Amundi
ASSET MANAGEMENT

Cross asset investment strategy

Strategy and economic research

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Executive summary

1 **What is really happening with recession risks and the euro debt crisis?** Following the onset of the debt crisis and the introduction of new budget and fiscal policies, growth is clearly losing ground amid fears of further credit contraction. The euro debt crisis is far from over. Contagion overtook all markets during September, and this will certainly be a leitmotif for the 4 November G20 meeting. Meanwhile, the immediate task is to prevent Greece from defaulting.

2 **Germany: slowdown or recession in 2012?**
Germany's growth will inevitably slow because its largest trading partners are the other European countries. But it is unlikely to slide back into recession. Among other things, domestic consumption should be underpinned by the two-year decline in unemployment.

When excessive debt threatens to cause a plunge in growth...

3 The current crisis resulted in part from soaring debt, both public and private, over the last 30 years. Economic agents became overleveraged, and the current crisis has heightened the need to pay down debt. As a result, the risk of slipping back into a classic recession is outweighed by the danger of becoming mired in depression, compounded by deflation pressures.

4 **A moderate recession is no longer a risk factor for European risky assets.** Since the summer, financial markets have been caught in a crisis of confidence. Central to current concerns is the lack of leeway on economic policy. We are defending the idea that European equities and credit have attractive risk profiles because they already factor in an imminent recession in Europe.

5 **Growth or recession: what will be the impact on corporate earnings in 2012?** The problems of managing peripheral sovereign debt this summer overshadowed the risks of a recession next year. We try to estimate the resilience of each listed sector in this unstable economic environment and to determine the correlation between a sector's stock market performance and its dependence on the macroeconomic environment.

6 **What about the Eureca plan?** Germany's rescue plan for Greece is based on the Treuhand model, created during German reunification. This vehicle allowed more than 8,000 companies to be sold (at low prices), while saving jobs and promoting growth. Eureca is attractive for Greece but does nothing to solve the contagion problems.

7 **For inflation-linked bonds, crises are coming one after another but every one is different**
Inflation-linked bonds have recently behaved very differently than they did in 2008. Inflation breakevens have eased only slightly, while real interest rates have plunged. This asset class is attractively valued, especially in the USA.

8 **What value should be allocated to CDS premiums? The case of the Greek CDS curve**– What do sovereign CDS premiums say about default expectations for the countries under review? We will look at CDS. To be sure, they are often not very liquid, and with only a handful of traders dealing in them, they tend to exaggerate actual situations. But they receive plenty of attention, and we believe that they are worth examining from several vantage points.

9 **Will French banks be able to overcome their recent refinancing difficulties?** They are capable of meeting the challenge, for two reasons. First, the risks to short-term funding appear limited since the ECB and other central banks have clearly stated that they will inject the necessary liquidity. Second, the sector has built up its liquidity and capital over the last three years.

10 **Equities: which European markets will benefit most from fresh momentum in emerging markets?** In 2008, the US recession triggered a plunge in emerging markets, still etched on everyone's memory. If developed countries manage to avoid the worst, emerging markets may bring some developed markets with them on the upside.

11 **Transmission of a sovereign debt crisis to equities: the example of OTE** – OTE is Greece's incumbent telco. It earns two-thirds of profits in Greece and the rest in Romania, Bulgaria and Albania. As OTE's stock is highly exposed to the domestic Greek market and has significant weight in the local index, its recent price movements can be viewed as a proxy for the Greek equity market as a whole.

More about it +

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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. The probability of a recession rises with growing credit crunch risk. • 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. The G20 meeting on November the 4th will be crucial. • No normalisation of monetary policy for now, and lower for longer interest rate environement. • Divergences amongst euro zone countries are expected to last. • Economic activity still more solid in emerging countries	• Do not capitulate on emerging equities. This is an area of stand-alone and solid growth with more credible governance, a public debt under control, and strong currencies. Inflation has peaked. • Go to neutral on duration • Preserve liquidity • Continue to scale back risk in portfolios (cash) • It is too soon to increase equity risk budget: amid downgraded growth and earnings outlook, volatility, debt crisis, etc. • No increase or reduction in credit or emerging debt (both are currently slightly overweighed)
Money markets	• Forward curves have been pricing in a monetary status quo in the US until 2013 (as a result of the Fed's commitment to keep unchanged its key rates) and an easing of monetary policy by the ECB. We expect the ECB to cut rates in H1-2012 by 50bp to 100bp.	• The Eonia rate will remain very volatile looking ahead, with a downward pressure likely. • 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, at least for the US. In the euro zone, bond markets are very volatile including in core countries. Nevertheless, yields should stay low for several reasons, including weaker growth, more accommodating monetary policies, and more restrictive fiscal and tax policies… No improvement is in sight for euro zone peripherals… a lot of volatility still, according to the political agendas, rescue packages and rumours… • Inflation-linked bonds: no attractive opportunities , even though the risks of recession are already mostly priced in. The backdrop remains deflationary, which is no argument for this asset class.	• Hard to see how short-term bond yields can continue to fall: 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, (impact of the sovereign crisis), liquidity is drying up, and flight to quality episodes have not disappeared. • The overall environment is bleak for banks. • For the high yield segment, the continuous decline in default rate is not enough. Even if, corporate bonds are still of better quality than sovereign ones, the environment justifies a prudent approach. • Liquidity is once again becoming key	• Banks: it is best to remain cautiously on the sidelines even though spreads look attractive, and despite impressive rebounds (especially on equities though) • High yield: we prefer defensive securities • 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	• A lot of volatility and rebounds….But equity markets are very likely to remain depressed in current environment. We maintain our preference for three themes : • An "emerging " theme. Preference for companies with heavy footprints in emerging markets and with an upside potential on valuations (some of which might have been affected by the sovereign crisis in their country) • A "financials" theme. The crisis is not over, stay on the sidelines. • A "commodities" theme: a big gap remains to be exploited between commodity prices and commodity equities.	• Caution on directional bets • Further reduction in the proportion of risky assets in the portfolio
Emerging markets	• Sharp fall of emerging equities, worst monthly decline since 2008. The contagion scenario is being priced in, the G20 meeting will be crucial. • Nonetheless, growth will remain more solid in emerging economies than in developed ones, as the latter are being forced into pro-cyclical fiscal and tax policies just as economic indicators are turning down. Some emerging economies enjoy stand-alone growth, current accounts surpluses, light debt, monetary policies that are now less restrictive and margins for manoeuvre to support growth if need be... They remain attractive.	• 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. The path will remain volatile given the sharp economic deceleration forecasted in 2012, and the recession risk for some euro zone countries.	• Oil prices will remain elevated, probably around 100$ per barrel in 2012. • Gold remain attractive as debt crisis intensifies.
Currency markets	• EUR: as long as extreme risk scenarios loom ahead in the eurozone, the euro will remain weak. In the medium term, it remains overvalued vs USD. • JPY : heavily overvalued and weakened somehow by the comments and attitude of the central bank (who have highlighted the impact of overvaluation on economic activity, excessive appreciation, etc.). It should nevertheless remain solid. • CHF : its safe haven status is undermined by its "peg" against the euro • 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: their sharp depreciation over last month does not call into question the fact that developed currencies have a strong downside potential vs emerging ones	• We are negative in the short term on the EUR/USD • 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. • Emerging currencies: stay long vs. USD, particularly in Asia and particularly in countries running current accounts surpluses.

1 What is really happening with recession risks and the euro debt crisis?

August darkened the overall scenario, with the markets fearful of both an economic recession and a new phase of contagion in peripheral euro-area countries. Italy, which once again suffered a rating agency downgrade, was a reminder of the fragility of the euro area in terms of its public debt.

Euro-area economic growth is on a knife edge

All indicators are pointing to sluggish economic growth, and the probability of a real recession (deep and long) has increased sharply over recent weeks. We have assessed this likelihood at 35%, so it is a major risk scenario, a risk that we need to guard against. Last month, we revised our growth forecasts down for both the United States and the euro area. These downside revisions were more significant for the United States in 2011 than in 2012, and more marked in the euro area in 2012 than in 2011. This is due to the lag time for the impact of restrictive budget and fiscal measures. Nonetheless, although we have been more pessimistic that the market for several months now, we revised our growth forecasts down once again. GDP growth will remain positive in 2011 and 2012 but, in the euro area, growth will remain sluggish throughout the second half of the year (in light of our forecasts and carry-over, our projection of 1% for the euro area implies zero growth for the second half of the year. We will certainly not escape one (or two?) negative quarters of GDP growth. What is "saving" the euro area, is continuing acceptable growth rates in the core countries, which themselves have been "saved" by global growth, particularly in emerging countries, with China leading the way. The fragility of the core scenario therefore comes from this part of the world, and the euro-area countries which are not currently in recession (section 2). In fact, for the euro area itself, everything, or almost everything, has been written. There are three clearly separate areas:

• **Peripheral countries "in difficulty"** (Greece, Portugal, Ireland in particular), impacted by weak growth and the need to adopt pro-cyclical political and tax policies, have been in severe and undoubtedly long recession for more than a year now, with GDP declining between 3% and 6%.

• **"Intermediate" peripheral countries** such as Spain and Italy will see their growth rates fall to levels between 0.5% and 1%.

• **"Core" countries** are no longer a consistent bloc (some are more vulnerable than others) but their growth rates fluctuate between 1% and 2%.

Beyond the area's heterogeneity, how should we qualify its growth? Since the 1930s and the conclusions of the NBER, some economists have the tendency to qualify a recession as two consecutive quarters of negative GDP growth. Other, more pragmatic economists consider that growth which is not sufficient to reduce unemployment is tantamount to a recession (G. Mankiw, for example). Without delving into the problems of definitions, we note that euro-area growth will remain below its potential, that it will be zero in the second half of 2011, that the employment situation will continue to deteriorate and that this will encourage the ECB to ease its monetary policy. This is our core scenario. The risk that the situation will deteriorate further, which has been unchanged for several months, remains.

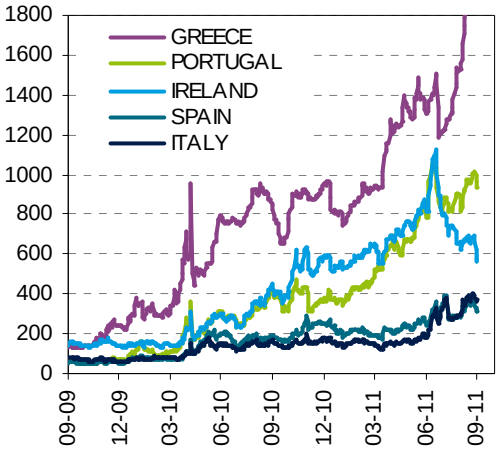
We must also bet on continued **disparities in the euro area**, with the impending impact of budget and fiscal policies (which are now more rigorous in some countries), which will be visible in 2012 growth figures.

In our scenario, **growth will remain stronger in emerging countries (those with autonomous growth, low debt and current account surpluses, etc.)**, due to a relatively independent economic cycle and substantial room for manoeuvre in terms of policy mix.

> *"Emerging countries are tracking growth, advanced countries are tracking the cycle"*

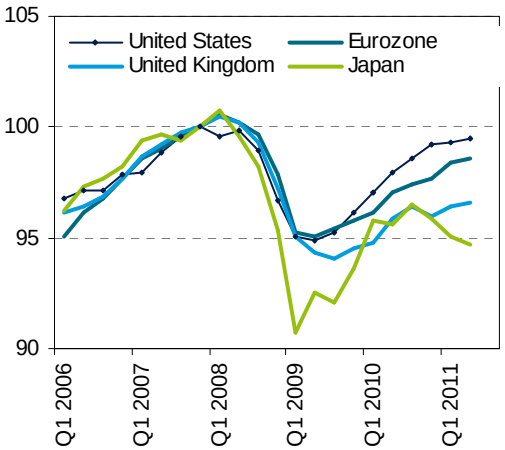
Although the Chinese PMI index remains under the 50% threshold, China has the resources to underpin growth if necessary. Moreover, China succeeded in avoiding the 2008 crisis and the subsequent recession. Through their actions, "converging" emerging countries (see section 8 of our September issue) are tracking growth, whereas indebted advanced countries are tracking the cycle (which is already on a downward trend). Despite this, emerging markets sharply outperformed in August overall.

10 yr sovereign spreads with Germany (in bps)



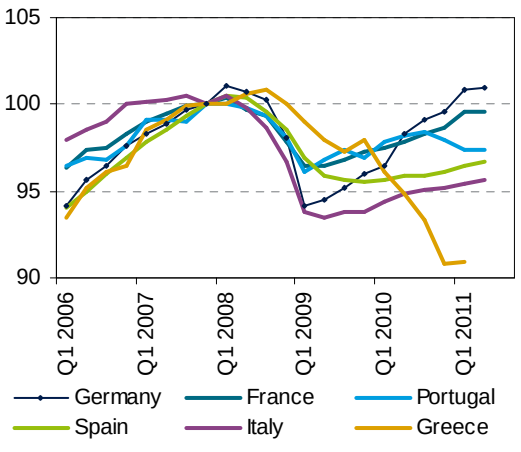
Source: Datastream, Amundi Strategy

GDP in volume (100 in Q4 2007)



Source: Datastream, Amundi Strategy

GDP in volume (100 in Q4 2007)



Source: Datastream, Amundi Strategy

The euro debt crisis is (still?) not over...

Expectations of an imminent Greek default are increasingly strong and justified in light of the current situation, which is bringing to light political dissension and institutional impasses. In our previous issues, we have insisted many times that the anti-crisis and anti-contagion mechanism is insufficient. The ECB is having difficulty playing its role of lender of last resort and July's decision, which aimed to modify the status of the EFSF, will not be ratified before mid-October. In order to achieve this, more bitter negotiations between Governments will be needed.

Box 1: Euro area debt crisis: key dates to remember

The EFSF is expected to have its new mandate (decided on July 21) validated by all Governments before mid-October. Most of them already voted in favor of EFSF new powers, with the exception of Malta and Slovakia. In particular, uncertainties remain high for Slovakia.

- October 10: Malta
- Between October 11 and 14: Slovakia (possible delay)

Other important European meetings to note:

- October 17 or 18: meeting of European Union Heads of State
- November 4: G20 summit in Cannes (France). A crucial meeting as all the countries are now hit by contagion.

Despite what we may read here or there, **any Greek default will occur as part of the euro area**. If the Treaty is respected, no country can be excluded from the European Union or the euro area and a country can only withdraw (from the Union) on its own request. For that to happen, Greece would have to stop accepting all aid from the countries of the European Union. At that point, negotiations would begin on all aspects of the Union (we should remember that the EMU is "only" one of the Treaty's three pillars and that negotiations would be on all chapters of the Treaty) and withdrawal would become effective after two years, unless the negotiation period is extended by EU members. This process is very (too) long in light of the current critical situation.

A Greek default clearly carries risks of contagion (banks, other sovereigns, etc.) unless a more efficient anti-crisis mechanism than the one currently planned is implemented.

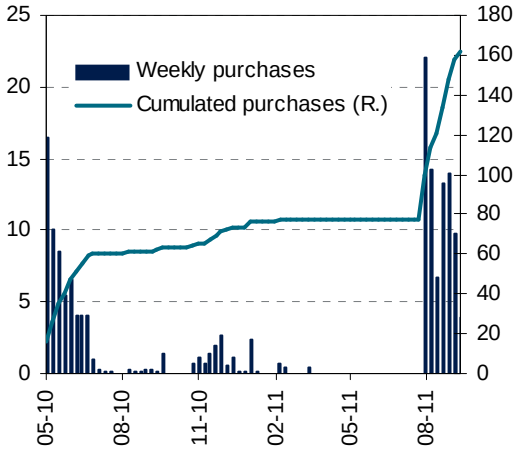
> *A Greek default carries risks of contagion*

It should be noted that risks for banks in terms of liquidity have been somewhat exaggerated. In particular, we cannot determine capital requirements using CDS prices, as the IMF did. In an exercise to stress European banks in the event of a default by Greece, Portugal, Ireland, Spain, Italy and Belgium, we never reach the figure put forward by Christine Lagarde and the IMF (which was subsequently retracted, but the damage is done) and are far from it (section 3).

