

## Strategy and economic research

## Market Insights

### KEY TOPICS

#### Don't write off the British economy too quickly

Recently, the markets have had trouble digesting the record public deficit posted in January and the publication of a poll suggesting that neither the Labour party nor the Conservatives will be able to obtain a majority at the next legislative elections, i.e. the Parliament should be a "hung Parliament". However, the economic outlook and medium-term public finances seem to be improving. Long bond yields are expected to rise in the second half of 2010 and the pound is also expected to appreciate against the euro.

Page 2

#### Equities: the country factor is back

The financial bubble burst in autumn 2008, tipping the global economy into a synchronised recession. Now, however, countries are exiting the crisis at different speeds. In these varying geographic conditions, the country factor, which scarcely mattered in 2009, may make a bigger difference in 2010. To identify the winners in 2010, we have ranked countries according to their main economic and stockmarket characteristics. Among developed countries, the UK, France and Germany lead the USA and Japan. Italy is the pick of the PIIGS, and Russia leads the BRICs.

Page 3

#### Emerging economies local currency debt markets: coming of age

A quiet "revolution" is currently under way in emerging economies locally traded, local currency-denominated sovereign debt markets. For several years now, this asset class has attracted investors' attention while the globally traded, dollar-denominated counterpart shrinks in relative size. More recently though, the generalized deterioration of fiscal accounts in developed markets – highlighted by Greek debt woes – has cast a new light on the attractiveness of emerging markets locally traded, local currency-denominated government bonds.

Page 4

### Market Data

Page 5

## Don't write off the British economy too quickly

Investors have appeared to be rather circumspect towards the British economy since the beginning of the crisis. Recently, the markets have had trouble digesting the record public deficit posted in January and the publication of a poll suggesting that neither the Labour party nor the Conservatives will be able to obtain a majority at the next legislative elections, i.e. the Parliament should be a "hung Parliament". However, the economic outlook and medium-term public finances seem to be improving.

### > Decoupling with the euro area

The British economy remains fragile due to a variety of factors to which investors appear to be sensitive, such as high levels of household debt (80% of GDP) which are causing households to save more, the real estate crisis, the deterioration of public finances, etc. However, recent indicators suggest that the UK economy should outperform the euro area in 2010-2011.

In the fourth quarter, GDP posted a modest increase of 0.3% qoq, but a rise that was above the 0.1% qoq reported by the euro area. In contrast to the euro area, unemployment has stabilized since last summer (7.8%) notably thanks to the flexibility of the labor market.

**GBP Real Effective Exchange Rate**  
(IMF, CPI basis, 100 = Average)



The residential real estate sector is showing signs of stabilizing. It should be noted that the UK real estate bubble was nowhere near the scale of what was witnessed in the United States, Ireland or Spain. Building starts in these countries soared, leading to an excess of supply which would take several years to clear. Nothing of the sort took place in the United Kingdom. Declines in property prices (-25% between the end of 2007 and April 2009) and interest rates enabled households' accessibility to property to be restored. Property prices have suddenly regained an upward trend since last May.

Company leaders in the manufacturing sector are showing the highest level of confidence witnessed since 1994 (PMI) and are demonstrating this through promising order books. There, we must certainly note the sharp rebound in exports (+6% in the fourth quarter), in line with the recovery in global trade and, above all, the depreciation of sterling. Since its 2007 high, sterling's real effective exchange rate has lost 30%. In terms of purchasing power parity, sterling is undervalued by around 17% against the euro, its main commercial partner, and appears slightly undervalued against the dollar.

Lastly, in light of improvements in lending conditions, businesses' confidence, cash flow and investment rates (150%), corporate investment, which is at its lowest level since 1970, should rebound sharply over the coming months.

