

Executive summary

- 1 European debt crisis: what can be done and how do we get out of it?** Three scenarios are jostling for pole position (stalemate, easing and break-up). "Stalemate" will lead to a deterioration in the situation and exacerbated contagion. In order to move towards "easing", credible and viable solutions are needed. If these do not emerge, the transition towards a "break-up" of the eurozone could be inevitable. The fact that all eurozone countries would suffer from contagion means that we can maintain the hope that European officials will implement the appropriate solutions, which must combine austerity, governance and an anti-contagion mechanism.
- 2 European debt crisis: one crisis after another.** The debt crisis took another turn for the worse in October and November, with contagion to core European countries (France, then other AAA-rated countries, and finally Germany). It is difficult to see how European Governments and central bankers can fail to act now. The measures announced by the Europeans and their strategies nonetheless reassured the financial markets. Solutions must not fall below markets' expectations, nor must they destroy the hopes of the European population, who, in their view, are simply being hit with austerity and tax hikes. This is the price of credibility...and growth.
- 3 The euro is stabilising amidst a full-blown sovereign debt crisis: the return of a paradox.** The strength of the euro during the debt crisis has been somewhat of a surprise. In fact, Germany was a safe-haven investment while portfolio reallocations occurred largely within the eurozone. There was no negative impact on the single currency. This was no longer the case in November. Unless there is a break-up of the eurozone, there is no great reason to expect that the euro will collapse. US bonds and the dollar itself have to face up to increasing difficulties.
- 4 Deleveraging, but no European credit crunch yet!** Although recent trends are negative both for credit supply conditions and loan demand, we do not anticipate a future credit crunch yet, but the risks are sharply higher.
- 5 Country effect: an analysis using risk measures.** With markets' extreme instability, risk indicators such as correlation, dispersion and concentration throw helpful light both in terms of active risk management within portfolios and of detecting potential alpha. We then illustrate them using the examples of country allocations in the eurozone and emerging markets.
- 6 China: a choppy but controlled domestic slowdown.** The slowdown in export growth and the reduction of surplus inventory on the housing market are expected to lead to upheaval and lower Chinese growth. However, continued development of infrastructures and measures to boost consumption planned as part of the Twelfth Five-Year Plan are expected to prevent a hard landing for the Chinese economy. We predict that growth will remain above 8% in 2012.
- 7 Energy: Improving fundamentals despite skepticism.** Oil prices have remained very resilient in recent months, despite increasing fears of deterioration of macro outlook. For next year, we expect Brent prices to average at around \$100/bbl.. The Energy sector's fundamentals are expected to improve slightly despite a persistent scepticism from many investors. We have maintained a very positive view on the Energy sector since late 2010, and we keep our positive view for the time being.
- 8 Is third round of QE needed for oil?** While some are increasingly talking about a third round of Quantitative Easing in the United States, we reassess the impact of the two earlier rounds on the price of oil and the potential threat it poses to oil prices in the long run.
- 9 Hope for equity is based more on reflation than on profits:** Overall economic growth is close to the fateful 3% threshold, beyond which profit growth poses a significant risk of dropping into negative territory. The positive argument, if one exists, is looking toward the reflation of PERs. This requires relaxation on the part of central banks, starting of course with the ECB. Though there is urgent need for central banks to take action, there is no urgency for investors to anticipate that action.
- 10 Q3 2011 Earnings Season.** The decline in results was largely expected in Europe. Drops in margins were due to the rise of the euro and commodities, in addition to the impacts of cost-cutting plans being exhausted. Against this backdrop, it is extremely likely that earnings revisions will continue to be revised downwards. The scale of this will depend on the severity of the recession, which itself will be contingent on the debt crisis solution.

Sent to press on Monday 5 December.

More about it

- 1 European debt crisis: what can be done and how do we get out of it?** **Box 1:** What would be the impact if France loses its AAA rating? **Box 2:** How did we get to this state? page 3
- 2 European debt crisis: one crisis after another** page 8
- 3 The euro is stabilising amidst a full-blown sovereign debt crisis: the return of a paradox** **Box 3:** Is a plunge in the euro/dollar below parity possible? page 10
- 4 Deleveraging, but no European credit crunch yet!** page 13
- 5 Country Effect: an analysis using risk measures** **Box 4:** Correlation, dispersion, concentration: 3 measures to qualify risk structure page 14
- 6 China: a choppy but controlled domestic slowdown** **Box 5:** Chinese banks – a recent IMF assessment page 16
- 7 Energy: Improving fundamentals despite skepticism** page 19
- 8 Is third round of QE needed for oil?** page 20
- 9 Hope for equity is based more on reflation than on profits** page 21
- 10 Q3 2011 Earnings Season** page 22

