Amundi
ASSET MANAGEMENT

Cross asset investment strategy

Strategy and economic research — monthly

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Executive summary

1 **Financial crisis, economic environment and investment advice.** The European sovereign-debt crisis is not over, the debate over ratings is heating up, and a recession is looking increasingly likely. We do not see a disaster scenario coming (no unravelling of the euro zone), but nor do we see much chance that things will improve significantly over the coming months. Only emerging markets are on favourable ground. Caution is the watchword in portfolios, along with further reduction in risk.

2 **Financial crisis: what are the consequences for the global economy?** The financial crisis will cause a sharp slowdown in economic activity, and a slight contraction cannot be ruled out in one quarter. We have lowered our growth forecasts. The severity of the euro zone banking crisis makes a recession more likely there than in the US, but we do not expect a global recession. Emerging economies will continue to grow at a robust pace.

3 **Sovereign debt: the US leaves the (very exclusive) AAA club**
This is no surprise. Based on all the criteria reviewed (both quantitative and qualitative), the ratings agencies have often stressed that a fine line separates AAA and AA, and that qualitative criteria play a big role. With this in mind, many European countries may soon find themselves in their line of fire.

4 **Federalism, eurobonds, expanded EFSF role … what path are we truly taking?**
The creation of eurobonds, the adoption of a fiscal "golden rule", and the expanded capacities of the EFSF (European Fund for Financial Stability) are three recurring themes that are driving the financial markets. Eurobonds can only be the culmination of European convergence. In the short term, only the expansion of the EFSF could provide a lifeline. As for the golden rule, care must be taken to avoid implementing pro-cyclical fiscal policies.

5 **What lessons are to be learnt from financial stress indicators in the euro zone and the US?** Financial stress indicators aim to use a synthetic measurement to capture trends in financial variables likely to affect economic activity. Stress is greater in the euro zone than the US, due to pressures on banks, which are threatening to cause a bank credit crunch.

6 **Liquidity and monetary policies: what impact will they have on the yield curve?** Central banks have changed gears. The Fed has pledged to keep its rates level until mid-2013. No QE3 is in sight, but the Fed does have some margin for manoeuvre. In the euro zone, meanwhile, the ECB can cut its rates. We forecast a 50bp reduction in the ECB's key rates in the first half of 2012.

7 **Credit has once again been weakened by fears over the economy and sovereign debt.** The credit market is already pricing in an unfavourable outlook, somewhere between a conventional recession and something akin to the Lehman crisis. This is due mostly to steep liquidity premiums. If the recession is avoided, the mix of low yields and a sustained accommodating monetary policy could favour the quest for returns. But don't expect a significant improvement without a lull on the sovereign debt front.

8 **Emerging economies are truly attractive… but are they truly emerging?**
"Emerging" is a catch-all term. Distinctions must be made between countries. We discuss the various types of criteria for doing so. As a group, emerging economies offer more attractive prospects than developed economies (in debt, equity, and other areas), but we prefer converging economies, with solid growth, current accounts surpluses, and other advantages.

9-11 **Equity markets: the drawback of being "born" European.** Drops in the indices have dragged down many stocks for no fundamental reason. Within the euro zone, many stocks are unjustifiably trading at a sovereign crisis discount. A thorough review of sectors, individual companies, etc. shows that there are opportunities out there. But, given the lack of visibility, a cautious sector strategy is still necessary. Despite attractive valuations, caution is the watchword in Europe as well, where earnings have been disappointing.

12 **The yen and the Swiss franc: safe haven status has a cost…** These two currencies have served as safe havens during the crisis. In terms of real effective exchange rates, the Swiss franc set a record in August, which put a heavy burden on the Swiss economy. The yen is "strong" but not at its current peak. The Japanese and Swiss central banks have set the tone. As might be expected, it is in Switzerland that action has been the most decisive…

Document completed on Thursday, 1 September 2011

More about it

ASSET CLASSES	INVESTMENT THEMES and OUTLOOK	Amundi INVESTMENT STRATEGIES
Asset allocation	• The risks of systemic crisis (sovereign debt crisis, banking risks, etc.) now go hand-in-hand with the risks of recession. • We do not expect an unravelling of the euro zone, or the demise of the euro … but nor do we see any significant improvement within a foreseeable timeframe. The deficit of governance and the weakness of the anti-crisis mechanism are not reassuring. • As no pro-cyclical fiscal and tax policy is likely to provide reassurance in the current environment, the equity markets (cyclical and financial stocks in particular) have dropped sharply. This modifies the economic and financial environment and in particular the outlook for growth, the normalisation of monetary policy, and the overall environment on the fixed-income and equity markets. • We do not expect a recession, neither in the US, nor in the Euro zone. More pessimistic for long than the consensus, we nevertheless revise down GDP (and corporate profits) forecasts for both 2011 and 2012. • Divergences amongst euro zone countries are expected to last. • Economic activity still more solid in emerging countries	• Overweight emerging equities. This is an area of stand-alone and more solid growth with more credible governance, public debt under control, inflation peaks now in the past, and strong currencies • Close out the short EUR/long USD position • Go to neutral on duration • Preserve liquidity • Continue to scale back risk in portfolios (cash) • Reduce the equity risk budget: downgraded growth and earnings outlook, volatility, debt crisis, etc. • No increase or reduction in the credit portion or the emerging debt portion (both are currently slightly overweighed) • Add to commodity shares positions
Money markets	• As a result of the Fed's commitment to keep unchanged its key rates, forward curves have been pricing in a monetary status quo in the US until 2013. • The Euribor curve is now discounting monetary easing by the ECB. Such re-pricing is new, having emerged during August (-60bp on June 2012 maturities). We expect the ECB to cut rates in H1-2012 by 50bp.	• The Eonia rate will be very volatile looking ahead, with a downward pressure likely in 2012. • In the US, the 2-year bond yield (0.2%) dropped below Libor rates (1 to 4 months). The Fed will keep unchanged the size of its balance sheet in the coming two years. Against this backdrop, monetary rates will remain under pressure.
Bond markets	• Nominal bonds: the environment for long bond yields is favourable on the whole, at least for the US and the euro zone core for various reasons, including weaker growth, more accommodating monetary policies, and more restrictive fiscal and tax policies. No improvement is in sight for euro zone peripherals. • Inflation-linked bonds: we currently see no attractive prospects, even though the risks of recession are already mostly priced in. The climate remains rather deflationary, which is no argument for this asset class.	• Hard to see how short-term bond yields can continue falling: the risk is asymmetric. • Bond yields: go to neutral on duration • Yield curve: hard to take curve positions, as trades are currently too directional and volatile, on both the 2/10 and 10/30.
Credit	• Volatility has increased; visibility is still low, even in the short term, due to the debt crisis; and liquidity is drying up. The overall environment is sombre for banks. For the high yield segment, the constant decline in yields is not enough. Weaker economic growth, the sovereign debt crisis, lower liquidity and the prospect of phases of flight to quality give pause. Corporate investment grade bonds are expensive, and company managements put out a cautious line when reporting results. Even so, corporate bonds are still of better quality than sovereign ones.	• Liquidity is once again becoming key • Banks: it is best to remain cautiously on the sidelines. • High yield: we prefer defensive bonds • Corporate investment grade : too expensive at this point in the cycle • No change in portfolio weightings: no incentive for getting out, no incentive for investing more
Equities	• No satisfactory directional outlook. The equity markets are very likely to remain depressed amidst an environment of steeper volatility. Three themes are nonetheless becoming clearer: • An "emerging " theme. Detection of companies with heavy footprints in emerging markets and valuation upside, some of which have been affected by the declining quality of their own sovereign-debt issuer. • A "financials" theme. The crisis is not over, and banks will have to be recapitalised (with a risk of dilution, a risk of losses, etc.). • A "commodities" theme: a wide gulf exists between commodities shares and cash commodities. The former have been driven down by the drops in the equity markets, while the latter are still riding the growth story in emerging economies, led by China.	• Caution on directional bets • Further reduction in the proportion of risky assets in the portfolio • "Emerging" theme: Select companies with a heavy footprint in "converging" emerging markets (the major countries of Asia and Latin America) • "Financials" theme: Maintain the long industrial vs. financials position. • "Commodities" theme: take advantage of the gulf between equities and underlying assets, gold mines in particular.
Emerging markets	• Growth will remain more solid in emerging economies than in developed economies, which are being forced into pro-cyclical fiscal and tax policies just as economic indicators are turning down. Some of them enjoy stand-alone growth, current accounts surpluses, light debt, monetary policies that are now less restrictive, margins for manoeuvre to support growth if need be, and so on.	• Emerging equities: overweight converging countries and regions with stand-alone growth, current accounts surpluses, etc. (in Asia and Latin America). • Emerging debt: stay on the sidelines for the moment.
Commodities	• As long as growth remains solid in China and in the major emerging economies, and as long as liquidity remains abundant, commodity prices are likely to hold up well. This is our central scenario. • Despite the economic slowdown, the International Energy Agency (IAE) revised up its forecasts of oil-demand from non-OECD countries in 2012. • Global uncertainty plays in favour of gold.	• Oil prices will remain elevated, probably around 100$ per barrel in 2012. • The ongoing financial crisis is an argument in favour of gold, which is already very overvalued. In real terms (2011 USD), it still has some room to move up, compared to its peak in the1980s (USD 1960/ ounce).
Currency markets	• EUR: Given the downgraded outlook on growth (steeper in the US than in the euro zone core), and the revised outlook on ECB rates, no clear trend is likely to emerge in the short term. In the long run, the euro is overvalued vs USD. • JPY and CHF: these two currencies are now heavily overvalued and undermined by the comments and attitude of the central bankers concerned (who have highlighted the impact of overvaluation on economic activity, excessive appreciation, etc.). • GBP: sterling is undervalued, but will remain so for some time to come. • Nordic currencies: expensive, but they are still attractive (given the countries stronger growth than in the euro zone and the US, less dissension in governance, etc.) and provide protection in the event of a new downturn in the situation of the euro zone. • Emerging currencies: It is vs. emerging currencies that the currencies of developed economies have the greatest downside risk. The potential returns on emerging assets are likely to drive up their underlying currencies, particularly in Asia.	• We are short-term neutral on the EUR/USD exchange rate. • The dollar remains, on the whole, undervalued, and the euro is overvalued to the US dollar (fair value is around 1.20). We are therefore bullish on the dollar vs. the euro two to three years out. • Nordic currencies: maintain long NOK and SEK positions … even if they are overvalued at the moment • Emerging currencies: stay long vs. USD, particularly in Asia and particularly in countries running current accounts surpluses.

1 Financial crisis, economic environment and investment advice

The crisis broke new ground in August. **The risks of systemic crisis (the sovereign debt crisis, banking risks, etc.) now go hand-in-hand with the risks of recession**. A few months ago, we had stressed the vulnerability of the United States and the fact that the US sovereign debt situation was a topic of concern, given how quickly it was getting out of control (as fast as in Portugal) and given how much of an effort would be required to bring it back down to manageable levels (as much as in Greece).

The political difficulties in managing the debt ceiling ultimately led S&P to downgrade the US, and the loss of AAA status has dealt a fatal blow to prospects for growth. The fiscal effort that the US will have to make to reduce its deficits and the efforts that euro zone core countries will have to make to retain control over their debt and hold onto their AAA rating come at a time when economic indicators have stalled in both Europe and the US.

As no pro-cyclical fiscal and tax policy is likely to provide reassurance in the current environment, the equity markets, cyclical and financial stocks in particular, have dropped sharply. This modifies the economic and financial environment and in particular the outlook for growth, the normalisation of monetary policy, and the overall environment for the fixed-income and equity markets.

Worsened economic and financial outlooks

Topic # 1: Deterioration in economic perspectives in developed countries … while growth potential remains stronger in emerging countries

Confidence surveys conducted among businesses and households have started to show a decline due to the resurgence of financial pressure, which is likely to continue. Businesses will probably postpone their investment plans to limit their financing needs and wait for a better economic outlook. Clearly, **the likelihood of recession has grown significantly on both sides of the Atlantic over the past few weeks**. Under these conditions, we cannot rule out a contraction of GDP in the second half of the year. However, the world's major advanced economies, especially the US, are not experiencing the same imbalances as in 2008, which may lead to a marked and long-lasting contraction in activity. **The most likely scenario continues to be a downward revision in economic growth projections for 2012** (Section 2), **along with a downward revision in corporate profit projections** (Section 11).

The potential growth of emerging economies is much greater than that of developed countries. Moreover, developed countries must endure the unbearable weight of their public debt. **In the event of a significant economic slowdown, "converging" emerging countries** (Section 8) **still have room for manoeuvre in terms of fiscal policy to stabilise their economy** (unlike developed countries)..

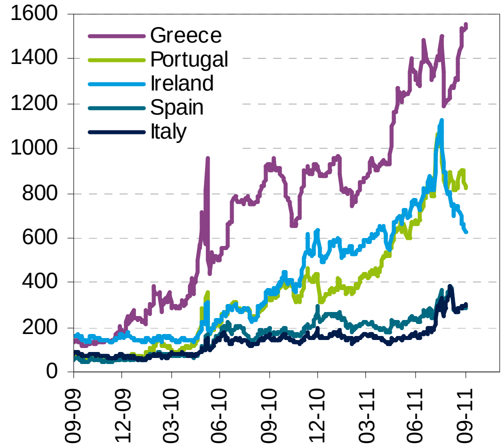
Finally, the decline in oil prices reduces the risk of inflationary pressure in emerging countries in the short term, therefore reducing the risk of monetary tightening, which would derail local growth. Ultimately, **emerging countries appear to be better positioned in the current crisis.**

> *"Emerging economies still have some growth potential"*

Topic # 2: Worsening sovereign debt crisis

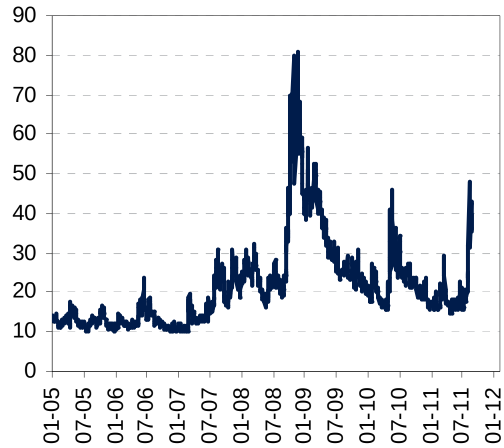
While the wariness of markets with respect to euro zone fiscal policies increased, the European Summit of July 21 was disappointing. No complete answer was produced for the Greek solvency issue. The prerogatives of the European Financial Stability Facility (EFSF) were expanded so that it can act as a lender of last resort, but this will only take effect after ratification by all euro zone countries' Parliaments. In addition, the size of EFSF has not been increased, which prevents it from helping Spain or Italy if necessary (Section 4). Against this backdrop, Italian and Spanish government bonds suffered speculative attacks. The issue of European sovereign risk has taken on a systemic nature considering the size of these countries (note that Italian public debt is the third largest sovereign debt, in nominal terms, in the world).

10 y sovereign spread with Germany (in bps)



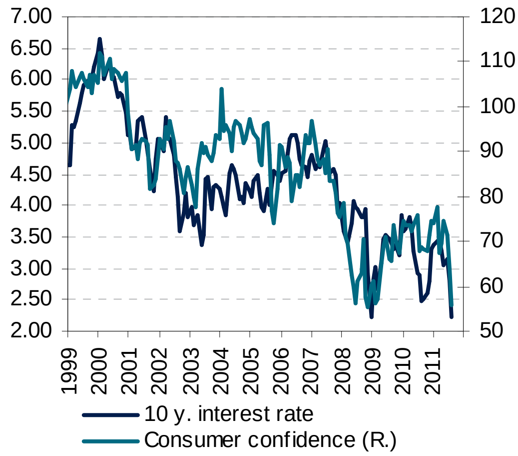
Source: Datastream, Amundi Strategy

Implied Volatility on the US equity market (VIX)



Source: Datastream, Amundi Strategy

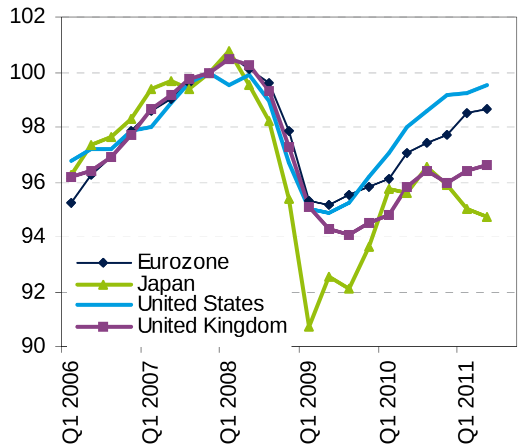
US 10 y. bond yield vs Consumer Confidence (University of Michigan)



Source: Bloomberg, Amundi Strategy

The dissension among European countries in how to deal with Greece, and the US's difficulty in reaching an agreement to raise the debt ceiling highlight the difficulties that developed countries are having in shifting the trajectory of their public finances. **We do not see an extreme disaster scenario coming (e.g., an unravelling of the eurozone, a country's leaving the eurozone, the end of the euro, and so on), but nor do we expect a rapid resolution to the crisis**. **All it would take is for the ECB to stop buying peripheral country debt or for growth prospects to darken further, for pressures to resume on peripheral countries like Spain and Italy**.

GDP in constant prices (100 = Q4 2007)



Source: Datastream, Amundi Strategy

Topic # 3: Good governance is at the heart of the debate in the US … and in the euro zone

The starkly diverging outlooks between the Congress and the White House were a major factor in S&P's decision to remove the US's AAA rating. Just remember that **the difference between AAA and AA is not based on quantitative criteria only, but can be purely qualitative** (Section 3).

The prompt ratification by EMU member-country Parliaments of the agreement reached on 21 July to expand the EFSF's role and capacities was a prerequisite for restoring market confidence but will probably not be enough. **If speculative attacks resume on euro zone core countries, there is likely to be talk of a further expansion in the EFSF and the creation of eurobonds** (Section 4).

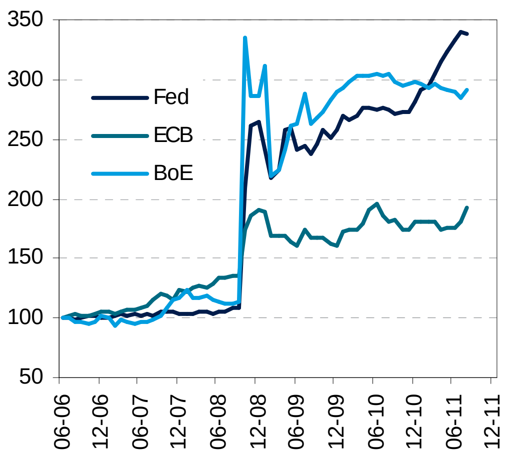
Topic # 4: Central banks are working to stabilize the financial system … and the normalization of monetary policies will not implemented soon

Faced with the crumbling economic and financial environment, central banks have been particularly responsive. The ECB returned to unlimited six-month refinancing operations and reactivated its securities purchase programme, with the intention of limiting the volatility of Italian and Spanish government bonds (which has significantly relaxed their yields). The Fed has indicated that its key rates will remain close to 0% until the middle of 2013.

Meanwhile, given the current economic environment, the ECB may put off any further monetary tightening or even return to an easing cycle (Section 6). Note that the ECB has more leeway here than the Fed, and that should be seen as a positive point.

> *"The ECB cannot keep tightening monetary policy"*

Central banks' balance sheet (100= june 2006)



Source: Datastream, Amundi Strategy

Topic # 5: A necessary but difficult government fiscal consolidation

The actions of central banks have helped to calm market volatility. Still, markets remain unstable due to the risk of a downgraded credit rating. This emphasises the need to quickly clarify the trajectory of public finances. **Governments must find a balance between reducing their deficit without crippling growth.**

Topic # 6: Still highly volatile markets

Fears surrounding the trajectory of public finances in developed countries have resulted in highly volatile markets and a sharp correction in risky assets. Investors are now focused in this topic (budget performance, central bank meetings and implemented reforms). **Their concerns are amplified by worsened economic projections and the increased risk of recession.**

Investment policy recommendations

Topic # 7: Maintain a cautionary bias in portfolios

The sovereign debt crisis is far from over. The exchange of Greek bonds, the parliamentary ratification by Euro zone member states of extended EFSF prerogatives, and the introduction of the 2012 financial laws are events that could create volatility in the markets. Also, **renewed tensions in the financial system are expected to cause a significant slowdown in the second half of 2011**.

Topic # 8: Favour liquidity

Liquidity is a valuable asset in tense markets. The attractiveness of liquidity is compounded by uncertain economic outlooks and by the high value of asset classes that are traditionally considered to be safe havens.

Topic # 9: Overweight emerging assets

Emerging assets (equities and bonds) were hurt by fears of an inflationary overheating in the first half of 2011. The decline in commodity prices lessens this risk in the short term, particularly for emerging Asia. **The European sovereign debt crisis and the risk of a significant economic slowdown mainly affect developed countries and make the assets of emerging economies more attractive**. Emerging countries (those having autonomous growth low debt and current account surplus) and European corporates exporting to these countries are attractive at this stage.