Europeans' objective for Greece is "simple" (at least for certain countries): avoid default ("the worst-case scenario", as defined by European central bankers) and/or make the country solvent again – an impossible goal without erasing a substantial portion of Greek debt. As a result, it is very difficult to imagine that Greece will not ultimately default. The question is what will be the scale of this default and the recovery rate. A major default (recovery rate of 20% to 40%) would have a substantial impact on the balance sheets of the European financial system (banks and insurance companies) and would revive the risks of contagion to other peripheral countries. A minor default (recovery rate of 70% to 80%) would have the benefit of not excessively impacting the banking systems, but it would not return Greece to solvency either. There is also the risk for the markets that more defaults will follow, as was the case for Peru, which had to default several times subsequently.

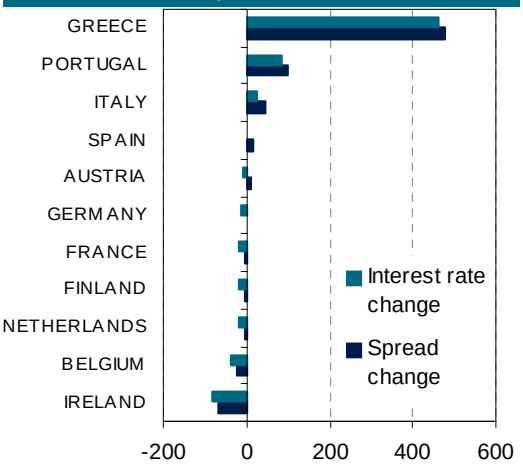
We do not anticipate the worst for the euro area, i.e. a break-up of the Monetary Union, the disappearance of the EMU and the euro, a scenario which would undoubtedly result in a deep and long recession. This is not our core scenario. We believe that there are still two possible solutions. They will certainly require improved European coordination and governance, a more significant anti-contagion mechanism (notably with a greater contribution from the ECB and Governments), external aid such as that recently proposed by Brazil or similar to that which enabled the merger of two Greek banks, but the current climate is not conducive to deploying risk into portfolios.

Securities Market Program (in € bn)



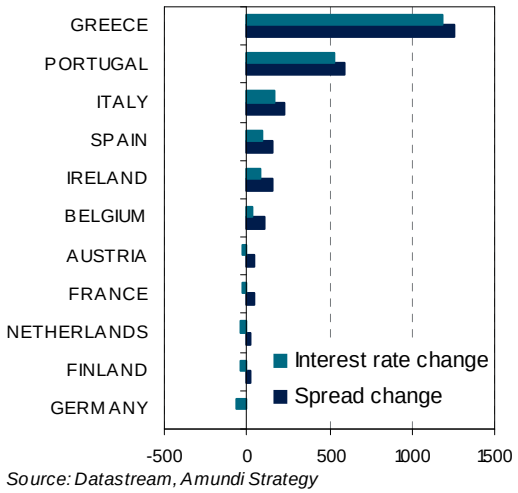
Source: Bloomberg, Amundi Strategy

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



Source: Datastream, Amundi Strategy

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



Source: Datastream, Amundi Strategy

Risk deployment vs. capital preservation

In this difficult environment, there is still good news: markets are already pricing in a recession (section 4) and even the risk of a break-up of the euro area. Furthermore, according to surveys, asset managers' positions are already conservative, in line with what we have been able to observe during the darkest moments. This portfolio positioning shows that risky assets (once institutional mortgages have been removed) have an attractive rebound potential, but the current risk-return ratio is not yet favourable - far from it. There are far too many asymmetric risks on risky asset classes.

Valuations of certain assets do seem extremely attractive (equities, credit in particular), because we are not pricing in the actual occurrence of the extreme scenario, but also because long rates are low (and will remain so) and the normalisation of monetary policies has now been (significantly) postponed, However, the risk associated with the extreme scenario is still too great. If the debt crisis deteriorates further, we will then be in the extreme risk scenario.

As a result, we are maintaining our cautious attitude in our portfolios due to volatility (negative for equities and credit), lack of visibility (high institutional risks), liquidity (negative for credit, including emerging debt), the flight to quality (favourable for US Treasury securities and German Government bonds (Bunds) over any other sovereign and risky asset classes).

> *High volatility, low visibility, liquidity risk, flight to quality = caution on risky assets*

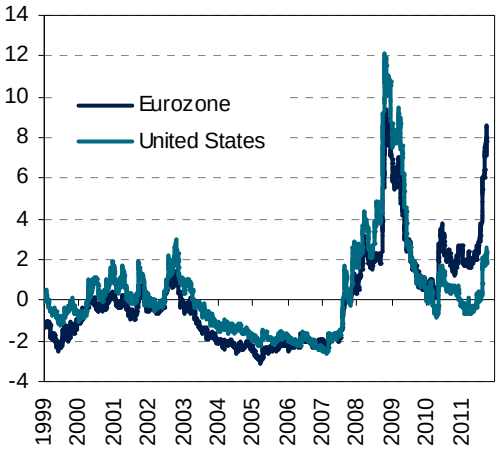
Rising volatility, loss of liquidity, lack of visibility and recurring flight-to-quality episodes are clearly factors which give negative momentum to the credit asset class but, as the corporate financial situation is much better than that of Governments, we are not, however, negative on credit. Credit spreads will undoubtedly become attractive again. However, an exit to the sovereign crisis will be needed (there are several exit possibilities), which will enable collateral damage to be better assessed.

In contrast, against the current crisis backdrop, the euro has potential for depreciation, insofar as it is highly overvalued against the dollar (in terms of purchasing power, parity for the euro is at around $1.20). Another way to take into account the current risk factor on the euro area is to purchase currencies such as the Scandinavian currencies for example. The Swiss franc is now pegged to the euro, which gives more weight to "alternative" currencies such as the Danish krone and Swedish krona.

The likelihood that alternative scenarios will occur over the core scenario has little importance against the current backdrop. This is true both for euro-area debt and the probability of recession. This phenomenon was previously known as the "Mexican peso problem". In the 1970s, the peso and the dollar were linked by a fixed exchange rate. The probability of devaluation was virtually zero, and the interest rates between the two currencies showed that the risk finally materialised in 1976 with the float of the peso - this had major economic and financial impacts.

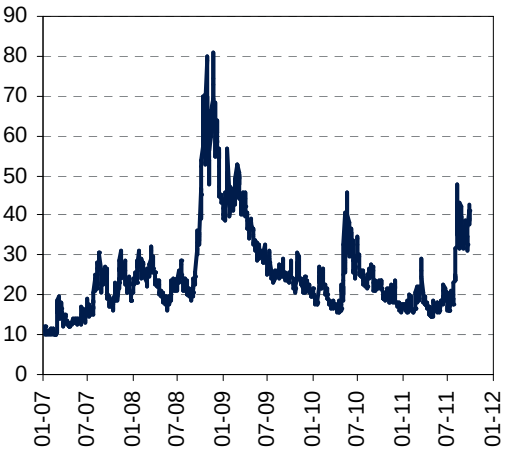
Assuming that the extreme risk scenario is unlikely to occur (which, we should remember, is not really the case), when the risks associated with this scenario are too great ("tail risks"), we should protect ourselves. This means that peripheral sovereign bonds which are affected by contagion should be avoided. The risk-return ratio of certain sovereign bonds is therefore not attractive. In the event that risks ease, highly-indebted sovereign spreads would undoubtedly narrow by 100 bp, but if the risk materialises, the spread could widen by 500 bp.

Financial stress index: Eurozone vs United States



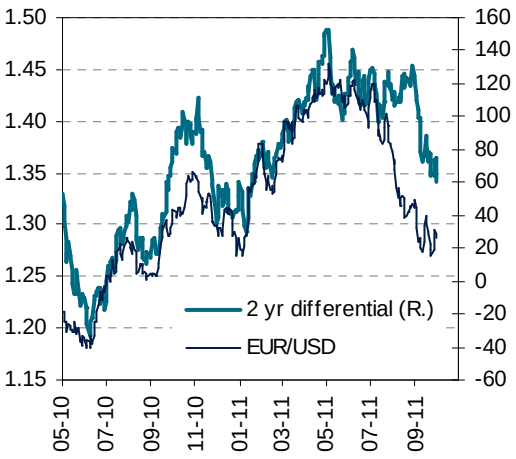
Source: Amundi Strategy

Implied volatility of the US stock market (VIX)



Source: Datastream, Amundi Strategy

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



Source: Datastream, Amundi Strategy

Box 2: Bear market rally - characteristics and instructions

The market rebound since September 22 has reinspired optimism and an increasing number of market players questioned the continuation of this trend. On this occasion, the expression "bear market rally" has blossomed in market commentaries and is often used in a less-than-accurate way.

We are aiming to clarify the meaning of this term and compare its characteristics in Japan and Europe in order to ascertain if it is an investable notion in the euro area today.

In order to properly define a "bear market rally" we should first remember how main market phases are linked. A "secular" trend is a bull or bear trend lasting between 5 and 25 years, which consists of a series of primary trends. A "primary" trend corresponds to a dominant bull or bear market trend, lasting from one to three years. A "secondary" trend corresponds to changes in trends, lasting between a few weeks and a few months, which occur within a primary trend. A "bear market rally" is therefore a specific variant on a "secondary trend", which consists of a momentary rebound in share prices before the longer primary trend takes over again.

In practice, the Dow Jones has witnessed a number of bear market rallies — after the crash of 1929, towards the end of the 1960s and the beginning of the 1970s. Since 1990, despite a cumulative decline of 73% (excluding dividends), the MSCI Japan has also witnessed several sharp bear market rallies. Lastly, in Europe, since its peak of the 2000s, the MSCI Europe has declined 40% (excluding dividends), but here again we have observed several bear market rallies.

Comparing the MSCI Japan and the MSCI Europe is informative:

- in Japan, we identified six bear market rallies since 1990. These are characterised by the scale of the rally, averaging a rise of 49%, and their relatively long average duration of 11.5 months.

- in Europe, bear market rallies are also common with no less than seven since 2000. In contrast, they were much less extensive, averaging gains of 10%, and much shorter, averaging 1.8 months.

In other words, the same term covers very different situations. And, although the Japanese bear market rally is sufficiently extensive and sharp to be investable, the European bear market rally is more of a technical rebound. In these circumstances, the basic investor in the European market must, above all, aim to capture the primary bull trends and manage the secondary bull trends or bear market rallies.

Are we currently on the cusp of a primary bull trend, as in March 2009 (+67% in two years) or just a technical rebound? The answer remains contingent on the quality of responses provided by European authorities. Generally, primary bull trends are associated with rebounds in cyclical sectors, such as basic materials, industrials and consumer discretionary. This time, as the origin of the crisis is financial; exit from the crisis must involve a rebound in financials. The recent market rebound was based on hopes that the debt crisis would be resolved. However, to differentiate a flash in the pan from a trend, we must monitor among others the easing of the interbank market, become insensitive to rumours and witness a recovery in volumes.

MSCI Japan price index

Secular bear market

start	end	top	bottom	% change	length in month
1-Jan-90	26-Sep-11	1655.0	448.0	-73%	261.0

Bear market rally

start	end	bottom	top	% change	lengh in month
1-Oct-90	18-Mar-91	861	1155	34%	5.5
17-Aug-92	13-Sep-93	672	987	47%	12.9
3-Jul-95	29-Apr-96	719	1032	44%	9.9
5-Oct-98	7-Feb-00	632	1045	65%	16.1
28-Apr-03	26-Apr-04	462	730	58%	12.0
9-Mar-09	5-Apr-10	435	623	43%	12.9
Average				**49%**	**11.5**

MSCI Europe price index

Primary bear market

start	end	top	bottom	% change	length in month
5-Sep-00	11-Mar-03	241.6	105.2	-56%	30.1
17-Jul-07	3-Mar-09	245.0	108.5	-56%	19.6

Bear market rally

start	end	bottom	top	% change	length in month
3-Apr-01	22-May-01	188.9	210.3	11%	1.6
25-Sep-01	1-Jan-02	152.8	180.3	18%	3.2
23-Jul-02	27-Aug-02	126.5	144.6	14%	1.2
8-Oct-02	26-Nov-02	115.8	132.6	14%	1.6
28-Aug-07	30-Oct-07	225.2	240.5	7%	2.1
18-Mar-08	20-May-08	193.6	211.9	9%	2.1
15-Jul-08	2-Sep-08	173.5	189.6	9%	1.6
Average				**10%**	**1.8**

2 Germany: slowdown or recession in 2012 ?

Germany accounts for 30% of euro-area GDP. Its contribution to EMU growth was almost 65% in 2010 and 51% in the first half of 2011. Bolstered by this performance, Germany is aiming at regaining a political position in Europe commensurate with its economic weight.

This political factor is clearly crucial to the current developments associated of the sovereign debt crisis. Beyond these aspects, Germany will remain key to the EMU's economic outlook for 2012. Regarding the financial market fall, worries have shifted from a potential Euro area GDP contraction to a comeback of Germany into recession.

Investment and exports will shrink at the end of the year

In 2010, net exports accounted for 39% of German growth. The euro area accounted for 42% of German exports, a figure which rises to 70% when taking into account the entire European Union.

In light of its trade ties, Germany will find it difficult to remain immune from economic developments in other European countries. Considering the IMF's 2012 growth forecasts for Germany's main trading partners and assuming that Germany maintains the same market share of global trade, German export growth is expected to fall by 20% in 2012 compared to 2011.

Moreover, German companies are suffering from deteriorating financing conditions in the wake of renewed financial market tensions. With fewer foreign outlets and increased financial stress, gross corporate investment is expected to diminish. Furthermore, the PMI manufacturing reading indicated that annual growth is expected to decline to zero at the end of the year. This means that, quarter-on-quarter, investment is expected to contract by about 0.5% at end of the year.

Germany's growth will therefore sharply slow down towards due to the investment-export double shock, but the country should nonetheless avoid falling into recession thanks to the resilience of its domestic demand.

A domestic consumption supported by the unemployment decline

> *"The German unemployment rate is at its lowest level since 20 years"*

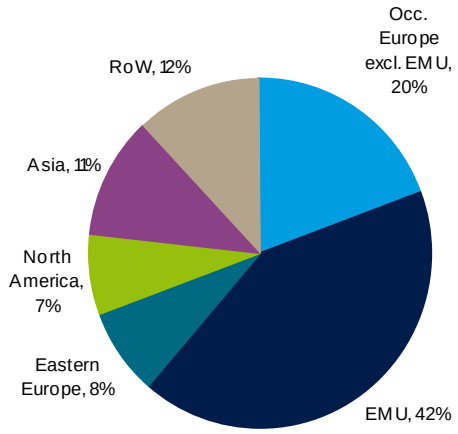
Germany has experienced buoyant growth since 2009 and its rebound in activity has enabled it to post higher GDP growth than before the crisis, in contrast to the other main European countries.

As a result, the unemployment rate has dropped from 8.3% to 6.9% over the past two years. However, this improvement in the job market has been limited in light of the activity levels recorded. Consequently, productivity has increased sharply, rising by 3.8% over the past two years. This trend is a key factor as it is expected to encourage the German economy to continue creating jobs despite a less robust growth over the coming months.

Based on IMF data, total employment is therefore expected to increase by an annual average of almost 0.5% until the end of 2012, even if GDP growth declines by more than half. Moreover, PMI analysis reveals that employment is holding up much better than the production and new orders components.

At the same time, the first wage agreements signed suggest that per-head wages will increase by around 2.5% in 2012, following a close to 3% growth in 2011. The increase in nominal household income is expected to increase by 3% overall next year, thanks to the additional positive contribution of the number of hours worked.