| SCENARIO | CONTEXT | AMUNDI INVESTMENT STRATEGY |
|--|--|---|
| <p>Warning</p> | <ul style="list-style-type: none"> A recession is underway in the eurozone : its severity will depend on the duration of the stalemate phase. The longer it is, the more the markets are likely to position themselves in expectation of a break-up - and the longer and more severe the recession will be. Whatever the scenario, eurozone sovereign debts are very likely to be downgraded by rating agencies (including most AAA countries). The ECB's key rate will be cut to 0.5% or even lower under the scenario. | <ul style="list-style-type: none"> Regardless of the different scenarios, portfolios are currently defensive as the risk that the stalemate scenario will last is too great. Concrete and viable measures must be made before the asset allocation can be reversed. |
| <p>STALEMATE</p> <p>Status quo for nearly 2 years</p> <p>30% probability that situation will continue well into the future</p> | <ul style="list-style-type: none"> No solution to the crisis Contagion continues ECB: No "quantitative easing"...or the markets remain fearful that sovereign debt purchases will stop Impossible to increase the size of the EFSF sufficiently Wariness towards the entire eurozone Euro weakened by the situation Wide sovereign spreads continue AAA ratings remain vulnerable Some countries (all?) lose their AAA rating Banks reduce their balance sheets even further; deleveraging is fast and massive Economy experiences a true credit crunch The eurozone heads toward a severe recession Impact on global growth Germany remains the safe haven in the eurozone Germany's role as an international safe haven is questioned | <p>STRATEGIES</p> <ul style="list-style-type: none"> Capital preservation Overweight on current AAA issuers in the eurozone Go underweight on EUR vs USD Go underweight on eurozone equities Go underweight on financial stocks Go underweight real assets (commodity specifically oil and metals) Go underweight on credit Go long sovereign emerging debt in USD Go underweight on local emerging debt Choose cash and liquidity in portfolios <p>MAJOR RISK FACTOR:</p> <ul style="list-style-type: none"> Inevitable transition to an easing scenario...or a break-up...the stalemate scenario is not a stable one |
| <p>EASING</p> <p>Scenario targeted in the eurozone and by central bankers</p> <p>65% probability that current stalemate moves toward an easing scenario</p> | <ul style="list-style-type: none"> Governments and central bankers are able to reach a credible and viable solution Anti-contagion system combining the ECB, EFSF and the IMF New stability pact Fiscal discipline etched into constitutions Improvement in governance Modification of treaties Voting procedures simplified and decision-making processes sped up Budget and tax systems streamlined ECB announces sovereign debt purchases will continue ECB adopts a QE policy in order to fight the deflation risk. Germany stimulates growth "Orderly" default of Greece "Orderly" recapitalisation of banks Eurozone undergoes a mere "light" recession | <p>STRATEGIES</p> <ul style="list-style-type: none"> Risk is brought back to the portfolios Underweight on current AAA issuers in the eurozone Go long on peripheral sovereigns: "covering the underweight" will spur a positive trend Go short gold Go long on equities Go long on financial stocks Go long on credit German curve steepening Go long emerging markets (equities and corp. debt) Go long commodity (energy, metals & basic materials) Overweight on credit vs. sovereigns Reduce cash in the portfolios <p>MAJOR RISK FACTORS</p> <ul style="list-style-type: none"> Do not underestimate the fact that the eurozone is in recession (lower profits, drop in margins, etc.) Do not underestimate that the sovereign ratings of core countries remain at-risk |
| <p>BREAK-UP</p> <p>"worst-case scenario" that governments and central bankers want to avoid</p> <p>5% probability</p> | <ul style="list-style-type: none"> Entering into uncharted territory Anticipation of a eurozone break-up ...or a major country exits the eurozone... ...or end of the eurozone Three blocks emerge: AAA countries (if any remain) with no solvency problems; a group that is struggling to avoid default and a block that has defaulted. Severe recession for the countries in the 2nd and 3rd blocks Less severe recession for the countries in the 1st block. | <p>STRATEGIES</p> <ul style="list-style-type: none"> Capital preservation: go long on cash and underweight on risky assets Go underweight on European debt, including current AAA countries Go long gold Go underweight on the euro Go underweight on equities Go underweight on financial stocks Go underweight on credit Go underweight real assets (commodity) Choose cash and liquidity in portfolios Overweight on credit vs. sovereigns Reduce cash in the portfolios Conserve liquidity <p>MAJOR RISK FACTORS:</p> <ul style="list-style-type: none"> Widespread contagion (US debt, US banks) Isolation of the eurozone on the international scene, economic and political ties between emerging economies and the US strengthen Banks default |

1 European debt crisis: what can be done and how do we get out of it?

The capitulation by investors is entering its final stages. Germany's vulnerability makes finding and implementing solutions – without delay – all the more urgent. But is this easier said than done? What can be done to get out of this crisis? Three scenarios are clearly shaping up:

- **Easing:** introduction of measures that investors view as credible.
- **Stalemate:** prolongation of the current situation and a gradual worsening of the crisis with international investors capitulating further...
- **Breakup:** countries leaving the European Union and the Monetary Union, the end of the eurozone...

Scenario #1: Easing

It's been two years now that EU Member States have been striving to solve the crisis and reassure the financial markets and foreign investors. The stakes are high: investors must be convinced to continue financing government debt. The more a country relies on foreign investors, the harder it is to get financing. History shows that sovereigns have defaulted when government debt-to-GDP ratios were along the lines of 40%...but strangely the problem has never arisen for countries with ratios in excess of 100% or even 150%. **It's all a matter of credibility, the ability to manage debt (available latitude), to inverse the trajectory or the nationality of the investors who are financing the debt.** Going beyond the medium term, it's also a matter of governance and an anti-contagion mechanism. And what the eurozone severely lacks is precisely this type of mechanism.

Having an investor of last resort, as is the case in the United States or the United Kingdom, will prove to be very useful because it buys time to carry out needed reforms and to foster budgetary rigour and fiscal discipline without jeopardising the outlook for growth. A solution to the crisis involves not only growth-inhibiting austerity but, first and foremost, an anti-contagion mechanism.

Having a sound anti-contagion mechanism is a prerequisite for easing the crisis

Not every problem can be addressed, such as the risk of France losing its AAA rating (see the box below), the lack of budgetary discipline/rigour, weak governance, the risk of a severe recession, etc.

Box 1: What would be the impact if France loses its AAA rating?

