

The & Letter

Funds & Strategy

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May 2011

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Completed in May 21st 2011

EDITORIAL



Choosing between two haircuts

It is now clear that Greece will be incapable of returning to the markets for refinancing in 2012, as initially anticipated. The outline of a new EU and IMF financing package, as well as a stronger set of conditions, are gradually being laid out. The markets, a large number of analysts and the English-speaking financial press are clamouring for the quick fix of a restructuring of Greek debt. Nevertheless, they are forgetting that the euro has been "sold" to international investors as the currency of a stable economic space that is free of risk, whether of inflation (independent ECB) or credit-related (stability pact). On this last point, the fact that commitments have not been completely kept does nothing to mitigate the loss of credibility for the entire eurozone that would result from a restructuring. A haircut on Greek debt would also be a haircut on the political capital invested in the economic and monetary union, the first achievement by the European Union in 20 years. European decision-makers must therefore choose between two haircuts.

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United States

NET SLOWDOWN IN THE 1ST HALF

Growth weakened significantly in Q1, dropping from 3.1 % to 1.8 %. It was penalised by a return to normal of private consumption, which grew at only a 2.7 % rate, versus 4 %, and by the tightening of public spending, which lost 1 point in its growth rate. Finally, real estate investment suffered from an increase in long rates, dropping at an annual rate of some 25 % in commercial, although residential held its correction to 5 % through intense price discounting. The slowdown is expected to continue, affecting large companies in particular, as indicated by the sharp reversal in the ISM non-manufacturer index. Although business investment, which was weak in Q1, should have been more dynamic, inventories are not expected to inflate growth. Residential real estate is likely to continue to decline: the number of new mortgage loan applications is falling, as is broker confidence. Only a significant drop in mortgage rates would improve the real estate market, both residential and commercial. Finally, household consumption is expected to slow further, to only 1.5 % in Q2 and Q3, due to lower job creation and a rise in inflation from 2.8 % to 3.5 %. Overall, growth is not expected to exceed 1 % in Q2.

Euro zone

PEAK GROWTH IN Q1

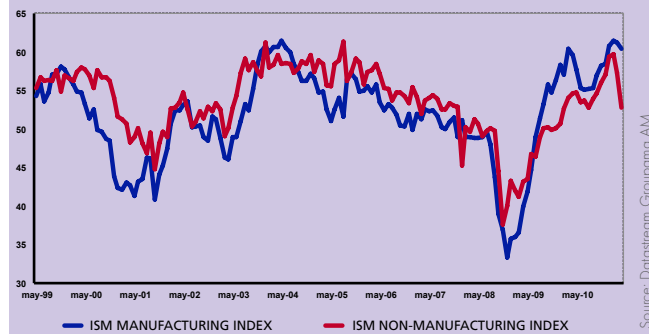
According to the flash estimate, which provides no breakdown, growth was significantly more dynamic than expected in Q1, rising from +0.3 % to +0.8 %. It was probably driven by the catch-up in activity in construction, which was handicapped at end-2010 by severe cold, and by the global trend toward industrial restocking. On the other hand, it was negatively affected by the tightening of consumption in peripheral countries, due to austerity plans. Prospects are clearly less positive for Q2. Leading indicators (PMI, European Commission surveys) are declining in all sectors, particularly in construction and retail trade. The increase in long rates has worsened real estate credit conditions. Household consumption is expected to decline under the impact of the drop in purchasing power: the forthcoming increase in inflation, from 2.7 % to 3.2 %, will not result in additional wage increases. Second-round effects are thus virtually non-existent: production price increases for final goods (equipment, durable goods) are very low, while the pricing prospects for manufacturers are turning down. The sharp decline in production prospects in all countries, including Germany and France, points to lacklustre growth in Q2.