Breakdown of German exports by geographic areas

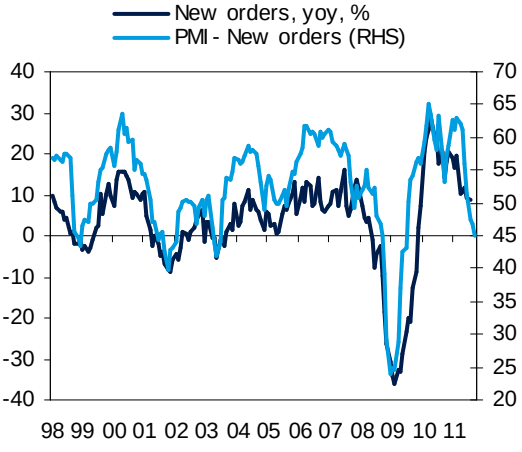


Source: Datastream, Amundi Strategy

New export orders

Source: Datastream, Markit, Amundi Strategy

New orders



Source: Datastream, Markit, Amundi Strategy

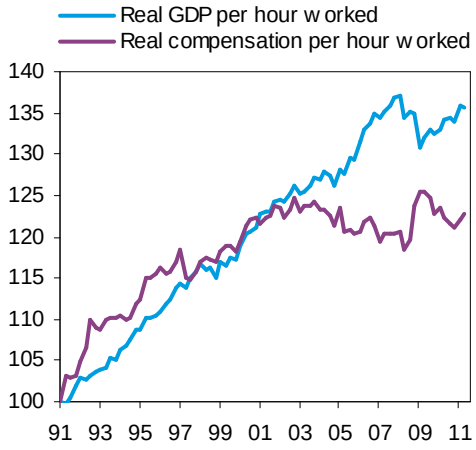
Based on our forecasts, inflation is expected to ease to an annual average of +1.3%. German households are therefore expected to benefit from an almost 2% increase in their real employment income next year. Even we anticipate a rise in the savings rate due to the shock on household confidence, real consumption is expected to post a positive growth of 1.5% in 2012.

As a result, a renewal of the German growth drivers is expected, with household demand posting a substantially higher contribution to growth next year. After a period of growth stagnation in H2 2011, German GDP should not come back in recession but exhibit a mild growth, expected at +1.6% for 2012 in our baseline scenario, due to a resilient consumption.

Of course, the risk hanging over this forecast is that financial stress exacerbate market tensions and lead the German financial sector to sharply restrain its lending. In this case, companies would be forced to cut their expenditures (investment and jobs) much more drastically. German consumption's expected resistance would be wiped out and the savings rate would strongly rise.

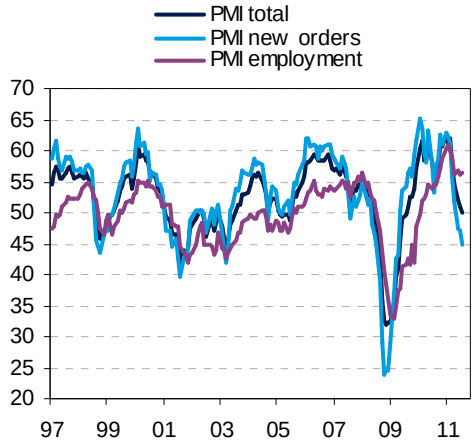
Nonetheless, it should be noted that, at that point, budgetary efforts would certainly be ramped up in order to underpin the domestic economy. Germany's deficit is expected to be merely 1.7% in 2011, which gives the country the privilege of adopting counter-cyclical budget policies.

Productivity and compensation



Source: Datastream, Amundi Strategy

Manufacturing PMI component dynamics



Source: Markit, Amundi Strategy

	GDP (yoy, %)			Inflation (yoy, %)			Public balance (yoy, %)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
US	2.9	1.5	2.0	1.6	3.3	2.0	-8.9	-9.3	-7.3
EMU	1.6	1.6	0.8	1.6	2.5	1.5	-6.0	-4.1	-3.2
Germany	3.5	2.8	1.6	1.2	2.4	1.3	-3.3	-2.2	-1.8
France	1.4	1.7	1.2	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

Source: Credit Agricole, Amundi Strategy

3 When excessive debt threatens to cause a plunge in growth...

Recession or deflation risk?

The threat of recession resurged with the financial crisis this summer. This threat must certainly be taken the most seriously in the euro area. In this region, the intricate links between bank balance sheets and sovereign debts have transformed the peripheral debt crisis into a broad-ranging banking crisis. There is a risk that the threat of credit drying up or becoming more expensive ("credit crunch") will lead to another recession. This threat should be taken all the more seriously given that economies have been weakened by the 2008-09 recession. With the exception of Germany, as of the end of the first half of 2011, none of the advanced economies had returned to their end-2007 activity levels. A recession of this magnitude had not been witnessed in the United States or Europe since the 1930s.

However, the current economic cycle stands out more for its nature than its scale. The current crisis is partly the result of soaring public and private debts over the last 30 years. Agents' debt levels have become excessive. The crisis sparked by the collapse of Lehman Brothers led agents to revise their expectations, thereby exacerbating the need to clean up their debts. In this type of crisis, the contraction no longer concerns only output and employment, as in a normal recession, but also debt and credit. As a result, the risk is less about falling back into a "classic" recession (associated with the business cycle) than sinking into a long recession, accompanied by deflationary pressures. However, let's not be mistaken—this risk concerns several advanced countries at the moment, not just those in the euro area. Even in the best case scenarios, examining previous financial crises shows that economies only recover slowly.

Initially (as of summer 2009), the depressive effects on the real economy were masked by the stimulating impact of unprecedented expansionist economic policies—both monetary and budgetary.

Public debt was substituted for private debt. Some were able to believe that this transfer would enable economies to get back on their growth track which prevailed before the crisis. However, the fact that the debt of all sectors combined was excessive and that sooner or later, reducing debt would be an unavoidable obligation for agents, was forgotten.

> *"All sectors combined, debt remains excessive... and will drag down growth"*

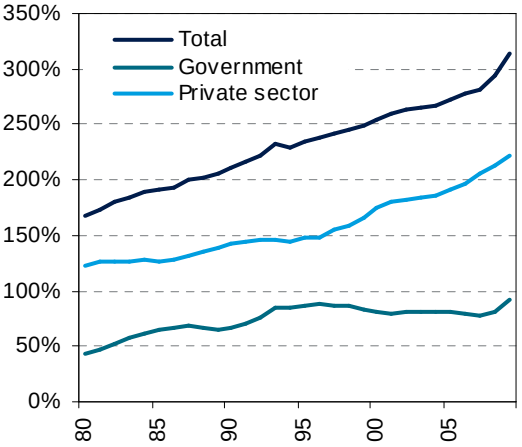
A general increase in debt over the last thirty years...

Increasing debt—household, non-financial company and Government debt—is not a new phenomenon but a gradual trend observed over the last thirty years.

Debt accumulation is not limited to a few advanced countries. Total non-financial debt exceeds 450% of GDP in Japan, 350% in Portugal and Spain and 300% in most OECD countries. However, there are some major differences between countries in terms of debt composition. In certain countries, non-financial companies are in more debt than Governments (Belgium, Norway, Spain and Sweden). Whereas in other countries, it is clearly public debt which carries the most weight (Japan, Italy, Greece). In the United States, debt accumulation over the last thirty years has been spectacular in light of history. Between the 1940s and the mid-1980s, non-financial debt was stable at around 150% of GDP. However, since then, public and private debt have increased alongside one another.

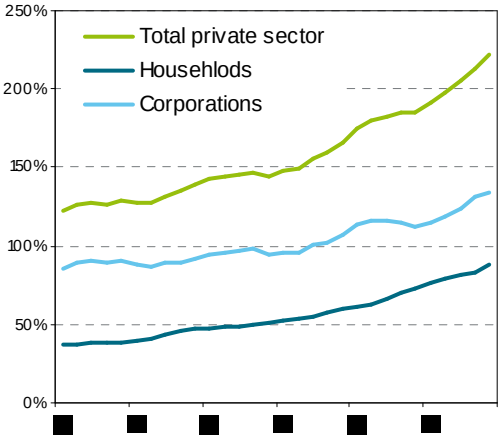
Debt trends are naturally not the same for different countries. However, what is the most striking, is the concurrent debt increases in OECD countries.

OECD: Non-financial sector debt as % of GDP



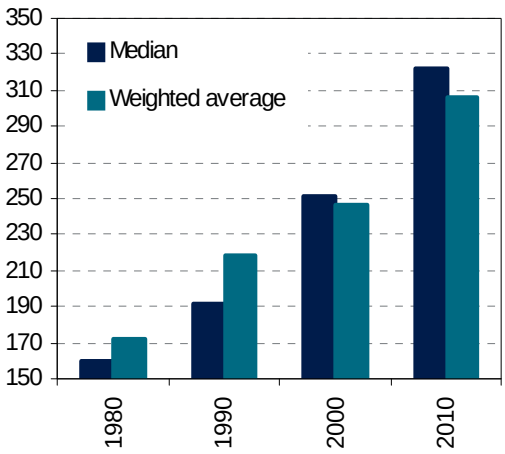
Source: Cecchetti et al. (2011), Amundi Strategy

Breakdown of non-financial private debt as % of GDP



Source: Cecchetti et al. (2011), Amundi Strategy

OECD : Total Debt Outstanding (Median vs GDP weighted average) as % of GDP



Source: Cecchetti et al. (2011), Amundi Strategy

Overall, the debt-to-GDP ratio (for households, non-financial companies and Governments) has increased from 165% of GDP in 1980 to 310% today, i.e. a rise of five percentage points (pp) per year over the last thirty years, with public debt increasing by 45pp, corporate debt by 50pp and household debt by 50pp. In real terms (adjusted for consumer price inflation), the increase in non-financial debt is just as impressive: since 1980, non-financial company debt has increased three-fold (i.e. an annual growth rate of 3.8%), Government debt has increased 4.5 times (+5.1% per year) and household debt by six times (+6.2% per year).

...caused by more liberal markets, technological progress and less unstable economic cycles

Before we return to the expected economic impact of "excessive" debts, let us briefly touch on the causes of debt. Since the beginning of the 1980s, the development and liberalisation of the financial markets, coupled with technological progress (enabling complex securitisations to be structured), have clearly contributed to the general increase in debt—all the more so during times of a high-growth backdrop. On the one hand, lower macroeconomic volatility (i.e. less unstable economic cycles), contained unemployment and disinflation characterised a period of "great moderation" from the mid-1980s to the current crisis (which began in 2007). In this "reassuring" environment, it is completely natural that economic players would have recourse to credit to finance their spending.

On the other hand, over-abundant saving in major emerging countries has indirectly contributed to rising debts in advanced countries, particularly over the last 20 years. Due to the lack of local investment opportunities and flexible foreign exchange regimes, (ex ante) excess savings in emerging markets were recycled in the form of Government bond purchases from advanced countries.

> *"Over-abundant saving in emerging countries has contributed to rising debts in advanced countries"*

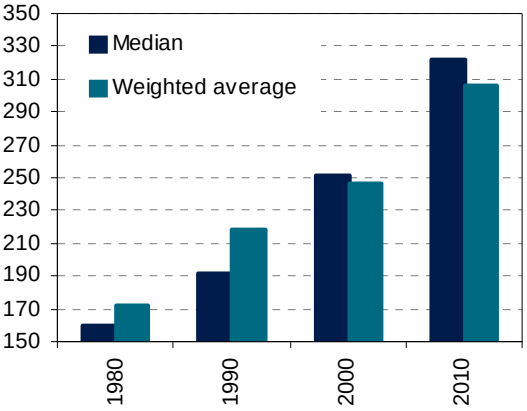
These investments accentuated the downward trend in interest rates, fuelled by households' and companies' appetite for credit, and encouraged financial institutions to create increasingly innovative financial products, with unprecedented development of complex structures enabling benefit to be drawn from low rates.

The accumulation of public and private debt threatens growth...

The link between debt and growth is complex and controversial. It is clear that low levels of debt are not detrimental to growth, quite the contrary in fact. For households, the use of leverage allows them to spread consumption over their life cycle. For a company, debt enables better management of investment programs faced with very unpredictable sales fluctuations. Finally, debt allows governments to maximise their tax policies based on medium-term objectives, as a portion of expenditures and revenues are cyclical in nature. With the free play of automatic stabilisers, cyclical fluctuations are smoother. While this may occur with a cost of reducing public finances, if the latter is controlled and temporary it is not a problem. Recall that the use of debt allows governments to fund ambitious spending programmes (infrastructure, education, R&D) to stimulate future growth and thus to benefit future generations.

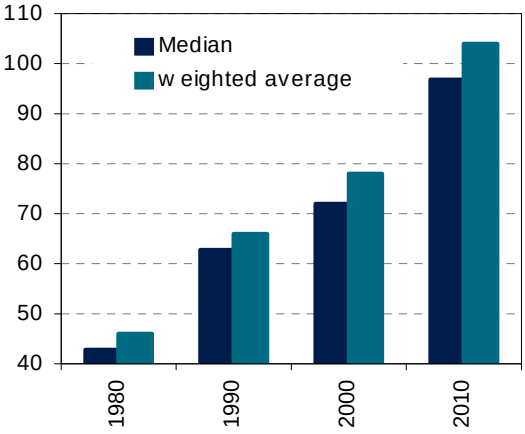
Over the past 30 years, one can easily argue that the accumulation of all debts played a part in the virtuous circle of “great moderation". When this is said to surpass a certain threshold, the disadvantages of debt ultimately prevail. This is hardly surprising: as the interest charges increase, the ability of borrowers to honour their debt decreases, their probability of default increases and investors require higher risk premiums. This further increases interest charges and downgrades the position of debtors. Following an exogenous economic shock, those debtors can quickly become insolvent. In other words, beyond a certain threshold, debt ceases to improve the efficiency of the system, and even becomes a source of financial fragility and macroeconomic volatility.

OECD : Government Debt (Median vs GDP weighted average) as % of GDP



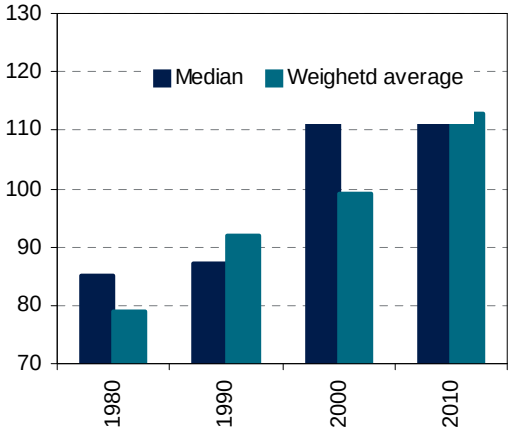
Source: Cecchetti et al. (2011), Amundi Strategy

OECD: Non Financial Corporate Debt (Median vs GDP weighted average) as % of GDP



Source: Cecchetti et al. (2011), Amundi Strategy

OECD: Non Financial Corporate Debt (Median vs GDP weighted average) as % of GDP



Source: Cecchetti et al. (2011), Amundi Strategy

Before long, the virtuous circle in which low levels of debt maintain or even stimulate growth can turn into a vicious circle, where the need to deleverage excess debt weighs continuously on business.

In their influential work, C. Reinhart and K. Rogoff (*) already showed that beyond a certain threshold of public debt (90% of GDP), growth tends to decline. Their conclusion attracted even more attention considering—after the 2008-2009 recession—public debt in advanced economies had already surpassed or would soon exceed this threshold! Several interconnected factors may explain the drop in growth: increased risk premiums required by investors and the subsequent high cost of capital, crowding out of private demand and implementation of budgetary adjustment policies that weigh on economic activity.6

Then there is the recent work by S. Cecchetti et al. (**) which confirms more than the existence of the threshold. It concludes that it is the level of total debt that has restricted growth, not only the accumulation of public debt. Clearly, there is interaction between public and private debt. When one is too high and the other is low, they are balanced out.

> *"It is the level of total debt that has restricted growth, not only the accumulation of public debt."*

The sustainability of public debt, meanwhile, is clearly related to the ability of governments to collect taxes. The ideal is that an increase of debt in one sector (public or private) is offset by deleveraging in the other, leaving the total debt unchanged. With regard to public debt, the authors find that the threshold at which growth begins to drop is between 80% and 100% of GDP. For corporate debt (excluding finance), the threshold is close to 90%. In terms of household debt, the threshold is the same, but with more uncertainty of measurement. Yet in many advanced countries, these levels have been reached or exceeded, suggesting that these economies will experience slow growth at best in the coming years.

Towards sluggish growth in advanced countries?

If they intend to withstand another exogenous shock, governments and the private sector must get out of debt without delay, and in some cases simultaneously. As for governments, demographics will make it difficult. It should be noted that the 2008-2009 recession has only accelerated a trend by bringing the level of public debt to levels they would have inevitably reached some fifteen years later due to lack of reforms. Indeed, we have long known the problems posed by the trend of snowballing health costs and pension funding. An ageing population and increasing dependency ratios are also waiting around the corner. This problem will affect advanced countries well before the large emerging countries.