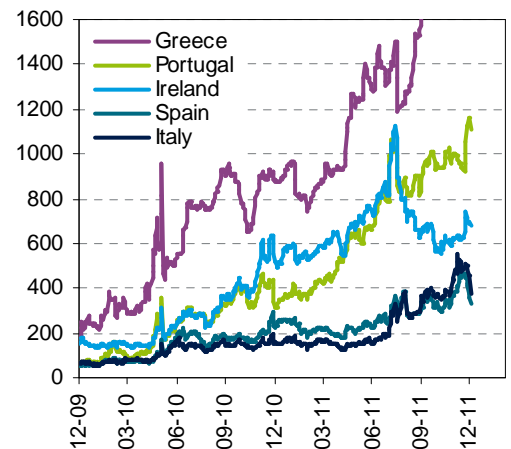
Loss of its AAA rating would have three major consequences for France:

- Higher borrowing costs, perhaps for an extended period of time. This has already happened, because the spreads reflect the very strong probability of a downgrade. Again, a rate increase of 100 bp represents an additional €3 bn in financing costs per year.
- **A risk of further downgrades** if the country is unable to improve the management of its public finances, governance and debt path. This is not our core scenario. For now, there is no reason to expect a series of downgrades as happened in the case of other European sovereigns.
- **Real difficulty in getting back its triple-A rating.** As far as sovereigns are concerned, it takes an average of a decade to get back a AAA rating.

For the eurozone, the loss of France's triple-A rating would have two major consequences:

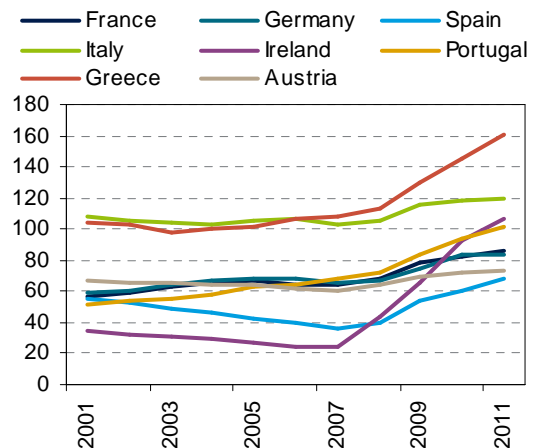
- **France would no longer be truly regarded as a core eurozone country**, which would in fact confirm that France has indeed lost ground compared to its European AAA peers in several key areas (on this score, see the November issue and the article on France's rating).
- **The European Financial Stability Facility would also be weakened.** France's contribution accounts for slightly more than 20% of the facility and the rating of the EFSF itself would be jeopardised. But according to the facility, "There is a credit enhancement structure used under the EFSF. Therefore a downgrade of a member country would not necessarily lead to a downgrade of EFSF securities". Perhaps this is true for a small country (just noting the various downgrades that have occurred so far this year is proof enough)...but this may not be the case when it comes to a state such as France.

10-year spreads over Germany



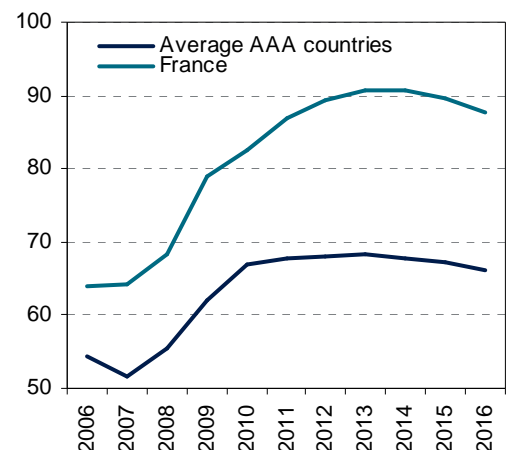
Source: Datastream, Amundi Strategy

Gross government debt to GDP



Source: Datastream, Amundi Strategy

Public debt (as % of GDP): France vs an average of AAA Eurozone countries



Source: IMF, Amundi Strategy

Under an easing scenario, coupled with control of contagion and a credible mechanism, time could be bought to carry out needed structural reforms, without necessarily impeding growth, and to restore stronger EMU and eurozone cohesion. Budgetary rigour and fiscal discipline policies could have disastrous impacts on the people of Europe. This is all the more true since major elections will soon be held in France and in Germany.

Under this scenario, the October 26 European plan could be put into action: an orderly default by Greece, an orderly recapitalisation of the banks, a debt swap as part of the Private Sector Involvement package, a redesign of the European Financial Stability Facility (EFSF).

The effects of an easing scenario would be the following:

- **A rebound in German long rates** due to a slowdown in the flight to quality and increased interest in the instruments of some European sovereigns (those states for which contagion is not linked to an increase in their chances of defaulting but rather to a lack of confidence in the eurozone or which have been hurt by the weakness of the anti-contagion mechanism).
- **Narrower credit spreads:** they are not expected to return to the levels prior to the 2008 financial crisis, however, for some countries, (Italy, Spain, France, etc.), the potential for narrowing is nevertheless substantial.
- **A shift in risk to risky asset classes**, primarily debt issues and equities, and especially to those countries that have suffered the most due to sovereign risk.
- **Higher market prices for financial stocks.**

This market recovery will, however, be limited: the severity of the recession will determine the reach and the long-term viability of the rebound brought about by an easing scenario. The longer it takes to transition to an easing scenario, the deeper the recession (additional budgetary rigour and fiscal discipline, a dimmer outlook for growth, more inappropriate deleveraging by banks, a potential long-term credit crunch, etc.

Box 2: How did we get there?

