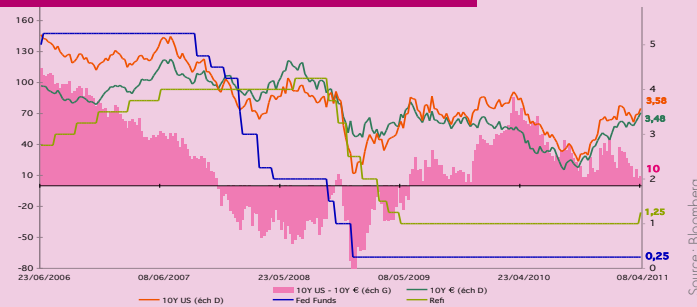
The continued rise in long rates expected in the next few weeks favours the adoption of a new underexposure to rates, primarily on intermediate maturities.

Our country allocation continues to underweight countries for which solvency problems persist: Greece, Portugal and Ireland. The country allocation was revised mainly on Italy, which we are now overweighting for the carry trade. The allocation on Spain remains neutral, with a preference for maturities of more than 5 years.

On credit, we raised our credit allocation and sensitivity to neutral. We are overweighting corporate debt from the “core” countries and BBB-rated debt for the carry trade, mainly on the 5-7 year segment.

G.M

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



Changes in 10-years rate spreads in the peripheral countries of the eurozone



## Equity Management

### EARNINGS FORECASTS AND VALUATIONS

#### ■ Earnings forecasts: the outlook darkens on Europe

• We are maintaining our earnings forecasts below the consensus: margin compression, disruptions related to the earthquake in Japan.

#### ■ Valuations: equity markets remain attractive, but the rebound in valuations is running out of steam...

• Europe is nearing the lower bound of the historic valuation levels of 2003-2007, whereas the U.S. is still far from it.

### OTHER FACTORS

#### ■ Cash and flows: slowdown of inflows into equity funds, but booming mergers and acquisitions

• Acceleration of global mergers and acquisitions (727bn in Q1), featuring significant premiums

#### ■ Small Caps: following a painful sector rotation, a return to outperformance?

• The M&A cycle is focused mainly on this asset class, as exemplified by the Solvay/Rhodia transaction  
• A comeback of emerging countries in investment flows

### ■ Chart analysis: a coming period of consolidation

• In the very short term the markets have the potential to extend their bull trend, but the momentum is slowing. A broader period of consolidation is emerging in the coming months when we could once again see significant declines, probably in the early summer?

### OUTLOOK

#### ■ Pausing to catch their breath?

• Macroeconomic news confirms the projected upturn in the U.S., while at the same time Europe struggles to benefit from the German economic engine. A dichotomy is growing between the two regions, with the corollary that expectations for earnings growth are deteriorating in Europe, but still improving in the U.S.

• The negative impact of high commodity prices on corporate margins, as well as on consumption, and the difficult fiscal outlook for the states confirm our forecasts of earnings growth below the consensus.

• It seems that the market rally following the earthquake in Japan—low in volumes and with listless volatility—is being slowed by pressing technical factors (deflated appetite for risk, boundary resistance, weak inflows) and decelerating fundamentals (revaluations, profit guidance), despite some support from M&A activity.

• Against this backdrop, we are maintaining our short-term expectations, which, due to the recent rally, points to a pause in the equity markets. Long term, we are beginning to raise our targets, owing to ever-abundant cash and the absence of obvious alternatives to the equity markets, still with a bias for the U.S. as opposed to Europe.

### A WORD ABOUT THE INVESTMENT STRATEGY

■ **The expected pause in the equity markets will lead us** to take profits on a number of sectors, either due to a lack of potential upside, or out of concerns over a worsening outlook. More than ever, stock picking takes priority in our portfolios, with an emphasis in each sector on players capable of maintaining their pricing power.