Japan

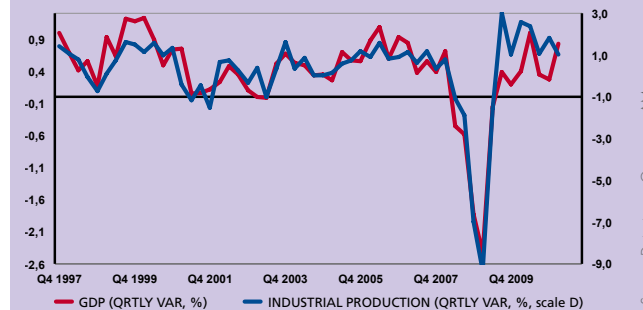
DROP IN ACTIVITY, RECOVERY AT YEAR-END

Industrial production dropped over 15% in March, led by the automobile sector (-50%) and semiconductors (-30%), which suffered from the sharp decline in demand and component shortages. The disorganisation in production may be seen in the nearly 8% drop in exports in March. The non-manufacturing sector has also been affected: the activity indicator for small, non-manufacturing companies dropped 20 points, returning to the level of October 2008. All these indicators confirm a decline in GDP in Q2, after an annualised contraction of almost 4% in Q1. Activity is expected to rebound, thanks to exports, then decline again due to household consumption. Salary purchasing power is expected to deteriorate, a direct consequence of the fall in activity. The number of hours worked and the average salary are already decreasing. Employment will likely follow. A recovery is expected in Q4, driven by reconstruction spending: an initial budget allocation of €35 billion, out of the projected €250 billion, has already been applied. The remainder of the financing continues to be a subject of discussion between the government and deputies.

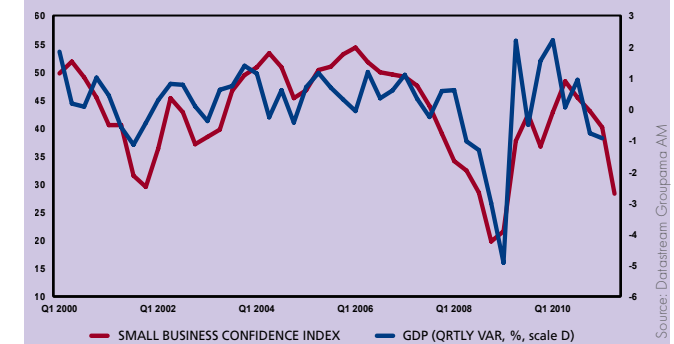
United States: ISM indices are in the process of a sharp rebound



Euro Zone: GDP in clear acceleration due to the catch-up effect in the construction sector, while industrial production slows



Japan: GDP expected to fall in Q2, after a slight decline in Q1



CORE MANAGEMENT



Money Market Management

Markets bottled up

Anaemic volumes on a CDS or a Greek bond would be enough to allow us to imagine a revaluation of the entire portfolio, throwing the market into a panic. An end to the flows, the QE2 purchase in the US, and the supply of liquidity from the ECB are critical factors for rates. A recovery in mergers and acquisitions and an overall under-weighting are systematically propping up the equities markets. For its part, credit is holding out against everything, with investors still long on liquid assets and with sharp declines in the months to come. Even the inter-bank market has experienced violent jolts related to the building up of bank reserves. Although it is important to take these factors into account, we must not forget the fundamentals that argue for a prudent stance on the macro side, and a reasonably positive one on the micro side.

P-H.B

CENTRAL BANKS

M. Trichet is not showing his hand

After offering the bait of a return to normalcy in monetary policy in April, the European Central Bank calmed the waters by making it understood that it would not intervene before July.

The risk factors are indeed there. In the face of a growing inflationary risk, the sovereign debt crisis remains unsettled, dampening the Central Bank's willingness to take action.

The diagnostic will be completed before the next meeting, which will be held to discuss topics such as inflation and growth, naturally, but also the new topic of the level of the European currency. The trend in rate increases is expected to be very gradual.

In any case, M. Trichet offered a strong reminder that monetary policy in the Euro zone would remain accommodating.

The money markets acknowledged this change of tone, and short rates have dropped back.

We maintain our expectations of two rate increases of 0.25 % on the 12-month horizon, thus bringing the Refi rate to 1.75 %.