The causes of the crisis notably include laxity on the part of some countries, the inability to provide solid guarantees on debt path management, low growth, etc.. But there are also less obvious aggravating factors. In a nutshell, there are four such factors:

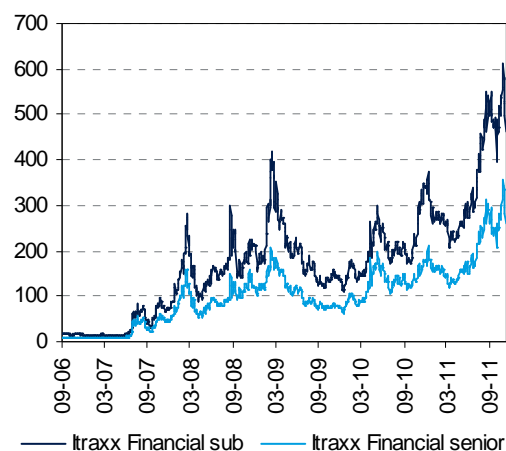
Dogmatism: as the EMU was being built, convergence was the keyword. Prior to the institution of the EMU, convergence was elevated to a dogma and, as a result, any possibility of an asymmetric shock (exogenous and especially endogenous) was ignored. Convergence became a reality (however, history shows that convergence leads to divergence and that divergence begets convergence). The absence of interest rates spreads between Germany and the other countries of the eurozone generated shortsightedness from central banks, governments, markets, rating agencies... The central bank's unique objective was also elevated to dogma (that was very hard to criticise or to question), making quantitative easing impossible in the eurozone. For the builders of the eurozone, it was impossible to call into question (challenge) the pseudo-theoretical body of thought that governed treaties and decision-making...

Denial: as the crisis unfolded and worsened, it reflected the lack of objective reasoning on the part of many officials, who answered solvency-related issues with liquidity, treated capitulation selling as speculation and equated fiscal discipline with fear of recession, etc. There was so much misunderstanding between officials and international investors that it contributed to the severity of the current crisis. After all, at the very beginning the crisis seemed by and large manageable (Greece + Ireland + Portugal) but then slowly but surely spiralled out of control.

Lack of governance: the only safeguard against the temptation to drift (no mention was made of divergence) was the Stability and Growth Pact, but breach of this pact (first by Germany then by France, not even the mildest sanction), shattered all credibility. The shoddy audit of national statistics (Italy as the EMU was being created and Greece more recently), a very democratic albeit unwieldy voting system (unnecessary in time of crisis), Franco-German leadership that was often viewed by investors as lacking in credibility, the slowness of procedures, political gamesmanship, etc. cast a pall of doubt on the credibility and the durability of the union.

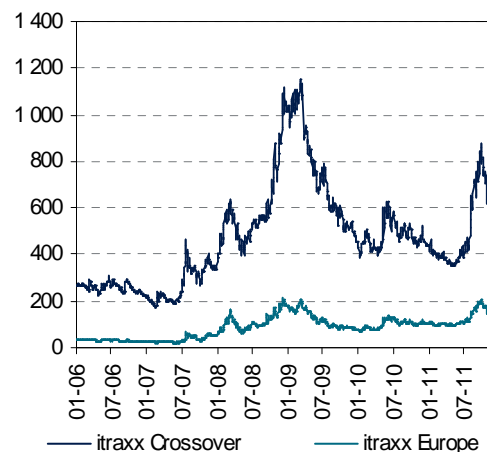
Communication: for the last few months, attempts at sending a clear message have been inefficient: differences of opinions, open conflicts and even excessive transparency. Is it really useful while in the throes of a crisis to harp on "the big problems facing Italy" instead of the solutions in the process of being developed or on "remarkably low German rates" and instead of the assistance it has been offering to countries in trouble (it is better to assist countries in difficulty than to weaken the more solid countries...) ...

Itraxx financial indexes



Source: Bloomberg, Amundi Strategy

Investment Grade and High Yield 5Years CDS indexes



Source: Bloomberg, Amundi Strategy

Scenario #2: Stalemate

The stalemate scenario is nothing more than what we have been seeing these last two years: not only the continual worsening of the situation (see the previous section for a presentation of the various stages of the crisis), solutions put forward by European countries that have been ineffective in stemming the contagion and expectations of default but also the fact that it took so much time to devise measures that they were obsolete by the time they were implemented (the EFSF is a good example).

Under a stalemate scenario, international investor scepticism toward the eurozone is protracted. The solutions proposed under the 26 October European plan not only lack credibility, they are unworkable. The probability of a default by Greece turns out to be greater than 50% and the recapitalisation needs of the banks are found to have been underestimated. Contagion continues apace and, with no effective means of combating it, European banks are forced to provide additional guarantees of their financial strength. They will deleverage faster and more substantially (selling assets in dollar which would make the euro stronger), limit credits, which is likely to lead to a full-blown credit crunch. The eurozone settles into a severe and long-lasting recession that will inevitably have an effect on Germany given the destination of its exports (more than 40% go to the eurozone).

We do not ignore that European banks are also deeply involved in trade financing, a channel for contagion towards most of the emerging economies. It is actually already a material concern. To state it in another way, score of countries have no interest in seeing European banks deleveraging gaining more traction.

Contagion could even spread to countries outside the eurozone, which would produce a second round effect on German imports.

“ *A major risk for Germany* ”

Admittedly, the German economy is doing far better than that of its European counterparts (Germany certainly has the means to stimulate growth if need be) but, in reality, a stalemate scenario would be very negative in absolute terms.

Furthermore, budgetary rigour required in times of contagion would certainly increase expectations of default by weaker European sovereigns. Europe would end up substantially weakened politically, economically and financially.

In fact, we think this scenario is very dangerous because it is non-stable and inevitably sets the stage for breakup.

“ *Stalemate: a unstable and dangerous state* ”

Scenario #3: Breakup

The current stalemate scenario is not easily sustainable and there is little doubt that it will ultimately lead to breakup with no credible and permanent solutions. Unlike Italy, Greece has very little interest in leaving the eurozone. Such a scenario would spell the de facto end of the monetary union. History shows (see our November issue) that divergent interests and politics are factors that can be blamed for unravelling monetary unions.

