

## Strategy and economic research

## Market Insights

### KEY TOPICS

#### Outlook for bond issuance and interest rates

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#### Tokyo market poised to rise as recovery kicks in and yen pressure abates

Until November 2009, Japan had lagged the broader recovery in global equities, but we believe that lingering negatives might have played out already. The outperformance of the Tokyo market since then was generated by the economic recovery and the much improved earnings picture helped by a weaker yen, both of which favored the cyclical sectors, especially the export sectors of the market. In our central scenario of a global economic recovery led by Asian economies and supported by the US, Japanese firms can take advantage.

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#### Ukraine tries to start over...again

Ukrainian external debt (sovereign, quasi-sovereign and corporate) has rallied significantly in the past couple of months and bonds now seem to price in a fair bit of continued good news about Ukraine. Further spread tightening would seem to require continued healthy risk appetite and/or surprise policy out-performance after Ukraine's presidential election on Sunday, February 7th.

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Outlook for bond issuance and interest rates

The recession in 2009 was much deeper than expected. It caused government deficits in most countries to worsen sharply, prompting a steep rise in government bond issuance. Although the economic situation is now improving, govie issuance is likely to remain very high in 2010 – and probably in 2011 as well.

New issuance this year is expected to rise 19% in the USA (compared with 78% last year), 32% in Germany and 14% in France. Paradoxically, in Europe, debt is likely to increase more strongly in the higher-rated countries (Germany, France, Holland) than in countries such as Greece, Ireland, Italy and Spain, which will consolidate. In general, governments are likely to increase the duration of their bond debt, both to reduce refinancing risk and to take advantage of a keener appetite for long maturities.

Expected bond issuance programmes: gross issuance in € billion

Country	2008	2009	2010	% change 2008-2009	% change 2009-2010
Germany	140	157	207	12%	32%
France	131	165	188	26%	14%
Italy	168	235	245	40%	4%
Spain	60	92	110	53%	20%
USA	1,090	1,940	2,300	78%	19%
UK	146	177	200	21%	13%

Source: Amundi Strategy

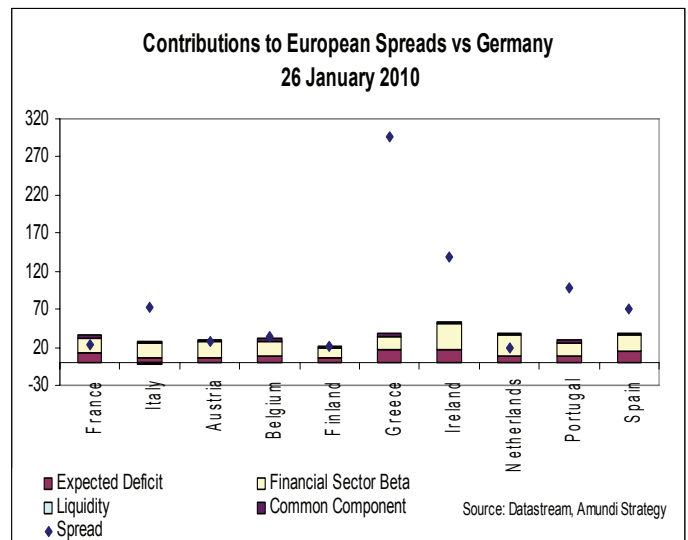
Inflation-linked bonds will not be left out. France expects to increase gross ILB issuance from €36 billion in 2009 to €60 billion (net issuance of €40 billion) in 2010, with two new bonds, a 10-year and a 15-year. Germany plans to issue a 30-year linker. Italy will also float new five- and 10-year bonds. And Spain is expected to launch its first-ever bond indexed to European inflation.

Given this ample supply of new paper, will long-term interest rates rise steeply? That outcome is far from certain, since two key factors should keep them in check:

- On the one hand, 2010 will probably see considerable economic uncertainty and relatively high risk aversion. Investors are likely to respond by flocking back to government debt, at least in countries considered the safest, such as the USA, Germany and to a lesser extent the least risky eurozone economies.

- On the other hand, central banks' greatest fear now is that long rates may soar, thereby impacting negatively on the financing of the real economy. Although central bankers have indicated their readiness to withdraw liquidity as soon as necessary, they could do so only gradually, while continuing to send out the right signals in order to anchor inflation expectations.