A WORD ABOUT THE INVESTMENT STRATEGY

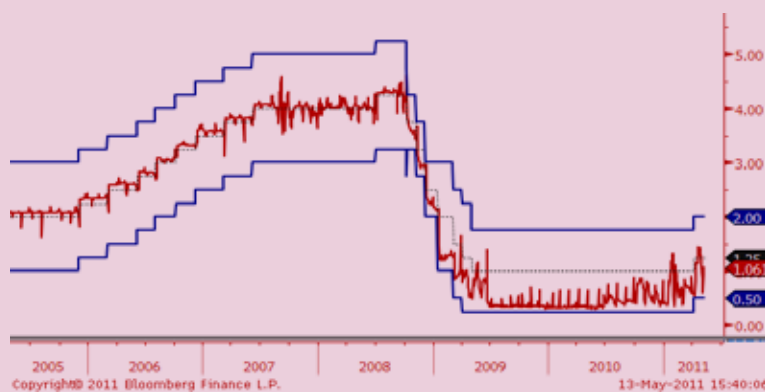
Management policy

EONIA's volatility has been sharp this month, fuelled by the banks' desire to quickly build up their reserves, as well as by the surplus reserves.

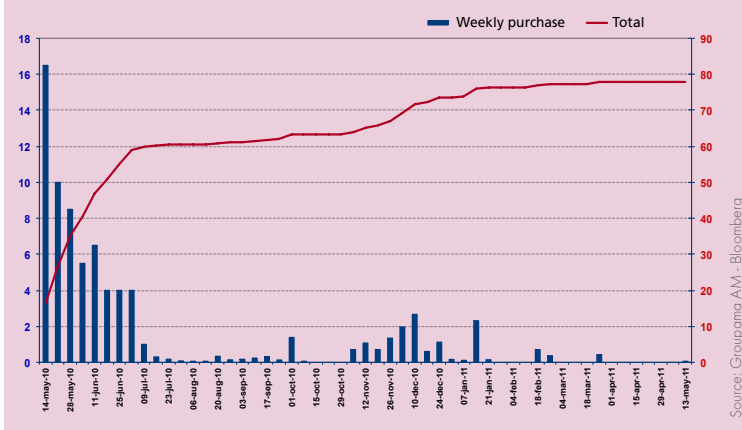
We have increased the share of variable rates in our portfolios, to reflect the trend in money rates.

D.B

Corridor, refinancing Rate & EONIA
Average EONIA from 01/01/11 to 30/04/11 : 0.75%



History of peripheral debt purchases by the ECB



- 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 eurozone's sovereign debt crisis is making the headlines again.** Fears on the debt and solvency of certain countries, especially Greece, have increased with the announcement of new upward revisions in projected public deficits for 2010. However, the rhetoric on risk premiums in the three countries that are on European life support has been especially fed by rumours of a restructuring of Greek debt, which are constantly denied by the authorities.

We do not expect a restructuring of the Greek debt in the short term, and foresee an official announcement of an extension of the rescue plan in the weeks to come. The authorities are trying to gain time.

In directional terms, the factors putting upward pressure on short-term rates are still present: no further acceleration in growth is expected on either side of the Atlantic, and higher inflation surprises are expected to continue until the middle of summer. In the eurozone, we foresee a pause in the sovereign debt crisis (with the announcement of the plan), which will no longer prop up short-term rates in the core countries. In the US, suspension of the Fed's treasury purchases upon expiration of the QE2, even though anticipated, will no longer constitute automatic support for US rates.

Given current rate levels (down for the past month) and the end of the acceleration of growth, we are returning to our 10-year rate targets over the next three months, at 3.5 % in the US and 3.70 % in France. Our one-year targets remain unchanged.

CREDIT

■ **Credit performance remains positive, despite rumours of Greek debt restructuring.** Risk premiums continue to tighten, with financial and BBB-rated debt taking the lead. The financial sector has been particularly well supported by the first capital increases announced by several banks. This resilience in the credit markets, the quest for returns by investors and improved banking fundamentals (capital increases) indicate strong support for this class of assets. We remain tactically positive.

INFLATION-INDEXED

■ **Inflation-indexed euro bonds performed in line with nominal obligations.** Although inflation levels have dropped back in recent weeks, they were offset by very positive carrying rates. In other markets, the US saw the most favourable performance, followed by Japan.

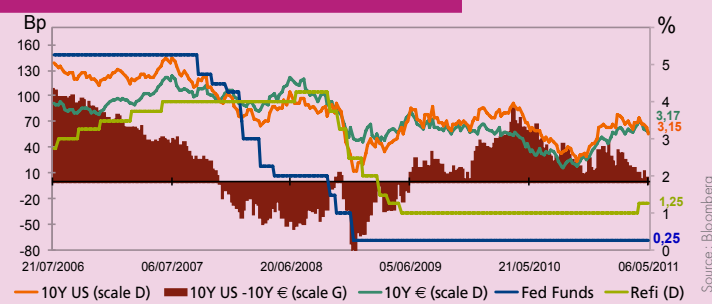
Inflationary pressures remain present at the global level, and we foresee a continuing increase in inflation in the months to come. We favour US and Japanese indexed instruments, and remain neutral on the eurozone.