Topic # 10: duration of fixed income portfolios

The debt crisis is not over, and episodes of flight to quality will reoccur. Short-term interest rates will remain low (the Fed won't tighten until 2013 and the ECB could loosen monetary policy). **We are returning to duration-neutral stance** because **conditions are broadly favourable for long yields** (weaker growth, more accommodative monetary policy, more restrictive fiscal and tax policies, etc.) – at least in the United States and the core euro zone. **In peripheral euro zone markets, there is no improvement in sight**.

Topic # 11: Yield curves

Both short- and long-term rates should remain low for some time to come… We do not recommend yield curve positions, because **yield curves are too directional and volatile at the moment**. This applies equally to the 2/10 and 10/30 segments. It is hard to imagine short-term rates will keep falling. **The risk is asymmetric**.

> *"Both short- and long-term rates will remain low for some time to come… with few shifts in the curve"*

Topic # 12: Credit markets, neither positive, nor negative … do not sell, do not buy further yet

The four key issues are volatility, visibility, quality (flight-to-quality) and liquidity. Volatility has increased, visibility remains low even in the short term, and liquidity is drying up. Liquidity is now a major problem across the board.

The environment for **bank** bonds remains adverse, even if all or most 2011 issuance is complete. Steer clear.

A steady decline in the default rate is not enough to warrant more investment in **high yield** bonds. Weaker economic growth, the sovereign debt crisis, liquidity and likely flights to quality argue for caution. Prefer defensive investments.

We find **investment grade corporate** bonds expensive and corporate managers are cautious in their earnings reports: fairly stable in the first half but probably down in the second half … and in 2012. The second quarter was down on the first.

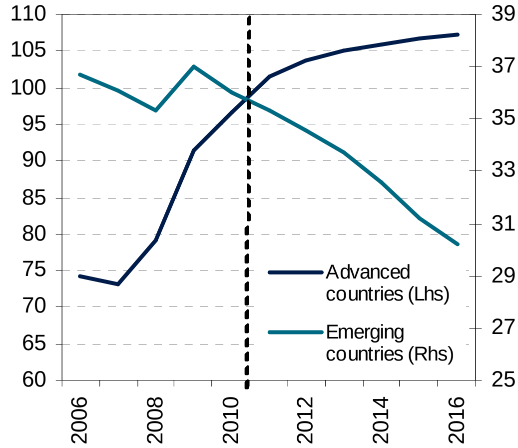
We are not adding any credit to the portfolio, which is currently slightly overweight via high-yield bonds.

The debt crisis is affecting governments, but businesses are exhibiting a favourable debt structure and high margins (section 7). Within sovereign bonds, the best signatures have been considered safe havens. This rush toward quality has caused a sharp drop in their government bond yields. From this context, credit represents attractive diversification. Risk premiums on the high yield market have soared for liquidity reasons. This asset class remains attractive in a buy-and-hold approach. Under the same logic, short-term liquidity products offer an attractive carry.

Topic # 13: Equity markets in developed countries: favour stock-picking

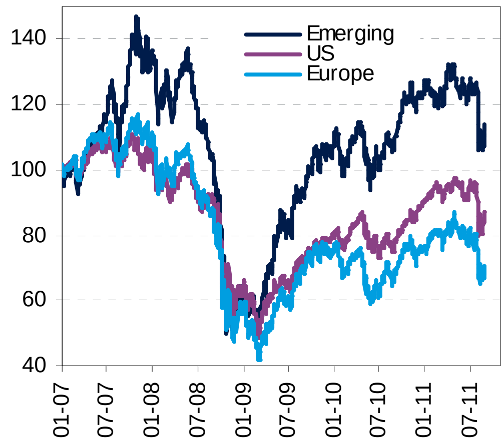
Corporate profits disappointed in Q2 2011 compared to those in the United States and European equity markets have underperformed compared to US equity markets since the start of the summer. **On a macroeconomic level, the slowdown will be experienced worldwide, but Europe may be further affected by the overvaluation of the euro and the need to adopt austere fiscal policies**, particularly in peripheral countries and in Italy. However, **the potential for downward profit revisions remains high on both sides of the Atlantic, and (with currently discounted profits) European valuations are more attractive than US valuations**. At the end of the day, the arguments balance each other out. The location of company matters less than its geographical specialisation.

General government gross debt (% of GDP)



Source: IMF, Amundi Strategy

Equity markets (MSCI indexes, basis 100 = 01/01/2007)



Source : Datastream, Strategie Amundi

In these conditions, we have identified the following investment strategies: No satisfying directional opportunities. Equity markets will very probably continue to struggle amid greater volatility. But there are three possible investment themes.

An "emerging" theme. Identifying companies with businesses strongly linked to emerging markets (sales, profits, etc.), with upside potential, some of which have been affected by sovereign downgrades at home.

A "financials" theme. Maintaining the long position on industrials vs financials. The crisis is not over, and banks will need to raise capital to cope with the risk of dilution, losses, etc.

A "commodities" theme. The big gap between commodity equities and cash commodities. Commodity shares have been pushed down by the general equity market decline, whereas cash commodities are still buoyed by growth in emerging countries, led by China.

The location of company matters less than its geographical specialisation. In these conditions, we have identified the following investment strategies:

- In Europe, focus on defensive stocks outside of utilities...

With the mounting uncertainty surrounding the economic outlook, defensive stocks offer a clearer business model. Downward revisions of results should be less unfavourable, and they are expected to yield a higher dividend compared to the domestic market.

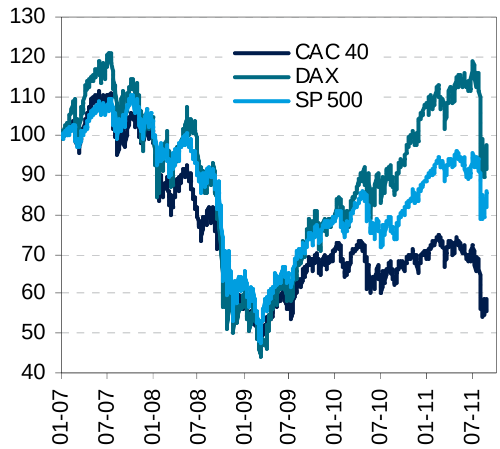
- ... and continue to underweight securities tied to sovereign risk and the economic cycle of developed countries

Ongoing questions about government solvency are expected to bring down financial stocks even more than non-financial stocks in developed countries. Lower economic projections (declining confidence indices, downward revisions by analysts, etc.) are not going to benefit to cyclical stocks in the short run. Finally, required fiscal consolidation by governments could harm those sectors that are most sensitive to taxation and public spending, such as utilities.

- Choose stock-picking over directional trades

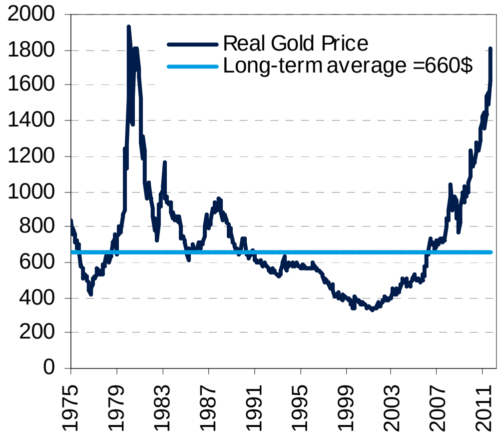
The financial crisis has caused panic in the markets. **Some stocks have clearly over-corrected, and have become attractive from a valuation standpoint**. At the same time, the poor economic outlook limits the options for directional investment strategies. In an environment of sluggish growth and low interest rates in developed countries, this should exacerbate the search for high dividend-yield stocks. Moreover, **businesses that are the most exposed to emerging countries are expected to hold their own, regardless of where they are located**. On a different note, gold shares (and mining shares in general) remain attractive assuming that the commodity markets do not experience a big hit (i.e. no global recession).

Stock markets (100 = 1 January 2007)



Source: Datastream, Amundi Strategy

Real price of gold (in 2011 USD)



Source: Datastream, Amundi Strategy

Topic # 14: Commodities are expensive, but some potential, still … for some of them

As long as the Chinese growth remains strong and sustainable, and considering that some other emerging countries are consuming commodities too, commodities prices might remain solid. It is our central scenario. In real terms, gold price is below its record high (1950$ in 1980).

> *"In real terms, gold price is below its record high"*

Topic # 15: Prefer emerging currencies to the so-called safe haven currencies

- Neutralize the EUR/USD position

The euro is holding up "surprisingly" well given the debt crisis and interest-rate spreads. Despite the financial crisis, downward growth revisions, re-pricing of the ECB's monetary policy, and political discord in the euro zone, the EUR/USD exchange rate has fluctuated between 1.40 and 1.45 since March. The dollar is negatively impacted by the US's policy of near-zero interest rates and downward growth revisions (and also by the debt situation), while the euro is burdened with government debt problems. For some time now, forward curves have pointed to a stand-path monetary policy in the US until 2013, while the Euribor curve is now expecting the ECB to lower its rates. This re-pricing is a new development: it appeared in August with a decline of 60 bps on the June 2012 maturity.

Given downward growth adjustments (larger in the US than in the euro zone core), and revisions to ECB interest rates, no major trend is expected in the short term (**we are neutral in the short term on the EUR/USD exchange rate**). But the dollar remains undervalued (it is at a 55-year low in effective terms!) and the euro is overvalued against the dollar (the equilibrium exchange rate is around 1.20). **We are therefore bullish on the dollar against the euro on a two- to three-year horizon.**

- Yen and Swiss franc are now overvalued (Section 12)

These two currencies are strongly overvalued and undermined by the comments and positions of the Japanese and Swiss central banks (impact on growth, over-appreciation, interventions, etc.).

- No position on the GBP

The Sterling is clearly undervalued from a fundamental standpoint. But this undervaluation may last long. Indeed, we expect a monetary status quo at least until mid-2012. Moreover, the BoE could opt for more quantitative easing if economic conditions worsen. All other things being equal, this would weigh on the currency. At the end of the day, we expect the GBP to evolve in a trading range in the coming months.

- Choose Nordic currencies vs the euro

The economic situation in the Nordic countries (growth, governance, etc.) is better than in the euro zone. **Their currencies should benefit from renewed interest vs. the euro and thus do offer a good opportunity of diversification**.

- Choose emerging currencies over the currencies of developed countries

The downgrade in the US credit rating by Standard & Poor's and the Fed's prolonged zero-rate monetary policy are working against the US dollar. Still, the dollar continues to have a dominant role in international trade, which prevents it from falling. Meanwhile, **the euro appears to be more overvalued than ever from an EMU fundamental standpoint**. Also, safe haven currencies (the Swiss franc and the yen) are now being heavily targeted by central banks to curb their appreciation. The Swiss National Bank is determined to stop the rise of the Swiss franc, which would have a negative effect on its domestic economy. Japanese authorities are also expected to intervene to stop the rise of the yen (which is overvalued). **Therefore, developed market currencies have the potential to fall significantly versus emerging currencies. Potential returns from emerging assets are expected to sustain the appreciation of the underlying currencies, particularly in Asia, and especially countries with autonomous growth and current account surplus.**

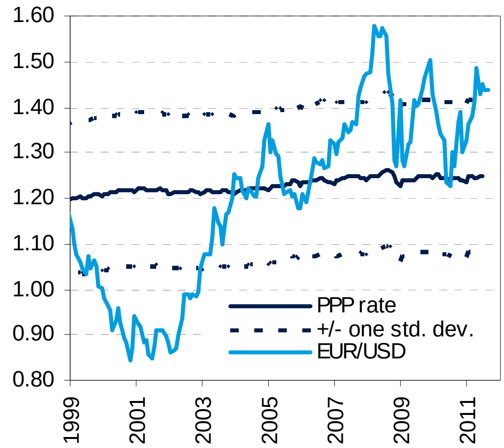
Topic # 16: Overweight real assets

Ongoing uncertainty surrounding the economic outlook and the credibility of fiscal policies, combined with monetary policies that are expected to remain extremely accommodative should continue to support real assets. **Real estate may continue to attract investors, regardless of its value, with real interest rates being kept at very low levels**. Commodities are expected to continue benefiting from the liquidity glut. Finally, gold, which is highly overvalued, would continue to serve as a safe haven if the financial crisis worsens or if confidence in the dollar falls.

Topic # 17: Use asymmetric profiles

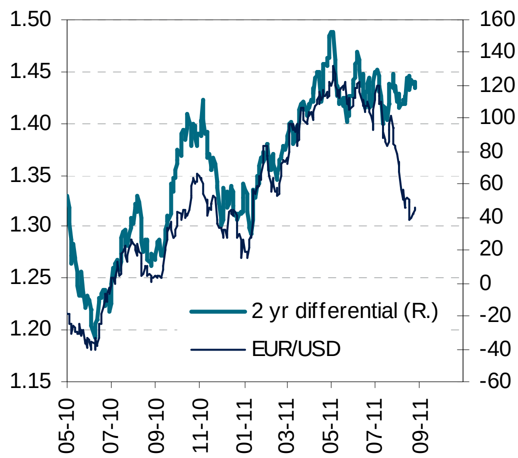
Convertible bonds have historically low deltas. This is a protective profile, and these instruments should fully benefit from their convexity. Processes built around minimal variance are also expected to be relatively attractive in the current environment.

EUR/USD vs PPP equilibrium value



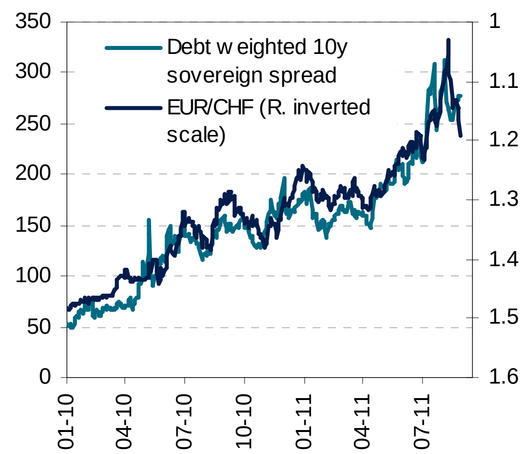
Source: Datastream, Amundi Strategy

EUR/USD vs 2 yr interest rate differential between Germany and the United States



Source: Datastream, Amundi Strategy

EUR/CHF vs eurozone sovereign spreads



Source: Datastream, Amundi Strategy

2 Financial Crisis: What is the outlook for global growth?

The major developed economies have emerged weakened from the financial crisis of 2008. From the United States to many European countries, the private sector continues to exhibit significant imbalances, yet governments must now clean up their public finances. Summer 2011 was a time of worrying governance failures on both sides of the Atlantic in carrying out this needed budgetary reform. This has sparked renewed tensions in the financial markets. The worsened business environment means weaker growth outlooks, fuelling fears that the world's economy will fall back into a recession. We are not endorsing this assumption as a central scenario, particularly with regard to the financial standing of companies in developed countries and the growth opportunities that are still available in emerging economies.

United States: A rating downgraded and an economic outlook worsened

In the United States, the revision of public accounts revealed that the economy has been significantly worse than expected over the past five years. The recession caused a peak-to-trough -5.1% drop in GDP (compared to the original figure of 4.1%), while annualized growth was only +2.4% q/q annualized on average during recovery. Ultimately, five years later, GDP has still not returned to its pre-crisis level, not seen since the end of World War II.

This outcome reflects anemic domestic demand. Consumption is suffering, as a result of the process of households' debt reduction, along with the continuing structural problems in the housing and job markets. Over the entire first half of 2011, household spending, battered by a series of shocks (dislocation of the automotive industry due to the crisis in Japan, soaring commodity prices, etc.), increased by an average of only +1.3% q/q annualized.

Meanwhile, local and federal governments have had a negative impact on growth since the first half of 2010 (-0.2% on average since early 2010 and -0.7% in the first half of 2011 alone). The budget plan adopted as part of raising the federal debt ceiling will further amplify this negative relationship. Public spending will be reduced by $40 billion (0.3% of GDP) next year and is expected to drastically cut 2012 growth by about -1.5%, accounting for multiplier effects.

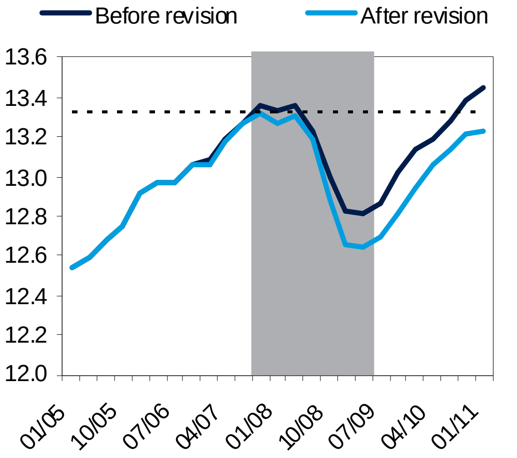
In addition to these mechanical consequences on economic activity, the budget issue focused on raising the federal debt ceiling rekindled market tensions and deteriorated business surveys.

> *"In 2012, the fiscal tightening will cut the US GDP growth by 1.5%."*

The heated debates between Democrats and Republicans and their successive failures in reaching an agreement raised fears over a U.S. payment default in July, and then the downgraded U.S. credit rating by Standard and Poor's dealt a heavy blow. Consumer confidence, as measured by the University of Michigan index, plunged more than 30 points, reaching its lowest level since May 1980. Meanwhile, confidence surveys among manufacturing purchase managers have sharply corrected, returning to 2008 levels.

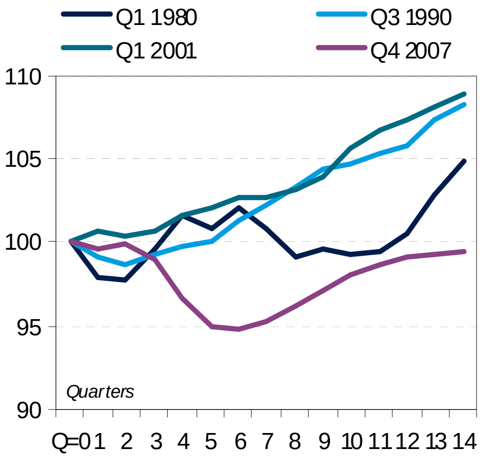
These results suggest that the final demand should revise spending downwards. In particular, businesses are expected to adjust their gross investments (capital and stocks) at least temporarily to limit their refinancing needs and to wait for a clearer economic outlook. This should prompt analysts to continue revising their growth forecasts downwards. Consensus Economics data actually show that the Consensus hasn't really considered any impact of the crisis on companies' spending. We thus remain more cautious than the consensus. For 2011 and 2012, we expect GDP to grow +1.4% and +2% (compared to +2.6% and +2.5% in July), while the consensus is at +1.8% and +2.5%. The sharp downward revision in 2011 forecasts mainly comes from a reduction in the carry-over effect following the review of public accounts.

United States: GDP before and after revision (Trs $ 2005)



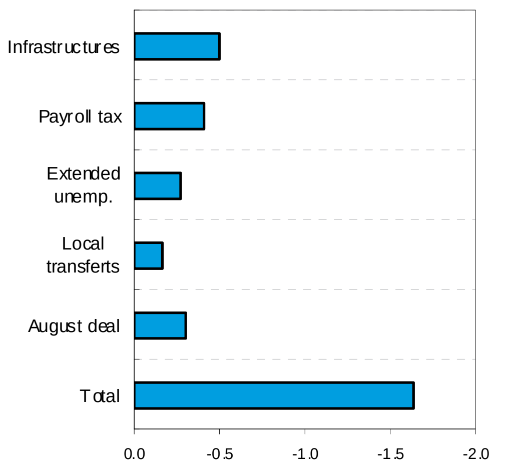
Source: BEA

United States: real GDP (recessions-recoveries compared)



Source: BEA

United States: Fiscal tightening impact in 2012 (% of GDP)

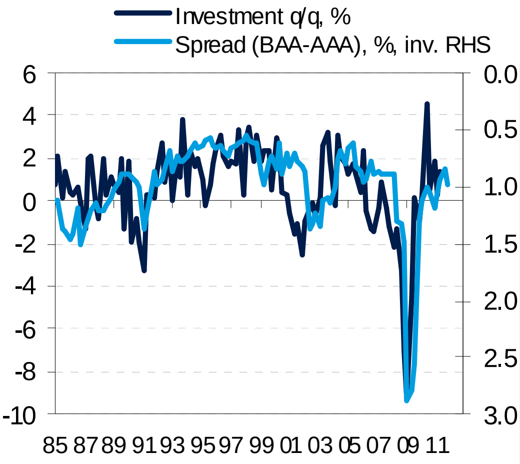


Source: Amundi Strategy

While we believe that increased financial stress will have an impact on final demand, we are not considering into our central scenario the fact that, like in 2008, it will lead to a significant and sustained contraction in activity. At least for now, things are much more contained, and the impact on business spending should be much more limited, especially since investments have fallen far below the long-term average. Businesses also show a healthy debt structure and high margins. Consumption is expected to remain in the positive range. New unemployment figures do not suggest a significant impact on job creations, and the recent decline in oil prices is expected to support the growth of disposable income. The U.S. economy does not exhibit the same imbalances as in 2008, which should make it more resilient. There could be, in fine, discrepancies between the evolution of hard data and the magnitude of the drop in confidence surveys, as this drop doesn't seem to be attributed only to economic factors (symbolic meaning of the lost AAA rating for the US, …)

In the short term, it is best to remain cautious. As indicated above, analysts will continue to revise their outlooks downwards, and strong market tensions may create panic movements, destabilizing financial players and the real economy.