For the time being, therefore, long rates should continue to fluctuate around current levels, very close to their fundamental values (3.4% in the USA and Europe). But they may begin rising gradually once the Federal Reserve adopts a more restrictive monetary policy. Also, considerable variations are likely to persist within the eurozone, though some spreads, which have widened sharply, should narrow back towards their fundamental values\*, especially for Greece, Ireland, Spain and Italy.



Marie Brière

\* Marie Brière and Bastien Drut, "Towards a Stronger Differentiation in Eurozone spreads", November 2009.

**Tokyo market poised to rise as recovery kicks in and yen pressure abates**

Until November 2009, Japan had lagged the broader recovery in global equities, but we believe that lingering negatives might have played out already. The outperformance of the Tokyo market since then was generated by the economic recovery and the much improved earnings picture helped by a weaker yen, both of which favored the cyclical sectors, especially the export sectors of the market. Excluding financials, Tokyo Stock Exchange constituents are now looking at 50-60% aggregate recurring profit growth for 2010 vs almost zero growth in 2009.

**> Japanese firms are economy-sensitives**

Structurally, Japan is now home to an increasing number of "global companies", and the influence of the global economy looms larger than it used to. On top of this, over 60% of the Tokyo market (in market cap terms) consists of economy-sensitive sectors, such as autos, electric machineries, and chemicals. In the US, the figure is around 40%, and in Europe 30%. This profile should have helped the Japanese market to outperform other developed markets in H2.2009.

This did not happen and this was due to the sharp appreciation of the yen. It was unfortunate that the Japanese government seemed to have only a limited concern about its own currency strengthening, while all the other major countries were experiencing weaker currencies in a deflationary scenario. Since the Japanese economy still relies heavily on external demand, especially in an initial recovery phase, the disadvantage of yen appreciation is more significant than such advantages as improving terms of trade. This significance concentrates investors minds, so avoiding a sharp rise of the yen is needed for the stock market to bottom out.

Moreover, further monetary easing by the Bank of Japan in early December helped the market recovery. It was rather a positive surprise for the market, as no action had been taken at all since the new government's "deflation declaration" in November. And in January, former Finance Minister Hirohisa Fujii, who was supportive of yen appreciation, resigned, and Prime Minister Yukio Hatoyama picked his deputy, Naoto Kan, to take over the Finance portfolio. Naoto Kan is known as an expert on policy matters, and in favor of yen stabilization or even weakening.

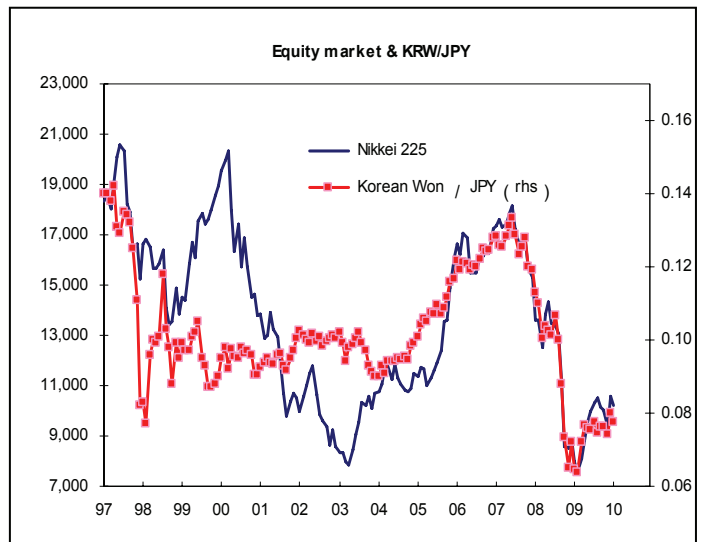
**> Japanese stocks now tracing the Korean Won rather than the USD/JPY**

Most observers looking at how the currency market affects the Japanese stock market, tend to focus only on the USD/JPY rate. But we cannot ignore other currencies while globalization is accelerating, especially in the manufacturing sectors. Exchange rates with, and between, those countries can have a big impact on Japanese manufacturers' earnings.