A WORD ABOUT THE INVESTMENT STRATEGY

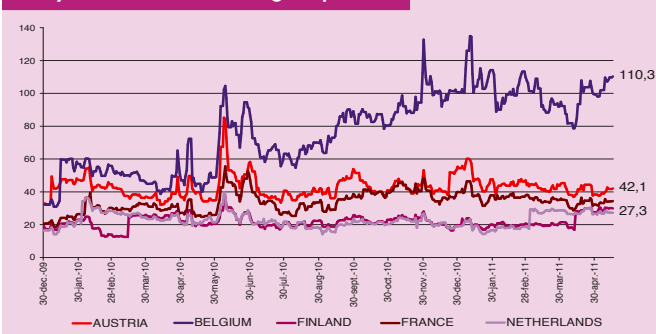
■ **We remain under-exposed in our portfolios in a rising rate environment** on both sides of the Atlantic. In the eurozone, under-exposure has extended to short maturities, in expectation of an upward trend in leading rates in July. Our rate exposure is neutral in the 10-year zone, given the flattening trend in the 2-10 year segment. Our country allocation continues to underweight the three countries that have called for European aid, Greece, Portugal and Ireland. Our allocation to Spain increased to overweighting, and Italy remains over-weighted. We expect a continuing lack of correlation between the risk premiums of these two countries, and those of the other peripheral countries. Regarding credit, we are increasing our credit sensitivity to 105 %, given the favourable environment, especially on senior and LT2 banking. We remain over-weighted on BBB corporate debt for holding purposes, especially in the 5-7 year segment.

G.M

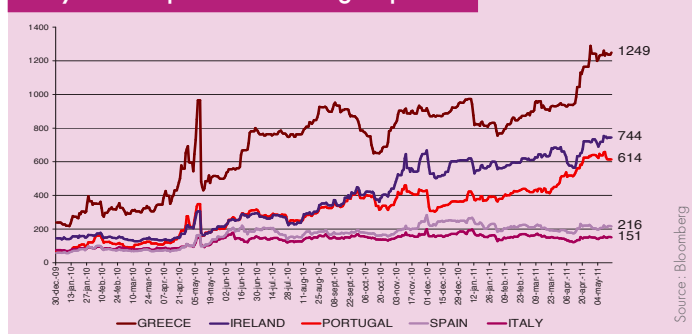
Change in the short and long rates in the United States and the Eurozone



10 year Core Sovereign Spreads



10 year Peripheral Sovereign Spreads



Equity Management

PROJECTED RESULTS AND VALUATIONS

■ **Trends still good for the US, but negative momentum for Europe and particularly Japan**, where the “ %NetUp” is negative (more downward revisions than upward). In addition to commodities prices, the cost of labour, higher depreciation charges, the price war, and the decline in public spending are expected to weigh on margins.

■ **The rebound in valuations eased up in April**

Europe is bumping against the low point of the 2003-2007 historic valuation levels, although the US is still very far from doing so.

OTHER FACTORS

■ **Small-caps: The abrupt rotation hampering small caps at the start of the year did not last.** Indeed, among these stocks, the end of banking issues rebound, poorly weighed, and the return to grace of industrial issues, allowed this class of assets to regain its trend of over-performance.

■ **Flows: a slowing in flows to European and US markets**, but a return to emerging markets. By contrast, a great deal of appetite on the business side, with strong merger and acquisition activity.

■ **Graphic analysis: consolidation period to come.**

The trend has exhausted itself, and we are probably at mid-term highs. There is a risk that the summer will become a period of consolidation. For now, however, long-term trends are not in question, and remain positive.

OUTLOOK

■ **Many questions, few answers...**

- This spring, the gap continues to widen between European and US prospects: in Europe, expected earnings will barely improve, while in the US momentum remains positive. The sovereign debt crisis in the eurozone threatens the financial sector, particularly with greater needs for capital.

- Once again, the micro-economy has carried and supported the markets, in terms of both results and the increasing number of mergers and acquisitions.