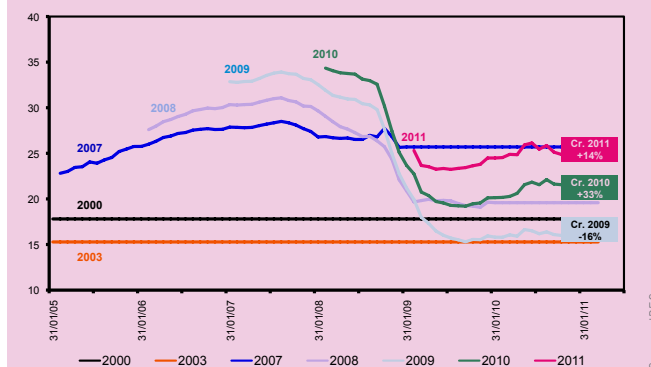
C.CO

### Performance of the main indices since the start of the year

	07/04/11	Var. 2011 in euros
DJ Euro Stoxx 50	2793	0 %
SBF 250	2798	-0,1 %
CAC 40	3810	-0,1 %
FTSE 100 (UK)	5718	-4,9 %
S&P 500	1279	-3,5 %
Nasdaq	2644	-5,4 %
Topix (Japon)	830	-12,4 %

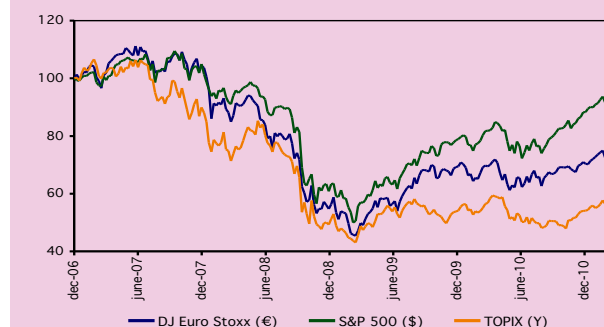
Source: Datastream

### 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

### FINALLY: PROFIT-TAKING!

The strength and magnitude of the post-Fukushima stock market rebound were enough to plunge a large number of participants (including us) into a state of perplexity. Certainly, the reasons to see the glass "half full" remained present: These included the well-known assertions related to the valuation levels deemed appropriate by the markets and, especially, to those based on the acceleration of M&A activity, a theme which is undoubtedly driving the markets today.

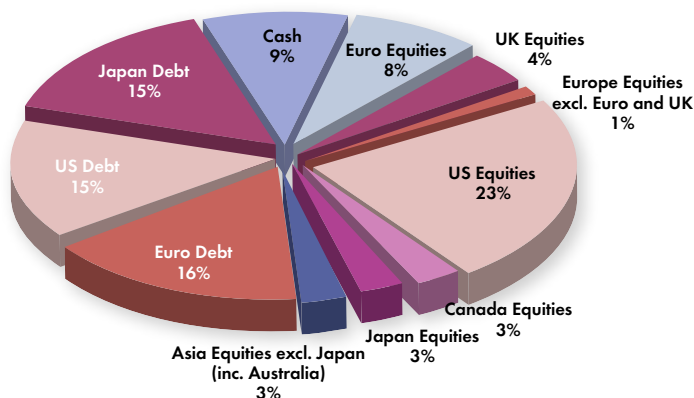
But on the "glass half-empty" side, the reasons to remain cautious were legion, starting with the notion that is central to any interest in the equities markets: that of profits. These are logically expected to be lower after an exceptional 2010, but it's impossible not to notice that the first results released in the U.S. were disappointing and failed to reassure as to their supposed resilience for the entire year in a less-favourable context.

On this side of the Atlantic, the eurozone is itself far from being outdone in terms of uncertainties; indeed, the pressure is stronger than ever on the debts of the weakest peripheral sovereign states. This is down to speculation (despite the traditional denials of some prominent leaders) about a restructuring of Greek debt—fears that, unfortunately, appear to be more well founded with each passing day.

Lastly, to round out our review of global uncertainties, add to these the rise of inflationary pressures observed throughout the world and, more specifically, the fact that we do not know all that much about the emerging countries, especially China.

This environment—complicated to say the least, but not disastrous—therefore pleads for a short-term correction.