### > Debt downgrade is far from certain

UK public debt has increased from 44% of GDP in 2007 to 80% in 2010, and the public deficit for this year is expected to be over 12% of GDP. Despite being placed under negative watch by S&P, a downgrade of the UK's AAA rating is far from certain. A substantial portion of the increase in public debt is due to the purchase of holdings in the country's banks (7% of GDP). These stakes will be sold once market conditions and banks' balance sheets allow. Moreover, debt will automatically be reduced as soon as the global economy consolidates. While retaining largely unfavorable assumptions for the British economy, i.e. potential annual growth of 1.8% (compared to 2.7% over the last decade), inflation at 2.5% and 10-year interest rates at close to 6%, the United Kingdom will not require austerity plans to reduce its debt-to-GDP ratio. A primary surplus (excluding interest expenses) of around 1% of GDP will have to be generated, compared with a historical average of 0.4%. This corresponds to an increase in VAT from 17.5% to 19.5%, for example. Of course, this is under the condition that the Government has a stable majority in Parliament and a clear mandate to tighten budgetary policy. We should therefore expect the pound to fluctuate based on polls for the upcoming legislative elections, which are expected to be held by June.

In our central scenario where growth is moderate, but higher than the euro area, and where political stability makes the sustainability of public finances credible, the Bank of England (BoE) is not expected to broaden its Government bond purchase programme. Given that it has already purchased the equivalent of 2/3 of issues from the UK Treasury in 2009, long bond yields are expected to rise in the second half of 2010. The pound is also expected to appreciate against the euro. The rise in long bond yields will be quicker than for German yields, but will remain moderate (25-50bp). Indeed, the Bank of England is fearful that a sharp rise in financing costs will only cause the economy to plunge again. The BoE would intervene if necessary.

*Michel Martinez*

Equities: choice of country matters again

> Exiting the crisis at different speeds

The collapse of Lehman Brothers in autumn 2008 burst the financial bubble and tipped the global economy into a synchronised recession. Now, however countries are exiting the crisis at different speeds.

This dispersion, linked to differences in fiscal stimulus efforts and sensitivity to global trade, is clearly visible in the regional growth rankings in the fourth quarter of 2009.

In these varying geographic conditions, the country factor – which scarcely mattered for developed countries in 2009, when US, UK, PIIGS and non-PIIGS equities were on an equal footing – is likely to make more of a difference in 2010. And logically so, because each country's recovery, as well as its schedule of monetary and fiscal tightening, will unfold at a different pace, even within a single region such as the eurozone. This has already been observed year-to-date, with the PIIGS clearly underperforming the non-PIIGS and especially the USA and UK. At the same time, all the BRICs have underperformed, though not in lockstep.

To identify the winners in 2010, we have ranked countries according to their main economic and stockmarket characteristics.

> Greater geographic selectivity

From an economic standpoint, we applied three criteria to each country: growth as measured by GDP changes, monetary and fiscal policy as seen in the projected timing and methods of tightening, and currency competitiveness in terms of current exchange rates and expected movements this year.

As regards developed countries' growth as they exit recession (2010-2011), the first observation is that gaps have widened between PIIGS and non-PIIGS on the one hand and between the eurozone, the USA and the UK on the other. Among PIIGS, now that Russia and Brazil are back on track, gaps have diminished. Combining the three criteria, we find that:

1. the UK, with the help of its very competitive currency, is performing surprisingly well
2. the PIIGS, with a simultaneous lack of recovery and turn of the fiscal screws, are unsurprisingly exhausted
3. USA, BRICs and non-PIIGS are on a fairly equal footing. The USA and the BRICs are leading in growth, but the non-PIIGS should benefit from a more favourable monetary schedule and forex environment.

Regarding stockmarkets, we computed a score based on three criteria: valuation as estimated by the difference between the rolling 12-month P/E ratio and its long-term average, EPS growth and dividend yield. Under this approach, France and Germany stand out from the crowd with top scores. And not all

PIIGS are equal. Portugal, where the ratios are still fairly high, makes a poor showing, while Italy comes out on top. Finally, given rather lofty valuations, patchy EPS growth and low yields, the overall picture for the BRICs is lacklustre, but Russia looks better positioned than its peers.