United States: Investment and credit spreads

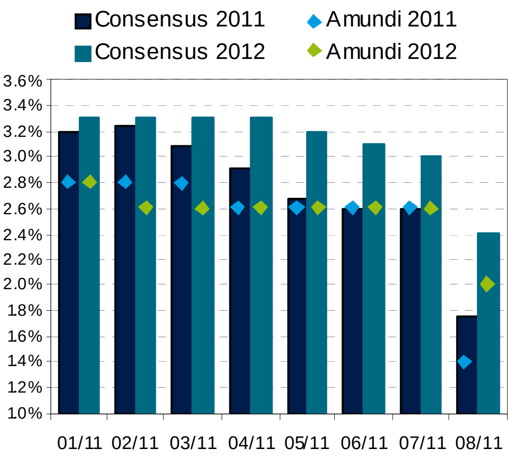


Source: Datastream, Amundi Strategy

The situation in the Euro Area is still very worrying

Although the fear of the U.S. falling back into recession has been haunting markets since the start of summer, the situation in Europe is even more worrying. Financial stress has mounted much more significantly on this side of the Atlantic due to the inability of euro area leaders to develop a full community response to the sovereign debt problem. The issue of Greece's solvency has not yet been settled a year-and-a-half after the beginning of the crisis. The EFSF's size is still not sufficient to deal with a potential contagion to Spain and Italy, and some European leaders do not agree on the ECB's role as a last resort lender. As a result, the financial markets have been particularly stressed, and European banks are suffering from the reluctance of investors. Additionally, faced with the EMU's inability to provide a credible cooperative solution, some governments have had to implement austerity plans under market pressure to relieve tension on the markets. All of these factors could generate harmful loops between the financial sphere and the real economy and could deteriorate the economic outlook of the euro area.

United States: Real GDP growth forecasts Amundi vs Consensus



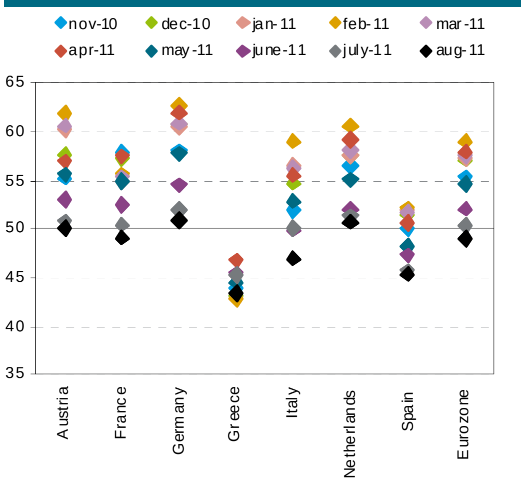
Source: Datastream Amundi Strategy

In peripheral countries, economic activity is expected to remain depressed as these countries will have to maintain a particularly restrictive fiscal policy in order to keep their public finances from slipping. Greece, Ireland, and – to a lesser extent – Portugal have experienced a drift away from the fiscal targets set in the first half of 2011. Only Spain has managed to maintain a budget in line with its objectives, but there are significant concerns over the financial standing of its regional governments.

In mid-August, Italy had to adopt a new €45.5 billion austerity measure for 2011 and 2012 (in addition to the €48 billion from mid-July) in order to reach a budget equilibrium in 2013. These plans, combined with a sharp rise in stress on the Italian banking sector after speculative attacks against its sovereign debt (resulting in tightening of its credit conditions), are expected to cause negative growth for Italy in Q3 2011 and will only enable GDP to growth by +0.6% in 2011 and +0.4% in 2012.

> *"The risk of recession is higher in Europe than in the US"*

EMU: PMI Manufacturing



Source : PMI, Amundi Strategy

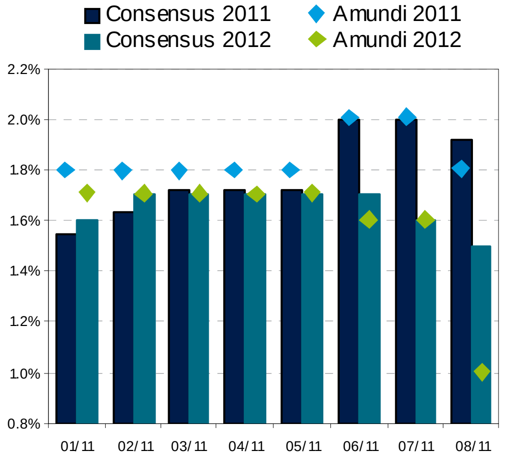
In France, the government deficit wasn't lower at the end of June compared to end of June 2010 (€61.3 billion vs. €61.7 billion). GDP growth stagnated in the second quarter, partly due to a contraction in household consumption (related to the end of the cash for clunkers). These results led the French government to revise its growth forecasts downwards for fiscal years 2011 and 2012 and to announce a €12 billion budget austerity plan in order to bring the public deficit to +4.5% in 2012 and to prevent France's AAA credit rating from being downgraded. The announced measures and lower indicators lead us to lower our growth forecasts for France from 2.1% and 1.5% to 1.7% and 1.4%, respectively, for 2011 and 2012.

Germany is not experiencing the same budgetary constraints as most other countries in the euro area. However, the country did not escape a tangible slowdown in its activity in Q2 2011. Like France, this disappointing result is explained mainly by temporary factors (compensation on consumption and construction after very high figures in Q1 2011). However, Germany's main driver, combining investment and exports, is expected to be curbed by increasing financial stress in Europe and by the slowdown of the country's main trading partners (the EMU and EU representing 40% and 72% of Germany's exports, respectively). German growth is then expected to barely recover in Q3 2011 and drop from an average annual rate of 3% in 2011 to 2% in 2012.

In all, euro-area GDP is expected to be zero at best in Q3 2011, with a possible contraction in activity. Unlike the United States, business surveys are unlikely to reflect over-reactions and are therefore expected to decline. Recent developments lead us to significantly revise our growth outlooks downwards for 2011 and 2012 (from +2% to +1.8% and from +1.6% to +1.0% respectively). In addition, there are many factors that could apply even more financial stress in the coming months (Greek bond exchange procedures, the roll-out of European bond auctions (particularly for Italy), the adoption of the 2012 financial laws and possibly budget consolidation rules at the constitutional level, the adoption of the new prerogatives granted by the EFSF during the July 21 summit) and lead to a much less favorable scenario.

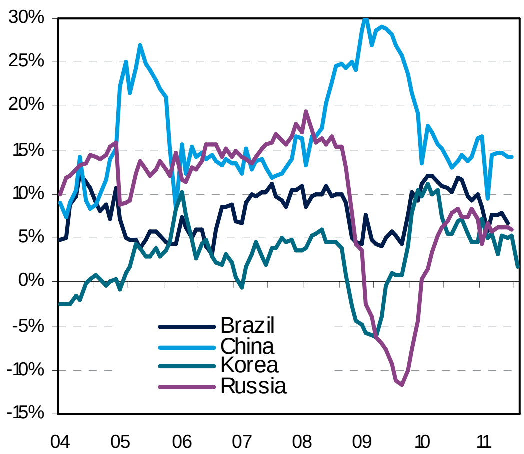
In the end, we are revising our global growth expectations from 3.9% to 3.5%. More than ever, emerging countries are standing out as a key driver of growth in the world. Even if they are expected to suffer from the slowdown in world trade, their domestic demand remains high. Retail sales are holding up well, thanks to a rise in incomes over the past year. In the context of a global slowdown and a decline in commodity prices, the risk of inflationary overheating is expected to be less of a concern in the short term. Total inflation indexes in these countries will experience a strong negative impact on their food components. This should allow central banks to adopt less restrictive monetary policies. Finally, unlike developed countries, emerging economies have the room in their budgets to cushion the economic shock.

Euro area: Real GDP growth forecasts Amundi vs Consensus



Source: Datastream Amundi Strategy

Selected Emerging Countries: Retail Sales (real, y/y)



Source: Datastream, Amundi Strategy

	GDP (yoy, %)			Inflation (yoy, %)			Public balance (yoy, %)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
US	2.9	1.4	2.0	1.6	3.3	2.0	-8.9	-9.3	-7.3
EMU	1.6	1.8	1.0	1.6	2.5	1.5	-6.0	-4.1	-3.2
Germany	3.5	3.0	1.8	1.2	2.4	1.3	-3.3	-2.2	-1.8
France	1.4	1.7	1.4	1.7	2.1	1.3	-7.1	-5.9	-4.7
Italy	1.2	0.6	0.4	1.6	2.3	1.5	-4.6	-4.2	-3.7
Spain	-0.1	0.8	0.6	2.0	3.0	1.4	-9.2	-6.9	-5.4
UK	1.3	1.2	1.2	3.3	4.3	2.0	-9.7	-8.1	-7.0
Japan	4.0	-0.7	2.5	-1.1	0.4	0.2	-9.5	-8.7	-9.1
China	10.3	9.3	8.8	3.3	5.6	3.8	-2.6	-1.7	-1.2
India	9.1	7.2	7.5	9.5	8.3	6.0	-9.0	-8.4	-7.4
Brazil	7.5	3.6	3.5	5.9	6.3	5.2	-2.9	-2.7	-2.9
Russia	4.0	3.7	2.0	8.8	7.7	10.0	-3.6	-2.1	-2.7

Box 1 : Oil - The WTI/Brent price spread will not last

The difference in the quoted price between Brent crude oil listed in London and West Texas Intermediate (WTI) listed in New York, which is on average $1.20, reached a record high of $26.30 in August. Brent declined much less than WTI despite the outlook for slowing global growth. According to the International Energy Agency (IEA), the demand for oil will continue to increase in 2012 due mainly to growth in non-OECD countries.

The historical price spread between the two classifications of oil naturally garners attention. Two questions arise. First, can this spread last a long time? And second, is this price spread likely to have macroeconomic consequences?

1. The inventory of WTI at Cushing has been down since April 2011, returning to its year-end 2010 level. Historically, the relationship between the Brent-WTI price spread and inventory is negative. In other words, when the oil inventory at Cushing increases, the price of Brent increases relative to WTI. All things being equal, the decline in inventory should have increased the value of WTI relative to Brent. But, the opposite has occurred since April. The slower decline in Brent relative to WTI can be explained by a supply shock linked to the events in Libya (1.5 million barrels/day fewer). Graph 1 shows that the WTI inventory points to an abundance of oil while Brent inventory suggests a shortfall in supply. These opposing movements therefore lead to an increase in the price spread in favour of Brent.

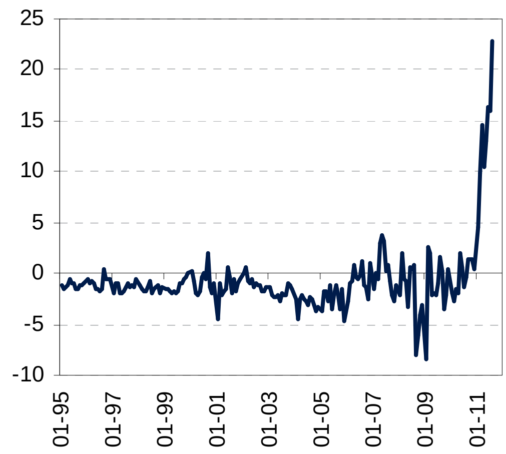
Fundamentally, the price spread between the two classifications of oil should not exceed the cost of freight of a barrel of oil between Cushing and the United Kingdom, plus a risk premium. These costs are estimated at $10 per barrel, it is also necessary to add some logistical costs. So a spread of more than $25, by giving hopes of substantial gains, should foster physical arbitrage between WTI and Brent. This arbitrage may already be at work on petroleum products. In we see that net US exports of petroleum products are positive (in Btu), a first since 1991 (start of the series). This reflects the fact that it is advantageous for other countries to import goods that are priced based on WTI.

In addition, the IEA also watches changes in Brent and could intervene in the oil market again by selling a portion of its oil reserves in order to limit the rising price of Brent, as it did in June (60 million barrels).

A financial strategy (long WTI - short Brent) that aims to capitalise on the narrowing of this spread may prove to be profitable, but the timing will be critical to the performance of such a strategy. WTI is in contango (graph 2), while this is no longer the case for Brent. This means that the longer investors hold WTI futures, the more the strategy will prove to be costly because, in this case, rolling over a position represents a cost. In the end, investors should therefore count more on physical arbitrage to narrow the price gap between these two oil classifications.

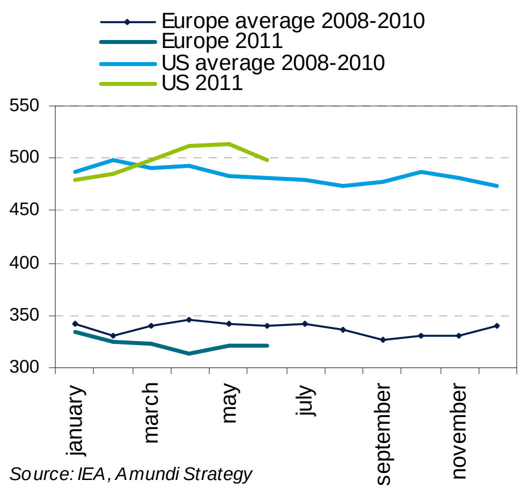
2. With regard to macroeconomics, do not overestimate the consequences of this spread. On the one hand, the price of petrol at the pump in the United States turns out to be much more sensitive to changes in the price of Brent than WTI. Yet, the price of Brent is higher than at the beginning of the summer. The US economy's greater sensitivity to the price of Brent is not surprising insofar as the United States is a net importer of petroleum products. On the other hand, if the United States takes advantage in terms of exports of the physical arbitrage strategies that seem to be in place, this will not change the game for the oil bill which, at $3 billion in 2011, represents 20% of the United States' trade deficit.

Brent- WTI spread



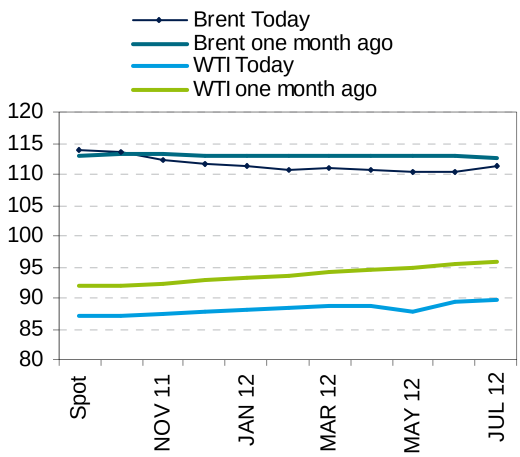
Source: Datastream, Amundi Strategy

Crude oil inventories (mb)



Source: IEA, Amundi Strategy

Crude oil forward curve



Source: Bloomberg, Amundi Strategy

3 Sovereign debt: the US leaves the (very exclusive) AAA club

While all eyes were focused on European debt and the risk of contagion, and while many observers were contesting the AAA rating of some EMU core countries, it was ultimately the United States that left the now very exclusive club of sovereign issuers having a AAA-rated long-term debt. S&P downgraded the US in reaction to hesitations and dissension between the Congress and the Obama administration. For the raising of the debt ceiling had been belated and complicated. This ceiling was raised for the third time since the Barack Obama took office in 2009, for the 10th time in 10 years, and for the 75th time since 1962! Twice the raising of the debt ceiling has been "brought forth in pain": the first time in 1995, with a conflict between Bill Clinton and Newt Gringrich, and the second time this summer, with Barack Obama pitted against John Boehner. This time, given the level of the debt and the budget deficit, the ratings agency sanctioned US governance and downgraded it from AAA to AA+) . Remember that only two countries saw their public debt/GDP and public deficit/GDP ratios both rise in 2010: Japan and the United States, and the credit ratings of both have been downgraded in recent weeks.

It is rather amusing to remember that a little more than 10 years ago, the US was looking forward to paying off its debt by 2015, and the burning issue then was what might be best replace US sovereign debt. Many observers felt that Fannie Mae and Freddie Mac were the best candidates as risk-free assets! Nothing came of that, obviously. The agencies in question almost went under during the 2008 financial crisis; US sovereign debt has risen from less than 6000 billion dollars in 2000 to more than 14.6 trillion in 2011, and the CBO (Congressional Budget Office) projects it at almost 19000 billion for 2015. More than its sheer level (worrisome though that may be), it is the debt trajectory that gives pause: which means this won't be the last we hear about this issue. As you can see, the subject has been turned on its head: instead of asking what will become the international risk-free benchmark when US sovereign debt is eliminated, the same question is being asked because of the downgrade in the US sovereign debt rating and its trajectory, which is now out of control.

Only 15 sovereigns have held onto an AAA rating

Only 15 countries are now rated AAA by S&P's: Singapore (112% public debt/GDP ratio in 2010), Canada (84%), Germany (83%), France (82%), the United Kingdom (80%), Austria (72%), the Netherlands (63%), Finland (48%), Norway (45%), Denmark (44%), Sweden (40%), Sweden (40%), New Zealand (39%), Luxembourg (18%) and Australia (14%). As we can see, an AAA rating goes alongside a very different reality regarding sovereign debt. Remember, however, that an economic slowdown has greater consequences for a heavily indebted country than for a lightly indebted country. This is what Moody's recalled a few days ago after its decision (the first since 2002) to downgrade Japan from AA2 to AA3. Remember that to move back up to AAA… it has taken some countries 10 years, while others will probably never managed to do so. It is hard to imaging Japan's being upgraded back up to AAA, given its stock of debt and weak economic growth.

In other words, the economic cycle and shortfall in governance are likely to play a key role in rating outlooks. And in this area, neither the US nor the euro zone are on completely firm ground. Even so, let's not overlook the fact that ratings are based on quantitative criteria, but that the difference between an AAA and an AA is essentially qualitative.

> *"The economic slowdown and shortfalls in governance are undermining the quality of debt"*

Sovereign ratings: debt quality criteria

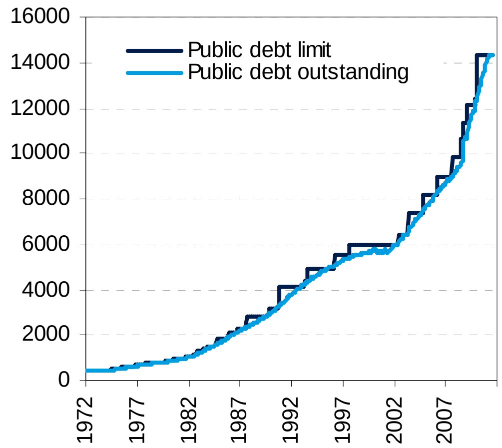
Many economic and financial ratios are used by the agencies in setting their ratings, including whether it is "sustainable". The ratings agencies tend to look at three broad criteria :

-the economically and politically acceptable level of debt;

-the level of debt that can be financed;

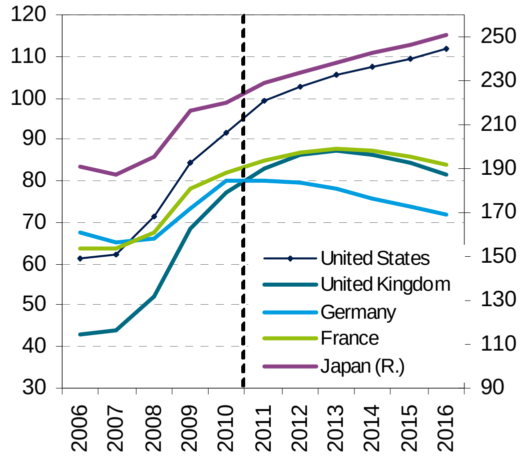
-the level of debt that is reversible.

United States: public debt ceiling vs outstanding (in USD bn)



Source: Datastream, Amundi Strategy

General government gross debt (% of GDP) for advanced economies



Source: IMF, Amundi Strategy

In determining an **acceptable level of debt**, the agencies look at a number of indicators, financial ones in particular, including the size of debt, its cost, its percentage of government receipts, and so on. In short, they try to measure to what extent public debt is likely to make political, economic and social choices difficult. This is obviously the case of European countries. Adopting a pro-cyclical fiscal and tax policy is a clear illustration of this phenomenon, and that is why we will continue to hear a lot of talk about ratings.