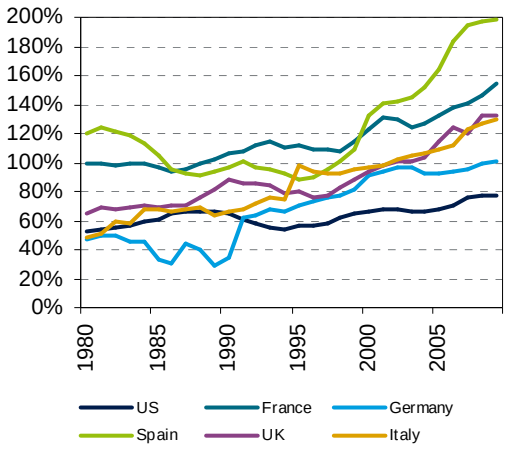
Whereas pitfalls related to excessive government debt are well-known, it seems that authorities have not fully taken stock of the risks to major advanced economies. It is no longer possible to depend on a continued virtuous circle of debt and growth, either on the side of private or public debt. The "model of high debt" was sustainable only so long as growth was inevitable. With a downturn, debt rapidly becomes unsustainable, forcing borrowers to pay off debt, sometimes precipitously, and maintains the economic slowdown or even fuels a recession accompanied by deflationary pressures.

In Europe, particularly in peripheral countries, reduction of public debt is a necessity. But the debt reduction phase is not without danger. The concurrent implementation of restrictive fiscal policies in a largely integrated trade region will limit growth in the euro area.

(*) C. Reinhart et K. Rogoff (2010): "Growth in time of debt", *American Economic Review Papers & Proceedings, no. 100.*

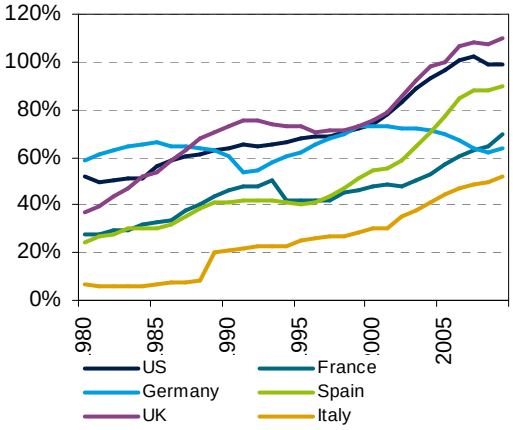
(**) S. Cecchetti, M. Mohanty and F. Zampolli (2011): "The real effects of debt", *BRI, September.*

Non-financial corporate debt as % share of GDP



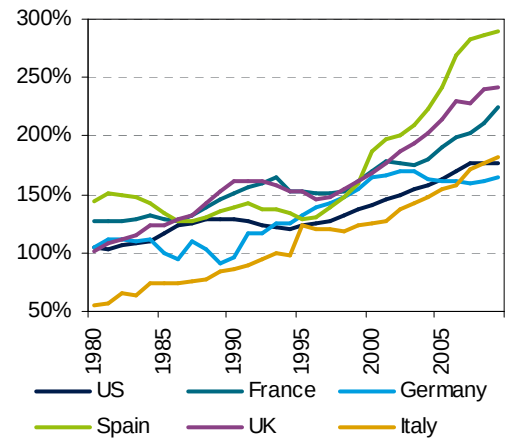
Source: Cecchetti et al. (2011), Amundi Strategy

Household Debt As % of GDP



Source: Cecchetti et al. (2011), Amundi Strategy

Government Debt As % of GDP



Source: Cecchetti et al. (2011), Amundi Strategy

The status quo is no longer possible. To refrain from deleveraging is to run head-on into disaster. To accelerate debt reduction would be to risk a "lost decade", like that experienced by Japan in the 1990s. The remaining option is to reduce debt very gradually, just enough to be visible and credible, but so strong as to hinder growth. Make no mistake, this is a difficult path to follow! In the best case, there is "sluggish growth" ahead for major developed countries in the coming years. In the US, household deleveraging has begun but it is still far from complete (debt decreased from 130% to 115% of disposable income but still well above the 85% recorded in 1995). In terms of government deleveraging, it has not even started! In Europe, the burden of fiscal adjustment is also on the horizon. At best, authorities can try to smooth the economic cost of these adjustments over several years. But ultimately we should be aware that the price to pay on both sides of the Atlantic will be slowed growth and higher structural unemployment.

In conclusion, it should be noted that the challenges of "deleveraging" are of greater concern to advanced rather than emerging countries. The great rebalancing of the global economy underway will negatively impact the former and benefit the latter (where domestic demand is expected to grow). This may be good news for the medium and long-term stability of the global economy, but the road promises to be a rocky one for advanced countries; under these conditions, interest rates in the short and long-term should stay sustainably low.

Household, corporate and government debt

% of nominal GDP	Levels				Changes		
	1980	1990	2000	2010	1980–90	1990–2000	2000–10
US	151	200	198	268	49	-2	70
Government	46	71	58	97	25	-13	39
Households	52	64	74	95	12	10	21
Non-financial corporate	53	65	66	76	12	1	9
Japan	290	364	410	456	75	46	46
Government	53	66	145	213	13	78	68
Households	60	82	87	82	22	5	-5
Non-financial corporate	176	215	178	161	39	-37	-17
UK	160	203	223	322	43	20	99
Government	58	42	54	89	-16	12	35
Households	37	73	75	106	36	2	31
Non-financial corporate	64	88	93	126	23	6	33
Germany	136	137	226	241	1	89	15
Government	31	42	61	77	10	20	16
Households	59	61	73	64	2	13	-9
Non-financial corporate	46	35	91	100	-11	56	9
France	160	198	243	321	37	45	78
Government	34	46	73	97	12	27	24
Households	27	46	47	69	18	2	22
Non-financial corporate	99	106	123	155	7	17	32
Italy	109	180	252	310	71	72	58
Government	54	93	126	129	39	33	4
Households	6	21	30	53	15	9	23
Non-financial corporate	48	66	96	128	17	30	32
Greece	92	139	195	262	47	55	67
Government	26	83	124	132	57	42	7
Households	8	9	20	65	1	11	45
Non-financial corporate	59	47	51	65	-12	3	15
Portugal	144	141	251	366	-2	110	115
Government	36	68	63	107	33	-6	45
Households	15	23	75	106	7	52	31
Non-financial corporate	93	50	114	153	-42	63	39
Spain	172	187	258	355	15	70	97
Government	27	49	71	72	21	22	1
Households	24	41	54	91	17	13	37
Non-financial corporate	120	97	133	193	-23	36	60

Source : Amundi Strategy, data from Cecchetti, Mohanty and Zampolli (2011), "The real effects of debt", BIS, September

4 A moderate recession is no longer a risk factor for European risky assets

Markets have been beset by a crisis of confidence since the summer. A lack of room for manoeuvre on economic policy amid a worsening European sovereign debt crisis is the main cause of concern. The key question for investors is whether they should remain underweight risky assets (equity and credit) in the hope of better visibility next year. **We argue that for some risky assets, especially European equities and credit, risk profiles have become asymmetric to the upside in the medium term .**

Risky assets are structurally sensitive to growth prospects.

Specifically, future cash flows from risky assets depend on the profits cycle. So their behaviour carries a great deal of information on future growth. In most cases, expectations of higher profits result in rising prices for risky assets, through two mechanisms:

> *"The behaviour of risky assets carries precious information on future growth"*

(i) contingent future cash flows from risky assets: higher dividends at constant payout rates, lower probabilities of default on debt payments;

(ii) falling risk premiums: higher profits reduce uncertainty, which in turn fuels a downturn in risk premiums.

From this view point, there is very little difference between credit products and equities. At most, the latter are more dependent than the former on growth expectations. As fixed-income instruments, credit products are less risky than equities. Unsurprisingly, we find a strong correlation between the performance of risky assets and macroeconomic momentum indicators (Chart 2). We can use this relationship in a probit model (Inset 1) to estimate the probability of negative growth in the USA and the eurozone in the coming quarter, and even the quarter after that.

Box 3: Modelling implicit probability of negative growth

- The probit model is one of the classic specifications of binary response models. For the purposes of this analysis, we attempt to determine the probability of negative growth in the USA and Europe in one and even two quarters' time.
- The model's specifications are based on the existence of a strong linear correlation between excess equity and high-yield performance over 10-year government bonds and economic performance (Chart 2). The behaviour of equities is therefore examined from the point of view of the economic expectations implied in asset prices.
- Formally, the probability calculation is based on a simple latent regression model of GDP growth against excess equity or credit performance over government bonds: $\Delta \log(GDP_{t+2}) = \alpha + \beta r_t$ where r is the excess performance from equities or credit over the previous 12 months against 10-year government bonds.
- Properly speaking, the probit model is founded on a binary variable Y* defined as $Y^*_t = 1$ **if** $\Delta \log(GDP_{t+2}) < 0$ and $Y^*_t = 0$; if not, it is assumed to be normally distributed.
- We have refined our model by making it conditional on the behaviour of business surveys used as proxies for variables representing "the state of the world". The implied probabilities presented are conditional on two states of the world: survey results are up or they are down. Formally, Charts 4 and 5 correspond to

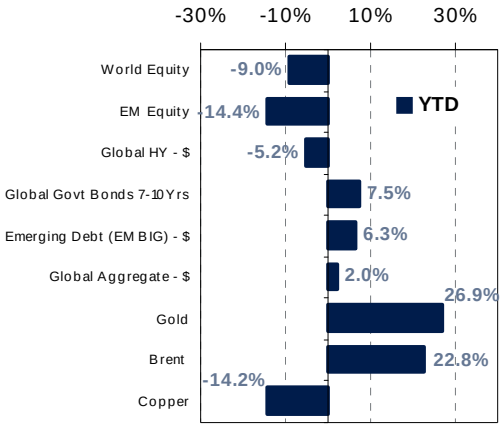
Prob($\Delta \log(GDP_{t+2}) < 0 / r_t , \Delta ISM_t$) or Prob($\Delta \log(GDP_{t+2}) < 0 / r_t , \Delta Ifo_t$)

The main risk is renewed recession

The summer has been anything but quiet. So far this year, and within a diversified universe, the only assets returning positive performance are gold, government bonds and low-yield currencies like the Swiss franc and yen (Chart 1). The market's present jitters stem largely from the fact that **today's performance trajectories are similar to those seen in 2008** (Chart 3). This phenomenon is all the more alarming for the fact that the situation has a lot in common with three years ago, with a banking crisis in Europe, pressure on the money market and the partial shutdown of the credit market.

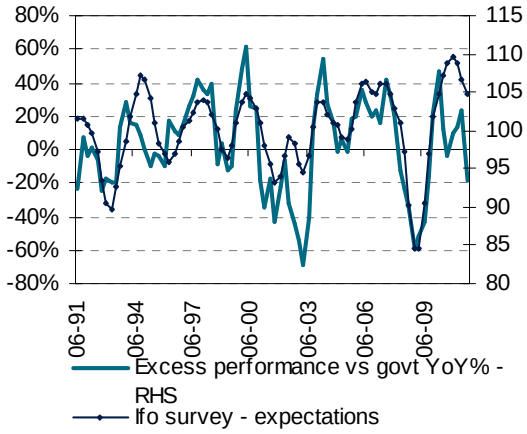
> *"Jitters are focused on similarities with 2008"*

Performance by major asset class since the beginning of 2011



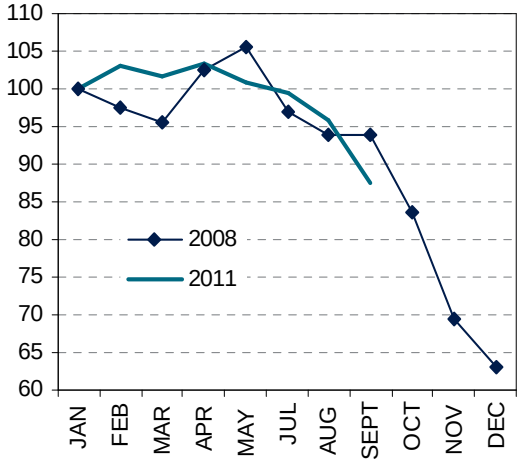
Source: Datastream, Amundi Strategy

Excess performance from equities over last 12m and business survey results



Source: Datastream, Amundi Strategy

Excess performance from equities over bonds in 2008 and 2011



Source: Datastream, Amundi Strategy

Even so, the situation also differs in may respects, starting with **the commitment of international institutions and central banks to active stabilisation strategies** that include liquidity injections, balance sheet expansion and the purchase of heavily discounted debt. This is by no means negligible because, **if we lend some credit to these policies** aimed at containing systemic risk, **the worst-case scenario is renewed recession.**

Implied probabilities of recession: European assets stand out

What probabilities of recession are priced into risky assets? We cannot answer this question fully because our models enable us to evaluate the probability of recession only in the next one or two quarters. Moreover, and as explained in Inset 1, our estimates take the state of the cycle into account. And for obvious reasons an increase in the implied probability of recession is more worrying when business survey results are deteriorating. In this configuration, it would be wishful thinking to interpret a market correction as a simple technical consolidation.

Before considering our estimates, it is worth highlighting a few regional particularities, notably in Europe. During the 1988-2011 reference period, and on average, Germany reported two negative quarters out of every five. And we note several episodes in which growth was negative for just one or two quarters (Chart 5). In contrast, economic volatility was much lower in the USA, with only three clearly distinct recessions (in 1990-91, 2001 and 2008). This leaves the empirical probability of a negative quarter at 15% in the USA, compared with 20% in Germany and by extension Europe as a whole.

As it happens, **the prices of European risky assets reflect this instability through higher implied probabilities of recession**. This is simply a restatement of the observation that European assets offer more attractive returns than their American equivalents. The implied probability of recession derived from the equity and high-yield credit markets is three times higher on average in Europe than in the USA (30% vs. 10%). In the aftermath of a torrid summer, what are the implied probabilities of recession in two quarters' time, i.e. in the first quarter of 2012? In America, it has risen but at 20% is no higher than at its peak in May 2010, when sovereign risk among European peripheral countries worsened.

In Europe, in contrast, the implied probability of recession in two quarters' time has already hit its 40% warning threshold and has since eased two points to 38%. The probability implied in high-yield assets has also risen and may well remain at its present level.

> *Simple pragmatism means recognising that recession risk is already priced into European assets*

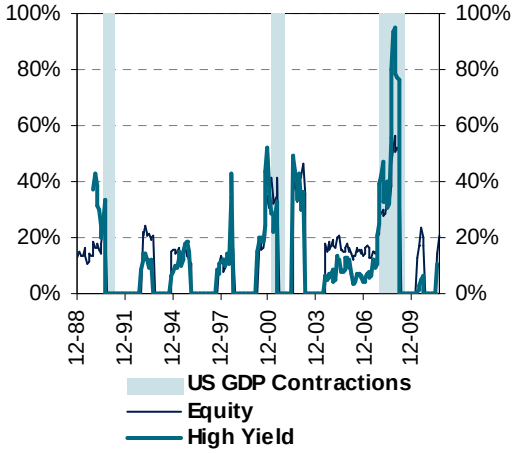
Pragmatism, not opportunism

No matter how severe, a correction is not in itself a sufficient argument to turn buyer on an asset class, and valuation considerations are scarcely more relevant for tactical plays. Macroeconomic volatility leads inevitably to higher expected long-term interest rates or more generous risk premiums. It can hardly be denied that European equities are attractive from this point of view. Straightforward arithmetic highlights the point: the cyclically adjusted PER for these assets is 9, giving us a long-term yield of 12.5%*. And this yield is far higher than the trend volatility of GDP (and therefore sales), which can currently be estimated at 10%.

Importantly, the slump in European equity prices has produced a significant rebound in the implied probability of recession out to the first quarter of 2012, leaving these assets in an asymmetrical position. **From a tactical perspective, and even if euro zone growth turns negative – as we expect – before the end of 2011, the downside to euro zone equities is fairly limited.** Conversely, renewed activity following a positive exogenous shock such as a swift resolution of the sovereign debt crisis would make these assets a first-choice opportunity. In contrast, the implied probabilities priced into American equities are still too low with respect to their historical levels. The European high-yield credit market is in an intermediate position, although it would benefit from ECB easing.