**Japanese companies sales breakdown by regions (FY2008):**

Ranking	Company	Sales (Y Bil.)	Overseas Sales breakdown (%)			
			America	Europe	Asia	Total
1	Toyota	20,530	30.7	13.9	29.0	73.6
2	Honda	10,011	45.1	11.8	28.6	85.6
3	Hitachi	10,000	9.0	9.0	23.3	41.4
4	Nissan	8,437	34.2	17.4	24.3	75.8
5	Panasonic	7,766	12.8	12.4	22.2	47.4
6	SONY	7,730	23.6	25.7	26.4	75.8
7	IT	6,832		29.3	17.2	46.5
8	Toshiba	6,655	16.3	13.8	21.3	51.4
9	Nippon Steel	4,770	7.4		21.5	28.9
10	Fujitsu	4,693	8.3	14.0	9.6	32.0

Interestingly, the Nikkei 225, an index with a relatively high weighting to manufacturers and exporters, has been tracking rival country currencies, such as the Korean Won. Many Japanese and Korean companies are regarded as head-on rivals, such as SONY vs. Samsung and Honda vs. Hyundai Motor. Simply put, an exporter-heavy index like the Nikkei falls as the Yen rises against the Won.



Source : Bloomberg, Strategy and economic research Amundi

**> Yen set to depreciate**

Looking ahead, we believe that Japanese corporate can benefit from the depreciation of the Japanese yen, as the BOJ should remain behind the curve compared to the major central banks and appears unlikely to hike rates ahead of the US and Europe. There could be also a Renminbi exchange rate hike sometime in early 2010. Although we can not rule out that further appreciation of the yen, such a development would probably be limited, regarding the stable BoJ policy and no doubt would be counteracted by public authorities.

For the time being, Japanese firms are not in a bad position and there is growing upside potential for Japanese stocks. In our central scenario of a global economic recovery led by Asian economies and supported by the US, Japanese firms can take advantage. They have room for aggressive cost-cutting. And were the yen to weaken further to 100 JPY/USD or more, we might expect upward earnings revisions.

Masanaga Kono

## Ukraine tries to start over...again

Ukrainian external debt (sovereign, quasi-sovereign and corporate) has rallied significantly in the past couple of months and bonds now seem to price in a fair bit of continued good news about Ukraine. Further spread tightening would seem to require continued healthy risk appetite and/or surprise policy out-performance after Ukraine's presidential election on Sunday, February 7th.

### > Economy remains fragile

Although real GDP likely contracted around 14% in 2009, the free-fall in economic activity bottomed by mid-year thanks to the improving global economy. Domestic demand remains weak and there is very little credit growth. Instead of writing new loans, banks are mainly focused on restructuring old loans and buying government bills (with yields around 25%). And if global steel prices turn down later this year, Ukraine will feel the pain quickly. Some analysts now project average annual GDP growth of just 3% over the next five years, without any significant drivers of momentum, (i.e., Ukraine's GDP would be the same in 2015 as it was in 2008 before the huge 2009 contraction). The key issue is that many foreign investors see no meaningful improvement in Ukraine's flawed political environment and system over the medium-term.

Bank loan restructuring has been massive, but according to the World Bank, system-wide non-performing loans (NPLs) stand between 15-20% of total loans and are expected to increase further during 2010. While foreign-owned banks have turned more sober about Ukraine's prospects, most continue to fund their local subsidiaries. To a considerable degree foreign banks are stuck if they want to liquidate their subsidiaries. One recent example of the bind foreign banks face here is the story of ING, which wanted to reduce its operations in Ukraine. It couldn't find a buyer for its local bank and simply walked away empty-handed after returning money to depositors.

### > The IMF program back on track

Opposition leader Viktor Yanukovich beat PM Tymoshenko in the February 7 run-off. The new president must now appoint a Cabinet and build a new ruling coalition in the parliament. After a fiscal deficit of 12-13% of GDP in 2009, the President will have to pass through Parliament a 2010 budget law in line with the IMF program. Note that new parliamentary elections could prove necessary, which may delay the budget law a few more months. Gas tariffs are expected to rise between 60-100% p.a. over the next couple of years. Along with higher tariffs, an important focus of the new government will be to fix the subsidy system so that only low income populations are buffered against the tariff increases.

Note that the IMF program currently envisions a fiscal deficit of 4% of GDP in 2010 (excluding bank recapitalization), which is

anticipated to cost almost 3% of GDP. This implies a 5-6% fiscal adjustment this year, which looks difficult unless GDP growth substantially exceeds current expectations.

In the absence of IMF flows during the past few months, Ukraine's financing gap is being filled by local debt issuance of varying maturities (mainly 3-months to 3-years) with yields ranging from the 20% to 30%. Although the total stock of domestic public debt was just 9% of GDP in mid-2009, we should note that six months before that it was barely 2% of GDP. The central bank holds around 70% of Ukraine's domestic debt. Foreign investors have not previously been part of this market, but funds are starting to sniff around. Note that the Ministry of Finances is thinking seriously about a USD or EUR private placement of perhaps USD 300-400mn during Q2.10, even though the interest rate would inevitably be higher than for a public placement.