Markets	GDP growth				Tightening		Forex competitiveness
	2009	2010	2011	score	monetary	fiscal	
USA	-2,5%	2,7%	2,4%	☺	☺	☹	high and decreasing
Japan	-5,3%	1,7%	2,2%	☺	☺	☹	low and increasing
UK	-4,8%	1,3%	2,7%	☺	☺	☹	high and increasing
Eurozone	-3,9%	1,0%	1,3%		☺	☹	
Non PIIGS	-3,3%	1,3%	1,6%	☺	☺	☹	low and increasing
France	-2,3%	1,4%	1,7%				
Germany	-4,8%	1,5%	1,9%				
PIIGS	-4,2%	0,0%	0,7%	☹	☺	☹☹	low and increasing
Portugal	-2,8%	0,4%	0,9%				
Italy	-4,8%	1,0%	0,7%				
Ireland	-7,5%	-2,5%	1,0%				
Greece	-2,6%	-2,0%	0,0%				
Spain	-3,6%	-0,6%	0,9%				
BRIC	4,4%	7,9%	7,6%	☺☺	☹	☺	high and decreasing
Brazil	-0,4%	4,7%	3,7%	☺			
Russia	-9,0%	3,6%	3,4%	☺			
India	5,6%	7,7%	7,8%	☺☺			
China	8,7%	10,0%	9,7%	☺☺			

Source: IMF, Amundi Strategy

Markets	Performance		PER 12M Fwd	Long term change	Valuation score	EPS		EPS score	Div Yield 010	DY score
	2009	03/03/2010				010	011			
USA	22%	-1%	13,6	-16%	☺	27%	20%	☹	1,9%	☹
Japan	8%	-2%	17,7	-10%	☹	na	na	na	1,7%	☹
UK	21%	0%	11,1	-25%	☺	26%	21%	☹	3,5%	☺
Eurozone	21%	-5%	11,3	-26%	☺	26%	21%	☹	2,9%	☺
Non-PIIGS	19%	-4%								
France	21%	-3%	11,6	-26%	☺	31%	22%	☺	3,5%	☺
Germany	15%	-4%	11,6	-31%	☺	39%	22%	☺	3,4%	☺
PIIGS	21%	-8%								
Portugal	31%	-9%	12,8	-11%	☹	4%	17%	☹	4,6%	☺
Italy	17%	-8%	11,0	-32%	☹	20%	29%	☺	3,5%	☺
Ireland	7%	-1%	23,0	97%	☺	na	na	na	3,3%	☺
Greece	19%	-11%	8,1	-39%	☺	-2%	26%	☹	3,0%	☺
Spain	30%	-13%	9,6	-29%	☺	2%	15%	☹	4,5%	☺
BRIC	62%	-4%								
Brazil	57%	-4%	12,1	47%	☹	27%	20%	☹	2,9%	☺
Russia	80%	-1%	7,0	-16%	☺	35%	34%	☺	1,4%	☹
India	80%	-2%	16,1	16%	☹	30%	21%	☺	0,9%	☹
China	52%	-6%	12,7	3%	☹	23%	16%	☹	1,9%	☹
World	25%	-2%	13,3	-16%		29%	20%		2,4%	

Source: Datastream, Amundi Strategy

Combining economic and stockmarket aspects, the UK, France and Germany appear to lead the USA and Japan among developed countries. Italy would be the best bet among the PIIGS, and Russia among the BRICs. Sector factors are giving way to bottom-up analysis, but top-down considerations are still relevant to country arbitrage. This approach is certainly too rigid to track the stockmarket's gyrations, but since fiscal constraints are durable, it should provide some guidance in deciphering market fundamentals.