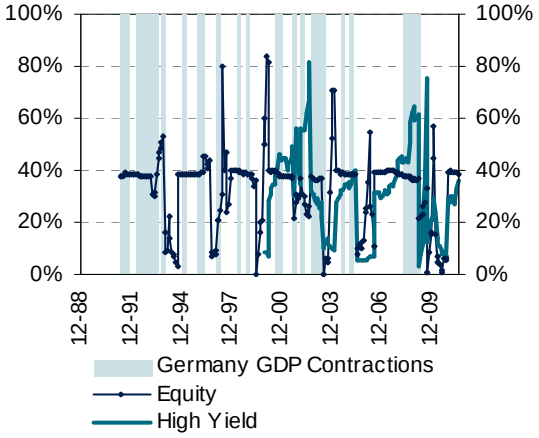
** the inverse of the multiple plus the long-term dividend growth rate of 1.5%*

USA – implied probability of contracting GDP in the next 2 quarters



Source: Datastream, Amundi Strategy

Eurozone – implied probability of contracting GDP in the next 2 quarters



Source: Datastream, Amundi Strategy

European equity risk premiums vs. US 5 years govt

Source: Datastream, Amundi Strategy

5 Growth or recession: what will be the impact on corporate earnings in 2012?

The peripheral sovereign debt management problems encountered this summer somewhat masked the risks of a fall-back into recession next year.

In order to better assess the challenges associated with the 2012 macroeconomic scenario, we have defined two alternatives to our core scenario. One is more "pessimistic", anticipating a fall-back into recession, and the other is more "optimistic", projecting a more pronounced rebound in growth.

The purpose of this study is to assess each sector's resistance in this unstable economic environment and see how closely correlated market performance is with the sector's dependence on the macroeconomic backdrop.

The two scenarios chosen by Amundi are the following:

- fall-back into recession with (i) growth of between -0.5% and 0% in the EMU, United Kingdom and United States and (ii) growth easing off in China (7%);

-a scenario of more pronounced recovery, with growth of 2% in the EMU and United Kingdom, 3% in the United States and 9.5% in China.

We obtain a growth differential of 28% (not weighted for market capitalisations) between the more optimistic and more pessimistic scenarios. The sharp corrections suffered by the sectors associated with the macroeconomic cycle (Banking, Autos and Metals/Mining for example) since August illustrate investors' current doubts. Faced with this high level of uncertainty, investors have taken refuge in more defensive sectors such as healthcare and consumer staples.

What will be the dominant theme this autumn: sovereign risk or recession risk?

The graph (see opposite) which details the correlation between earnings growth in the event of a recession and market performance over the last month demonstrates how much this has been in investors' minds (in comparison to the sovereign risk issue) in recent weeks.

Indeed, the sectors that have recently underperformed are the sectors which are most sensitive to a change in the macroeconomic scenario.

However, it should be noted that Utilities, which are traditionally considered to be defensive, have not been able to benefit from their supposed earnings capacity resilience due to their major involvement in the problems associated with sovereign debt, this summer's other dominant market topic.

> *"Semi-conductors: a contrasting indicator?"*

Semi-conductors: an exception?

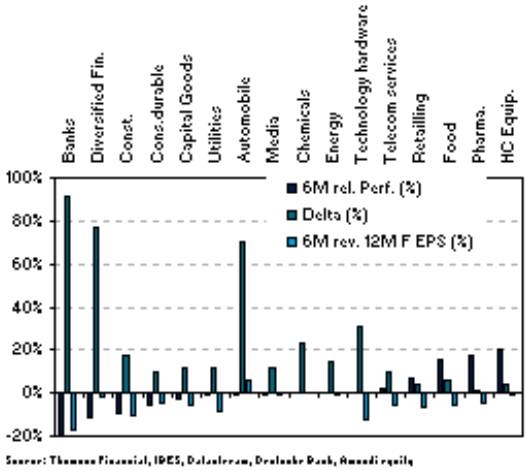
Semi-conductors are a different story. The downward revisions which began in March/April have picked up since that date. The recent outperformance is a sign that this cycle could bottom out during the second half of the year (we are already expecting growth of -25% for this sector in 2011). The continuation of this outperformance during the fourth quarter of 2011, which, in our opinion, is contingent on pricing in an "optimistic" scenario for 2012, could indicate an optimal solution for macroeconomic indicators.

Table of sensitivity of profit to different macroeconomics scenarios

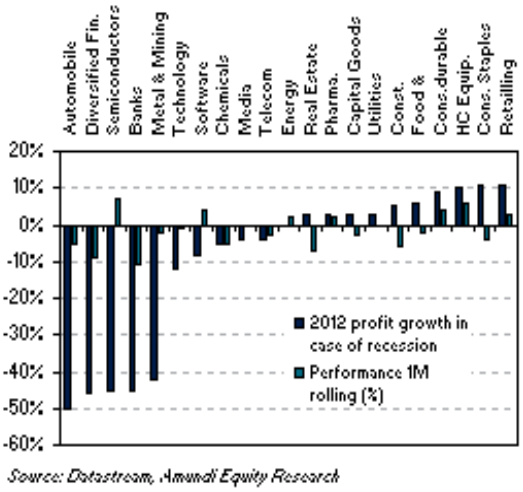
Macroeconomic scenario (GDP growth)	Euro zone: 1% US: 2% UK: 1,2% China: 8,8%	Euro zone: - 0,5% / 0% US: - 0,5% / 0% UK: - 0,5% / 0% China: 7%	Euro zone: 2% US: 3% UK: 2% China: 9,5%
Sector	2012 Profit Growth		
Banks	26%	-45%	46%
Diversified Fin.	15%	-46%	31%
Real Estate	2,7%	2,5%	4%
Pharma. & Biotech	4%	3%	4%
HC Equip.& Services	13%	10%	14%
Food & Staples	14%	10,8%	13%
Retailling	14%	11%	15%
Cons.durable & apparel	15%	9%	19%
Food & Beverage	10%	6%	12%
Media	5%	-4%	8%
Chemicals	6%	-5%	18%
Energy	8%	0%	15%
Metal & Mining	2%	-42%	16%
Const. & Building mat.	13%	5%	22%
Capital Goods	9%	3%	15%
Utilities	7%	3%	10%
Infrastructures	5%	-5%	12%
Automobile	10%	-50%	20%
Telecom services	3%	-4%	6%
Technology hardware	15%	-12%	19%
Software & Services	9%	-8%	25%
Semiconductors	11%	-45%	76%

Source: Datastream, Amundi Equity Research

Sensitivity of profit to different scenarios vs. Six-month performance vs. Six-month revision of earnings



Profit growth in the event of a recession vs. One-month performance



Source: Datastream, Amundi Equity Research

6 What about the "eureca" plan?

All eyes are on Germany's "Eureca Project". The plan is modelled on the Treuhandanstaldt, the government agency set up in June 1990 under West German law to privatise the assets of the German Democratic Republic after reunification. The Treuhand organised the privatisation of more than 8,500 East German state-owned enterprises, most of them between 1990 and 1994, when the agency ceased operations. Eureca is interesting, especially because it is backed by Germany's experience.

The new plan confirms Germany's determination to resolve the Greek crisis – and the dominant role it plays. That the proposal has been developed outside EU bodies by the consultancy responsible for coaching the Treuhand is telling. It also underscores Europeans' difficulty in reaching solutions collectively.

The main points of Eureca are:

- Greece would house all its privatisable assets (banks, ports, enterprises, real estate, etc.) in a special purpose vehicle. The assets would be valued at around €125 billion.
- The SPV would be sold to a European institution financed by EU governments. The new institution would oversee the privatisations until the end of its remit in 2025.
- Greece would use the €125 billion in proceeds to buy back all its bonds from the EFSF and the ECB, cutting its debt to below 90% of GDP (from 150% now).
- As in the German precedent, the institution would invest in some of the privatisable assets (€20 billion or €30 billion is being discussed, equivalent to 8% of Greece's GDP) to raise the privatisation value. That investment would have a positive impact on growth and jobs, thus reducing Greece's debt and deficit as percentages of GDP and mitigating social problems (it would also avoid further austerity, which is counterproductive and does not resolve the underlying problem of the country's insolvency). Greece would also promise to continue buying back its debt: the equivalent of 1% of GDP each year, which would bring its debt down to 60% of GDP by around 2020.
- Any surplus from the privatisations over the initial estimate of €125 billion would go to Greece; any shortfall would be incurred by Greece.

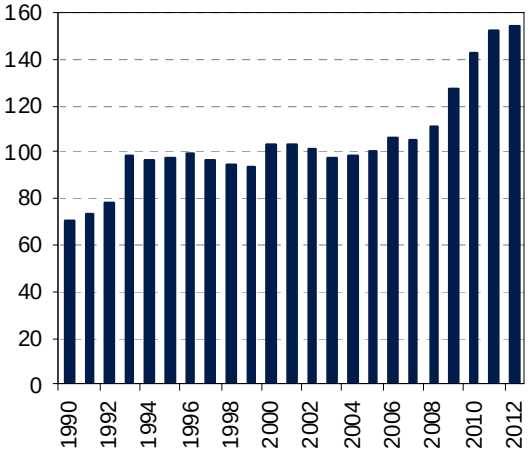
If the plan is followed there will be no Greek default, as described until now. The plan could also enable Greece to reissue bonds, return to growth, lower its public debt and deficit ratios, and reduce the nominal amount of its debt.

> *"A plan for Greece… but what about contagion risk ?"*

Where are the potential sticking points?

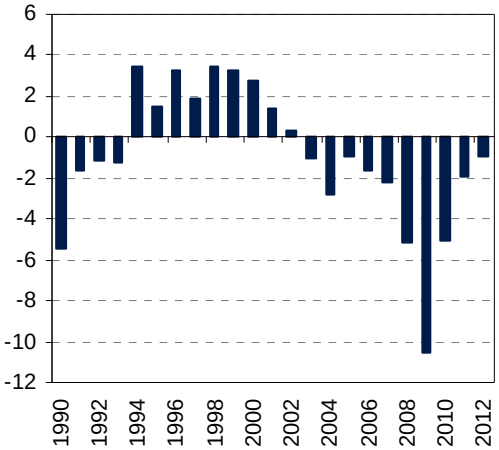
- **Lack of time (1)** … €125 billion has to be found in privatisable public assets, compared with the €50 billion – an amount often considered optimistic – identified by the Greek government.
- **Lack of time (2):** implementing a plan that requires creating a new European institution or extending its current role would take time (the EFSF serves as a reminder). But Greece needs a solution fast. In a few days' time, it must meet a payment deadline, and the sixth tranche of EU/IMF aid has still not been released. If the money is not forthcoming, a full-blown default will occur.
- **The price at which Greek debt is repurchased:** this point is crucial because it will determine the impact on public debt reduction and on the ECB's accounts.
- **Political consensus in Europe**, which has been shaken in the last few months. Remobilisation and more solidarity between countries are needed to adopt the plan. The advantage of the plan is that it does not commit governments directly, in other words they do not bear the direct cost. It is therefore conceivable that the countries until now hostile to any form of Greek bailout (which would imply a cost for them) could take a more favourable view.
- **The perception of a fire sale of Greek enterprises to foreigners:** the (East) German privatisations were strongly subscribed by (West) Germans. In the case of Greece, they would most likely be bought by non-Greek companies…

Greece: public debt (as % of GDP)



Source: Datastream, Amundi Strategy

Greece: government primary balance



Source: Datastream, Amundi Strategy

-The repurchase price for Greek debt: this point is crucial because it will determine the impact on the reduction of public debt and on ECB accounts.

-The perception of a cheap sell-off of Greek companies: possibly brutal, the goal is to find investors that have until now been skittish on Greek assets. Hence the idea to sell these assets at an attractive price and/or to grow their value through investments. This is what Brigit Bruel, President of the Treuhand meant when she said, "the objective was not to sell assets but to buy investors." We should not exaggerate—Greece is not 1980s East Germany and we can be sure that a number of companies and sectors of the Greek economy have everything they need to be valuable—but is there EUR 100-125 billion? That is another question.

What should we make of the plan?

For the time being, the Treuhand-esque structure is unarguably an interesting proposal. On the surface, it appears extendible to other governments but remains limited to Greece. It is difficult to imagine the implementation of such structures for any other country.

-To be credible, the plan must first be “carried” by Germany and the German government (the recent statements by Wolfgang Schäuble, the federal finance minister, give grounds for scepticism).

-The plan then has to be adopted by European member states: it involves creating another European institution (structure, implementation, adoption, etc.), admittedly one that might not lose money (it buys assets that it then resells at the purchase price). The footdragging over the EFSF’s new mandate since the end of July argues for caution.

-Eureca addresses the problem of Greece but not that of contagion. Solving the Greek problem does not guarantee an end to the risk of contagion.

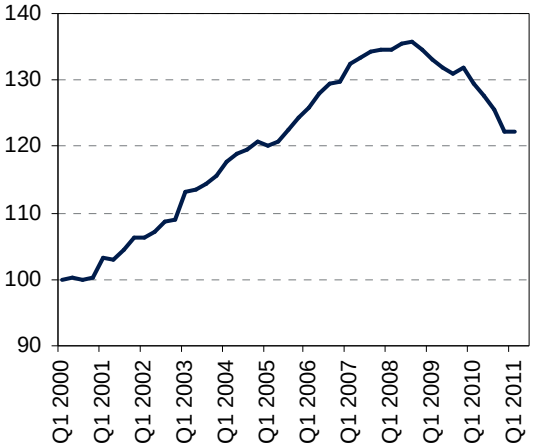
-There is still huge uncertainty over the EFSF vote, and the ECB does not seem to be in a position to announce a large-scale support package for the peripheral countries. The problem of the vulnerability of other countries therefore remains unresolved.

-A Treuhand-style SPV has its appeal. In theory it can be replicated in other countries, but in practice it will be limited to Greece. It is hard to see similar vehicles being set up for other countries.

-Not only must assets be found that can be sold for large sums, but a significant amount must be collected in order to make a sizeable reduction of Greece's debt

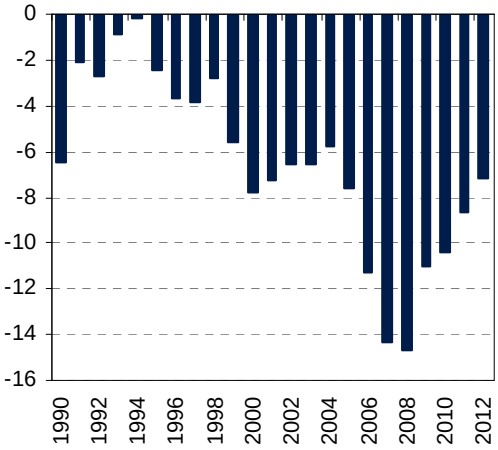
In other words, caution is the watchword.

Greece: GDP in volume (100 in Q1 2000)



Source: Datastream, Amundi Strategy

Greece: current account (as % of GDP)



Source: Datastream, Amundi Strategy

Box 4 : Was the Treuhand an indisputable success?

It is a fact that Treuhand accomplished some essential work: the privatisation of an entire economy, the restructuring and privatisation of 8,000 companies, the saving of a number of jobs (1.5 million) and significant investments—but at what price? A colossal deficit. In 1990, its President, Detlev Rohwedder announced that revenues from the sale of state-produced goods in East Germany brought in some DEM 600 billion (just over EUR 300 million). In the end, this figure plummeted to only DEM 75 billion (EUR 38 billion)! The Treuhand deficit was at DEM 270 billion (EUR 135 billion), payable by the German government—and its taxpayers. The Treuhand strove, with massive subsidies, to save businesses that were doubtless no longer worth the effort, such as shipyards, iron and steelworks, etc. Overvalued in their books and with parity between the East and West German currencies, many East German businesses were literally buried by German reunification. Nearly 3,000 businesses were also subject to MBOs on the part of East-German executives, a politically astute solution (what could be better than East-German companies being taken over by East-Germans?), but a large number found themselves on the brink of suffocation and aided by businesses which, with the support of the German minister of finance, ensured the continuation of the Treuhand. All this without even mentioning the various scandals such as subsidies used to takeover a business—that was promptly closed. The commission of inquiry into the Treuhand does not seem to have even been capable of carrying out its investigation, three-quarters of its files being classified as state-secrets. In a landmark publication, Otto Kohler spoke of a "great expropriation". ("Die grosse Enteignung : wie die Treuhand eine Volkswirtschaft liquidierte", Munich, Knaur, 1994)

7 For inflation-linked bonds, crises are coming one after another but every one is different

For inflation-linked bonds, crises are coming one after another and every one is different. While other asset classes are trending in much the same way as they did during the 2008 crisis, inflation-linked bonds are behaving very differently. Let us remind ourselves of the principle of these securities. The financial flows associated with these bonds (coupons and principal) are indexed to future inflation and their valuation by the financial markets therefore partly depends on inflation expectations. In particular, the difference between the nominal and real interest rate, i.e. the actuarial interest rate of inflation-linked bonds, is called the inflation break-even.