Debt-financing capacity is also a crucial criterion. Countries can default with very different debt levels, and the capacity to finance debt (i.e., the capacity to issue debt, to attract investors, etc.) is a major component in ratings.

> *We will be hearing a lot about European sovereign ratings for some time to come*

In the 1980s many emerging country governments defaulted. Some countries had faced a sudden spike in the cost of servicing their dollar-denominated debt during a phase of strong dollar gains (a problem of solvency). Others were unable to access the capital markets (a problem of liquidity). The more a country depends on international savings, the more it is vulnerable. The more a country is a benchmark, the less likely it is to be handicapped by such problems. The ratings agencies have often acknowledged that their comfort level with US sovereign debt lies in part to the resiliency of the US economy and in part to the fact that the dollar was the uncontested reserve currency.

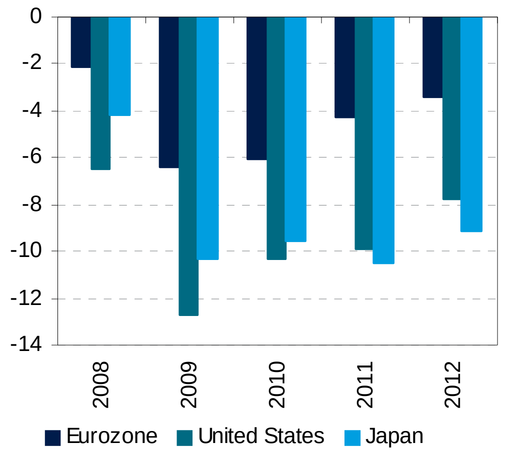
The criterion of **debt "reversibility"** is important as it determines whether a country is able to control the trend in its debt, as well as to bring it back down to manageable levels. What is worrisome today in the cases of Greece, Japan, the United States and others is the sharp expansion in the stock of debt, debt ratios to GDP, etc. A strong economy is a necessary, but insufficient, criterion. Political will (reduction of public expenditure, capacity to raise taxes and levies, etc.) or governance are essential qualitative factors.

In light of all of these criteria (quantitative and qualitative), the ratings agencies have often stressed that a fine line separates AAA and AA, and that qualitative criteria play a big role.

This is tantamount to saying that the remaining AAA countries, led by the European core, as well as the United Kingdom, will have to enhance the quality of their debt and demonstrate, in particular, a greater capacity to reduce debt levels, improve their capacity to reverse the trend that debt has taken on over the past two decades, and improve the quality of their economic and political governance.

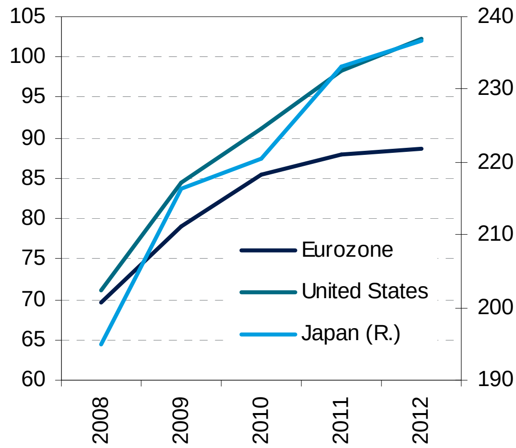
On all these points, Australia, New Zealand, Switzerland and the Nordic countries are clearly in a more comfortable place.

Public deficit forecasts



Source: IMF, Amundi Strategy

Public debt forecasts



Source: IMF, Amundi Strategy

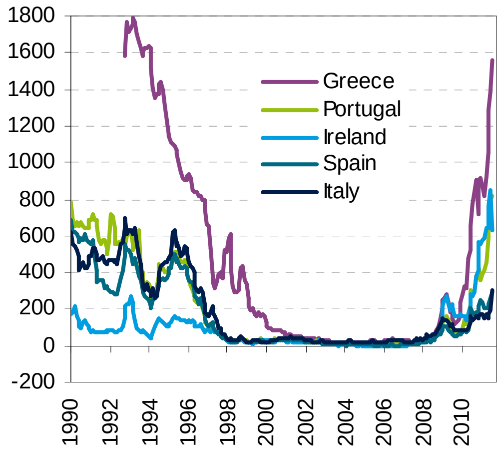
4 Federalism, eurobonds, expanded EFSF role … what path are we truly taking?

The creation of eurobonds, the adoption of a fiscal "golden rule", and the expanded capacities of the EFSF (European Fund for Financial Stability) are three recurring themes that are driving the financial markets. How did we reach this point? Clearly, the EMU, in many ways, remains a work in progress, given the political choices that have been made in the last two or three decades. The lack of a federal budget, for example, is one of the most persistent criticisms.

The creation of the EMU was original in many ways, but like other monetary unions, it was a long and complex process. In many ways, the EMU is an unprecedented phenomenon. However, the originality of the process and the advent of the euro must not hide the fact that its success was based implicitly on several important assumptions:

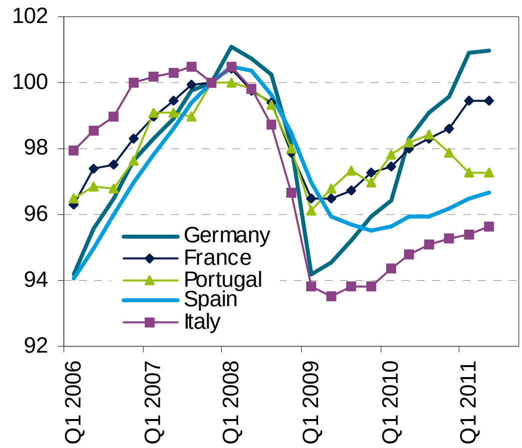
- "continuous" economic convergence and converging economic policies (fiscal policies in particular);
- the lack of asymmetric shocks, whether exogenous or endogenous;
- the impossibility for a government to deviate from the required convergence criteria under penalty of economic sanctions (this took the form of the Stability Pact, which later became the Stability and Growth Pact);
- the existence of a federal budget was not to be necessary.

Long term interest rate spread with Germany (in bps)



Source: Datastream, Amundi Strategy

GDP in volume (100= Q4 2007)



Source: Datastream, Amundi Strategy

Box 2 - EMU: coordination, convergence and single currency … some background

Without plunging into the history of the creation of the European Union, which was built on an economic foundation in order to mitigate or get around political difficulties and dissensions (even back then), let's go back over the main phases of European monetary union.

Phase 1: coordination. European countries focused first on coordinating economic policies – coordinating fiscal and tax policies to promote synchronous economic cycles, and coordinating monetary policies to forestall additional turmoil on the currency markets. It became essential to stabilise exchange rates (to prevent distortions among countries integrated economically and, above all, commercially). The idea was to prevent devaluations (often competitive ones) like those that occurred in the first half of the 1980s. This led to a stabilisation in interest rate differentials, which ultimately came to reflect differentials in inflation, which then had to be gradually reined in.

Phase 2: convergence. Once the first phase had been consolidated, European countries set up convergence policies, which resulted in similar economic cycles, similar monetary policies, and converging interest rates until rate differences vanished altogether. That left fiscal and tax policies as the levers of economic policy, with notorious divergences in executing these policies and in performances in this area. Efforts at monetary and fiscal convergence did not prevent the crises on the European currency market (in the early 1990s), as this had ultimately became a space for European financial markets to breathe.

Phase 3: the single currency. As coordination and convergence proceeded as preliminary phases to the adoption of a single currency, the European Union integrated an increasing number of countries whose economic performances obviously did not allow them to take part immediately in the monetary union. The convergence criteria for the adoption of the euro were thus the major discriminating factors between countries.

Let's not rehash the rationality of the convergence criteria but note simply that: 1) **the initial Stability Pact, which was meant to punish "deviating" countries, was never enforced** (ironically, Germany and then France were the first two countries to deviate); 2) the past decade has shown how powerful **asymmetric shocks** can be; and 3) the lack of a federal budget channel through which to transfer wealth has exacerbated the **divergences**.

> *EMU: a rationale undermined by asymmetric shocks and non-enforcement of criteria and sanctions*

It is also worth recalling the **inability of policy makers** to move forth on the issue of federalism, but also the **short-sightedness of the financial markets, which insisted on ignoring economic divergences** or, at the very least, the differences existing between euro zone countries: a single currency, a single monetary policy, very different economic performances (Greece or Portugal have never come close to equalling Germany's performances), but extremely narrow yield spreads for almost a decade. **More than the emergence of the current spreads, it's the lack of spreads between the mid-1990s and the mid-2000s that should be perceived as a strange phenomenon**.

Fluctuations in credit spreads between sovereign states have now supplanted currency fluctuations, and debt crises have supplanted currency crises. Such is the reality we are now experiencing.

> *From currency crises to debt crises*

Pooling costs and wealth: a politically impossible option

In a federal monetary union, such as the United States or Canada, for example, the federal budget allows for the transfer of wealth between regions (states, provinces, etc.), which smoothes out asymmetric shocks or differences in cycles or wealth. Such is not the case in the euro zone, given the weakness of the federal budget. Transfers of wealth are subject to tough bargaining during crisis situations. As member-states have not completely given up their fiscal and tax sovereignty, all sorts of profiles are found: structurally rigorous countries, lax countries, pro-cyclical policies, counter-cyclical fiscal policies, and so on. In a word, wide divergences that result in wide gaps between countries. **These divergences have been widening over the past several years, as their drivers are powerful and are no doubt hard to reverse**:

- **Flagrant gaps in competitiveness**, resulting in structural current accounts deficits in certain countries and surpluses in others;
- **Very different levels of growth**, and severely depressed labour markets in certain countries;
- **Contrasting fiscal situations**: part of Europe (mainly in the south) is now being forced into fiscal austerity but also to continue deleveraging;
- **A diverging stance vis-à-vis emerging markets and globalisation of trade**. Some benefit fully, such as Germany (25% of its exports are to emerging markets), while others hardly even notice;
- **High interest rates**, due to the debt crisis;
- **A currency, the euro, which is overvalued** compared to their competitiveness and their economic performances;
- A **restrictive policy for European peripheral countries**, and an accommodating one for the core countries.

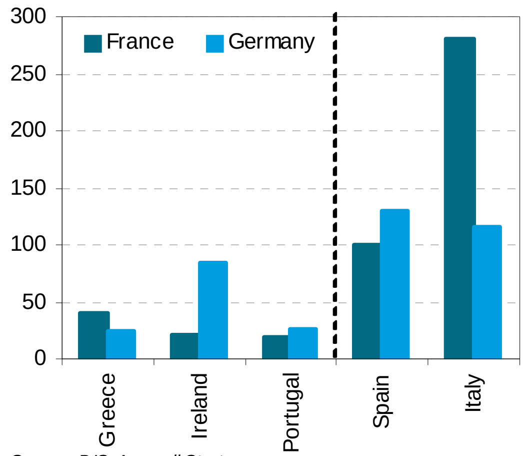
In other words, during periods of divergences and given the lack of a federal budget and "organised" transfers, the euro zone appears to have no choice but to pool risks, wealth, and so on, on an ex-post basis … and there's the rub. How can rigorous countries be forced into pooling wealth with countries that "cultivate" tax evasion, the use of public expenditure, debt and deficits, and that are incapable of undertaking structural reforms. In a word, how to avoid "free riders", i.e., how can countries be kept from being lax while hiding behind their euro-zone membership?

The adoption of the fiscal "Golden Rule" … an asset or a liability?

One solution to limit indulgence and pooling would be to have all euro zone countries adopt a fiscal golden rule, such as the elimination of structural public deficits. This proposal was put forth in mid-August jointly by Angela Merkel and Nicolas Sarkozy, with two main objectives: inscribe fiscal rigor in the DNA of European economies, while retaining some leeway for temporary deficits. This would make structural reform inevitable.

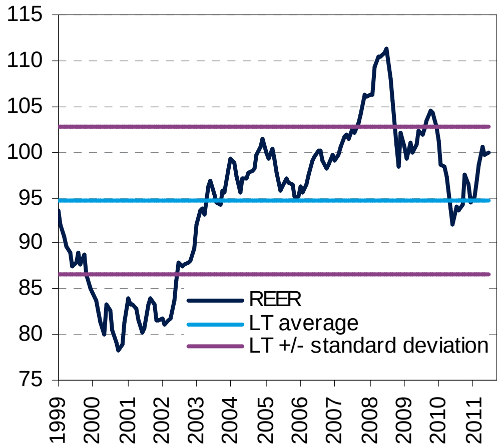
Remember that **Germany has written such a rule into its constitution, which is leading it to balance its budget, as defined, by 2016. Spain is preparing to do the same prior to the November elections**. This will require a big effort, as, with the exception of the Netherlands, Finland and Luxembourg, all euro zone countries are running a structural public deficit. **The difficulty obviously lies in adopting restrictive measures at a time when growth is slackening**.

French and German's exposures to peripheral countries (in € bn on Q4-2010)



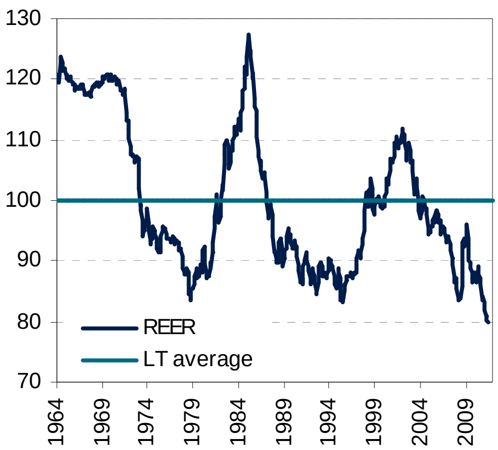
Source: BIS, Amundi Strategy

Real effective exchange rate of the Euro since its creation



Source: Datastream, Amundi Strategy

Dollar real trade-weighted exchange rate (100 = long term average)



Source: Datastream, Amundi Strategy

Making fiscal policy a pro-cyclical instrument (which amplifies the slowdown) is one of the markets' biggest fears. In other words, such a measure is without a doubt beneficial in the long term but would exacerbate the current economic slowdown, with knock-on effects on tax receipts, employment …and deficits and debt.

Issuing eurobonds: not such a good idea… as things now stand

The large number of European issuers allows investors to pick and choose among various sovereigns, which is dangerous during a crisis. A single issuer (i.e., an agency for the euro zone) would eliminate this risk. Moreover, once the principle adopted, it would be essential to prevent any lax behaviour… It is for precisely this reason that **rigor and convergence are prerequisites to the adoption of eurobonds, which are under no circumstances a solution to divergences and lax behaviour. The debate must be framed properly**. Eurobond issuance is one possible option, but only at the end of the European integration process. The existence of a European agency to issue on behalf of various sovereigns would also help resolve the market liquidity problems of certain sovereign issuers. This is nothing new. During the process leading to the single currency, the possibility had been mentioned of having the "small countries" pooling their issues. Let's not underestimate the advantages of eurobonds, but let's not overlook their drawbacks either, or the obstacles they would face and that would be hard to overcome.

The first of these is purely political in nature. The Germans, in particular, do not want to see eurobonds at a time when divergences and lax behaviour is so apparent. There is no way they would agree to pool risks and wealth.

The second obstacle is the rating that this agency would carry. Based on current ratings and in the midst of the debt crisis, an AAA rating looks out of reach. In other words, Germany – or France – would be handing in their AAA for a lower rating and higher yields. This is quite simply unthinkable, for economic and financial reasons but also political reasons. It's hard to see how Germany and Angela Merkel would give in to such a plan … with general elections coming.

No doubt that the question of eurobonds will continued to be bandied about, but **we see very little chance of it happening in the next few years. Eurobonds are no solution to the crisis.**

> *"European integration first, then eurobonds … and not the other way around!"*

EFSF: an essential role, but insufficient capacity

The creation of the European Fund for Financial Stability (EFSF) in summer 2010 restored some hope in a rapid and concerted resolution of the debt crisis. Alongside the ECB's SMP (Securities Market Programme) to buy up sovereign debt, it was a cornerstone of European governments' anti-crisis mechanism. These hopes were dashed, for two main reasons:

- The size of the fund: **set up to meet the needs of small, peripheral countries, it was completely unable to prevent any form of contagion to larger countries**. The ECB's securities purchasing plan also quickly met its limits.

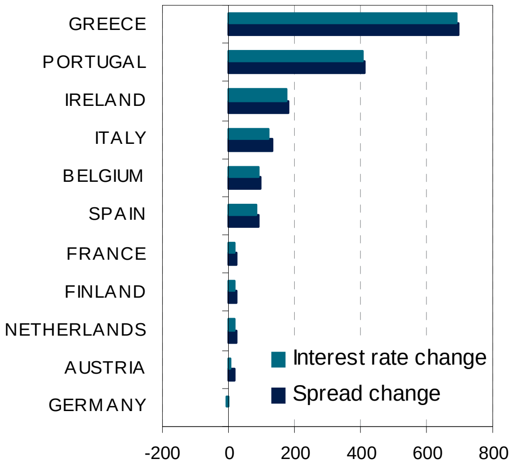
- The nature of the fund: **set up to assist countries having liquidity problems, it could not be considered a major player in the event of a solvency problem**. Worse yet, because of its system of guarantees, it undermined the standing of guarantor countries.

Box 3: Why doesn't the ECB buy more European bonds?

The ECB is coming under considerable attack from market observers for what is deemed its relative timidity in its purchases of peripheral sovereign debt. True, its purchases do look modest compared to similar ones by its counterparts. While the ECB has bought 74 billion euros in European securities, the Bank of England has bought up almost 200 billion in UK securities, and the Fed, almost 900 billion dollars in Treasuries (300 billion under QE1 and 600 billion under QE2), plus 175 billion dollars in agency debt and 1250 billion dollars in mortgage-backed securities during QE1. The ECB's position is different, for at least five reasons:

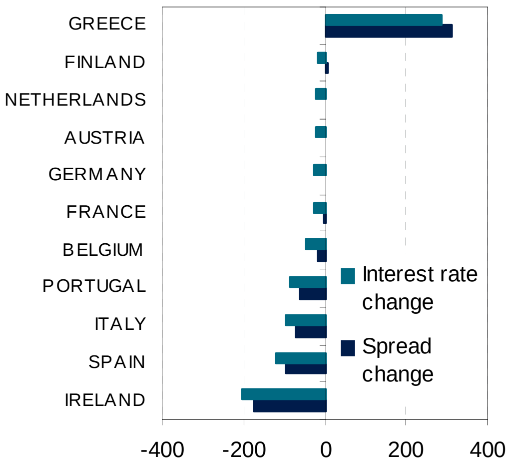
- it does not want to undermine the quality of its balance sheet;
- it is unable to sterilise its debt purchases, which is a crucial point for a central bank whose sole remit is to fight inflation;
- it is unable, ex-ante, to successfully fight a more serious contagion to Spain and Italy, given the size of those countries' debt;
- it does not want to look like a buyer of last resort of sovereign debt;
- it does not want to promote moral hazard: if the ECB is the buyer of last resort, member-countries might have no incentive to implement true fiscal austerity.

Evolution of the 10 yr sovereign spread with Germany over the year



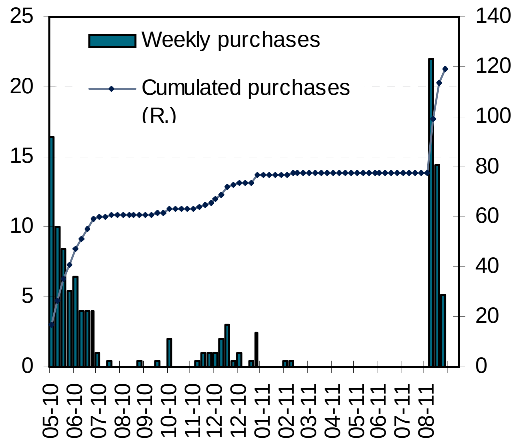
Source: Datastream, Amundi Strategy

Evolution of the 10 yr sovereign spread with Germany over the month



Source: Datastream, Amundi Strategy

ECB Weekly purchases of sovereign debt securities (€ Bn)



Source: ECB, Amundi Strategy

Clearly, the EFSF, even though it has been operational since August 2010, did not keep the Portuguese and Irish crises from happening or from spreading to other countries. This is probably why its role has been modified. On 24 June, the Europeans allowed it to buy securities on the primary market, and on 21 July, on the secondary market, subject to a review by the ECB.

Box 4: Who is buying EFSF-issued bonds?

Central banks and sovereign wealth funds account for 45% of purchases, followed by asset managers and banks, with 25% and 20%, respectively. Japan accounts for 22%, and Asia ex-Japan, a little less than 20%. The euro zone accounts for 38%, the UK 10%, and the US 2%. Note that the ECB does not buy EFSF bonds, as the EFSF is a private-law company owned by EU member-states, and the Treaty forbids the ECB from lending to member countries. In July 2013, the EFSF will give way to the ESM (European Stability Mechanism). The EMS will be a new fund with, most importantly, a new legal status. Like the IMF, the EMS will have the legal status of an international organisation (that's why it is often called the European Monetary Fund), a status that will allow the ECB to lend to it. This is clearly an important attribute during a period of crisis, but, like the authorisation to transact on the secondary market, this option comes a little late. The sovereign debt crisis would without a doubt have turned out differently with a fund transacting on the secondary market and if the BCE allowed to lend to the European fund.