Ibra Wane

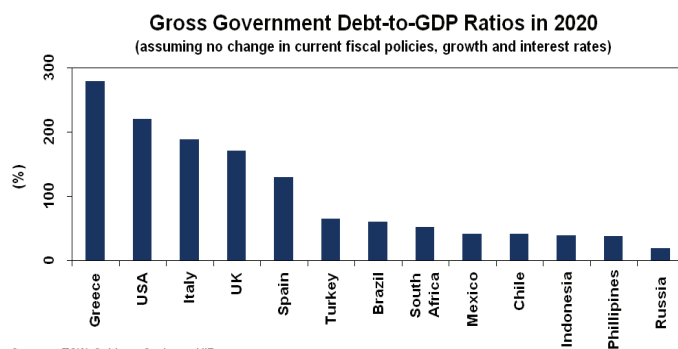
## Emerging economies local currency debt markets: coming of age

A quiet “revolution” is currently under way in emerging economies locally traded, local currency-denominated sovereign debt markets. For several years now, this asset class has attracted investors’ attention while the globally traded, dollar-denominated counterpart shrinks in relative size. More recently though, the generalized deterioration of fiscal accounts in developed markets – highlighted by Greek debt woes – has cast a new light on the attractiveness of emerging markets locally traded, local currency-denominated government bonds.

Due partly to healthy foreign inflows, these bonds have outperformed other asset classes so far this year. With a current weighted average yield (JPMorgan GBI-EM Global Index) of 7.1%, down from 8.2% a year ago, the asset class is posting solid returns even during bouts of higher risk aversion – and including segments of the local bond market that receive relatively weaker support from domestic institutional investors (such as longer dated, fixed rate, nominal government bonds). The JPM GBI-EM Global Diversified Index of emerging market sovereign local bonds is up a healthy 2.8% Ytd in USD terms, outperforming US high yield (+2.4% according to the Merrill Lynch US High Yield Master II Index), and significantly outperforming commodities (CRB commodity index, -2.1%) and a flat S&P500.

### > The attractiveness of healthier balance sheets

The chart below summarizes why many investors are looking at emerging market sovereign local bonds as a very attractive investment opportunity given its risk-reward profile. The chart shows projections of government debt-to-GDP ratios for selected countries in a 10-year horizon, assuming unchanged deficits, real growth rates and cost of debt.



While some emerging markets would be able to stabilize or even reduce debt to GDP ratios, countries like Greece and even the US could see the debt burden reaching previously unimaginable levels, unless strict spending controls are put in place. Perhaps even more worrisome is the fact that high debt burdens tend to be associated with low economic growth. This leads to a debt trap in which growth is not possible because government borrowing crowds out private consumption and investment,

while an improvement in fiscal accounts is prevented by low tax revenue growth due to lackluster economic activity.

On the contrary, several emerging markets have strengthened their government balance sheets by saving part of the *bonanza* triggered by buoyant global trade and high commodity prices. When hit by the global crisis in 2008-09, they were able to implement counter-cyclical fiscal policies (typically in the range of 1% to 3% of GDP) without compromising recent gains in fiscal consolidation. There are of course exceptions, with some emerging market economies (particularly in Eastern Europe) being forced to deleverage and are currently undergoing painful fiscal adjustments. Still, the fiscal picture in emerging markets is much brighter, particularly because better growth prospects make it much easier to keep debt to GDP ratios in check. The IMF currently forecasts that world output will grow 3.9% in 2010, with developed economies growing a modest 2.1%, significantly outpaced by 6% real GDP growth in emerging markets.