After the collapse of Lehman Brothers in September 2008, inflation break-evens fell to extremely low levels, particularly on short maturities. As an example, the one-year inflation break-even fell to -7% during December 2008. There are several reasons for this. Firstly, the global economy was entering its worst crisis since the end of the Second World War, notably with a brutal decline in global trade, which paved the way for substantial deflation risk. The market may therefore have sharply revised its inflation expectations to the downside. However, above all, a major flight towards liquid assets led to very strong demand for nominal bonds, which caused nominal rates to plunge. At the same time, investors shunned less liquid assets such as inflation-linked bonds, which caused real rates to rise. The liquidity premium on inflation-linked bonds rose sharply. Remember that, in the United States, the Treasury securities market is made up of 89% nominal bonds and 11% inflation-linked bonds.

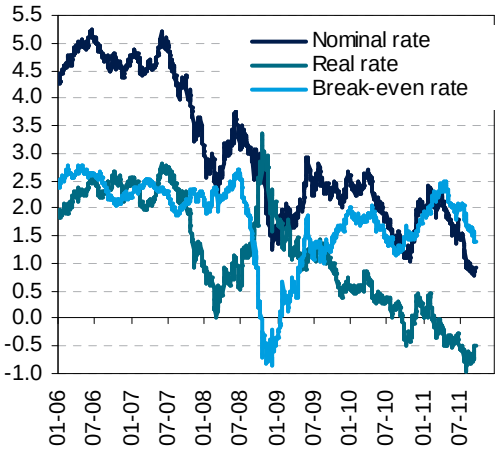
Where are we today? A major part of the trend in inflation-linked bonds over the last year should be associated with the Fed's second round of quantitative easing (known as QE2).

> *"The US' QE2 had a major impact on linkers"*

Under this plan, the US central bank purchased $600 billion in Treasury securities between November 2010 and June 2011. Substantial amounts of liquidity were pumped into risky assets and commodities, which caused their prices to rise. Thus, the fluctuations in commodity prices, particularly oil, impacted changes in inflation break-evens (see graph), but without enabling a systematic relationship between the two to be defined. Moreover, only 3% of the $600 billion in Treasury securities involved inflation-linked bonds (the other 97% went to nominal bonds). This put more of the downside pressure on nominal rates than on real rates. Inflation break-evens therefore increased sharply until spring 2011. Since then, negative macroeconomic newsflow on both sides of the Atlantic and the intensification of the public debt crisis have caused nominal rates to drop sharply, slightly more than real rates. As such, nominal and real long-term rates have reached extremely low levels (see graph). It is here that we are able to notice a substantial difference compared to the previous crisis. In 2008, real rates increased sharply and inflation break-evens collapsed. Today, we are in a completely opposite situation — real interest rates have plunged and inflation break-evens are far from collapsing and have only eased slightly. Real rates have moved into negative territory on short maturities in the United States and the United Kingdom and are close to zero in France and Germany. In contrast, Italy is in a different situation because real rates are very high there (5-year rates are close to 3.5% and 10-year rates are at 4.7%).

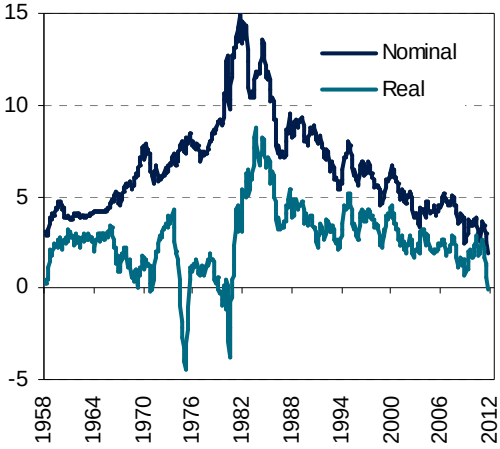
Currently, it is clear that, with the exception of Italy, inflation-linked bonds are attractive from a valuation point of view, particularly on short maturities, because the inflation expectations given by the market seem too low to us. In the United States, for example, during September the one-year inflation break-even was close to 1% whereas the 10-year break-even fell below 1.8%. However, the Survey of Professionals Forecasters published by the Philadelphia Fed listed 1-year and 10-year inflation forecasts of 2% and 2.4% respectively. The survey of US consumers carried out by the University of Michigan gave a 1-year inflation forecast of 3.5%. In contrast, investment opportunities are vastly different in the United States and Europe. As real interest rates are intended to measure real growth expectations, it seems clear to us that inflation-linked bonds are much more attractive in the United States than the euro area. Unlike Europeans, the United States can count on a weak dollar, the Obama plan, the Federal Reserve's aggressive monetary policy and particularly a possible QE3. In the euro area, risks of disinflation and even deflation are far more marked (section 2), which makes inflation-linked bonds much less attractive.

5 yr inflation break-even rates in the United States



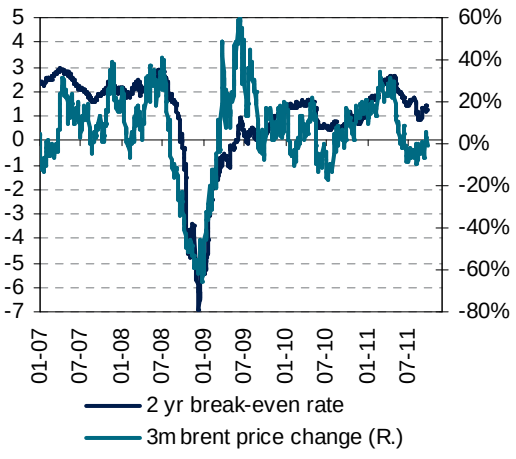
Source: Bloomberg, Amundi Strategy

Nominal and real rates (core CPI deflated) in the United States



Source: Datastream, Amundi Strategy

US 2-year inflation break-even and change in price of Brent



Source: Bloomberg, Amundi Strategy

8 What value should be allocated to CDS premiums? The case of the Greek CDS curve

The aim of the following survey is to enlighten the current perception by Credit Markets about some sovereign debt. Both CDS and credit spreads (for cash bonds) are very useful tools for analyzing market anticipations. Their liquidity could be questionable, only a handful of big players (Hedge Funds, Investment Banks, some big portfolio managers) are dealing them, they tend to exaggerate the real credit situation of some sovereign debts, but they are scrutinized by market participants and we think that their value as an anticipation tool is really huge. Our basic hypothesis in this survey is that in case of default of any country mentioned below, the recovery rate is estimated at 50% of the nominal underlying (100% cash for a bond or 100% of notional for a credit default swap). (this is much higher than the historical recovery rate for sovereign default which is around 30%).

1. Data and results table:

Country	Rating	CDS 5 Y in %	CDP 5 Y implicit	CDP 5 Y Moody's	Historical Spread	Credit risk premium	Country/Rating
Austria	Aaa	1.63%	15.04%	0.09%	0.009%	1.62%	Austria/Aaa
Belgium	Aa1	2.55%	22.51%	0.14%	0.014%	2.54%	Belgium/Aa1
Finland	Aaa	0.79%	7.60%	0.09%	0.009%	0.78%	Finland/Aaa
France	Aaa	1.76%	16.14%	0.09%	0.009%	1.75%	France/Aaa
Germany	Aaa	1.03%	9.79%	0.09%	0.009%	1.02%	Germany/Aaa
Greece	Ca	60.22%	99.76%	70.18%	12.099%	48.12%	Greece/Ca
Ireland	Ba1	7.35%	52.05%	7.29%	0.757%	6.59%	Ireland/Ba1
Italy	Aa2	4.60%	36.87%	0.20%	0.020%	4.58%	Italie/Aa2
Netherlands	Aaa	1.00%	9.52%	0.09%	0.009%	0.99%	Netherlands/Aaa
Portugal	Ba2	11.06%	66.91%	8.08%	0.843%	10.22%	Portugal/Ba2
Spain	Aa2	3.76%	31.34%	0.20%	0.020%	3.74%	Spain/Aa2
United Kingdom	Aaa	0.87%	8.33%	0.09%	0.009%	0.86%	United Kingdom/Aaa
USA	Aaa	0.52%	5.07%	0.09%	0.009%	0.51%	USA/Aaa

Assumption: in the event of a default, the recovery rate is estimated at 50% of principal debt (much higher than the historical default recovery rates, which have been closer to 30%).

In the credit universe, for a CDS premium given by the market with the corresponding issuer and maturity, analysts convert this premium into a cumulative default probability (CDP) between the origination and maturity of the CDS. This probability is calculated in a risk-neutral world (this is the same technical infrastructure which enabled the Black and Scholes formula on options prices to be established). The following simplified formula is used for this conversion.

Cumulative default probability (horizon T) = 1-exponential (-(CDS premium*T)/ (1-Recovery Rate)

By applying this formula, we obtain the results in column 4. These results (apart from the spectacular values for Greece, Portugal and Ireland), are logically (and falsely) compared to the historic cumulative default probabilities given in the mortality tables provided by Moody's (tables chosen from the period 1983-2009 because they are the most granular in terms of rating), which appear in column 5. As these latest CDPs come from the real world (historical defaults by rating category), they are therefore real-world probabilities and not directly comparable to the risk-neutral CDPs, but do allow real-world credit spreads to be calculated (column 6) by inverting the previous formula.

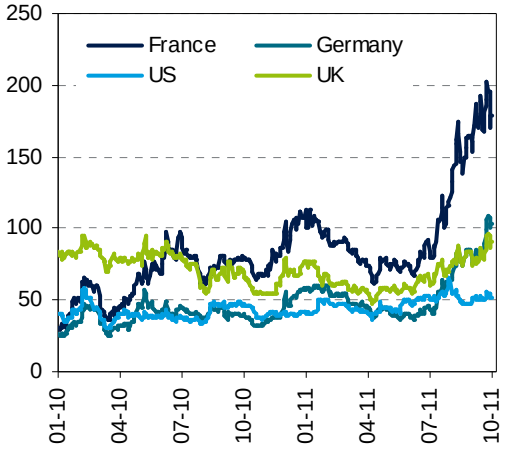
The difference between the CDS premium given by the market and the spread from the Moody's tables is analysed as if it were the risk premium demanded by the market for a given issuer and a given maturity and appears in column 7.

The results obtained are both logical and surprising:

Despite the recent downgrade issued by S&P (from AAA to AA+), the United States has the lowest risk premium at 52 bp. There are many reasons for this — the most simple is associated with the portion of global GDP accounted for by the US, the role of the dollar in global trade and its safe-haven status, despite a much deteriorated financial situation (as a side note, US three-month T-Bills are offering a zero return at the moment).

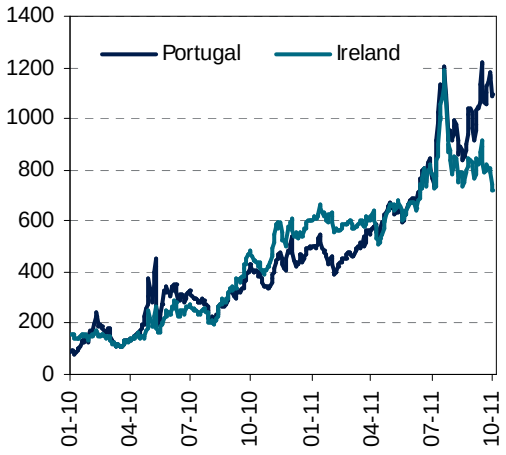
For the other Aaa-rated countries, the annual risk premium is spread between 80 and 102 bp (United Kingdom, Finland, Germany) and 160-175 bp for pseudo Aaa-rated countries (France and Austria).

Credit default Swap for France, Germany, Us and UK



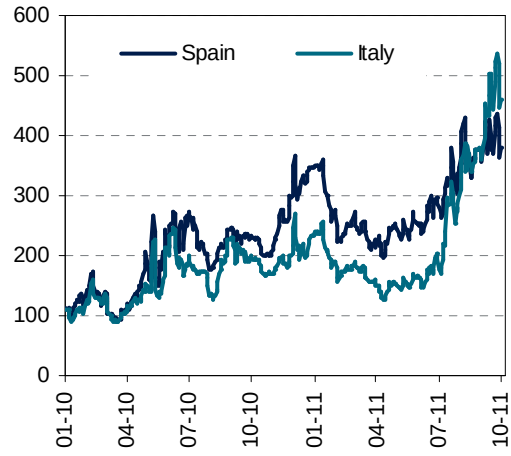
Source: Bloomberg, Amundi Strategy

CDS for Portugal and Ireland



Source: Blommberg, Amundi Strategy

CDS for Spain and Italy

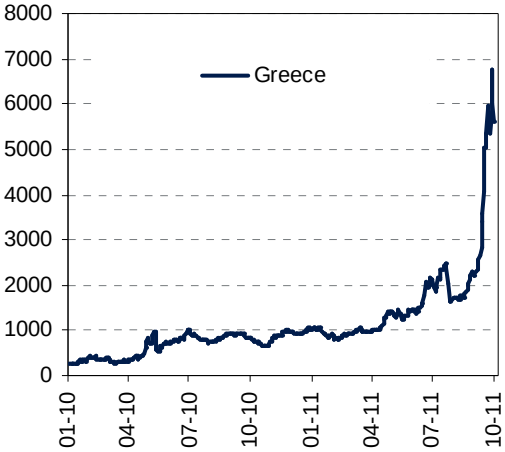


Source: Blommberg, Amundi Strategy

These substantially higher risk premiums for the second group compared to the first leads us to believe that the implied ratings given by the market are lower than Aaa. The risk premium for the United Kingdom is difficult to explain, except that the combined impact of budgetary tightening coupled with impressively accommodating monetary policy is perceived as likely to succeed in the United Kingdom.For Spain and Italy, which are rated Aa2, the 80 bp spread, which is unfavourable to Italy, is undoubtedly associated with market perceptions of a form of political malaise and structurally weak growth.

For the three non-investment grade countries (Ireland, Portugal and Greece): Ireland (659 bp, i.e. barely 100 bp more than Italy, despite being rated five notches lower) is perceived as likely to rise relatively quickly in the markets' estimations and particularly in terms of its rating; Portugal is perceived as a country that could do better but that is fragile at the moment, and the market considers Greece's default to be all but certain — Greece's one-year CDS is trading at a 96% premium, representing an 86% implied one-year probability of default (with the same 50% recovery rate assumption).

CDS for Greece



Source: Blommberg, Amundi Strategy

2. Specific study of the Greek CDS curve:

Maturity	CDS premium by maturity	CDP implicit	CDP Moody's by maturity	Historical spread by maturity	Risk premium by maturity
1	95.79%	85.28%	36.21%	22.48%	73.31%
2	77.36%	95.47%	48.44%	16.56%	60.80%
3	69.09%	87.42%	57.90%	14.42%	54.67%
4	63.72%	92.18%	64.58%	12.97%	50.75%
5	60.22%	95.08%	70.12%	12.08%	48.14%
7	53.98%	97.71%	74.76%	9.83%	44.15%
10	49.13%	99.26%	78.01%	7.57%	41.56%

As above, the cumulative and annual implied default probabilities are risk-neutral probabilities, whereas the historic default probabilities are real. We are maintaining the 50% recovery rate assumption.

The risk premiums are extremely high, but also largely inverted compared to maturities, with a significant gap between one and two years. The most logical explanation is that the market is pricing in an impending default (within one year). It is also likely that in order to finance one-year hedge purchases (96% premium), market operators are selling hedges on maturities greater than one year, which will cause the corresponding premiums to decline (between 77% for two-year maturities and 60% for five-year maturities).

A word of caution, however: CDS are by no means reliable. Lacking liquidity and dealt by only a handful of traders, they are suited more to speculation than to hedging. They do not, on their own, reflect the real-world situation. In 2008, for example, corporate CDS were showing that the vast majority of US investment grade issuers would either be lowered to speculative grade or go into default. Luckily, none of this happened. In fact, spreads tightened sharply and default rates plummeted. That said, trends in CDS do illustrate the level of market stress. Which is why they are of interest.

9 Will French banks be able to overcome their recent refinancing difficulties

We believe that European banks can withstand the recent upsurge in funding stress (i.e. more difficult access to $ funding, disrupting interbank markets, and risk-averse long-term debt capital markets) that was initially triggered by the drawn-out of the European sovereign crisis and emphasized by the growing risk of a double dip into recession of the large developed economies.