5 What do financial stress indicators teach us about the eurozone and the US?

What is financial stress?

Financial stress indices have seen a revival of popularity since the subprime crisis. Theses indices are mainly used by the IMF and US regional federal banks to measure the extent of the financial crises. They have tended to be built on the basis of US financial variables only because of the long track record and dominant role played by the US markets. In the past, these indicators succeeded in capturing the periods of crisis that hit all developed countries and were able to announce a little in advance the phases of slowdown in economic activity or recession.

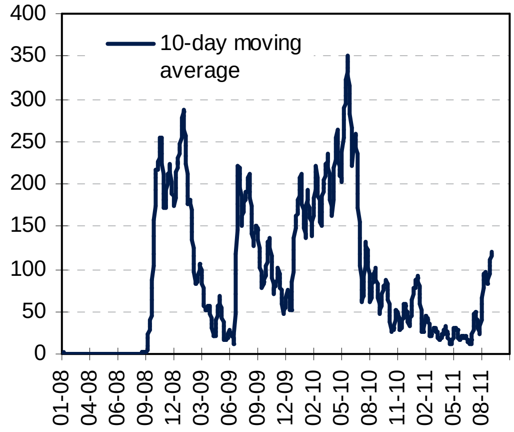
Since 2010, we have seen a disconnection between certain market segments on both sides of the Atlantic. We therefore built a financial stress indicator on the basis of financial variables related to the euro zone. The sovereign dimension of the European crisis is factored in on two counts. Directly via sovereign spreads and indirectly via the pressure on the euro zone banking sector (equities, credit, pressure on interbank liquidity). Our indicator also offers the advantage of being calculated daily, unlike most similar indicators which tend to be calculated monthly. It thus provides a synthetic measurement by which one can follow the intensity of financial pressure within the euro zone from day to day. The box below shows details of the variables and methodology used for the euro zone. We also built a similar indicator for the US.

Why are such indices important for growth?

Our index is calculated on the basis of 10 variables that take into account different measurements related to the credit market, the equity markets and pressure on liquidity. During periods of crisis, portfolio reallocations are accompanied by a reassessment of credit risk, and this is manifested in the credit ratings of financial issuers and non-financial issuers of developed countries.

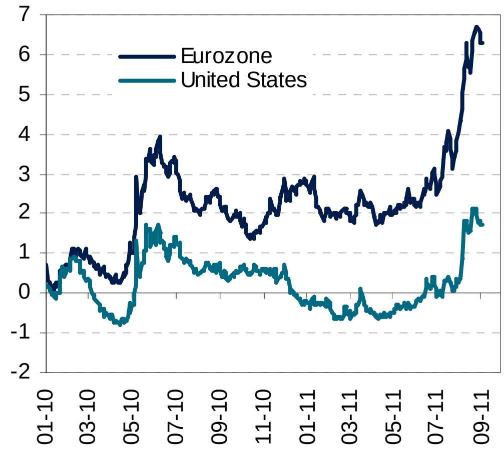
When there has been a rapid reassessment of risk, the financial pressures thus measured indicate the economic cycle ahead. The reason is simple: many companies are battling with restricted financing. The increase in credit spreads reflects a toughening of financial conditions which weighs on capital expenditure and thus on growth. The pressure on bank liquidity – and more generally all variables that reflect an increase in pressure on banks – raises the threat of a credit crunch. Small caps and mid caps corporates are naturally the most exposed. Large companies, even if they hold ample cash, are not immune to financing conditions on the markets when it comes to implementing their investment plans. With regard to these indices, the European economic outlook seems much more exposed than the US.

ECB Liquidity recourse to deposit facility (€ bn)



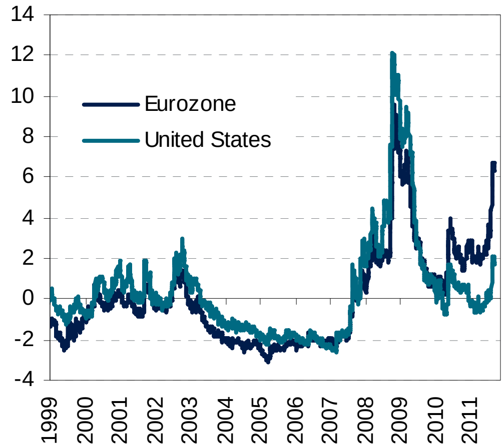
Source: Bloomberg, Amundi Strategy

Financial stress index: Eurozone vs United States



Source: Amundi calculations

Financial stress index: Eurozone vs United States



Source: Amundi Strategy

Box 5: the variables and methodology used to measure European financial stress

The ten variables used are:

1. The correlation between government bonds and equities

During normal periods, there is no reason for the returns on equities and bonds to be linked by a one-to-one relationship. However, during periods of crisis, investors rapidly turn away from equities towards government debt which is considered more secure. Under these conditions, the returns on equities and bonds evolve in opposing directions (or in other words share prices and bond yields evolve in the same direction). Several studies show that the correlation between returns tends to become negative during financial crises.

2. Implied volatility on the equity markets

This involves measuring the volatility anticipated by market operators, with any increase reflecting growing uncertainty regarding their anticipations. For this we used the implied volatility on option prices. Most empirical studies use the VIX (implied volatility on the S&P5000). We opted rather for a euro zone measure: implied volatility on the DAX.

3. Sovereign spreads within the euro zone (spreads vs Germany)

This is a measurement specific to the euro zone index designed to take into account the sovereign dimension of the European crisis since 2010. The spreads between 10-year government bonds and German bonds are aggregated and weighted for the share of government debt in the total debt of the euro zone. Note that the use of an alternative crisis measurement (weighting of sovereign CDS) would not change anything.

4. Corporate spreads: Baa vs Aaa

Baa rated companies are at the bottom of the “investment grade” ranking (Moody’s classification). This variable captures the flight to quality caused by the reassessment of credit risk.

5. High-yield corporate spreads vs Aaa

Before 2006, we used cash spreads. Since then we have favoured CDS indices which are more widely used and which better reflect tension in this segment. The increase in high-yield spreads can capture an anticipated rise in the default rates of companies that are most exposed to a marked slowdown in activity.

6. Spreads between Aaa rated companies and government securities

During normal times, this spread is low, with AAA rated companies showing virtually zero risk of default. During periods of financial pressure, however, liquidity premiums appear even for those companies with the highest rating.

7. Swap spreads

The yield spread between interest rate swaps and government securities reflects the hierarchy of credit ratings between the government and the banking system. An increase in the swap spread can also capture fears of future pressure on interbank rates. For our purposes we used the German 2-year swap spread.

8. Pressure on interbank liquidity

This is measured on the basis of the spread between interbank (Libor) and OIS rates.

9. Idiosyncratic volatility of banking stocks

Here we measured the volatility specific to banking stocks (i.e. the volatility that is independent of global equities). We regressed an index of euro zone banking stocks in relation to a global euro zone stock market index. Then we calculated the volatility of the residuals to isolate the volatility of the banking stocks component which is not explained by the volatility of the entire stock market.

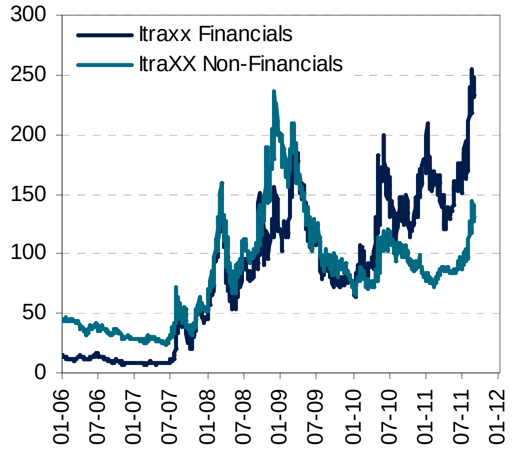
10. Bank credit spreads

To better factor in the distrust regarding the banking sector, we used bank CDS (Itraxx financial index). As there were no CDS before 2004, we retrograded this series with bank credit spreads to apply our stress index back to the beginning of the euro zone.

Note that we omitted emerging risk as the epicentre of the crisis lies in developed countries.

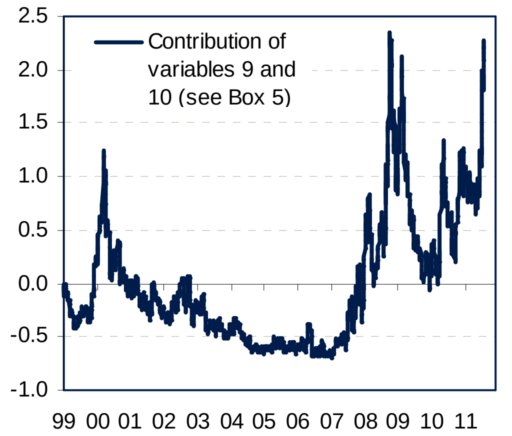
Because the variables used tend to vary concomitantly during phases of crisis, an analysis using the main components isolated the “common factor”. This common factor is the synthetic measurement of the financial stress. The component specific to the euro zone can then be understood through the spread between the euro zone index and the similar index build for the US. Once the synthetic index is calculated, it is useful to look at those components with the highest contribution. The contributions from variables 8, 9 and 10 measure the intensity of the banking crisis. It is striking to see from these variables that Europe is close to the tension peak observed after the demise of Lehman Brothers, which is not the case for the US.

ItraXX Financials vs Non-Financials



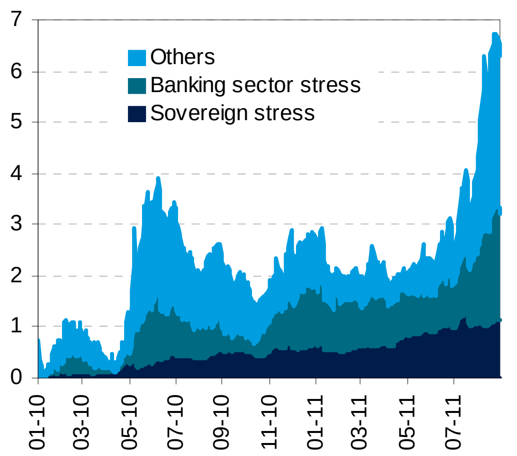
Source: Bloomberg, Amundi Strategy

"Banking stress" contribution to the financial stress in the eurozone



Source: Amundi Strategy calculations

Contributions to the eurozone Financial Stress Index



Source: Amundi Strategy

6 Liquidity and monetary policy : what might be the impact on yield curves?

The financial crisis and the slowing economies in most of the developed countries are changing the game for central bankers. Until this summer, the core theme was normalisation – in progress or in the future – of monetary policies. The central banks had opted for extremely accommodative policies to curb the financial crisis following the collapse of Lehman Brothers. With the economic recovery, the ECB was the only central bank of all the developing countries to be concerned with the rise of persistent inflationary pressures (see Cross Assets N° 05, May 2011). The sorely gradual economic recovery in the United States also prompted expectations that the Fed would start to normalise its monetary policy, but later on. The US authorities' more cautious approach could be explained by the deteriorating labour market – with long-term unemployment at its highest level since World War II – and an extremely sluggish real estate market (see Cross Assets n° 07, July 2011).

With the financial crisis worsening since the beginning of the summer and the economic slowdown, central banks on both sides of the Atlantic have already changed their approach. At the last FOMC meeting, the Fed pledged against all expectations to keep its key policy rates unchanged through mid-2013. This decision, unprecedented in the history of US monetary policy, essentially ties the Federal Reserve's hands for two years. The yield on two-year Treasury notes automatically fell to its historic low in August (under 0.2%), below 3-month interbank rates (Libor at 0.3%). Meanwhile, the ECB resumed its special liquidity operations and its Securities Markets Programme (SMP) implemented in spring 2010. Against this backdrop, the expectations for monetary policy were reversed.

How do we explain this reversal?

First, with the sovereign-debt crisis in Europe and the downgrade of the United States, governments have become aware of the need to balance public finances. In the United States, budgetary policy is going to further depress growth, like in the euro area, where austerity plans are multiplying (Italy, France) so that governments might avoid being downgraded by the credit rating agencies. We should emphasise that in terms of policy mix, fiscal tightening permits more accommodative monetary policy, all things being equal. In addition, this summer's financial crisis is going to depress private demand, at least temporarily (see the section on financial stress). With the slowdown in economic conditions, inflationary pressures are going to subside in the developed countries, allowing the central banks to let down their guard.

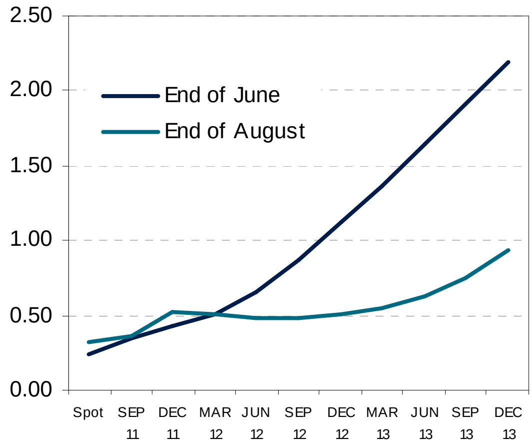
The consequences for the bond markets, and in turn for the other asset classes, are significant. Excess liquidity in major developed countries is not going to disappear anytime soon.

> *“The need to balance public finances has led central banks to alter their stances”*

Is the United States headed for QE3?

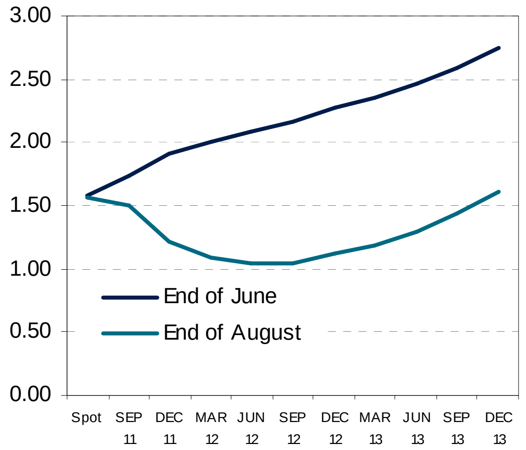
Despite the expectations of some commentators, the symposium held on August 26 in Jackson Hole did not produce any particular announcement from Ben Bernanke. No surprise there. First, economic conditions are very different from the situation that prevailed in the summer of 2010, particularly in terms of underlying inflation, which is distinctly higher now than what it was then. Furthermore, the effects of QE2 were unclear. By absorbing the supply of Treasury notes, the Fed induced investors to turn to other asset classes. The US stock market profited in particular since the profit cycle was especially strong. In the recovery phase, business profits rebounded more than economic activity in the United States. Today, the economic climate has changed radically. Growth is slowing and analysts are revising their 2012 earnings expectations downward. Furthermore, several members of the Fed have become aware of the dangers of QE. On the one hand, excess liquidity may have fuelled higher commodities prices, thereby thwarting growth. On the other hand, it is wishful thinking to suppose that an ailment which is in essence budgetary (lack of budgetary discipline) can be treated with a monetary remedy. This is especially evident since QE3 policy failed to stimulate economic activity, which slowed markedly in the first half of 2011. In the end, banks hoarded the injected liquidity, raising their excess reserves with the Fed in the same proportions as their Treasuries purchases (see chart). Indirectly, this means that the credit multiplier remains frozen in the United States. Even though securities buying was financed by monetary creation, the liquidity created is not circulating.

3 month US Libor interest rate futures



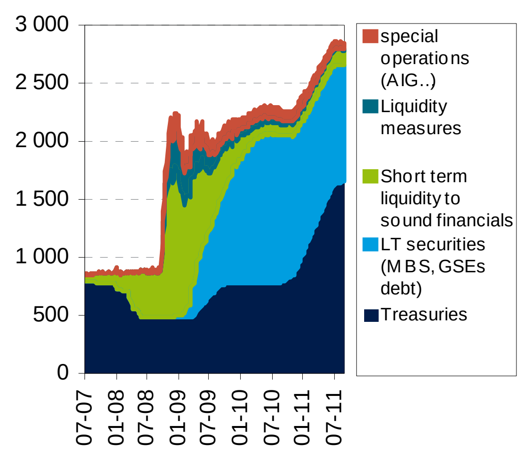
Source: Bloomberg, Amundi Strategy

3 month Euribor interest rate futures



Source: Bloomberg, Amundi Strategy

Federal Reserve - Assets (USD bn)



Source: Fed, Amundi Strategy

Under these circumstances, inflationary pressures on goods and services have no reason to emerge.

Does this mean that the Fed has become powerless to stimulate activity? No, because there are many other unorthodox measures to be considered that are not based on monetary creation. Linked to measures targeting real estate, these moves could stimulate activity (see box). The possible measures include the following:

1- The possibility of lowering the rate paid on banks' excess reserves, which currently earn 0.25%. Opting for a zero or even negative interest rate would amount to increasing the opportunity cost of holding cash in its vaults, and consequently would spur banks to extend new loans.

2- In the same way that the Fed committed to keeping rates close to zero until mid-2013, it could pledge to keep the size of its balance sheet unchanged for an extended period. The Fed would thus commit not only to refrain from selling assets already purchased, but to extend those that are maturing as well. The Fed could then take advantage of this situation to extend the duration of its portfolio.

3- Opting for an explicit target inflation rate could help to anchor long-term inflation expectations and thus respond to criticisms regarding the risks associated with maintaining excess liquidity. If the Fed wants to ease financial conditions over a long period, it could go even further by choosing to target price levels rather than the inflation rate. Like during the crisis, the inflation rate was lower than the target rate (approximately 2%), prices are at lower levels that they would have been if the Fed had hit its target consistently. Under these conditions, opting for a target price level would enable agents to anticipate a higher rate of inflation in the economic recovery phase, which would lower the real interest rate anticipated and would support domestic demand. But, prices would not slip out of control. As soon as the "right level" of prices is reached, the Fed would revert to targeting the inflation rate. The "excess inflation" tolerated in the short term would simply make up for the "lost inflation" during the crisis. Then, the Fed's credibility would be intact.

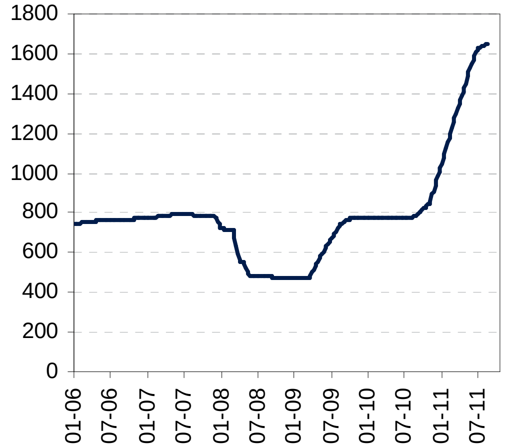
Box 6: Stimulus measures targeted at refinancing mortgage loans?

A New York Times article recently caught our attention. One measure to stimulate the real estate market is reportedly now being reviewed by the US Treasury. Currently, nearly 20% of households that have a mortgage loan have debt that is higher (with the collapse of real estate prices) than the value of their property. The difference between the outstanding on their loans and the current value of their properties is estimated at $700 billion (or close to 50% of GDP!). More than one-half of the loans were extended at interest rates above 5%. The authorities could set up a system that would take advantage of the recent drop in interest rates in order to enable these households to refinance their loans at lower rates. At the same time, the refinancing agencies Freddie Mac and Fannie Mae would launch a rental programme for foreclosed homes, which would prevent these properties from being put on the market, thereby exerting sustained downward pressure on selling prices.

According to estimates, households could thus free up to $85 billion per year in purchasing power. Waves of mortgage refinancing have historically always had a marked impact on household spending in the United States. A measure such as this would offer the advantage of containing household defaults (by reducing their debt burden) with no budgetary cost. This might also restore household confidence and encourage consumers to return to buying real estate.

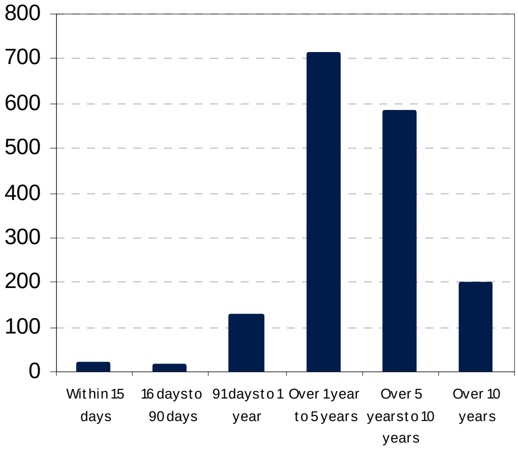
What could the Fed's role be in this context? By helping to recycle existing excess liquidity more effectively, all the options mentioned above would increase the plan's chances for success and would contribute to stimulating real estate by potentially attracting new buyers.