We would then be left with three distinct blocks of countries:

- **A block of triple-A countries** with sufficiently good economic performance in terms of government finance, debt path and current accounts;
- **Countries at the periphery engaged in a struggle to maintain reasonable growth while doing their best to control debt and avoid default.** These countries will not have – or will no longer have – an AAA rating and will have almost no chance of closing the gap with triple-A countries in any meaningful way in the underweight term.
- **Countries in default.** The longer Italy stays in an area that is stagnating, the greater its risk of default, especially since growth has sharply slowed and contagion has shown no sign of weakening.

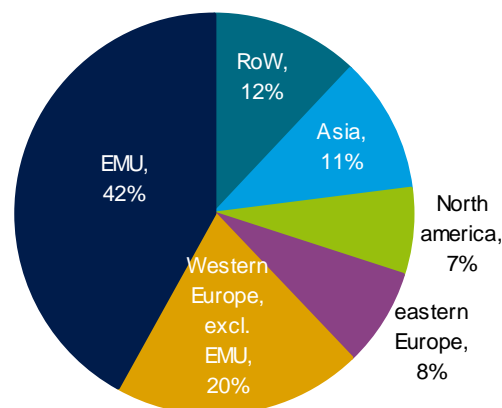
In other words, the European countries have every incentive to hope for Scenario #1 because all the other scenarios will presumably lead to some sort of breakup of the eurozone.

How can stalemate or breakup be avoided?

Scenarios 1 and 2 are synonymous with severe, long-term recession coupled with the risk of the collapse of the EMU. How can this be avoided?

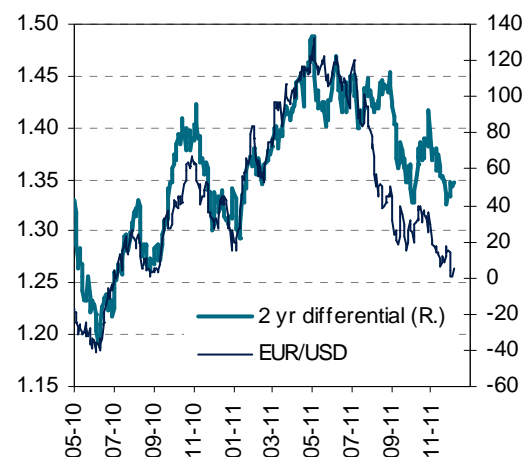
We have repeatedly outlined the requirements for fighting contagion. The No. 1 condition is having an **anti-contagion mechanism**.

Breakdown of German exports



Source: Datastream, Amundi Strategy

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



Source: Datastream, Amundi Strategy

This mechanism has been beset by problems since the beginning of the financial crisis, firstly because there are no investors of last resort and secondly because eurozone countries failed to set up a mechanism to compensate for this lack. Several solutions have been proposed but they run counter to ECB rules, the German Constitution and the Treaty of Lisbon. Quantitative easing in the United States or the United Kingdom has shown that this type of mechanism presents a number of benefits:

- On the one hand, it avoided free-falling prices because there was a buyer.
- On the other, it allowed the banks to deleverage far faster than the banks in the eurozone.

Admittedly, it hurt the balance sheet of the central banks and sharply increased their size but it was effective; many people do not understand why the ECB did not do the same. We know that the ECB cannot roll out quantitative easing, unlike the FED, it is supposed to sterilise its bond purchases, which obviously means withdrawing an equivalent amount from the money market, which is undesirable in the current crisis.

In other words, the ECB cannot, unlike the Fed or the BoE, announce a large bond purchasing programme (as the central bankers like to hammer home, "that's not its mission") without amending rules and treaties, which the Germans are reluctant to do.

“ The ECB has rolled out Quantitative Easing without really admitting it... ”

But in fact, the ECB is buying sovereign bonds: more than €200 billion since the institution of the securities markets programme, and €125 billion in the last four months, that is, the equivalent of ten months of Italian and Spanish budget deficits, which is far from negligible...

The major differences between the European purchasing programme and the US quantitative easing programme are:

- On the one hand, the ex ante announcement of a figure in the United States, but not in the eurozone.
- On the other, the certainty that the programme in the United States would continue and the fear that it would be suddenly curtailed in the eurozone.

Let's not assign too much blame to the ECB, which, after all, has to uphold its charter (it cannot lend to the Member States on which it relies for its capital) but which, nonetheless, agreed to waive the rules in light of the circumstances. However, we regret that it failed to take (or has not yet taken) steps to transform the EFSF into a bank (which would then have access to the funds made available by central banks), or to have the ECB make loans to IMF, which in turn could help European sovereigns in trouble, or to convert the European Financial Stability Facility to the European Stability Mechanism ahead of schedule (mid-2013).

The second deficiency to be addressed relates to the potential for growth (the euro is too strong for some countries, while interest rates are too high for others, competitiveness is too low, tax efficiency is too high, industry has need of being revamped, etc.), which will require extensive structural reforms.

“ Whatever the outcome of the crisis, European countries cannot fail to make far-reaching reforms ”

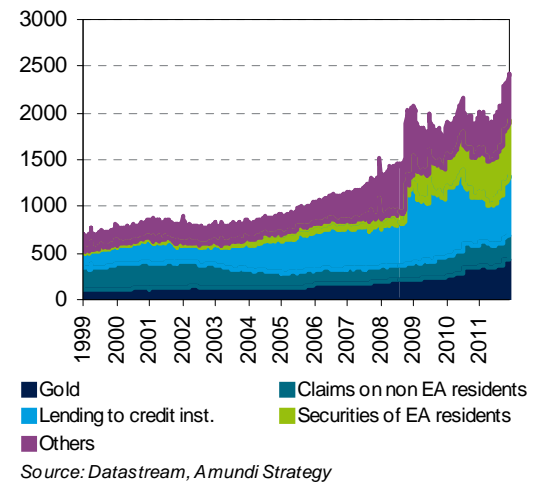
Obviously, the third deficiency is the failure to devise mechanisms to provide a better understanding and more effective monitoring of government finances, and, in particular, avoiding “free riders”. After all, Greece had no need of austerity in a climate where convergence and adjustment, coupled with guarantees provided by the core countries, reigned supreme. That world is no more...it is now up to the Europeans to introduce treaties, charters and rules in line with the new reality.