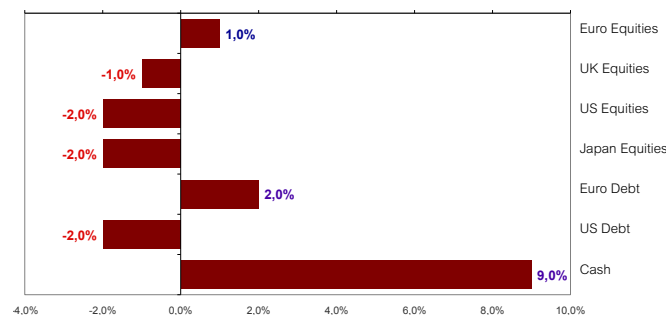
## Model portfolio



Portfolio closed on 14/03/2011. Benchmark composed of 50% JPM global hedged + 50% MSCI world. Source: Groupama AM

## % difference

### BETWEEN BENCHMARK AND MODEL PORTFOLIO



## Allocation

### GLOBAL ALLOCATION Equities 45% / Rates 46% / Cash 9%

#### EQUITY MARKETS (45%)

■ **USA (-1.5%):** As this is the single geographical region still in line with the benchmark's weighting, we decided to lighten the allocation. The scheduled end of QE2 could pose a genuine threat, to the extent that the programme has been the real catalyst for the rise in U.S. stock exchange. In addition, it is clear that, in light of initial announcements, the current earnings season may disappoint market participants.

■ **Europe (-0.5%):** The problems that are resurfacing on peripheral debt could lead to a "regional" selectivity that would be unfavourable for the eurozone as a whole. At the same time, the monetary tightening now clearly engaged by the ECB is hardly more positive.

■ **Asia (+2%):** We remain largely underexposed to Japanese equities and at this stage do not recommend strengthening our remaining positions. Since we consider that the Japanese market rebounded too strongly after the earthquake, we preferred to reinvest in equities in Asia-excluding-Japan, a region where growth remains strong and where we can hope to see the beginnings of a slight downturn in inflation.

#### INTEREST RATE MARKETS (46%)

■ **USA (=):** U.S. bonds continue to be resilient despite the uncertainties associated with "post-QE2" and the feared repatriation of capital by Japanese investors. We are maintaining the allocation.

■ **Europe (-1%):** Paring back: Whilst the interest rate markets in the core countries may circumstantially benefit from a phase of flight-to-quality from the equity markets, our expectations of a mild persistent tension led us to reduce the allocation.

■ **Japan (=):** Our reallocation on Japanese bonds proved judicious, given the resilience of the Japanese market to the tensions arising on the global bond markets.

#### CASH (9%)

A 1% increase due to the reduction of the interest rate allocation.

# IN THE BLINK OF AN EYE

## Our strategy

		Current level 07/04/11	Short-term tarjet	1 year tarjet
United States	Fed Funds	0.25	😊	😊
	10 yr T - bill	3.55	😞	😞
Eurozone	Refi rate	1.00	😞	😞
	10 yr OAT	3.75	😞	😞
Japan	BOJ rate	0.10	😊	😊
	10 yr JGB	1.32	😊	😞

Sources : Groupama AM, Bloomberg

## Our model portfolio in € 07/04/11

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 07/04/11

Indices 07/04/2011	Forecasts Groupama Asset Management short term ( < 3 months)		a 1 yr
	France (CAC 40)	4042	😞
Euroland (DJ)	289	😞	😊
United-Kingdom (FTSE 100)	6007	😞	😊
United-States (S&P 500)	1333	😞	😊
Japan (Topix)	840	😞	😊
MSCI Asia free ex-japan	583	😞	😊

Sources : Groupama AM, Bloomberg

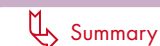
## Sector Outlook

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

## COMMERCIAL CONTACTS

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



Groupama Asset Management  
The Letter Funds and Strategy - N°103

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Alberico Potenza / +39 06 80 66 02 61 / apotenza@groupama-am.it

Fabrizo Salvi / +39 06 80 80 361 / fsalvi@groupama-am.it

Delphine Foucher / +39 06 80 66 38 41 / dfoucher@groupama-am.it



Groupama Asset Management SGR S.P.A - Via Savoia, 23 - 00198 ROMA - ITALIA