US Treasuries held by the Fed (in $bn)



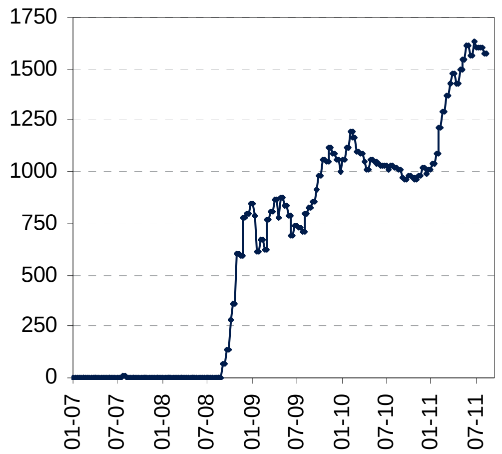
Source: Datastream, Amundi Strategy

Breakdown per maturity of US Treasuries held by the Fed (in $bn)



Source: Fed, Amundi Strategy

Banks' excess reserves held at the Fed (USD bn)



Source: Bloomberg, Amundi Strategy

What should we expect from the ECB?

In contrast to the Fed, the ECB still has some traditional room to manoeuvre. With its key rate at 1.50%, the ECB may decide to lower rates. Nevertheless, it is not likely to ease rates before the end of the year.

> *The ECB is to step backward on ist rates policy*

At first, the ECB will continue to favour measures that supply liquidity to banks that need it. Then, pro-cyclical budgetary policies will be put in place in most euro area countries to pave the way for lower rates. But, the ECB will certainly not act before it sees a marked drop in inflation. In the end, we expect key rates to step backwards, falling to 1.0%, but not before spring 2012 (-50 bp).

In the euro area, we should not expect monetary refinancing of budget deficits. The ECB by-laws do not allow it. In other words, monetary easing like in the United States (i.e. "QE") is not an option. Remember that the ECB's asset buying programme is not financed by monetary creation insofar as the securities purchases are sterilised: each week, the ECB taps the injected liquidity through its government bond purchases by offering banks one-week deposits that pay a rate close to the refinancing rate. These deposits are particularly attractive to banks because they are also eligible as collateral for the ECB's refinancing operations.

What impact would this have on yield curves?

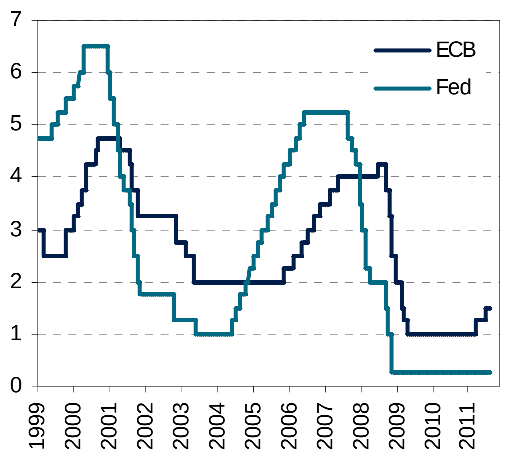
During the summer, despite the downgrade of the United States, and even though the sovereign-debt crisis was full-blown in the euro area, fears of recession won out, causing a clear flight to quality.

> *German 10Yrs bonds yields have fallen to their historical lows.*

Ten-year yields on government securities fell to historic lows in the United States and Germany. Consequently, the yield curve flattened significantly on both sides of the Atlantic. It is unlikely that the trend will reverse quickly. Recession fears are not going to fade quickly and, with unemployment, prices are not threatening to accelerate in the short term. It is interesting to note, though, that contrary to what happened in 2008-2009, real rates fell into negative territory, not breakeven inflation. **In other words, the markets are concerned about recession, but not about deflation. Market participants probably understand that the weapons still available to the Fed are likely to prevent such a scenario**.

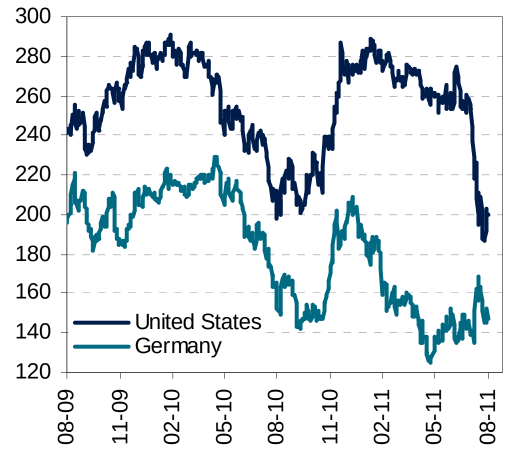
Insofar as returns on the short end of the yield curve remain contained by maintaining accommodative monetary policies over the long term, movements in the yield curve will be determined by changes in long-term rates. In the medium term, long-term rates in the United States could rise more quickly than in the euro area, particularly if the monetary policy options mentioned above are put in place. That said, in the short term, the threat of recession remains a support factor for the bond market. Nevertheless, in the recent flight-to-quality phase, the long ends of the yield curve (spreads between the 30-year rate and the 10-year rate) steepened on both sides of the Atlantic. The cocktail of deteriorating public finances and the possible slippage of medium- and long-term inflation may explain this trend..

Central bank rates: ECB vs Fed



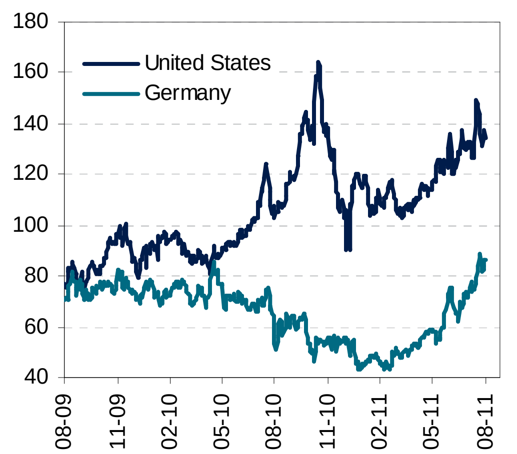
Source: Datastream, Amundi Strategy

Slope of the government bond yield curve (10y-2y)



Source: Datastream, Amundi Strategy

Slope of the government bond yield curve (30y-10y)



Source: Datastream, Amundi Strategy

7 Credit: Impacted further by sovereign and by macro fears too

August saw corporate bonds undergoing one of the most violent re-pricing in the history of Euro credit markets. A spike in volatility and risk aversion was caused by increasing fears of a vicious cycle between tighter fiscal policies needed to address the sovereign debt issue and a consequently looming double dip. Credit proved quite resilient to external shocks until July, but then couldn't escape from the effects of this new global financial crisis. Equity implied volatility, a measure of uncertainty about future trends in corporate profits, doubled in just three market sessions, moving from the 20% area to the 40% area, a territory reached in "normal" recessions like those experimented in early '90s and in 2001. The peak reached during the last recession and precisely in the aftermath of the Lehman crisis three years ago, saw an absolute peak of equity implied volatility to even the double (80%) of classical recessionary levels. Graph 1) shows that equity implied volatility drives shocks in credit spreads through crisis: as pointed out in previous issues, our fair value model on HY spreads incorporates equity implied volatility (the VIX index) as one of the most explicative factors, with a coefficient of 10. In simple words, this means that for each 1% rise in this indicator, HY spreads should correspondingly move higher by 10 b.p., all other factors unchanged. This factor may help to justify a strong upward move, but graph 2) shows that markets have probably gone too far. Our guess is that this gap is very much representative of another component which typically rises during crisis, namely the liquidity premium. June and July, usually busy months for new deals, proved to be poor in terms of primary market activity and August hasn't surely helped to generate positive net supply. Therefore, an increasing drain in available new debt issued in the primary market, coupled with lower volumes traded in the secondary markets, both as a consequence of the crisis, are major factors behind a higher liquidity premium very likely implied in current high beta corporate bonds.

What macro scenario is implied in current spreads?

So the next question is about what scenario is currently priced-in by credit markets. Current risk premium covers for different kinds of recession, according to what sectors/ratings and especially to what risk premium metrics are considered. Graph 3) shows that on a relative basis, on the back of the dramatic drop in safe heaven bonds (namely German bunds and US Treasuries), Euro HY spreads are now back to Lehman crisis peaks, as the spread over bunds component represents more than 80% of the total offered yield. In different words, HY average yield is now back to 6 times what investors may lock in buying bunds, the least-perceived risky bonds. The same is true, as well, in Euro Investment Grade world. Moving from relative to absolute spreads the picture looks a bit better: graph 4) shows how non-financial BBB and A rated issuers are now back to 2001 recessionary peaks. On the back of increased sovereign risk premium, financials offer spreads much higher versus 2001 but still much lower then in the 2008.

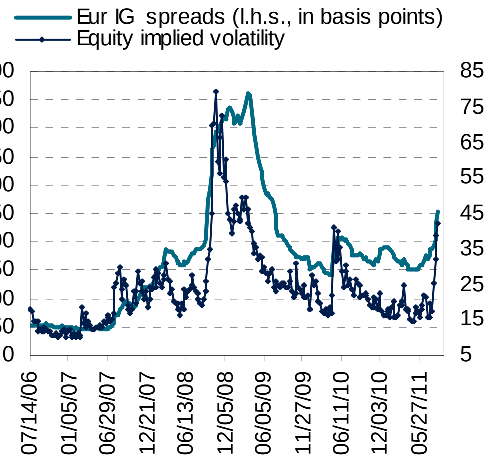
What default rate are speculative grade bonds implying now?

The following question we want to answer is about what default rates are implied in HY bonds, now. According to the historical relationship shown in chart 5) current spreads paid by US HY bonds are back to levels recorded three years ago, before the jump to the unseen peaks of the Lehman crisis. More importantly, they are consistent with a rise of default rates to the 10%/11% area.

Two considerations have to be done at this point: 1) as the graph shows, over the last twenty months global default rates rapidly dropped from 14% to current 2.6%, while European default rates reached even a lower 1.5%, 2) in a low yield environment, absolute spreads don't tell the whole story about potential default losses, as upon a default investors tend to lose more money given generally higher bond prices.

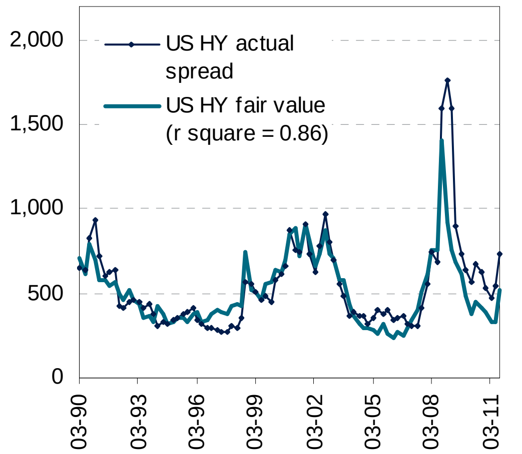
> *On an yield relative basis, Euro HY spreads over bunds are back to Lehman crisis' levels*

Equity implied volatility drives credit spreads through crisis



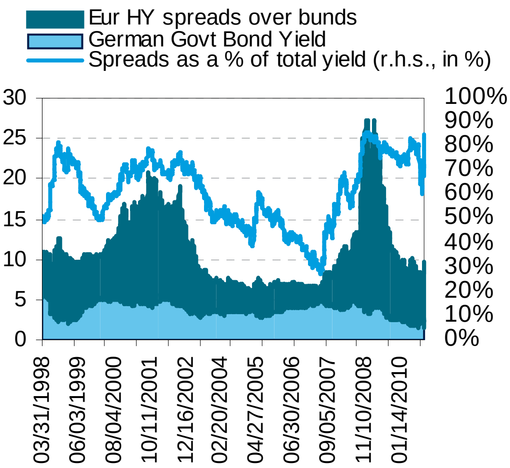
Source: Bloomberg, BoA ML, Amundi Strategy

US HY spreads vs modeled spreads



Source: Fed, BoA ML, Amundi Strategy

Eur HY absolute and relative valuations



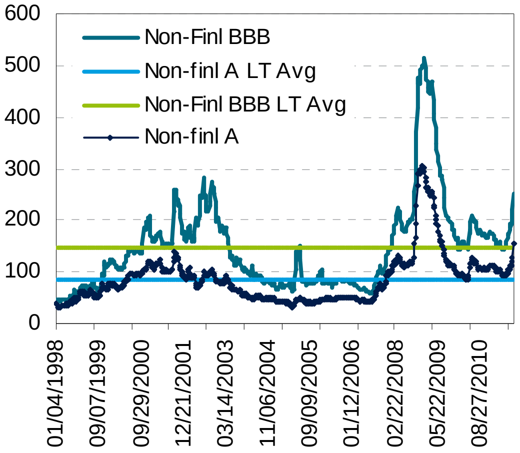
Source: Fed, BoA ML, Amundi Strategy

In any case, even considering for point 2), a sudden rise to a double digit default rate from current very low levels looks rather difficult to imagine, even considering a double dip scenario. In fact, company fundamentals are much better than three years ago and refunding risk over the next three years had been massively reduced thanks to last two years' record debt issuance.

> *HY spreads are now consistent with double digit default rates*

Under this respect, just to mention a few figures, debt issued by US HY corporates maturing over the next thirty months tumbled from a record figure of US$ 500 bn as of 2008-end to current US$150 bn, out of which only US$ 65 bn before 2012-end. These figures look relatively manageable also in an unfriendly macro scenario. Finally, potential negative effects coming from an eventual turn in banks' attitude towards C&I loans would take time to play a role. Interestingly, on August the 15Th the Fed released results of its quarterly survey on senior bank loan officer about standards applied to loans for companies. Last quarter's survey ended July, so it doesn't cover for August events: however, it showed easier rather than tighter lending standards, as the percentage of banks easing lending standards rose to 20% from previous reading of 16%. As graph 6) points out, bank lending standards are one of the most powerful explicative factors of future defaults, with a leading power of four quarters.

Eur Industrial spreads over bunds, by rating

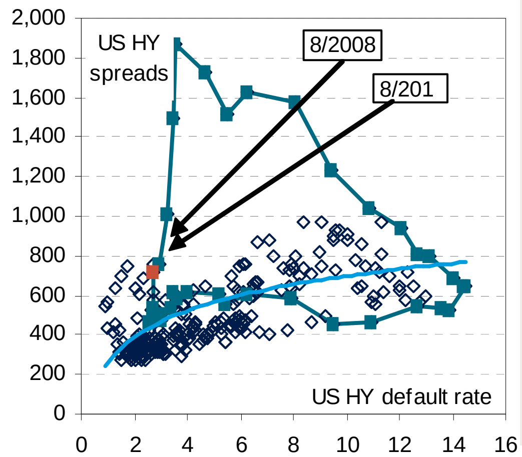


Source: BoA ML, Amundi Strategy

Are current valuations consistent with the fundamental picture?

Underlying the soundness of corporates' balance sheets has probably become a well-known and, to some extent, a boring remark, as the improvement in credit metrics achieved by companies over the last three years has been constantly proved by empirical evidence. According to Fed data, liquidity piled up by US companies reached more than 50% of their short-term debt value, strongly up from 2008 35% ratio. This evidence, together with the increased duration of their debt reduces companies' short-term refinancing risks. Net debt growth, while recovering from historical lows, is still moving in negative territory. At the same time, profits growth is normalizing from peaks, but in positive territory. Downside risks on future earnings growth clearly increased over the last few weeks, as shown by higher equity implied volatility. However, companies de-leveraged, are very liquid and are still managing cautiously their liabilities: this picture should help them to deal with an unfriendly macro outlook much better than three years ago.

US HY spreads vs default rates over the last twenty-five years

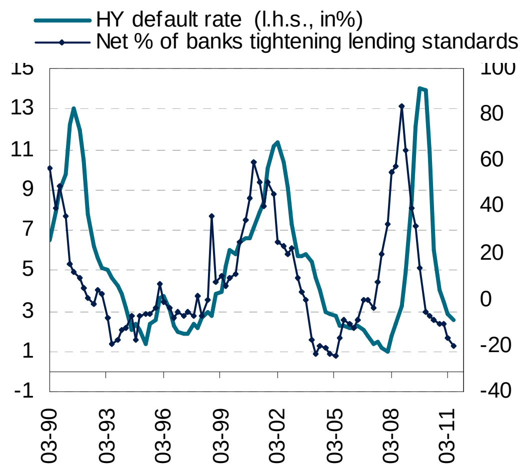


Source: BoA ML, Moody's, Amundi Strategy

Primary market will support secondary market to compress the liquidity premium.

Looking back to previous crisis, historical evidence shows that a recovery in bond issuance is needed to lead the resurgence of credit markets. The usual mechanism sees a virtuous circle triggered by new issue premiums large enough to attract investors and through a process of real price discovery to lead also a recovery of secondary market. Given the move in bund yields, the overall cost for issuing new debt remains contained for many issuers, even in presence of higher concessions. According to sell side surveys on institutional investors, market positioning has become very defensive over the last three months: beta in portfolios has been strongly reduced, with periphery and financials shorts at new peaks. If volatility subsides, therefore, a defensive market positioning may help a small short covering.

Bank lending standards lead default rates by four quarters



Source: Fed, Moody's, Amundi Strategy

Conclusions and short-term perspectives.

Credit valuations already point to a nasty fundamental scenario, between a classical recession, implied by absolute spreads, and a Lehman crisis, if yield ratios are considered. Spreads paid by speculative grade issues look higher than fair values, especially because of a higher liquidity premium: they imply a sharp rise of default rates to even a double digit figure from current lows, almost close to historical troughs. Recessionary risks clearly increased on the back of potential negative effects financial markets performance will produce on real economy over the next months and quarters. However, if valuations in some way already discount these macro risks to materialize, micro fundamentals are far from the vulnerable credit metrics companies exhibited three years ago. Therefore, thanks to much lower refinancing risks and much better liquidity positions, companies look better equipped to face tougher times. Moreover, if a double dip is avoided, a low growth-low yield environment attached to easy monetary policy for longer may help the return of the search for yield, a trend markets already experimented over the last year. At the same time, and notwithstanding a possible short-term short-covering driven by returning primary market activity, the decisive trigger for a strong rebound of credit markets is linked to a decisive solution to the sovereign debt crisis.

8 Emerging markets are really attractive ... but are they really emerging?

Growth prospects have been revised downwards for the vast majority of advanced countries, which stands in stark contrast to certain emerging markets. What should we conclude from this observation? First, it should be mentioned that the term "emerging markets" is not really satisfactory, because 1) it is deceptive as it tends to lump together countries that have very different realities and 2) it does not account for the spectacular progress in some emerging markets, which are now in a better position than the so-called "advanced" countries. In fact, both "emerging markets" and "advanced countries" are two terms that can be misleading. This is all the more regrettable given the current situation.

Relationship between growth and poverty provides initial source of differentiation
According to this analysis, which is based on a presentation by John Wolfensohn, former Chairman of the World Bank, there are three groups of "emerging" countries.

- Countries able to generate growth that is not only strong but stable ("converging countries"). These countries are capable of stabilising their growth and avoiding downturns resulting from the international context and activity from countries such as the United States. The strong health of China and Brazil, amongst others, at a time when the United States and the euro area were entering into recession in the wake of the 2008 financial crisis, immediately springs to mind. The leadership of these countries, which are converging with the affluent countries that have dominated the global economy for over half a century, in the global economy and within international organisations continues to grow.

-***Countries with low growth ("lagging countries")*** either because they are unable, unlike countries in the previous group, to maintain their growth rates due to a lack of leeway in economic policy or simply because they are unable to generate sufficient autonomous growth. Their dependence on an economic bloc prevents them from breaking free from the particular context found in the dominant zone. This is the case for certain European countries that are highly dependent on the euro area.

-***Finally, countries that are struggling to generate growth and reduce poverty ("poor countries")*** do not participate sufficiently in globalisation, which makes their struggle all the more difficult. This is the case of certain African countries, particularly those in Sub-Saharan Africa.

Emerging markets can also be differentiated based on specific economic characteristics such as commodities, exchange rates, monetary policy and other factors.

-**Consumption and commodity production**: China, the world's largest consumer, as compared with Brazil, for example, which is a large agricultural producer, Russia (gas and oil), South Africa (gold), Venezuela (oil), etc.

-The **autonomous nature of economic growth**

- The **independence of monetary policy**: while Brazil maintains an independent monetary policy at the international level (notably vis-à-vis the Fed), China has always kept a link between global exchange rates and its own monetary policy. Consequently, when Brazil was raising its interest rates, China chose to take action via bank reserves.