Three scenarios ... three asset allocations?

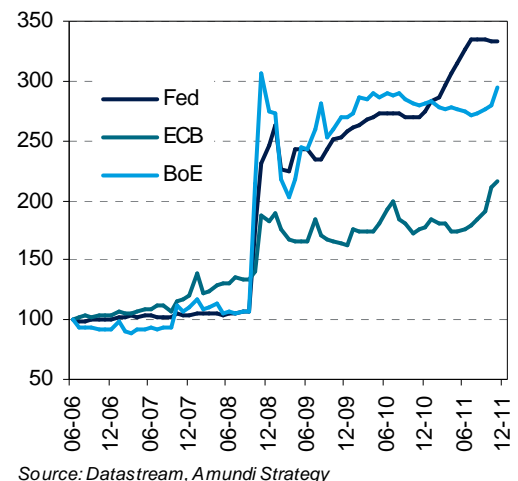
The three scenarios presented above represent very different outcomes ... and lead to very distinct allocations.

A few observations are essential: it is not a question of the probability of this or that scenario. Time and time again, we have indicated that we do not foresee a break-up scenario (very low probability), that the reality of markets and the current situation is of stalemate (high probability of 35%), but that we should be heading into an easing scenario (65% probability).

ECB assets (in € bn)



Central banks' balance sheet (100= June 2006)



Our asset allocation has remained defensive throughout this crisis because risks associated with the stalemate scenario are of concern. Simply put, **strong, viable and credible political action is needed to come out of the stalemate scenario while the transition to a break-up could be inevitable if solutions do not emerge.** If that is the case, the collapse in risky asset classes will not have bottomed-out. In any case, in the absence of any tangible signs on the part of central banks and governments, it does not appear reasonable to add risk to portfolios.

The framework enabling the definition of conditions for an easing scenario will have three main aspects:

- **An anti-crisis system combining the EFSF** (transformed into a bank, it would access the ECB's sizeable liquidity and reassure based on its sheer fire-power, though it may lose its AAA rating), **the IMF** (the ECB may lend directly to the IMF), **and the ECB** (one can imagine an announcement of Quantitative Easing not to save countries but to avoid deflationary pressure that low interest rates cannot address);

- **A "new formula" stability agreement** (?) ensuring austerity and discipline over the medium term (implementation of a scaled-down agreement with real sanctions, etc.), which would also reassure the ECB in its purchases.

- **Better governance** overall, with **budgetary and fiscal harmonisation.** France and Germany are studying this possibility, which would require modifying a bilateral treaty dating back to 1963.

The following is a framework providing a view of whether markets are adhering to solutions put forward by European governments and central banks:

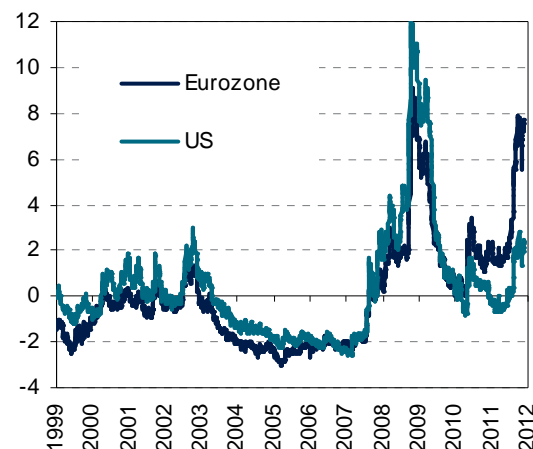
- **The drop (or lack thereof) in sovereign debt spreads**, notably in AAA countries, which indicates a decline (or lack thereof) in worries vis-à-vis the entire eurozone;

- **The weakness (or lack thereof) of the euro**, which indicates whether foreign investors are (or are not) still retrenching;

- **The disconnect (or lack thereof) between German and US rates** in potential phases of flight to quality.

The table page 2 presents the three scenarios and three corresponding asset allocations.

**Financial stress indexes:
The US vs the Eurozone**



Source: Datastream, Amundi Strategy

2 European debt crisis: one crisis after another

The European debt crisis has lasted two years now. Of course, a keen eye has been kept on the financial situation of industrialised economies for several years, but the 2008 financial crisis forced governments to take on additional debt in order to improve the economy, save banking systems, or both. This in addition to other expenses (notably military expenses in the US that are responsible for nearly half of public debt increases over the last ten years).

The sovereign debt crisis has played out in several stages that are easily identified. Each represents further deterioration of the crisis.

1st stage: the Greek solvency problem began in March 2011 when George Papandreou revealed his country's true public finance figures, which uncovered the actual difficulties of the country (inability to manage public expenses, inefficiency of tax system and tax collection, loss of competitiveness, etc.), but also the weakness of eurozone governance (monitoring of countries' economic indicators, cohesiveness of member countries, slow pace of decision-making process, difficulties implementing decisions, etc.).

2nd stage: contagion (end of 2010) spreads to Portugal (high deficits, weak competitiveness, etc.) **and to Ireland**, where the (outsized) weight of a completely adrift banking system following the financial crisis forced the government to adopt very costly protective measures (though hailed by financial markets upon implementation). These measures deteriorated public finances considerably and led these governments to seek IMF and EU protection.

