

## Fixed Income Management

### LONG RATES

■ **2012 is underway with continued uncertainty surrounding the progress** of the sovereign debt crisis in the eurozone.

Investor sentiment had nevertheless improved somewhat in recent weeks thanks to the success of the ECB's three-year refinancing operation (VLTRO<sup>1</sup>) of 21 December, which helped to ease tensions. Its announcement in early December, followed by the ECB's massive injection of liquidity into the banks, triggered a sharp drop in sovereign risk premiums on short maturities and senior bank debt.

But the stalled talks on the Greek PSI (private sector involvement plan) and the S&P's intervention on European government bonds reminds us that the road ahead appears long and steep for months to come.

Indeed, the risks are still significant in the short term. First, Greece must reach an agreement with its private creditors to be eligible for aid from international authorities before March. In addition, European governments must refinance their debt on the market in very large amounts, and reach an accord on the new EU Treaty, all in a context of continued pressure by agencies on their credit ratings.

Volatility is therefore expected to remain high with significant movements in risk premiums. Interest rates in core countries of the eurozone will be pulled between economic data, which is stabilising

(particularly in Germany), and the sovereign debt crisis, which should finally be resolved in the medium to long term. Core sovereign rates should thus change within the recent range before gradually tightening, leading to narrower risk premiums.

In France, the risk premium should hover around an average of 160 bp in the coming months given the electoral context, persistent risks on fiscal targets, and continued pressure from rating agencies (this does not exclude a return to levels of ~200 bp).

In the peripheral countries, caution is still in order, and our preference remains for the AAA countries of the eurozone.

### CREDIT

■ **The breathing space provided by the success of the ECB's three-year refinancing operation** allowed the credit market to rise in recent weeks, albeit in weak volumes. The massive injection of liquidity into banks reassured investors facing the risk of refinancing these institutions in early 2012.

However, risks are still present concerning the debt crisis and the expected persistence of volatility militates for continued caution on this asset class. Despite the reopening of the primary market at the start of the year, liquidity remains very limited.

### INFLATION-INDEXED

■ **The asset class once again found favour with investors**, supported by trends in sovereign risk premiums (and the increase of Italy's), and by the announced increase of the VAT in France. While inflation-indexed assets may not escape the expected volatility in the markets, they still offer attractive valuations and positive carry.

### A WORD ABOUT THE INVESTMENT STRATEGY

■ **In our portfolios, while our preference in country allocation still favours the core countries of the eurozone**, their order has been slightly revised this month.

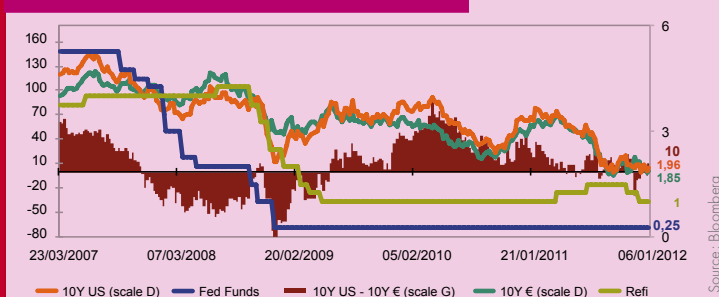
Austria was downgraded to neutral, less for rating reasons than for the risks inherent in Hungary's problems, and we reduced the overweight in Germany given the levels of its absolute rates.

In credit, caution is pushing us to maintain an underweight in the asset class and under-sensitivity in the portfolios. Changes were made in the finance sector, where we are reducing our underweight in senior bank debt and paring back our overweight in subordinated debt. In corporates, we are maintaining our overweight in BBB issuers.

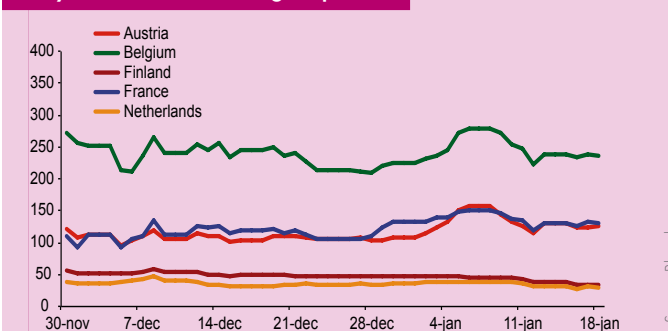
G.M

<sup>1</sup>VLTRO: Very Long Term Refinancing Operation

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



10 year Core Sovereign Spreads



10 year Peripheral Sovereign Spreads