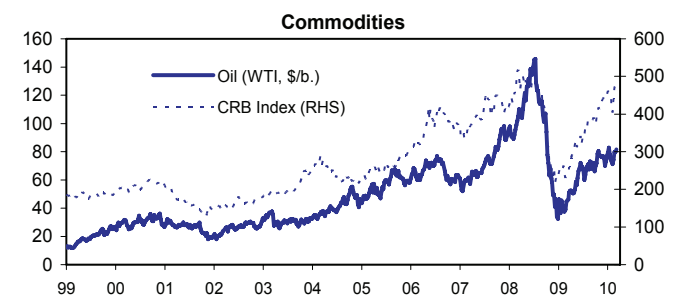
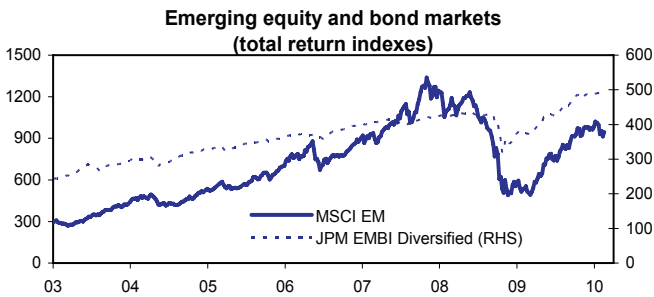
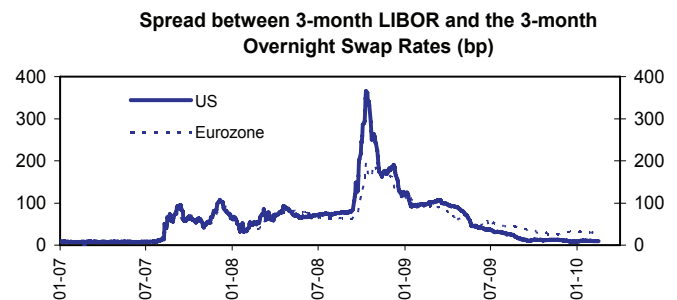
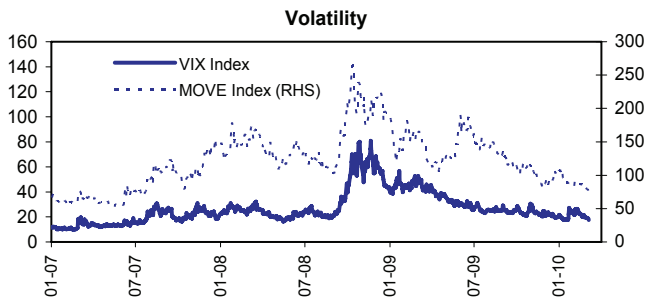
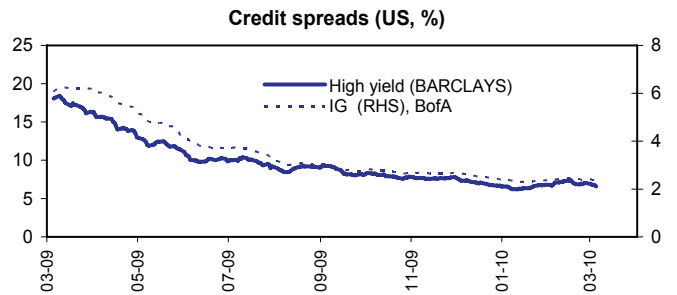
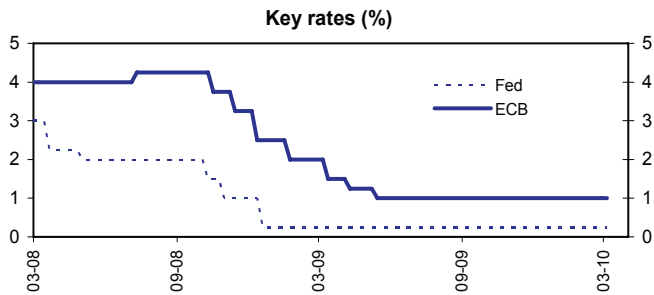
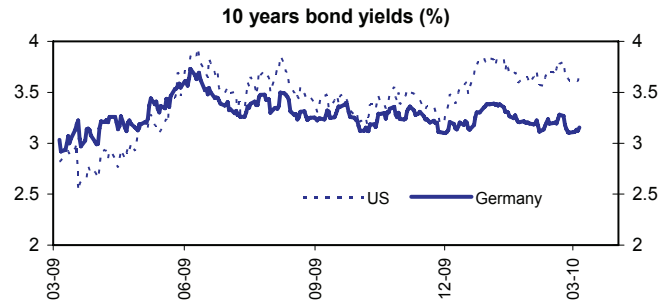
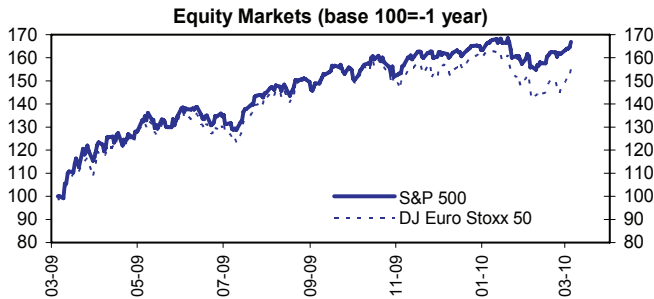
### > The risks: exchange rate volatility and discretionary government policy shifts