3rd stage: a very critical stage because it concerns large peripheral countries (Q1 2011). Insofar as the problem remained in Greece, Portugal and Ireland, it was entirely manageable: these three countries represented only 6% of the eurozone's GDP and 8% of public debt. The crisis was manageable as long as it remained confined to these countries. Unfortunately, this was not the case. Spain and Italy would quickly enter the eye of the storm. It was such a critical stage because no European institution could address these countries' difficulties (considering their size): Spain and Italy represent 28% of eurozone GDP and 1/3 of total public debt (25% for Italy alone). This led to the (lengthy) discussions which produced the European Financial Stability Facility (EFSF) and evaluation of the ECB's role in the crisis. These discussions ended with solutions that were each quickly—and unanimously—considered insufficient.

It is indisputable that during this phase, European governance disappointed and worried the financial community, which doubted whether it should invest in these countries. In other words, the crisis and contagion took on another, more worrying dimension during this phase.

“ The contagion took on another dimension with attacks on Italy and Spain ”

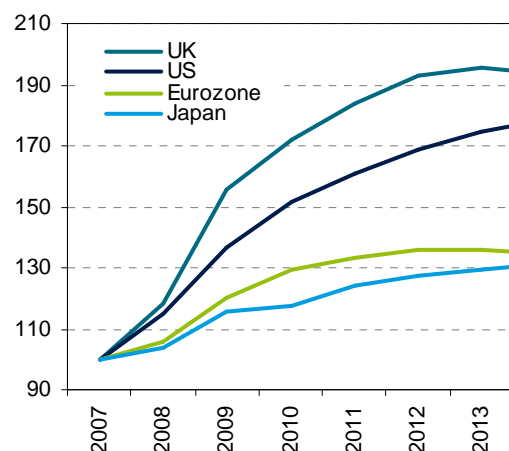
It should be noted, however, that during this phase, the euro absorbed the shock well, mainly for two reasons:

-First, because portfolio reallocations were carried out essentially within the eurozone. Investors – within or outside the eurozone – were inclined to reduce their exposure to peripheral countries, preferring exposure to core countries. In other words, we witnessed neutral reallocations in terms of banking.

-Second, because the rush to core countries enabled sharp reduction in bond yields (this flight to quality therefore amplified the widening of sovereign spreads), and massive Bund purchases buoyed the euro throughout the period. During this phase, German and US long rates tracked each other, as both markets were considered safe havens. On this note, we mention that the US losing its AAA rating had no effect on falling long rates.

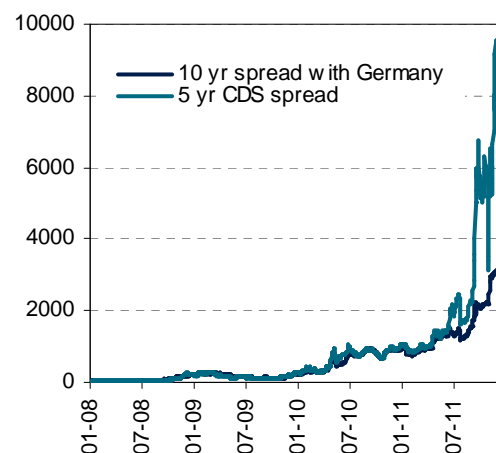
4th stage: This stage revealed the vulnerability of core countries, especially France (October to November 2011). We discussed in the previous issue the differences between France and other eurozone countries that still hold a AAA rating. Whatever the criteria (fiscal deficit, public debt, weight of debt, current account deficits, etc.) France will not suffer by comparison. In fact, it has been several years since the OAT/Bund spread had been affected, but the current context has pushed France's fragility to the front burner just when ratings agencies were beginning to express reservations over France's rating. The 10-year spread versus Germany thus increased from 40bp to nearly 200bp in a few months, whereas the cost of French default protection soared past risk levels assigned to countries such as Peru, Columbia, etc

Progression of public debt since 2007: US, UK, Japan, eurozone



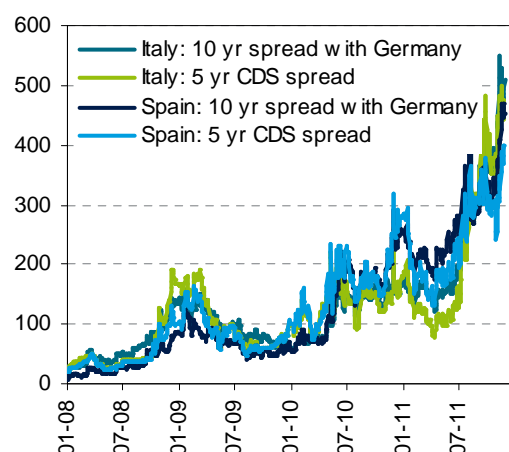
Source: IMF, Amundi Strategy

10-year spread between Greece and Germany and Greek 5-year CDS



Source: Bloomberg, Amundi Strategy

10-year spread of Spain and Italy versus Germany and Italian and Spanish 5-year CDS



Source: Datastream, Amundi Strategy

5th stage: contagion spreads to undoubted AAA eurozone countries (mid-November 2011).

In the progression of the crisis, this is a major stage. The spread of contagion to AAA countries whose solvency should really not be questioned demonstrates that it is now a question of doubts as to the survival of the eurozone itself (or worries over the impact of a steeper haircut on Greek debt, or even a haircut on the debt of other eurozone countries). The significant widening of sovereign debt spreads between Germany and countries such as Austria, Finland and the Netherlands as well as the euro's sharp drop clearly demonstrate that misgivings are now affecting the entire eurozone. It is no longer a question of portfolio reallocations within the eurozone, but misgivings about the eurozone itself. The progression of sovereign debt spreads, the decline of German rates and a weaker euro should now be closely followed to detect signs—positive or negative—of the current crisis.

6th stage: contagion spreads to Germany.

What only months ago seemed unthinkable is here. Germany, still perceived to be a safe haven is itself now under the spotlight of investors. Here, it is not a question of speculation against Germany or risk of default, but of the last stage of capitulation.