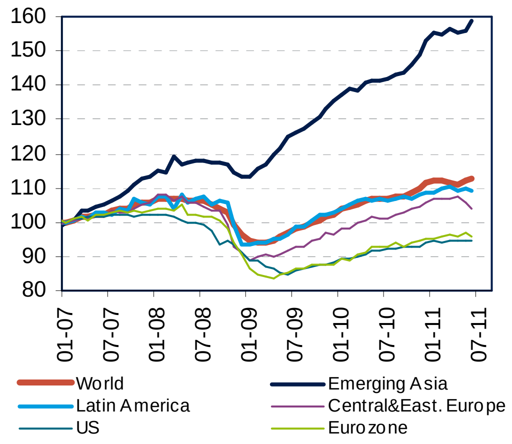
- **Inflation and inflationary pressure**

- **Managing exchange rates**: it is easy to distinguish between countries with over-valued currencies and those with notoriously under-valued currencies.

This distinction is obviously not devoid of consequences. It allows investments to be selected depending on specific themes such as international level of exchange rates, over- or under-valuation of currencies, de-coupled growth or lack thereof, commodities, etc.

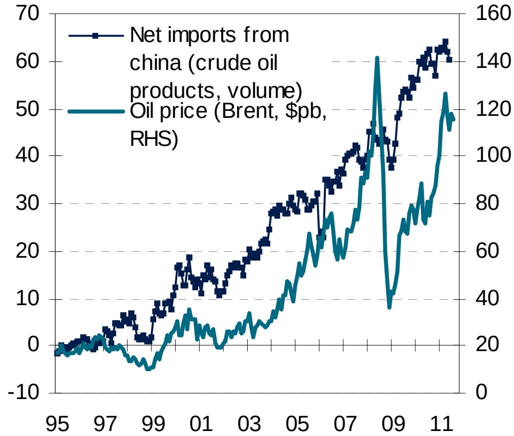
> *"Different groups of countries...and therefore different investment themes"*

Industrial production in emerging countries (volumes, January 2007 = 100)



Source: World trade database, Amundi Strategy

Net oil imports from China (in volume) vs oil prices



Source: Datastream, Amundi Strategy

It would be unwise to view emerging markets as a bloc or, worse, as a homogeneous bloc. The same goes for the euro area, the countries of which are in vastly different economic positions. How should we view these countries given the current environment?

Firstly, at the beginning of the year, we recommended caution on emerging indices, notably on account of inflation fears, which indeed played out in many of these countries. This pressure pushed several central banks to tighten monetary policy substantially. We also decided to be overweight on commodity-producing countries and underweight on consumer countries. These two allocation decisions paid off. In all, while reducing emerging equities, we increased our weighting in Latin America and the EMEA index, which is heavily biased towards Russia and South Africa. At the same time, growth resurfaced in the United States and in the euro area, hence their relative attractiveness.

"Emerging countries" vs. "advanced" countries

The *advanced countries* are suffering from several ills:

- economic indicators that are pointing lower, with downwards revisions for growth and profits
- the "forced" implementation of pro-cyclical budget policies
- a worrisome spiral of debt growth
- and debt governance both in the US and the euro area that leaves a lot to be desired

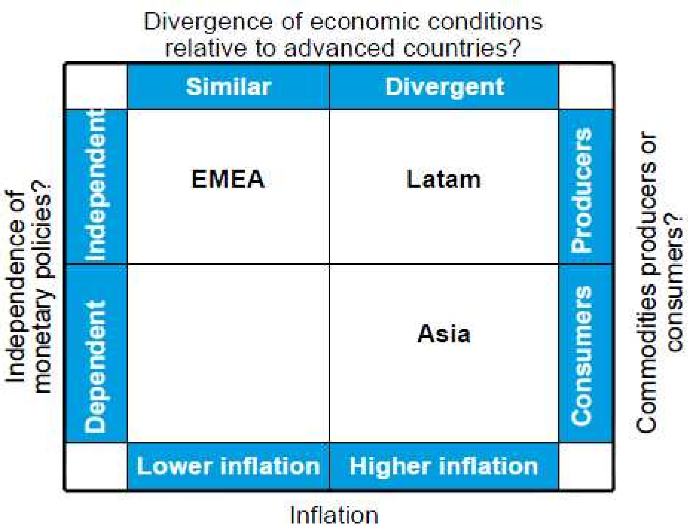
Meanwhile, *emerging markets* have many strengths:

- de-coupled growth, capable of withstanding the current global environment
- leeway to bolster growth if need be
- satisfactory public debt levels
- an inflation peak reached two months ago
- the quality of economic and political governance is better than in advanced countries
- solid currencies

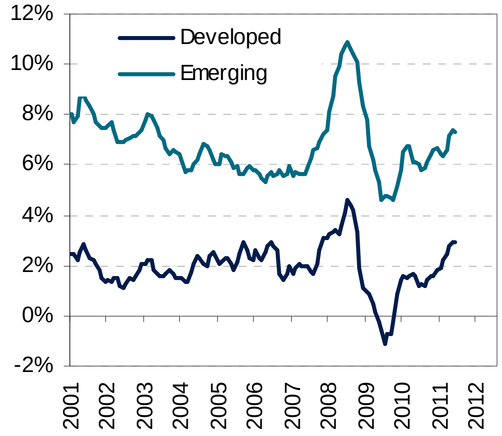
In the end, emerging markets (debt and equities) offer now a more attractive outlook than advanced countries. Among the former, we favour converging countries with solid growth and current account surpluses, etc.

> *Clear preference for converging countries*

The diagram below shows the emerging markets as broken down by specific factors. Obviously all countries in the EMEA area are not exactly in the same situation (in fact, South Africa and Russia account for 70% of the index's commodity production)...Likewise, not all Asian countries should be placed in the bottom right-hand box. However, this analysis provides a perspective from which these economies can be analysed and selectde as investment themes.

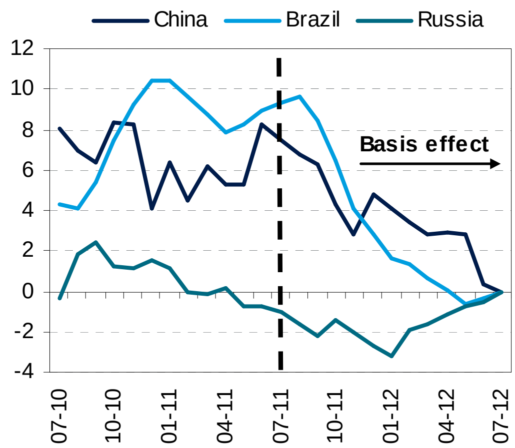


Inflation: developed vs emerging countries



Source: Datastream, Amundi Strategy

Emerging countries: CPI food - basis effect



Source : Datastream, Amundi Strategy

9 European stocks: the location of a company matters less than its geographical specialization

On a macroeconomic level, the slowdown will be experienced worldwide, but Europe may be further affected by the overvaluation of the euro and the need to adopt austere fiscal policies, particularly in peripheral countries. However, **the location of a company matters less than its geographical specialisation**, taking into account the stronger growth in emerging economies. Good news : markets already discount a recession in the US and in the Euro zone, while we "simply" expected a soft landing.

The financial crisis has caused panic in the markets too. All in all, **some stocks have clearly over-corrected, and have become attractive from a valuation standpoint**. At the same time, the poor economic outlook limits the options for directional investment strategies. In an environment with sluggish growth and low interest rates in developed countries, this should exacerbate the search for high dividend-yield stocks.

Businesses that are the most exposed to emerging countries are expected to hold their own, regardless of where they are located. As we demonstrate in section 8, the emerging world does not exist as such … countries can be massively different, and the most attractive ones are countries with autonomous growth, low debt, and current account surpluses. European corporates with strong connexions to these countries are therefore to be scrutinized closely in investment strategies. Note that some of them have been hurt by the fall of equity markets, the re-pricing of economic growth, but also by the (poor) quality of their sovereign debt … all reasons to consider their stocks attractive.

A number of European companies with close connection with **Latin American** countries have been hurt due to the sovereign crisis, and because of their own sovereign debt. Tensions in CDS markets have impacted companies and sectors such as consumer goods, automobile, telecoms, chemicals, building materials, utilities and banks (table n°1).

Contrary to general thinking, Latin America is not a private ground for Spanish companies : Belgian, Italian, Swiss, German and French companies are quite active in this part of the world.

Emerging Europe is certainly less attractive due to the high connections and dependence on the euro zone counties in terms of business cycle. As a reminder, the main representative sectors are telecoms, building materials, automobile, consumer goods, chemicals, energy and banks.

China is already the top contributor to a number of European companies' net results : Swatch, BMW, Richemont, Daimler, HSBC, Adidas, Volkswagen, PPR, BHP Billiton, LVMH …China has a strong appetite for European companies : some companies represent quality, luxury, success …(luxury goods, automobile, cosmetics, textile, consumer goods, distribution … all sectors where Europe is very well positioned). European companies are able to deliver quite high profitability, higher than the one delivered in some other geographical areas (operating margin above European and US standards).

European sectors being active in China are mainly consumer goods, semiconductors, automobiles, metals and mining, and equipment goods. Sectors where Europe is not that active are telecoms, infrastructures, financials (apart from HSBC, of course), construction materials, media and food distribution (table n°2).

Asia excluding China still offers good perspectives for economic activity, well above average global growth. The major sectors where European corporates are active in this part of the world are luxury goods, photovoltaic's, chemicals, metals and mining, banks, construction materials, energy and semiconductors (table n°3).

To conclude, we have to pay attention to companies with strong connections to emerging markets, and particularly sectors which are massively involved in Emerging markets growth. Some companies have been hurt due to the sovereign debt, the downward revision of economic activity and the sovereign debt crisis. However, as long as growth is solid in the "converging" emerging countries, the bulk of their net profits will come from abroad. Without any doubt, under the present circumstances, the location of a company matters less than its geographical specialization.

European firms: % of net profits in Latam countries

Name	Sector	% Net Profit LATAM	Net Profit LATAM
FIAT	Automobiles & Components	99	295
BBV ARGENTARIA	Banks	62	3,394
TELEFONICA DE ESP.	Telecommunication Services	50	3,967
AB-INBEV	Food Beverage & Tobacco	45	1,713
INTERNATIONAL POWER PLC	Utilities	41	521
SBM OFFSHORE	Energy	36	65
CASINO	Food & Staples Retailing	35	195
HOLCIM	Construction Materials	26	222
VALLOUREC	Capital Goods	22	93
ACTIV DE CONS Y SERV	Infrastructures	20	254
SYNGENTA	Chemicals	19	220
ADIDAS	Consumer Durables & Apparel	15	85
CREDIT SUISSE GRP	Diversified Financials	15	849
BAYER AG	Pharmaceuticals & Biotechnology	13	461
ANTOFAGASTA PLC	Metals & Mining	12	104
SOFTWARE AG	Software & Services	10	18
PUBLICIS GROUPE	Media	7	39

Source: Amundi Financial Analysts - Datastream

European firms: % of net profits in China

Name	Sector	% Net Profit China	Net Profit China
CENTROTHERM	Photovoltaics	60	31
BMW AG	Automobiles & Components	60	1,931
AIXTRON	Semiconductors	50	96
HSBC	Banks	40	7,398
RICHEMONT	Consumer Durables & Apparel	35	339
REMY COINTREAU	Food Beverage & Tobacco	30	31
RIO TINTO	Metals & Mining	28	3,148
PPR	Retailing	25	191
BASF AG	Chemicals	14	737
ABB LTD	Capital Goods	12	241
CGG VERITAS	Energy	10	7
CARREFOUR	Food & Staples Retailing	8	110
BAYER AG	Pharmaceuticals & Biotechnology	6	213
WPP GROUP	Media	5	47
SAP	Software & Services	5	135

Source: Amundi Financial Analysts - Datastream

European firms: % of net profits in Asian countries (excl. China)

Name	Sector	% Net Profit Emerging Asia (exc.China)	Net Profit Emerging Asia (exc.China)
STANDARD CHART.	Banks	69	1,637
HOCHTIEF	Infrastructures	65	192
LVMH	Consumer Durables & Apparel	30	909
HOLCIM	Construction Materials	29	248
TELENOR	Telecommunication Services	29	377
SAIPEM	Energy	25	184
AIXTRON	Semiconductors	25	48
LONMIN	Metals & Mining	24	25
CENTROTHERM	Photovoltaics	24	12
UNILEVER	Food Beverage & Tobacco	19	843
AKZO NOBEL	Chemicals	18	185
TESCO PLC	Food & Staples Retailing	16	496
ROLLS ROYCE GROUP	Capital Goods	15	111
BAYER AG	Pharmaceuticals & Biotechnology	13	461
ING GROEP	Diversified Financials	11	283
INTERNATIONAL POWER PLC	Utilities	11	140
TEMENOS GROUP	Software & Services	10	5
SCANIA	Automobiles & Components	9	86
WPP GROUP	Media	7	62

Source: Amundi Financial Analysts

10 Equities: fear of the void

The stock markets have plummeted since 7 July with the MSCI World index down 16% (to 8 August). This correction has been **a global affair** with Japan down -10%, emerging markets down -13%, the US down -17% and Europe down -19% (chart 1). It began quietly but picked up speed as of 29 July (chart 4). Also of note is the **spectacular rotation in favour of defensive sectors** (chart 2). In Europe defensives fell by "only" 13% versus -22% for financials and -23% for cyclicals. This outperformance of defensive sectors was widespread (all 7 sectors) with a particular interest in telecoms which were protected by their yield and in Food and Beverage which is generally considered the archetype defensive sector. The underperformance by cyclicals was also large-scale with 8 sectors out of 12 showing a relative underperformance while absolute declines were seen in the automotive sector at -27% and in the information technology sector at -28%.

This underperformance of cyclical sectors came despite the fact that they showed good resilience in the quarterly publications. This is not by chance. **It is linked to chain revisions to economic growth forecasts** and, consequently, to results. The parliamentary debate and downgrade to US debt on 5 August certainly provided much to write about, but the revision to the growth outlook truly took shape a few days previously, on 29 July (cf chart 3), when US Q2-2011 GDP growth was published at +1.3% q-o-q, or 0.5% below the consensus forecast.

On top of this, it was mainly weak consumption (+0.1%), the downward revision to Q1 (+0.4% versus +1.9%) and the entire period 2008-2010 that put a damper on things. Given the comparison base, the H1 growth carry led to a revision to US GDP for 2011 of around 80bp.

> *"Widespread downward revisions to growth forecasts and profits …"*

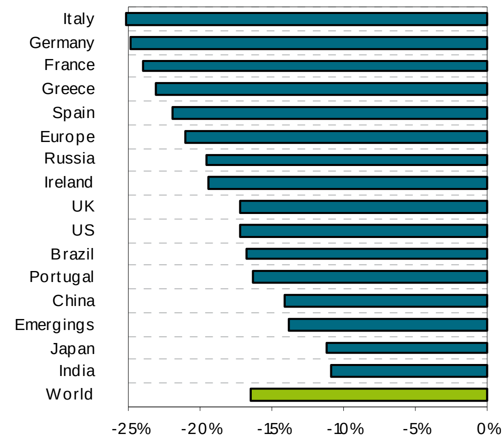
The 2011 consensus, which was at +2.5% before 29 July, should therefore be mechanically revised to around +1.7% (chart 3). Assuming that this growth rate of +1.7% for 2011 remains unchanged, the problem is that it is not sufficiently strong and casts a shadow over investment, employment and profit trends. In Europe, circumstances are different but the mechanisms are fairly similar. Budgetary credibility, now imperative, will weigh on growth. Also, a slowdown in the US economy will have spin-off effects. Lastly, the weak dollar will curb profits, in particular those of countries with strong currencies, such as Switzerland and Sweden, which together represent 20% of the MSCI Europe. So far, cyclicals were resisting on the back of a global growth buoyed by emerging countries. But the downward revisions of the US economy has tarnished those hopes. In a globalised economy, chart 4 confirms the synchronisation of the different indices. A disappointment over growth, essentially due to the US, is felt even more in Brazil and Germany where growth is highly linked to global exchange. All told, a damper effect that is clearly good for defensives is not very good news for cyclicals.

On top of an overall weak economic environment, cyclicals had become more vulnerable because their historical premium had tightened. To measure it, we used a multiple average (P/E, price to book, dividend yield and price cash flow). Graded from 0 to 100%, this indicator compares the sector premium in relation to the market and determines the percentage rate at which the market fell below its current level over the previous 35 years. 0% means the sector premium has not been this weak since 1976 and 100% means it has not been as high.

Prior to their slide, at end-June, cyclicals on the whole were at 79% versus 43% for defensives and 27% for financials. In other words, their premium was much higher than the rest of the sample.

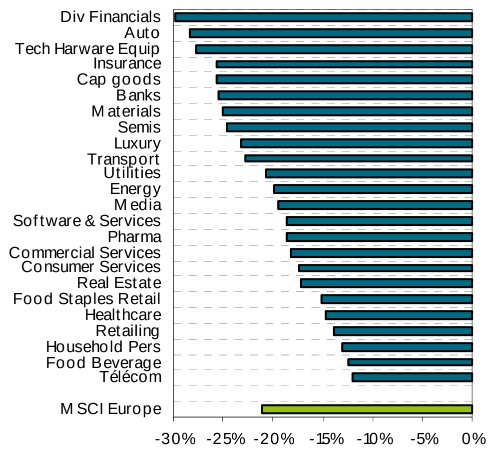
Also, within cyclicals, certain sectors such as Capital Goods (98%), Basic Resources (94%), Durable Consumer Goods (85%) and Automotives (80%) were particularly well valued. So, regardless of their qualities, these four sectors in particular have significantly underperformed (-6% on average versus -4% for all cyclicals) while the eight other cyclical sectors, whose valuations were lower, fell by only 1% relatively speaking (or outperformed (+2%) if we strip out Semiconductors and Information Technology which have a high beta and are heavily exposed to the economic environment).

MSCI indices from the monthly peak of 7 July to 10 August



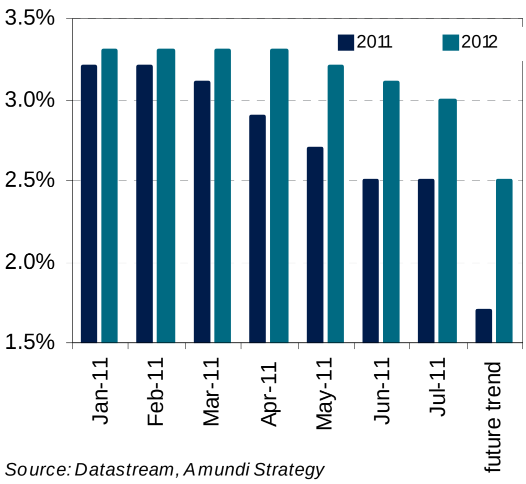
Source: Datastream, Amundi Strategy

MSCI Europe by sector From July 7th to August 10th



Source : Datastream, Amundi Strategy

US GDP growth: 2011 and 2012



Source: Datastream, Amundi Strategy

Moreover, until the end of June, analysts' earnings revisions (net up) for cyclical companies had been relatively low. In June, the month preceding the index falls, the net up of cyclicals had fallen by only 5% in relation to the average over the three previous months, versus 8% for defensives and up to 20% for financials. A similar scenario was seen in May. It was thus only in July that the cyclicals net up started to really deteriorate at -16% versus -11% for defensives, while financials continued their downward path (-16%).

The market has already integrated a significant relapse in activity. MSCI Europe has fallen by 21% since the start of the year. Its valuation is down sharply, as illustrated by the surge in the risk premium and the dive taken by the Schiller P/E ratio (chart 2). It is now close to the lows of Autumn 2008 - Spring 2009 and, excluding this period, at its lowest level in over twenty years. For example, at 8.4x versus 7.3x at the height of the Lehman crisis, the forward P/E ratio is 40% below its long-term average (14.2x) and lower than in Q4 1992- Q1 1993 ; a period marked by an anaemic growth and the European Monetary System crisis.

Similarly, the VIX, or fear index, has risen to 65, a level not seen since December 2008. And as regards to the dividend yield, it is now above 4% versus 0% for real long term rates - also an exceptional level.

> *"Particularly vulnerable cyclicals …"*

Valuation has therefore fallen sharply, but is this really a buy signal given the prevailing economic risks? Drawing a parallel between the ISM manufacturing index and the MSCI Europe provides an initial response. It indicates that after the fall in share prices, the market is already pricing in a relapse of the ISM to around 43 versus 51 in July, pointing to a stagnation of the US economy for at least 6 months (Q4-2011/Q1-2012?), instead of the 2% and above that is broadly estimated by the consensus. Where profits are concerned, this means that EPS growth over the next 12 rolling months (H2-2011 to H1-2012), initially expected at around 12% in Europe and 15% globally, will at first glance and excluding the currency effect, probably shaved to zero.