Governments in emerging markets welcome the increased appetite for their bonds, as it helps reduce their funding costs. But they are wary of the risk that these foreign inflows will result in excessive appreciation of the local currency against the USD and other developed market currencies. Some have imposed capital controls (by taxing foreign capital inflows, as Brazil did in 2009) or have used “policy chatter” to increase uncertainty regarding policy tools – such as a more decisive participation of the Central Bank in the exchange rate market, as a buyer of foreign currency. This noisy communication strategy discourages strong directional bets in the spot and exchange rate derivatives markets. As a consequence, hedge funds (HF) have chosen to trade these currencies (either in onshore derivative exchanges or offshore) by observing much tighter buy and sell ranges, as opposed to the strong directional bets on local currency appreciation observed in 2007/early 2008.

Recently, HF non-directional bets on emerging market currencies have led to more stability in the spot market, since these investors are usually happy to buy the local currency when it weakens against the USD, and also to sell the local currency if it appreciates rapidly against the greenback. But during moments of increased risk aversion, such as in late January, HF can build large speculative positions against emerging market currencies, triggering a selloff in the spot market that has little to do with fundamentals. Investors in local currency-denominated sovereign bonds need to be ready to differentiate this short-term volatility from more fundamental, medium-term trends in equilibrium exchange rates. These more fundamental trends continue to support a constructive view on emerging market currencies. Among other factors, a variety of emerging markets post solid current account surpluses or modest deficits, and continue to benefit from a secular upward trend in their terms of trade.

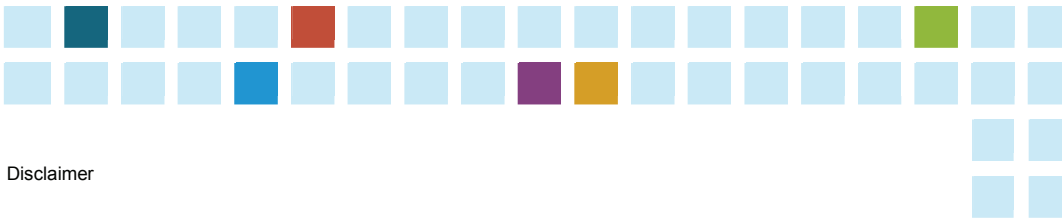
Marcela Meirelles

Market Data



Select Global Exchange Rates (March 5, 2010)

	F/X Rate	% Ch. WoW	% Ch. YTD	End year			
				2009	2008	2007	2006
USD/EUR	1.36	0.1%	-5.7%	1.44	1.39	1.47	1.32
USD/GBP	1.50	-1.0%	-7.2%	1.62	1.46	2.01	1.96
GBP/EUR	0.90	-1.1%	-1.6%	0.89	0.95	0.73	0.67
JPY/USD	89.44	-0.4%	3.3%	92.43	90.64	112.04	119.16
JPY/EUR	121.5	-0.5%	9.6%	133.2	126.1	164.9	156.9
CHF/USD	1.08	0.1%	-4.4%	1.03	1.07	1.12	1.22
CHF/EUR	1.46	0.0%	1.4%	1.48	1.49	1.65	1.61



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