Our relatively confident view for the immediate future reflects the following:

-**short-term refinancing risks seem limited given the proven track record of ability and willingness of the ECB and other central banks to provide large amount of liquidity on demand** since the Lehman failure in October 2008,

-**European banks have significantly strengthened their liquidity and capital positions** over the past three years,

> *"Short-term refinancing risks seem limited given the willingness of central banks to provide liquidity"*

Post Lehman Brothers, faced with the consequent distrust in the interbank markets, the ECB decided to stop its auction process and to provide unlimited amount of liquidity at a set price and over longer maturities (6 months and 12 months).

In early August 2011, faced with renewed stress in the European interbank market (triggered by concerns over the sovereign debt exposures of European banks) the ECB decided to extend a 6-month tender offer and renew its commitment to offer unlimited short-term liquidity against provision of eligible collateral as long as necessary and at least until January 2012.

Assets eligible for ECB refinancing stands at €5 trillions according to the Bank of France Governor against €580bn currently pledged at the ECB for refinancing purposes: we therefore take comfort that, at system level, refinancing risk is limited. We however recognise that the risk could arise at the individual bank level: in such case the bank can turn to its local central bank as part of the emergency liquidity insurance scheme (as did Irish banks and more lately Piraeus bank, which prevent their failure despite a more severe funding stress than was the case for Lehman Brothers). As at end of August, the usage of the ECB facility was less than post Lehman.

European banks have significantly strengthened their liquidity and capital positions over the past three years

Since 2009, banks have strengthened their liquidity and capital position both driven by:
- higher cost and more difficult access to wholesale debt markets,
- and regulatory pressures (tougher Basel 3 capital and liquidity rules).

> *"Since 2009, banks have strengthened their liquidity and capital position"*

1. Post Lehman Brothers, growth in customer deposits exceeded that of loans for most European banks, marginally reducing their reliance on market funding (lower loan to deposit ratios and lower wholesale funding issuance),

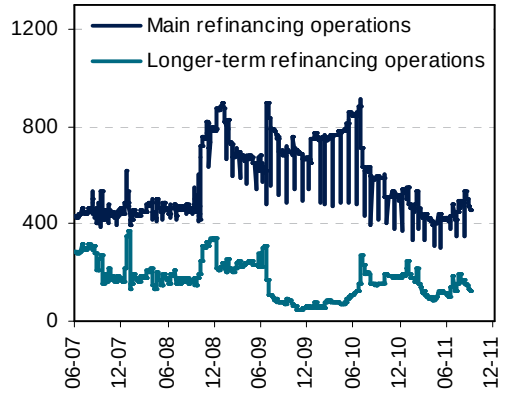
2. Banks decided to better match their asset and liability maturities through issuing debts with longer maturities,

3. The financial crisis of late 2008 frightened banks into stockpiling more cash and liquid assets,

4. And opportunistically prefund their 2011 wholesale funding maturities (91% pre funded as per a Deutsche bank study).

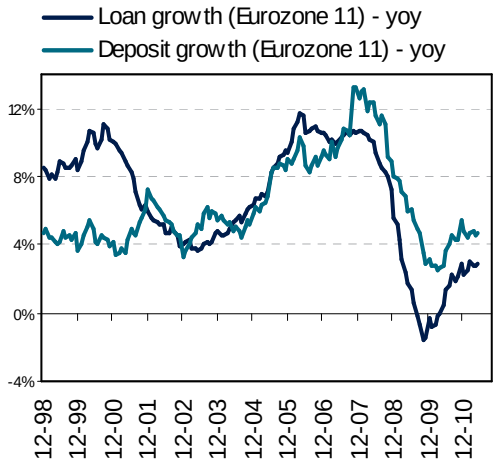
5. To conclude, following a wave of capital raising and heavy restructuring, banks capital positions are now historically high.

European Central Bank Open Market Operations



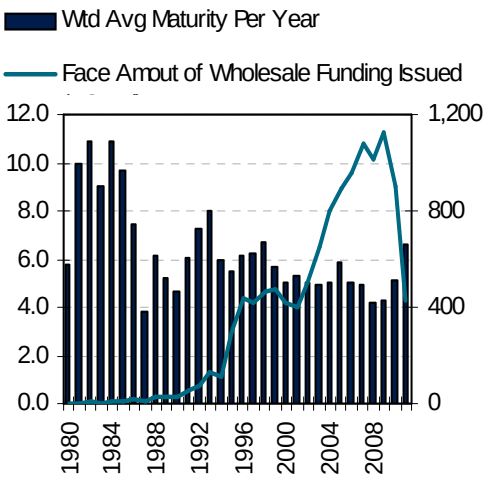
Source: European Central Bank, Amundi Financial Analysts

In recent years deposit growth has outpaced lending growth in the Eurozone



Source: Goldman Sachs, Amundi Financial Analysts

Euro Area : Historical Trend in Bank Wholesale Debt Issuances and Maturities



Source: Moody's calculations, Amundi Financial Analysts

European banks are better capitalized, but is it enough to cope with potential future losses?

Market participants question whether the increase in capital is sufficient to cover potential losses from sovereign debt markdowns and increased credit losses in a recession scenario, especially since the capacity of most European sovereigns to provide significantly more financial aid to their own banking systems has diminished compared with their capacity in 2007-2008.

If we expand the EBA stress test on 2011 and 2012 earnings (i.e. pre-provision income falling by 28% to €180bn in 2011 and 2012 vs. the already low levels of 2009-2010 of €250bn, and loan loss provisions equaled to the 2009 peak) by applying the market-implied haircuts to peripheral and Belgium sovereign bonds (see below), we find that the largest listed European banks excluding the Greek banks (whose recapitalization needs are dealt with in the second bail-out package released in July) would need to raise €40bn, significantly less than the €200bn argued by the IMF.

While this is less than 10% of the sector's market capitalization, there is currently very limited appetite for bank equities and governments' ability to subscribe it is now more limited. However, in the extreme scenario where all five peripheral countries and Belgium were to restructure, the new EFSF (to be approved by the 17 European parliaments by YE11) would be allowed to finance recapitalization of financial institutions through loans to government including in non programme countries (the EFSF new firepower is expected to be at least €340bn).

French banks under pressure

French banking sector, as well as European, has been under intense pressure over the last few weeks driven by a liquidity crisis triggered by the renewing risk aversion from the American money market fund managers toward the European banks exposed to peripheral sovereign debt (Greece, Ireland, Portugal, Spain, and Italy). Fears of downgrade for France after US lost its AAA rating added stress to the French banking sector.

Facing this increasing uncertainty on their solvency and liquidity, French banks have sought to reassure investors through transparency.

1. French banks unveiled their sovereign debt exposure.

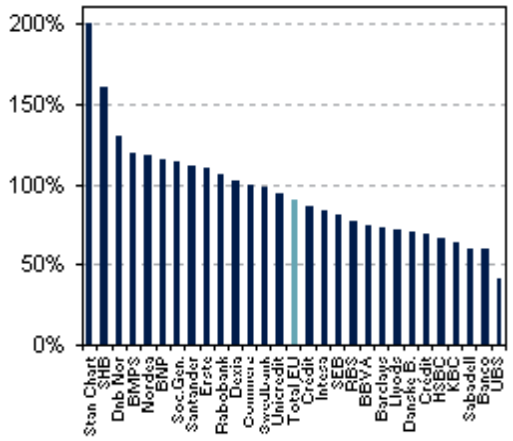
They wrote down 21% of their gross Greek Government bonds eligible in the PSI (Private Sector Involvement). In the adverse scenario (not confirmed so far) and taking into account haircuts on peripheral sovereign debt portfolio of 60% for Greece, 40% for Portugal and Ireland and 20% for Italy and Spain, French banks would withstand with a limited impact on their solvency ratios: around 50bps loss for Soc Gen and CASA and 100bps for BNP Paribas. SocGen and CASA capital generation ability have been 70bps and 50bps respectively for H1 2011.

2. French banks highlighted their refinancing needs in both short and long term.

At the end of June 2011, French banks have completed an average of 90% of their 2011 mid and long term refinancing program showing a significant advance on their refinancing plan. However, French banks will continue to reinforce their deposits gathering and to issue longer maturities debt (through covered bonds issuance). Recently, media abundantly communicated on banks' dependency toward American Money Market Funds (historically net buyers of short term debt issued by French banks).Both SocGen and CASA recently proved that they had enough liquid assets to offset American Money Market Funds withdrawal. In the scenario of a persisting sovereign debt crisis combined with a liquidity stress, French banks could tap the ECB as a last resort. However, at this stage, the situation seems to be all manageable. CASA has a limited exposure to American Money Market Funds (€25 bln to be compared with liquidity reserves of more than €120 bln). SocGen also decreased its exposure to the latter (for a current exposure of €53 bln) and has a €105 bln liquidity reserve.

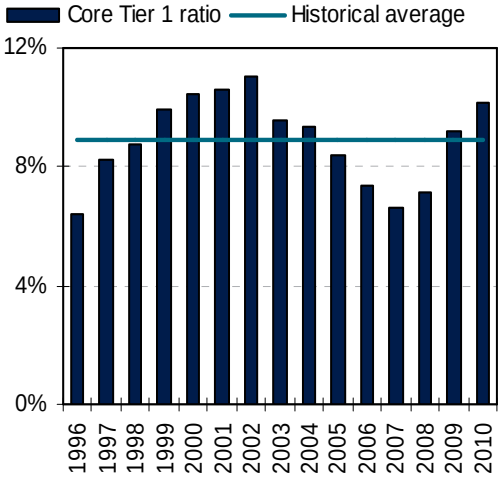
Consequently, we assess that French banks (in particular Soc Gen and CASA) showed a positive stance by reacting quickly. They appear well prepared in case of a lasting European sovereign debt crisis. They insisted in the diversification of their short term refinancing in dollar through Asia and Middle East markets, resulting in a lessen dependency toward American Money Market funds. Moreover, French banks can manage a liquidity stressed scenario as they considerably strengthened their liquidity position by stockpiling cash and liquid assets in their book and, in a last resort, they can also tap the ECB (unlikely today). In these conditions, markets concerns on French banks seem to us over exaggerated.

2011 LT debt maturities refinanced in H1



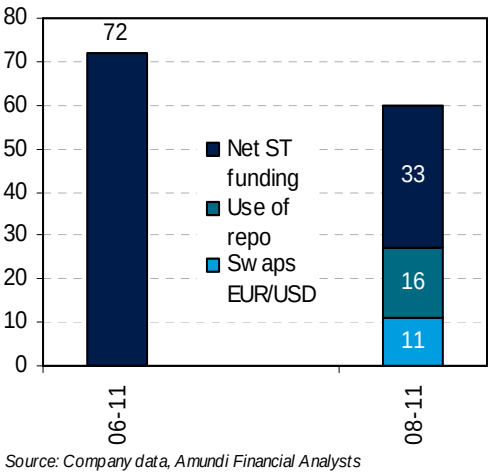
Source: Deutsche Bank estimates, Company data, Amundi

Core Tier One Ratio (% risk weighted assets)



Source: City estimates, Amundi Financial Analysts

SocGen : Managing down USD short-term funding reliance (in EUR bn)



Source: Company data, Amundi Financial Analysts

10 Equities: which European indices would benefit the most of a renewed momentum from emerging markets?

Equity markets plummeted in August. On the one hand, European and American authorities were having a hard time proving that they are able to resolve the structural debt crisis. On the other hand, emerging markets, while enjoying structural growth, were also in a fight against inflation and, hence, still in a tightening cycle. This no man's land in terms of economic leadership, even as the risk of recession was becoming palpable in the transatlantic world, triggered the drops in the markets, both developed and emerging.

Now that the cyclical inflation peak is past, emerging markets are likely to end their tightening cycles. Brazil struck first, cutting its rates by 50bp. Reassurance is needed, first of all, that the United States and Europe will not sink into recession and drag emerging markets down with them, as was the case in 2008. But it is also possible that developed countries will ultimately find a sufficient solution to prevent contagion, which would, on the contrary, allow emerging markets to pull up equity markets. This view is far from being generally accepted and would be a surprise. In this research note we examine this possibility, with a particular focus on European markets.

Actually, let's not over look the fact that companies in developed economies are highly exposed to growth in emerging markets. So a distinction must be made between those companies affected by the secular theme of deleveraging and those that benefit from growth in emerging markets. The former could benefit from a brisk short-term rally if the worst-case scenario is avoided. But the later would be longer-term beneficiaries and would therefore ultimately be more attractive.

To do so, we have undertaken a structural analysis of the European equity indices from three angles:

- secular trends of these indices in local currency terms, using, in tandem, their 10-year, 4-year and 1-year moving averages;
- emerging market exposure, based on the portion of cyclical and financial stocks exposed to emerging markets;
- deleveraging exposure, based on the portion of financial stocks not exposed to emerging markets.
-To determine company exposure, we used data provided by Amundi financial research.

Let's examine the various arguments, beginning with an analysis of very-long-term trends in these indices, which are also called "secular trends":

Seen from this angle, emerging markets are indeed the best-performing (see charts to the right): the 10-year moving average is moving up. Even the 4-year moving average (the average duration of an economic cycle) is up, despite the recent correction.

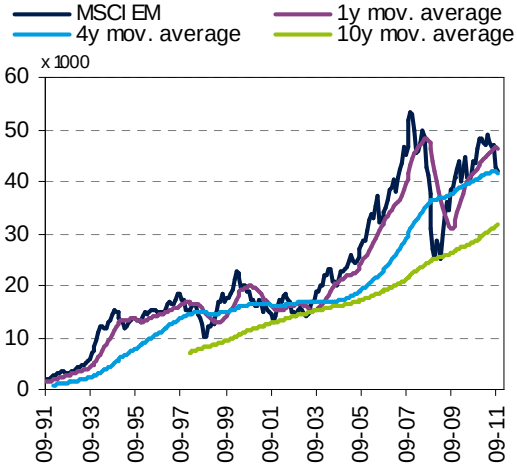
The US market's trend is already weaker: its 4-year moving average is moving down but is still above its 10-year moving average, which incidentally has turned up and could serve as a support level.

> *"The secular trend is more favourable for emerging markets"*

The euro zone has the least advantageous configuration: the 10-year, 4-year and 1-year moving averages are moving down. The market rally since March 2009 has ran into this unfavourable crossing of moving averages.

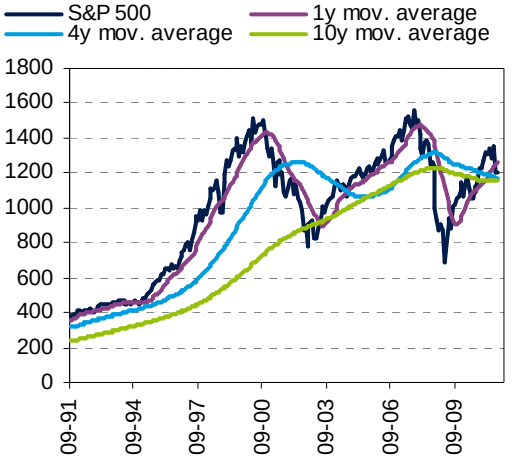
And yet, Europe has widely different configurations. Some markets have upward secular trends, including Germany, Sweden and the United Kingdom. Others have downward secular trends, including Italy, Belgium, Portugal, Greece, Ireland but also Finland, Switzerland, France and the Netherlands (see charts to the right of the next two pages and the summary table on the last page of this article).

MSCI Emerging Markets: upward secular trend



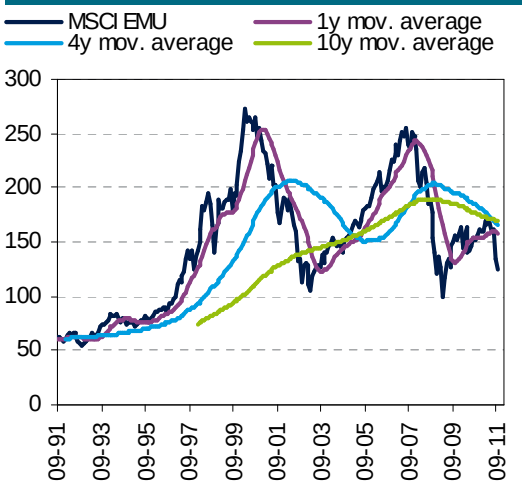
Source: Datastream, Amundi Strategy

S&P500: weaker secular trend



Source: Datastream, Amundi Strategy

MSCI EMU: the least advantageous configuration



Source: Datastream, Amundi Strategy

Now let's look at European indices' exposure to emerging markets.