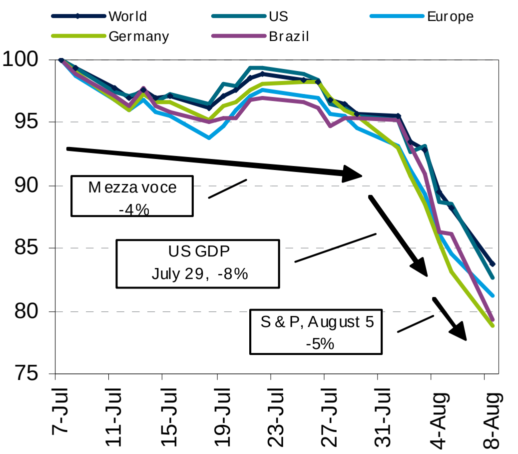
Unless there is a financial Armageddon, the market is already reasonably prudent in its forecasts. Namely, we can assume that the MSCI World is already discounting a 10 to 15% earnings drop, to compare with a Consensus earnings forecast for the next twelve month up 15%. Nevertheless, over and above technical rebounds, a real recovery in equities could take another few months because the stock market generally bottoms out only after growth has hit bottom.

Against this backdrop, a prudent sector strategy is still called for. Given the risks regarding economic growth, persistently high premiums and the relatively late revisions process, we prefer to remain prudent as regards cyclicals for now and to favour defensive sectors. As an illustration, among cyclical sectors, Capital Goods and Basic Resources - scarcely in fashion at any rate - should in our view be avoided temporarily due to the fact that their premiums in relation to the market are still particularly high (cf CVI at 98 and 94). The buy signal for cyclical sectors will be given when the leading indicators and industrial production show signs of a recovery. Until then, we will remain very selective, limiting any moves to quality stocks that show higher-than-average visibility through their exposure to growth in emerging countries, their industrial competitiveness, their technological superiority or their product innovation.

Conversely, the Food and Beverage sector, traditionally defensive, should return to favour, particularly as raw material prices which had handicapped this sector in the first half of the year (cf. article 9.2 on quarterly results) should start to fall.

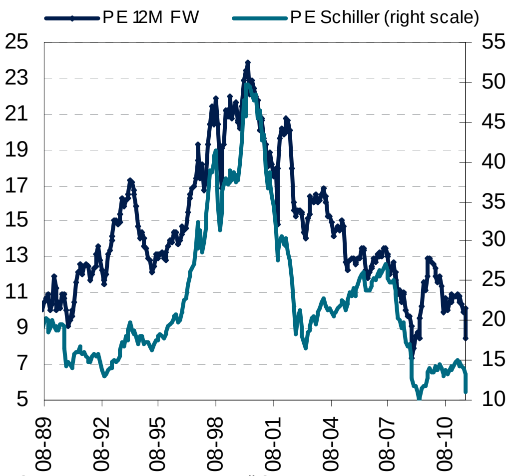
The financial sector purge was particularly violent. That said, the related risks are difficult to quantify and the sector's close correlation with country CDS shows that its return to grace is now largely dependent on the timing and credibility of decision by the monetary authorities and governments.

A three-staged slide (MSCI base 100 on 07 July)



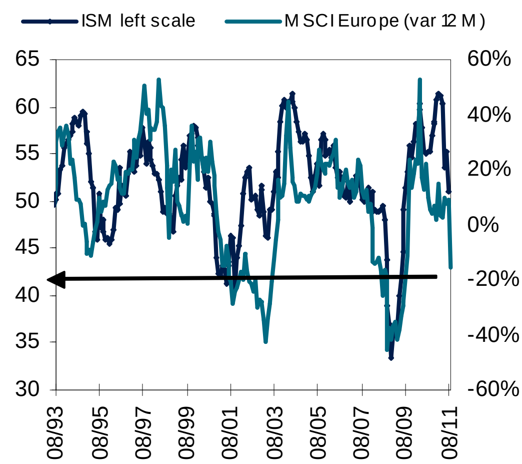
Source: Datastream, Amundi Strategy

MSCI Europe: the valuation is bottoming out



Source: Datastream, Amundi Strategy

Prices anticipate a slide in the ISM to 43



Source: Datastream, Amundi Strategy

11 Mediocre quarterly results in Europe

In Europe, the Q2-2011 publications season proved mediocre, providing **the lowest level of good news in two years** in terms of both sales and results. At a time when concern about macroeconomic growth and sovereign debt is reviving, this lack of resilience in company results is all the more unwelcome as it seriously weighs on the attractive market valuation argument.

On a more detailed level, we note that the percentage of good news as regards revenue (52%) and results (47%) fell by 9% and 16% respectively in one quarter, falling well back below the average (59% and 57% respectively), to the lows seen at the start of the crisis (charts 1 and 2).

At first glance, this fall is surprising in relation to the relative inertia of GDP from one quarter to the next; the change in growth in Q2-2011 (+1.7% over 12 months versus +2.5% in Q1-2011) coming out nothing like that seen in Q1-2009 (-5.1%), when a similar fall in “good news” was seen (chart 2).

A breakdown of the “good news” by country and by sector clarifies the origin of this slide. The poor results in Switzerland and Sweden and the strong performances in the UK confirm a strong currency effect (chart 3).

> *Currency effect and rise in raw material prices weighed heavily …*

As an illustration of the amplitude of these fluctuations, in Q2-2011 the **Swiss franc** appreciated by an average of +27% against the dollar over 1 year ($1.15 versus $0.90) and by +13% versus the euro (€0.80 versus €0.71). Similarly, the **Swedish krona** appreciated by 21% versus the dollar and by 7% against the euro. Over the short term, such differences have a devastating effect on companies. Conversely, the pound saw a limited appreciation against the dollar at just 9% ($1.63 versus $1.49) and fell by 3% versus the euro (€1.13 versus €1.17).

From a sector point of view, **the rise in raw material prices also weighed on the results**, as attested by the disappointment over the Consumer Goods sector, which turned in a very low level of “good news” (38%). Within this sector, which includes Automotive, Personal Goods, Food and Beverage, the sub-sector that was most impacted was Food and Beverage, which had a score of zero “good news” and a marked decline in results. The automotive sector came out fairly unscathed (83% “good news” and an increase in results of 34%) attributable to a hedging policy that smoothed out the raw material and currency impact, and to the improvement in its geographical mix and its ramp-up in emerging countries.

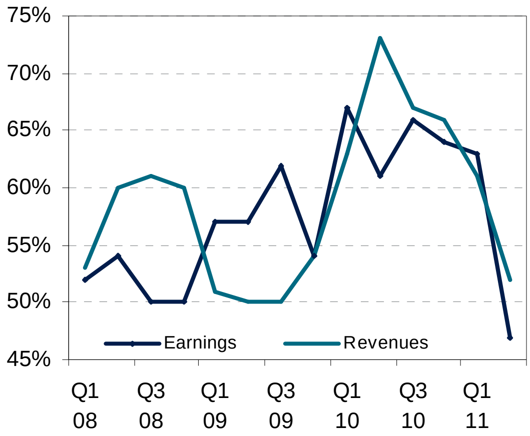
But a soon as released, Q2 results, already belong to the past… and the economic turmoil which has occurred this summer could change the game for the next future (see former article). So, cyclicals which showed good resilience in the last quarterly publications could well feel the pinch in the coming months.

Europe: Summary of quarterly results by sector

Europe	Sales		EPS	
	yoy change	Beat	yoy change	Beat
Consumer Goods	7%	68%	13%	38%
Consumer Services	5%	71%	-35%	44%
Financials	12%	59%	-14%	49%
Health care	9%	78%	1%	61%
Industrials	3%	70%	22%	44%
Inf. Technology	3%	75%	17%	38%
Materials	10%	83%	19%	45%
Oil & Gas	25%	94%	23%	53%
Telecom	-2%	23%	-60%	54%
Utilities	5%	85%	-3%	64%
Stoxx 600	**11%**	**52%**	**-2%**	**47%**

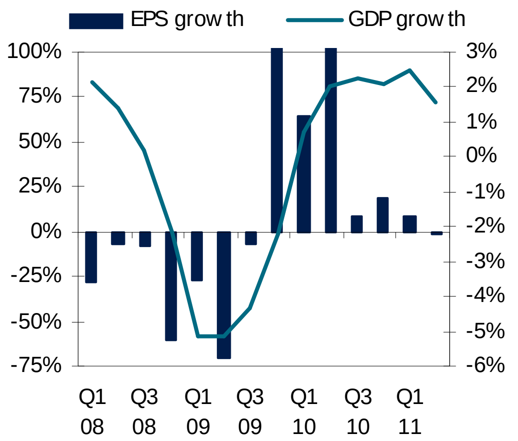
Source: Bloomberg, Amundi Strategy

Quarterly results on the Europe Stoxx 600 percentage of “good news”



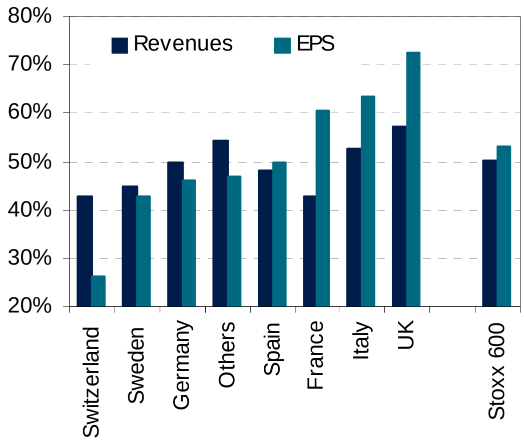
Source: Datastream, Amundi Strategy

Quarterly results in Europe Annual growth in EPS and GDP



Source: Datastream, Amundi Strategy

Quarterly results on the Europe Stoxx 600 Percentage of “good news” by country



Source: Datastream, Amundi Strategy

12 The yen and the Swiss franc: their safe haven status is weighing…

The yen and the Swiss franc have appreciated sharply recently. In July and August, they rose by 7% and 8% respectively against the euro. Rightly or wrongly, this trend is being associated by commentators with a flight to safety. In particular, the Swiss franc's evolution in relation to the euro is highly correlated to the evolution of the euro zone sovereign debt crisis: every sharp increase in the credit risk premiums of peripheral countries gives rise to an appreciation of the Swiss franc (see chart). Nevertheless the two currencies are in very different situations. Although the real effective exchange rate in Japan and Switzerland has risen by 25% and 30% respectively since the demise of Lehman Brothers, their situations differ: Japan's real effective exchange rate is close it its long-term average while that of Switzerland is at a record high (see chart).

Based on the usual valuation models, the yen and Swiss franc are both significantly overvalued. Purchasing power parity and BEER models show equilibrium values of between 1.30 and 1.40 for the EUR/CHF and between 90 and 100 for the USD/JPY.

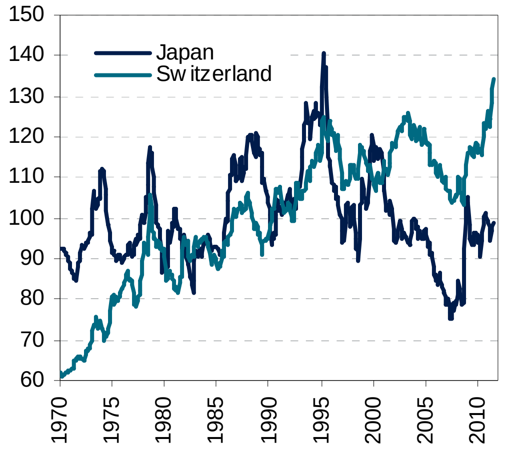
> *JPY and CHF : two overvalued currencies*

The Swiss National Bank (SNB) has qualified the Swiss currency as "extremely overvalued" on several occasions. However, there are fundamental arguments justifying a strong Swiss franc and a strong yen. Both Japan and Switzerland have been accumulating significant current account surpluses in recent years (respectively 3.4% and 11% of GDP on average over the last decade). As such, both countries hold considerable net assets abroad (see chart), which is, all other things being equal, a factor underpinning the appreciation of their real exchange rates. Moreover, the net assets held abroad could be seen as an indication of the countries' capacity to deal with a sharp deterioration in the economic environment (by selling these assets), which in a way justifies their status as safe haven currencies. Lastly, Japan and Switzerland have both flirted with deflation over the last several years: their inflation rates are very low in relation to other developed countries (see chart), even if unlike Japan Switzerland has not experienced long periods of price falls. Equilibrium of purchasing power parity with other countries would justify a nominal appreciation. Though we can understand to a certain extent the appreciation of the yen and the Swiss franc, it is undoubtedly weighing too heavily on their economies.

The sharp appreciation of these two currencies is posing a threat for the competitiveness of export sectors. In Japan, even before the catastrophic earthquake that struck in mid-March, the trade balance was already well below its pre-crisis levels and a further deterioration could penalise its already weak economy. While the volume of global trade has returned to pre-crisis levels (i.e. the Q3 2008 level), Japanese exports are still 10% lower. In Switzerland, the subject of exports is very important as they account for roughly 50% of GDP. The currency's overvaluation is penalising the different sectors in different ways (see inset). Companies that do not change their local currency prices lose competitiveness on the international markets and those that use international prices see their export revenues dive. The direct result is a reduction in margins that could potentially give rise to cost-cutting or reductions in headcount. Moreover, in the case of Switzerland, the strength of the franc is also penalising retailers as consumers are taking advantage of cheaper products across the border.

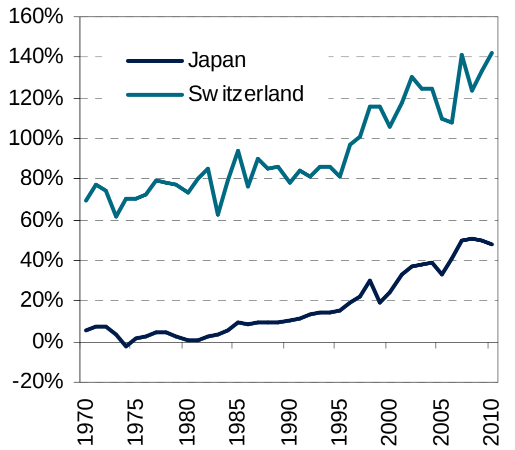
For this reason, the Japanese and Swiss authorities are determined to do something about their super strong currencies. Their task, however, has been made particularly difficult by the fact that key interest rates are already at zero. When the USD/JPY moved too close to the 75 mark, Japan's finance minister and the Bank of Japan (BoJ) intervened at the start of August and will not hesitate to do so again.

Real effective exchange rate: Japan vs Switzerland (100 = long-term average)



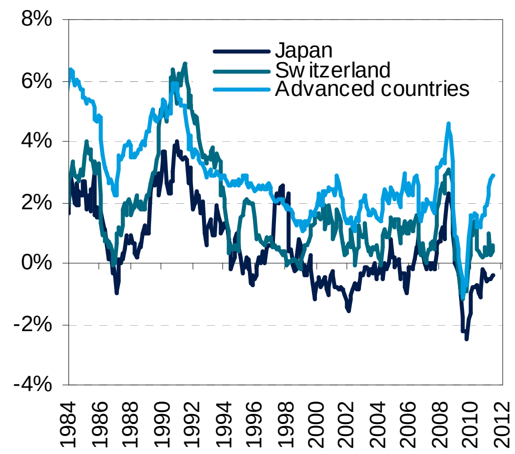
Source: Datastream, Amundi Strategy

Net assets held abroad (as % of GDP)



Source: Lane and Milesi-Ferretti (2007), Amundi Strategy

Inflation: Japan and Switzerland versus developed countries



Source: Datastream, Amundi Strategy

Box 7: Sector impact from the Swiss franc's overvaluation

The sharp appreciation of the Swiss franc is impacting the economy, but all sectors are not being impacted in the same way. Already over the last few quarters the SNB has been surveying companies in order to make a detailed assessment of the impact of the domestic currency's high valuation. The industrial sector, which is more exposed to international competition, has been much more heavily impacted than the services sector (see chart). Those industries that have been most heavily impacted are chemicals, manufacturers of electronic materials and of capital goods and the steel sector. The construction sector has been spared because this activity cannot be relocated. Lastly, tourism is starting to suffer, according to the statements from hotels queried by the SNB.

The government also indicated that it would intensify its supervision of the currency positions of financial institutions as of September in order to discourage speculation. Despite these efforts, the yen has not fallen much. The reverse is the case in Switzerland where the drastic measures taken by the SNB (see inset) caused the Swiss franc to fall by over 10%.

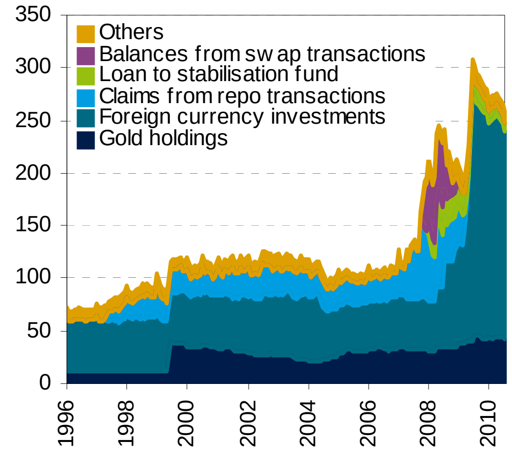
Box 8: Measures taken by the Swiss authorities to curb the overvaluation of the Swiss Franc

With interest rates in Switzerland already close to zero, the SNB, like the BoJ, is in a situation in which it can no longer use interest rates to juggle the Swiss franc's appreciation. The reduction in the Libor fluctuation band for 3-month deposits from 0-0.75% to 0-0.25% on 3 August only had a limited impact (quasi-stagnation of the EUR/CHF).

Like the Japanese authorities, the SNB already intervened massively in the currency market in 2010. Its currency reserves, 55% of which are in euros and 25% in dollars, increased sharply but this has not prevented the Swiss franc from appreciating significantly (gain of over 18% against the euro in 2010) and in particular it caused a loss for the SNB of over 19 billion Swiss francs in 2010 (losses of 10.8bn in the first half of 2011), i.e. 3.5% of GDP. In reality, direct intervention on the currency market has largely been ineffective but very costly.

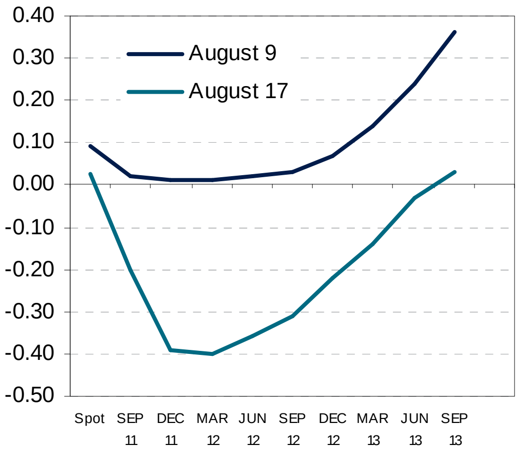
The strategy now favoured by the SNB is the creation of abundant liquidity on the Swiss money market. The underlying goal is to bring interest rates on the money market down enough to discourage foreign capital inflows. During August, this caused the banks' target holdings with the SNB to increase successively from 30 billion Swiss francs to 80 (3 August), 120 (10 August) and 200 (17 August). To reach the 200 billion target, the SNB will buy back notes that it issued (106 billion Swiss francs in June 2011), which is the equivalent of cancelling reverse repo operations. It will also intervene massively in currency swaps. So far, this strategy has been successful as the fixed-income markets are now pricing in negative future rates and the EUR/CHF has fallen from 1.03 on 10 August 10 to 1.1850 on August 30, a depreciation of over 13%.

SNB assets (in billions of Swiss francs)



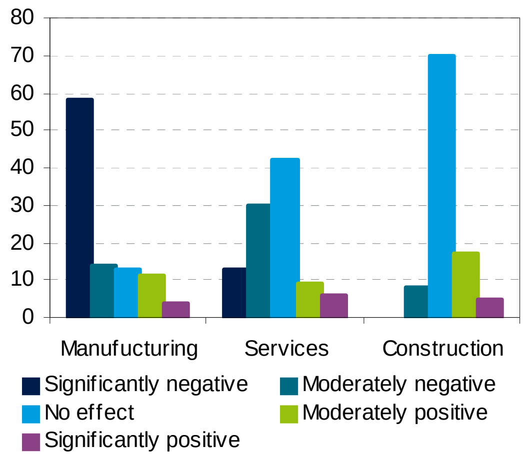
Source: SNB, Amundi Strategy

Switzerland: 3-month yield curve for futures



Source: Bloomberg, Amundi Strategy

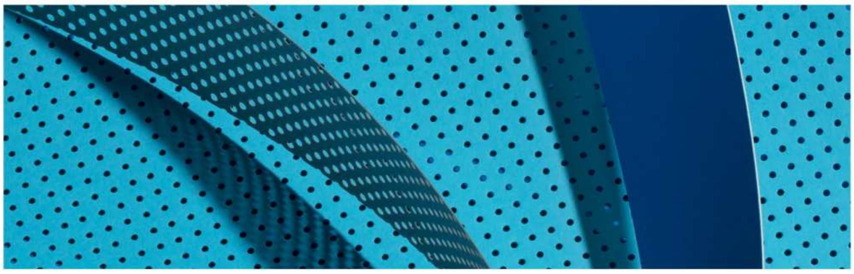
Swiss company comments on the impact from the Swiss franc (% of answers)



Source: SNB, Amundi Strategy

Cross asset investment strategy

Strategy and economic research



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