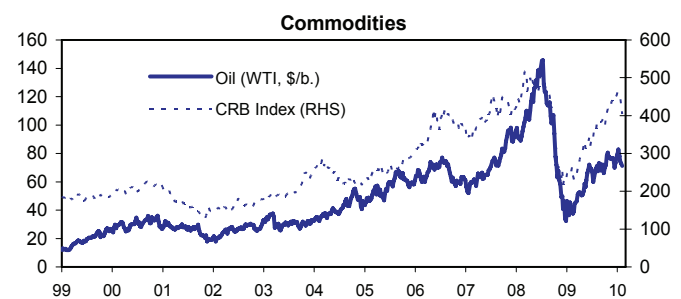
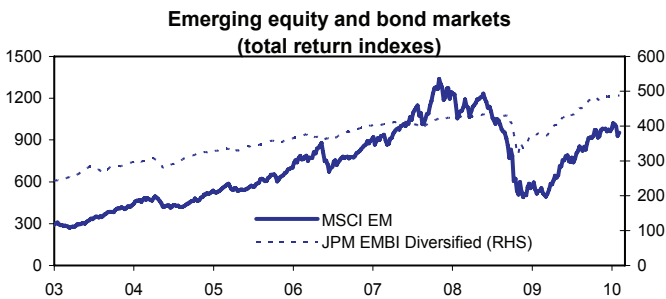
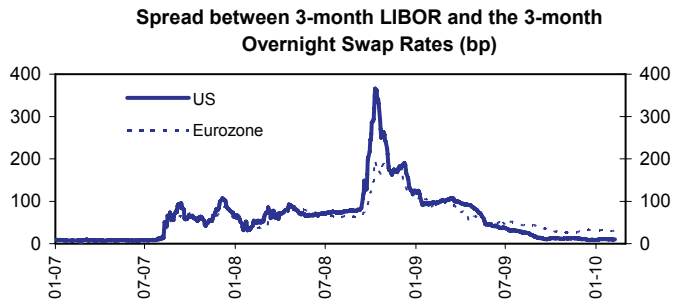
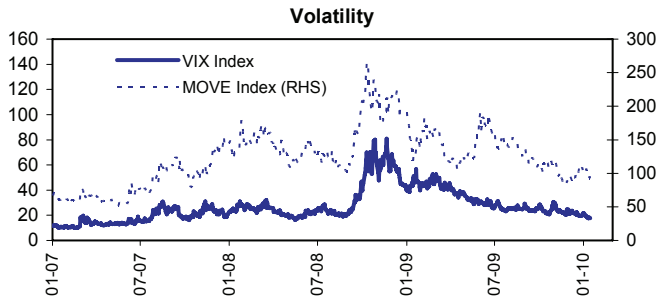
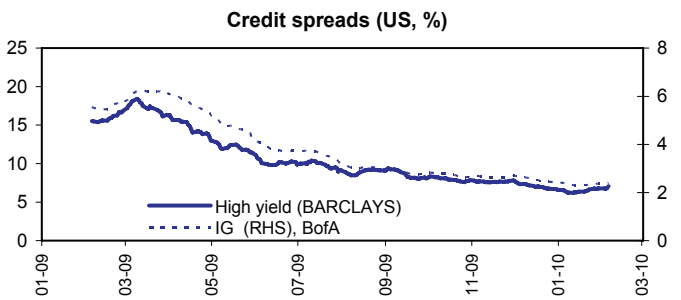
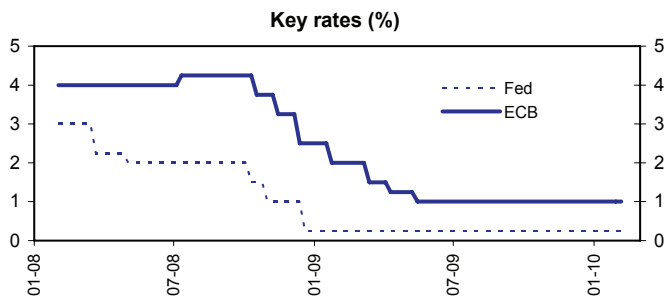
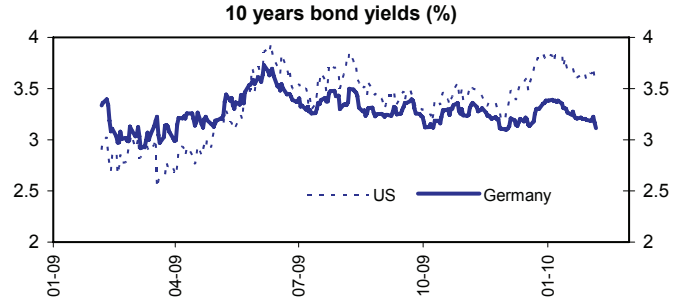
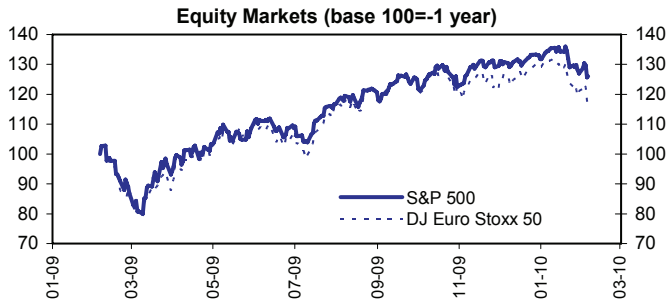
### > The Central Bank of Ukraine remains a mess