(% market cap) x (% of sales generated in emerging markets)

	Index	Defensive	Cyclical	Oil & Gas	Financials
Euro area	**24%**	**7%**	**12%**	**2%**	**4%**
Germany	23%	2%	20%	0%	1%
France	25%	8%	11%	4%	2%
Netherlands	22%	9%	9%	4%	0%
Italy	19%	4%	4%	8%	3%
Belgium	14%	7%	4%	0%	2%
Spain	31%	12%	3%	4%	13%
Portugal	39%	16%	11%	9%	2%
Austria	38%	5%	1%	12%	21%
Greece	22%	2%	0%	0%	19%
Ireland	9%	2%	7%	0%	0%
Finland	22%	2%	20%	0%	0%
Europe ex EMU	**24%**	**8%**	**7%**	**3%**	**6%**
UK	26%	7%	5%	5%	9%
Switzerland	22%	13%	9%	0%	0%
Sweden	28%	4%	23%	0%	1%
Norway	15%	6%	4%	4%	1%
Denmark	18%	16%	1%	1%	0%

Based on an initial reading (see first column of the table above), **Portugal, Austria and Spain have the most heavily exposed indices** – more than 30% of their market capitalisation – while Ireland, Belgium and Norway have the least.

We should point out that **some indices are heavily influenced by a small number of stocks**. For example, Novo Nordisk accounts for 67% of Danish exposure, Nokia 59% of Finnish exposure, Ericsson 42% of Swedish exposure, Inbev 77% of Bel 20 exposure, CRH 80% of Irish exposure, and Unilever and Heineken 50% of Dutch exposure.

We would also point out that the **sector breakdown in this exposure also varies widely** from one index to the next. Cyclical exposure is clearly heavier in Germany, Sweden and Finland. In oil, Austria comes out on top. As for financials, Austria, Greece and Spain are the most sensitive.

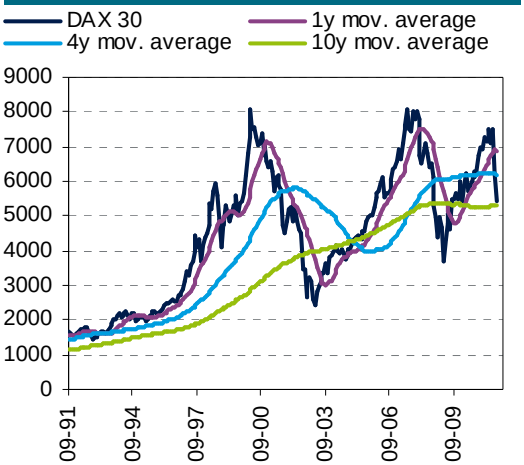
> *"Emerging markets exposure may be more or less cyclical"*

For our analysis, we have chosen to separate cyclical exposure to emerging markets from exposure to deleveraging.

To identify the indices most likely to benefit from renewed momentum in emerging markets, we have therefore combined the portions of cyclical and financial stocks that are most heavily exposed to these economies (see table on the next page): Sweden, Austria, Germany and Finland have significant exposure to emerging markets. Note that we are in a post-crash scenario here, which requires making distinctions, including among financials.

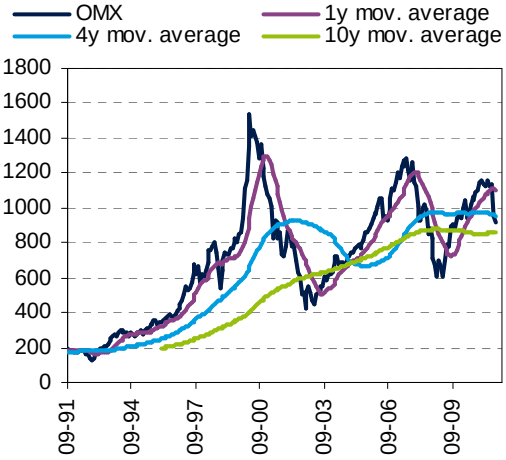
In contrast, to highlight the deleveraging theme, which is also secular, we have used, in the right-hand column, the portion of market cap of financial companies that are not exposed to the emerging theme. Greece and Austria are the most concerned here.

Germany: upward secular trend



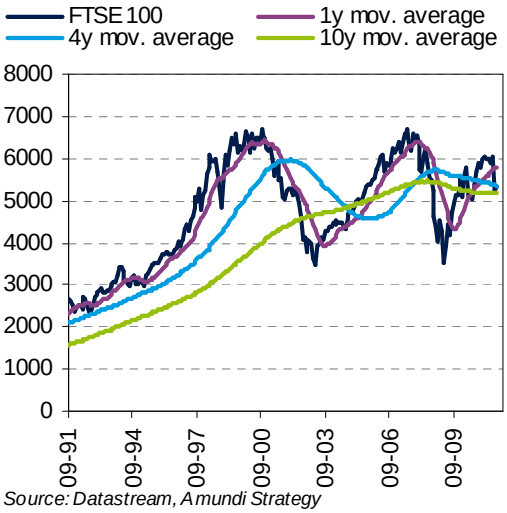
Source: Datastream, Amundi Strategy

Sweden: upward secular trend



Source: Datastream, Amundi Strategy

United Kingdom: upward secular trend



Source: Datastream, Amundi Strategy

The chart below lists the secular trends of European indices, exposure to the emerging markets cycle and exposure to deleveraging

	Secular Trend	Cyclical & Financials	Financials Non EM Expo	Conclusion
Euro area		**15%**	**19%**	
Germany	**Up**	**21%**	**15%**	**Positive**
France	**Down**	14%	**15%**	Neutral
Netherlands	**Down**	9%	**20%**	**Negative**
Italy	**Down**	7%	**23%**	**Negative**
Belgium	**Down**	7%	**24%**	**Negative**
Spain	Neutral	16%	**20%**	Neutral
Portugal	**Down**	13%	**11%**	Neutral
Austria	Neutral	**22%**	**27%**	Neutral
Greece	**Down**	19%	**33%**	Neutral
Ireland	**Down**	7%	**0%**	Neutral
Finland	**Down**	**20%**	**14%**	Neutral
Europe ex EMU		**13%**	**11%**	
UK	**Up**	14%	**10%**	**Positive**
Switzerland	**Down**	9%	**18%**	**Negative**
Sweden	**Up**	**24%**	**17%**	**Positive**
Norway	**Up**	5%	**15%**	Neutral
Denmark	**Up**	1%	**11%**	Neutral

Conclusion

Remember that we are trying to highlight the European markets that are most able to benefit from renewed momentum in emerging markets, assuming that the developed economies provide sufficient reassurance that they will not drag emerging markets down with them.

> *The trio of the UK, Germany and Sweden come out on top*

So the most attractive markets are those with positive secular trends, the heaviest cyclical exposure to emerging markets and the lightest exposure to deleveraging.

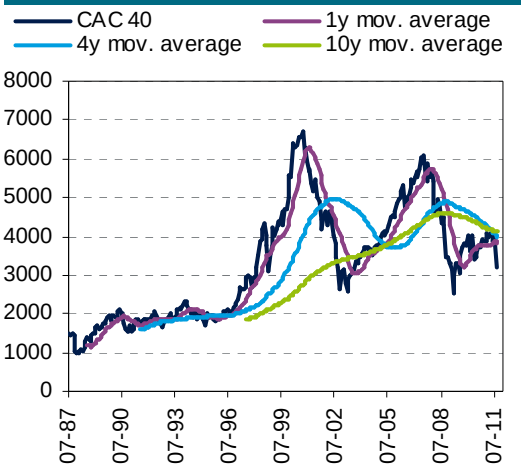
Based on this approach, the UK, Germany and Sweden come out on top.

At the other end of the spectrum, Italy and Greece are the least favourable. The weight of domestic banks is likely to keep them from reversing a downward secular trend. Nor is the trend promising for **Ireland**, even though it no longer has any banks in the index. Perhaps more surprisingly, **Belgium and the Netherlands** do poorly (little cyclical emerging market exposure and significant deleveraging exposure). Here again it would be difficult to reverse a negative secular trend on these indices. And, lastly, **Switzerland** is not sufficiently exposed to cyclical emerging growth, and, moreover, is suffering structurally from the strength of its currency, which is driving down corporate profits and its market's secular trend.

Between these two extremes are France, Austria, Finland, Spain, Portugal, Finland, Norway and Denmark.

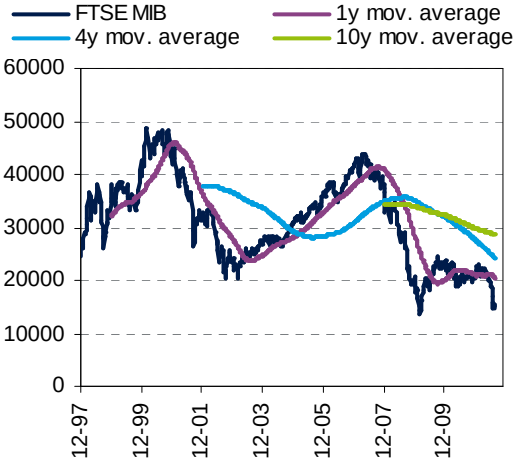
All in all, if emerging markets were ready to unleash a new market cycle, the German, Swedish and UK markets would have good chances of being among its beneficiaries, beyond a mere rebound. This looks like a nice turnaround story. The UK market, which is less cyclical and has an undervalued currency is clearly the least risky of the three. Place your bets!

France: downward secular trend



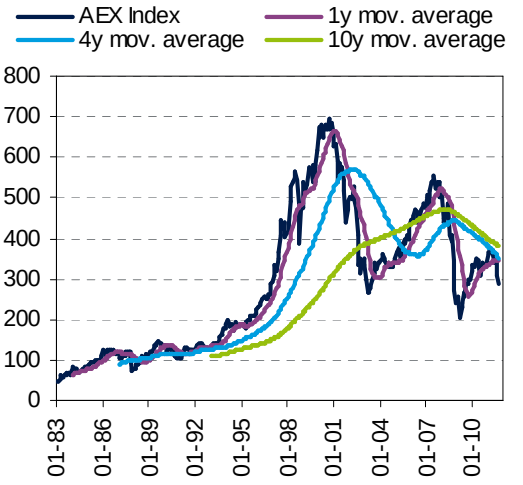
Source: Datastream, Amundi Strategy

Italy: downward secular trend



Source: Datastream, Amundi Strategy

Netherlands: downward secular trend



Source: Datastream, Amundi Strategy

11 Knock-on effect of the debt crisis to equities: the example of OTE

OTE is Greece's dominant telecommunications provider, which generates two thirds of its earnings in Greece, with the remainder coming from Romania, Bulgaria and Albania. As a stock which is highly exposed to its domestic market and a key component of the local index, trends in the OTE share price are synonymous with what we have been able to observe across the Greek equity market.

From June 2010 to July 2011, the OTE stock traded with relative stability around €6.00. It certainly benefited from a period of speculation from March to June 2011, as investors were expecting a possible buy-out of OTE's minority interests by Deutsche Telekom, which already held a 40% stake in the Group, in particular following the German provider's announcement that it was selling its US subsidiary, T-Mobile US. However, as Deutsche Telekom declared at the end of June 2011 that it did not intend to buy out OTE's minority interests as the Greek sovereign debt crisis remained too uncertain, the speculative premium that had pushed OTE's share price above €8.00 in April 2011 disappeared in June, with the stock returning to around €6.00, a price observed one year earlier.

At €6.00, the OTE share price reflected a WACC for the Group's Greek activities of around 12% and Greek sovereign spreads of around 1,000 bp. This implied level was in line with what we observed on the Greek sovereign debt market between June 2010 and March 2011, with 10-year Greek sovereign spreads fluctuating between 800 bp and 950 bp over this period, ending up at 900 bp on average.

However, a decorrelation began to appear as of April 2011, with 10-year Greek sovereign spreads widening from 950 bp at the end of March 2011 to 1,250 bp at the end of April 2011, remaining in the 1,250-1,350 bp band until the end of July 2011, while the OTE share price continued to reflect Greek sovereign debt spreads of around 1,000 bp.

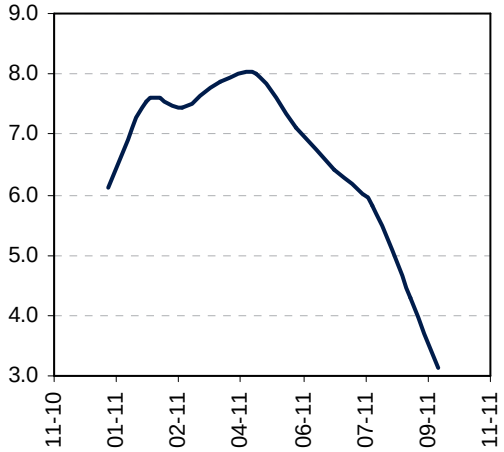
> *After 3 months of denial, OTE's share price finally adjusted*

The OTE share price adjustment ultimately happened in two stages. The stock suffered an initial brutal adjustment during the first week of August, with a drop of around 30% from €5.80 to €4.20, a level at which the stock stabilised until the end of August 2011. At €4.20, the OTE share price implied a WACC (Weighted Average Cost of Capital) for the Group's Greek activities of 14.8% and Greek sovereign spreads of 1,520 bp according to our estimates. We note that implied sovereign spreads had virtually realigned themselves with real 10-year spreads, which stood at 1,560 bp at the end of August.

OTE's share price suffered a second decline of around 25% throughout the month of September, from €4.20 to €3.10 currently. At €3.10, the OTE share price implies a WACC for the Group's Greek activities of 17.0% and Greek sovereign spreads of 2,160 bp according to our estimates, which are again relatively well aligned with 10-year Greek sovereign spreads, currently at 2,140 bp.

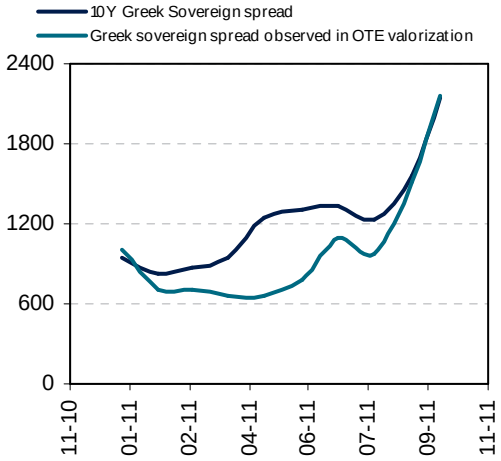
In conclusion, while the OTE share price denied the worsening of the Greek sovereign crisis until July 2011, despite it being reflected by tensions on Greek sovereign spreads since April, the adjustment in its value due to an increasingly likely Greek default scenario occurred very quickly - during the first week of August. Since then, OTE's share price has tracked almost perfectly the continued widening of Greek sovereign spreads, which continued throughout September, as sovereign risk has become the main variable for trends on the stock, which is no longer reacting to rather positive microeconomic newsflow (rumours of Greek mobile market consolidation, announcement of an agreement on Greek employee's working hours, etc.)

OTE share price trend since 31/12/2010 (in €)



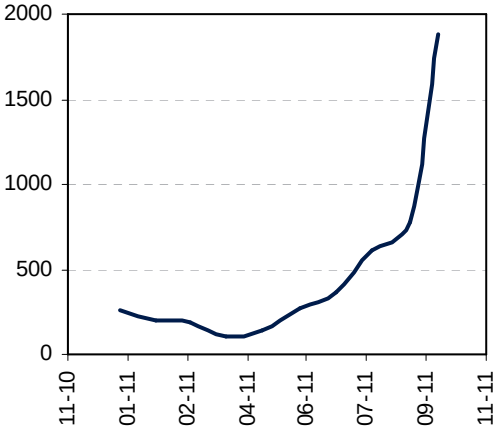
Source: Datastream, Amundi Equity Research

Implied vs. observed Greek sovereign spreads in the OTE share valuation since 31/12/2010 (in bp)



Source: Datastream, Amundi Equity Research

Spread observed on OTE debt maturing in 2016 (in bp)



Source: Datastream, Amundi Equity Research

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Cross asset investment strategy

Strategy and economic research

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