- Doubts remain, however, about the macro-economy, with H2 expected to be less dynamic than H1. Moreover, what will happen when the QE2 expires? Can the equity markets continue to advance without a cash infusion, even though, at the same time, the US cannot allow any new deficits?

- These multiple uncertainties prevent the equity markets from advancing beyond the 2010 highs, even though they fortunately remain supported by a still vigorous mergers and acquisitions trend and, by default, a lack of attractive investment alternatives.

- We have therefore not changed our short- or long-term targets, and remain cautious on the equity markets in coming weeks, for all regions.

A WORD ABOUT THE INVESTMENT STRATEGY

■ **More than ever, we favour companies with strong pricing power**, which is often synonymous with strong brands (hence our more favourable view on automobiles and durable consumer goods) and oligopolistic situations (chemicals, certain technologies). We are less confident of Retail, Telecom Operators and Utilities.

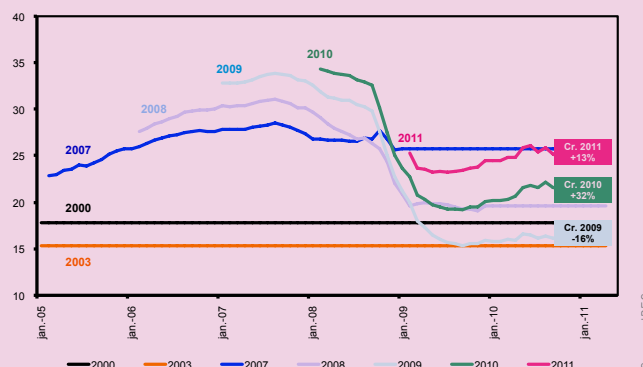
C.CO

Performance of the main indices since the start of the year

	09/05/11	Var. 2011 in euros
DJ Euro Stoxx 50	2902	3,9%
SBF 250	2954	5,5%
CAC 40	4007	5,3%
FTSE 100 (UK)	5943	-1,4%
S&P 500	1346	0,7%
Nasdaq	2843	0,8%
Topix (Japon)	853	-10,3%

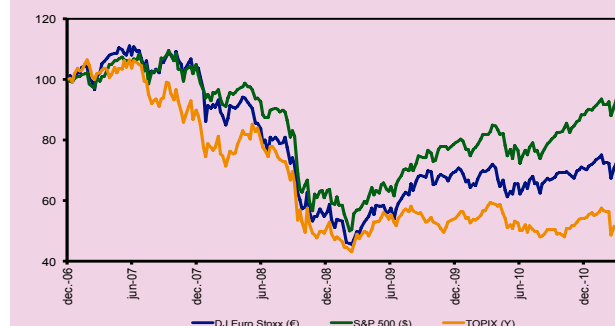
Source: Datastream

Profits forecast by the consensus on Euro Stoxx



Source: IBES

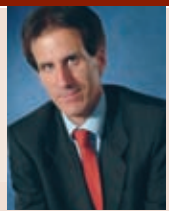
Performances of international stock market indices in local currency



Source: Datastream

GLOBAL BALANCED PORTFOLIO MANAGEMENT

Jean-Louis Autant,
Head of Global Balanced Management



Trend

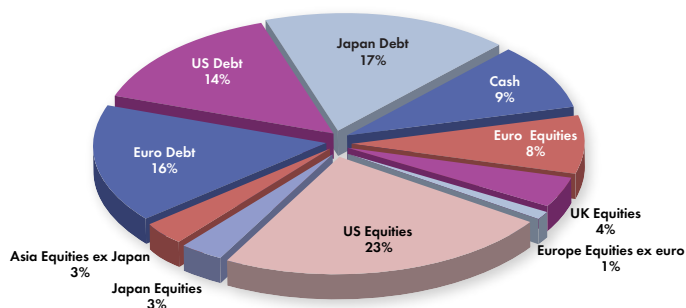
Corrugated sheet metal, saw-teeth or Russian mountains are the images generally used to describe recent market performance. Although the first two expressions appear particularly suitable to the movements occurring in all the "developed" stock markets, the Russian mountain metaphor is absolutely appropriate for the somewhat conflicting paths of the foreign exchange and commodities markets in recent weeks; thus, the turbulence encountered last 5 May will remain in the record books: a barrel of oil that drops some 10 dollars in a single trading session is anything but a common event. Moreover, tallying the list of commodities affected by this spectacular sell-off would be tiresome, but we vividly recall silver's stunning collapse, which occurred during the course of just a few hours.