The outlook for the Hryvnia (UAH) depends to a great extent on the Ukraine-IMF relationship. The current account is mostly balanced following the economic contraction, but the capital account remains in significant deficit and in need of IMF funds. If the IMF program does not come back online, or if it comes back online only after further lengthy delays, UAH depreciation pressures are likely to resume. It is hard to forecast the extent of depreciation, but 20-25% (to around 10/USD) is a likely number. If, on the other hand, politics stabilize quickly and IMF funding comes back online before mid-2010, the outlook for UAH is more benign. Having said that, Yanukovich is politically allied with Ukraine's biggest exporters and his advisors envision moderate UAH depreciation even with an IMF program in place.

The Central Bank of Ukraine remains a mess. It has no clear monetary target other than "fighting inflation" and preserving the currency's value. Its regulatory capabilities and market interactions are routinely disparaged by local bankers. The new President will choose a new Central Bank Governor almost immediately after the election. Until that appointment is known, it is hard to project the path of policy interest rates, the Central Bank's willingness to monetize sovereign debt, and the outlook for the Hryvnia. As for inflation, CPI ended 2009 at 12.3%, substantially below the end-2008 level of 22.3%. The Central Bank envisions CPI declining into single digits over the next two years, but analysts are more circumspect. Indeed, if gas tariffs rise substantially (as expected) they will push CPI higher. Moreover, if the UAH depreciates, it will push CPI higher. Additionally, there is a high degree of inflation stickiness in Ukraine. How else can one explain a GDP contraction of 14% alongside CPI of 12%? Inflation stickiness will prove difficult to break as the economy recovers. Thus, it seems probable that the real effective exchange rate will continue appreciating even if the nominal rate stabilizes this year.

*Blaise Antin*

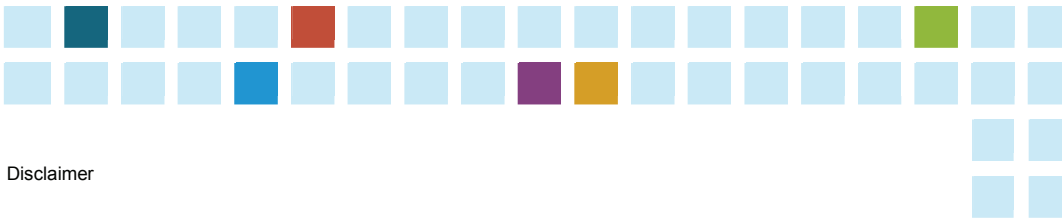
Market Data



Select Global Exchange Rates (February 5, 2010)

	F/X Rate	% Ch. WoW	% Ch. YTD	End year			
				2009	2008	2007	2006
USD/EUR	1.37	-2.0%	-5.0%	1.44	1.39	1.47	1.32
USD/GBP	1.57	-2.7%	-3.3%	1.62	1.46	2.01	1.96
GBP/EUR	0.87	-0.8%	1.7%	0.89	0.95	0.73	0.67
JPY/USD	89.47	1.0%	3.3%	92.43	90.64	112.04	119.16
JPY/EUR	122.5	3.0%	8.7%	133.2	126.1	164.9	156.9
CHF/USD	1.07	-2.1%	-4.0%	1.03	1.07	1.12	1.22
CHF/EUR	1.47	-0.1%	1.0%	1.48	1.49	1.65	1.61

Sources: Strategy and Economic Research Amundi Group, Datastream and Bloomberg.



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