

## Fixed Income Management

### LONG RATES

#### ■ Once again, the European calendar has set the pace for the markets in recent weeks.

The summit of 9 December, by progressing on the political issue of greater fiscal integration, highlighted the willingness of member states to address the region's underlying problems in order to provide a structural response to the crisis. The signed agreement, however, remains incomplete as to the issues of growth and solidarity within the eurozone.

This progress on fiscal integration was not sufficient to allay the distrust of investors, or rating agencies. The lack of a global solution to the crisis continues to fuel market volatility.

The eurozone debt crisis will remain the main focus of attention in the coming months. Our central scenario is based on the slow and gradual improvement of governance in the eurozone and on a step-by-step strengthening of economic and fiscal integration. That won't happen without conflict or volatility, and the risks are still present.

From an economic standpoint, as the year ends, the eurozone is entering into a moderate recession, with a rebound expected in the second half of 2012.

In this environment, we anticipate in the next 3 months stability "core" (German) rates. The impact of the weakening economy will offset the gradual reduction of the liquidity premium enjoyed by Germany and the risk of a general downgrading of eurozone

governments by the rating agencies. By the end of 2012, strong European integration coupled with the return of moderate growth should push interest rates higher.

Concerning France, due to political uncertainty fuelled by the country's upcoming elections, the risk of the country missing one of its fiscal targets, and the risks weighing on its credit rating, the risk premium against Germany is likely to be pushed higher during the first months of the year (target of 160 bp with a likelihood of a return to 200 bp). By the end of 2012, political uncertainty should be allayed and global governance improved in the eurozone. These factors argue for a tightening of the risk premium in the second half of 2012, though with a spread that remains higher than historical levels (around 100 bp).

As for the peripheral countries, the cautious stance taken early in the year continues to be warranted in a context of volatility, significant flows of issues and sustained pressure from rating agencies. Longer term, the gradual resolution of the crisis should push these countries' risk premiums lower and lead to a convergence of rates towards those of the core countries.

In the United States, the economic slowdown—which will intensify at the start of the year—coupled with continuing fiscal difficulties, should keep rates close to current levels in the first half of the year. Longer term, the return to weak growth, persistent budgetary problems and the election season will lead to higher U.S. rates.

### CREDIT

■ **Exiting the crisis will still be long and volatile, so caution on credit is still called for in the short-term,** reinforced by the context of a structural liquidity shortage.

Longer term, in a climate of "soft" recession and taking into account the risk premiums offered, the asset class remains attractive: rates are low and credit spreads incorporate extreme implied default rates.

### INFLATION-INDEXED

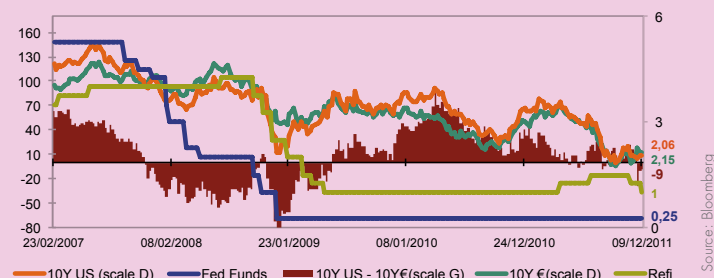
■ **The trend in sovereign risk premiums remains the main factor** behind the performance of inflation-indexed assets. Persistent volatility could still impact the asset class. Longer term, valuations of inflation expectations remain attractive, especially on short maturities.

### A WORD ABOUT THE INVESTMENT STRATEGY

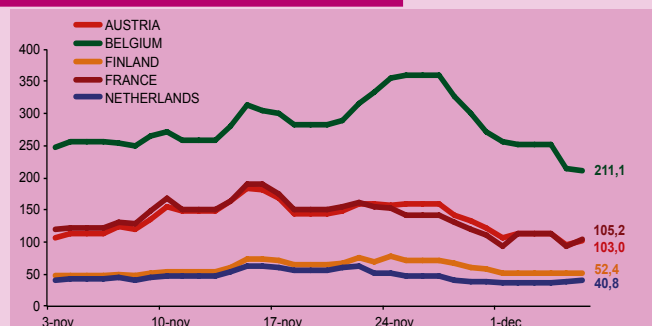
■ **We are approaching the transition from the end of this year to the start of 2012** by maintaining the overall positioning adopted in recent months in the context of the eurozone crisis: a neutral directional bias to rates, underweighting of peripheral countries, and continued underexposure to credit.

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