It is difficult, however, to maintain that the jolts occurring in the commodities markets are a direct result of concerns related to the slowing rate of world growth. The latter is clearly suffering from

the consequences of the Japanese earthquake in the Asia region, while on the other hand, Europe is tending to produce positive surprises, driven (as usual) by Germany and (what is somewhat more unusual) France.

Regarding performance viewed as corrugated sheet-metal, the major world markets have witnessed rather symmetrical growth: stock markets are regularly beginning to butt up against the highs in their fluctuation range, while at the same time, bond markets are dropping to their lows, far from being affected by the overall increase in inflation rates, post-QE2 projections or the yet more uncertain outcome of the budget discussions in the US. In a context such as this, we should celebrate the performance of the US stock market which, driven by positive earnings reports, has posted its 8th consecutive month of appreciation..

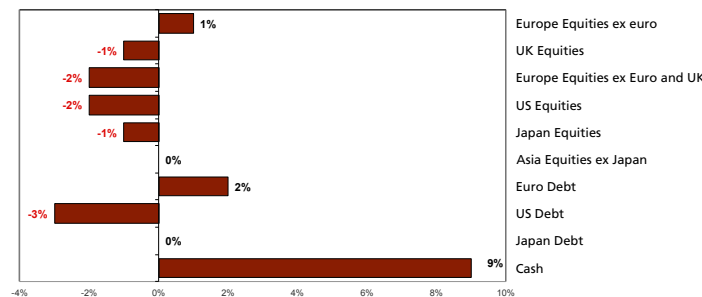
Model portfolio



Portfolio closed on 14/05/2011. 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%

In terms of allocation, the weightings of the various asset classes vary only slightly this month. We note the slight adjustment in the bond compartment due to arbitrage in favour of Japanese debt through a lightening of US rates.

EQUITY MARKETS (45%)

■ **USA (=):** The US stock markets have once again broadly outperformed their counterparts in these phases of testing the annual highs; the results season is considered good, with the analysts' consensus adjusting 2011 earnings projections upward. Plentiful cash on the balance sheets of US listed companies gives us confidence that mergers and acquisitions and share purchases will remain important factors.

■ **Europe (=):** The European markets have tended to mark pace in recent weeks, as recurring budget difficulties in the peripheral countries continue, in fact, to weigh heavily on the region's entire banking sector.

■ **Asia (=):** During the month, the region tended to make up a (small) part of the delay that has built up since the start of the year; we are maintaining our positions, thus validating our net under-exposure to the Japanese stock market.

DEBT MARKETS (46%)

■ **USA (-1):** The US debt market recently performed well, while uncertainty related to the problem of the debt ceiling remains a concern more than ever: we are emphasising our under-exposure.

■ **Europe (=):** Rumours of the restructuring of Greek debt, or Greece's departure from the UEM, are circulating everywhere and weighing on the market. If we were to choose to remain over-exposed, we would be increasingly selective in terms of signatures.

■ **Japan (+1):** The weight of Japanese bonds is strengthened by arbitrage against US rates.

MONEY MARKETS (=)

We are keeping our pocketful of money intact.

IN THE BLINK OF AN EYE

Our strategy

		Current level 10/05/11	Short-term tarjet	1 year tarjet
United States	Fed Funds	0.25	😊	😞
	10 yr T - bill	3.17	😞	😞
Eurozone	Refi rate	1.25	😞	😞
	10 yr OAT	3.47	😞	😞
Japan	BOJ rate	0.10	😊	😞
	10 yr JGB	1.15	😊	😞

Sources : Groupama AM, Bloomberg

Our model portfolio in € 10/05/11

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 10/05/11

Indices	09/05/2011	Forecasts	
		Groupama Asset Management short term (< 3 months)	a 1 yr
France (CAC 40)	4058	😞	😊
Euroland (DJ)	289	😞	😊
United-Kingdom (FTSE 100)	5977	😞	😊
United-States (S&P 500)	1340	😞	😊
Japan (Topix)	853	😞	😞
MSCI Asia free ex-japan	577	😞	😊

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
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