“ Germany in dire straits? Or when "the unthinkable" becomes reality... ”

The unsuccessful latest Bund auction demonstrates to what extent liquidity is crucial. Even if it is solvent, if access to markets dries up, all debt financing is problematic. Solvency is a medium- to long-term concept, liquidity is a binary—it is either there or it is not—and underweight-term concept (it can evaporate very quickly). Every member of the eurozone—including Germany—is exposed to this risk from the moment the survival of the organisation is in question. Indeed, many factors play into Germany's difficulties:

The cost of the crisis: the more countries that are affected and the more national banking systems that are affected, the less possible it is to resolve the crisis (problem of scale) and/or the more costly it is for "rescuer" countries, of which Germany is obviously on the top rung.

Germany's reputation as a safe haven is not as credible as before. Their status as a safe haven sent German rates and yields soaring to very unattractive levels, but this is not what reduced the incentive to invest. The disconnection of US (benefiting once more from the flight to quality) and German long rates (which set the pace for this criterion) is tangible evidence.

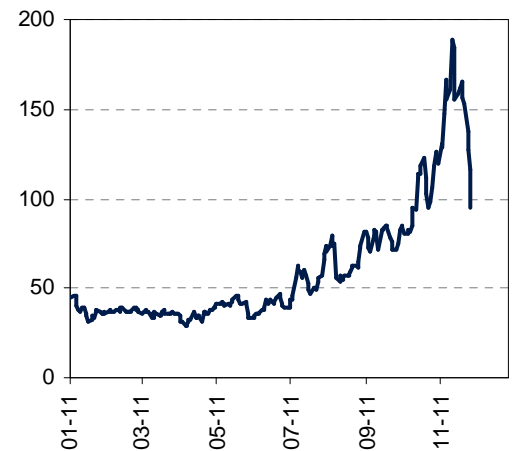
Some investors wish to completely remove their exposure to the eurozone, leading not only to a deterioration of European spreads (including "solid" AAAs), but it is also stoking a rise in German interest rates and a weakened euro. It is the final stage of capitulation.

Is the fact that Germany is directly weakened by the contagion good or bad news? We believe it is somewhat good news because the situation is clear. Germany is now relegated to the "vulnerable" club and its domestic authorities all have an interest in finding a solution in common with other member states, and notably to modify certain points of view that were too rigorous and tended to reduce the credibility of the eurozone and potential solutions. "After Germany, there is nothing left", we often hear. It is a fact. Let us hope that this will push Europeans toward a speedy and credible solution.

7th stage: regaining the markets' trust (end-November – early December).

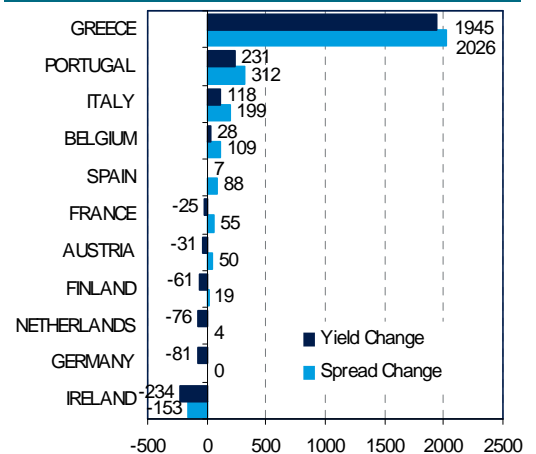
The financial markets responded well to the joint measures taken by central banks (the Fed, the ECB and the Banks of England, Japan, Canada and Switzerland) to lower the cost of dollar funding, while China cut its reserve requirement for banks. At the same time, discussions in Europe about fiscal austerity, a new stability pact and reform of the Lisbon Treaty seemed to convince the markets of European leaders' renewed determination to find solutions to the crisis that is now affecting all eurozone countries. Within one week, the European equity markets gained 12%, the euro/dollar was up 2% and sovereign spreads narrowed sharply – influenced by the climate and the buying back of underweight positions, which also helped French and Spanish auctions (the French 10y spread fell 60bp, the Belgian spread tightened 97bp, the Austrian 50bp, the Spanish 87bp and the Italian 44bp). At the time of writing, this promising market trend had yet to be borne out by tangible action. Going from "stalemate" to "appeasement" will require a degree of forbearance from the markets, but also credible and viable measures (see section 1). Only such measures will be able to ease the pressure from the streets and the financial markets, and also from the ratings agencies. S&P is now threatening to downgrade the credit ratings of all eurozone countries very soon, even the 6 countries rated AAA (including Germany). France even risks being downgraded two notches! Watch this space.

10-year OAT/Bund spread since July 2011



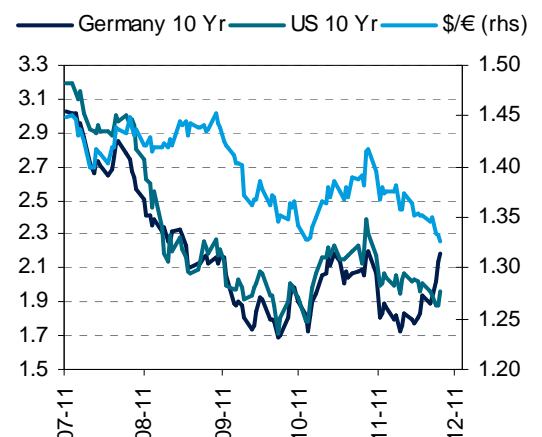
Source: Datastream, Amundi Strategy

Progression of sovereign debt spreads between AAA countries and Germany since June 30, 2011



Source: Datastream, Amundi Strategy

EUR/USD, 10-year German US since July 2011



Source: Datastream, Amundi Strategy

3 The euro is stabilising amidst a full-blown sovereign debt crisis: the return of a paradox

The underlying nature of the sovereign debt crisis changed when Italy and Spain were thrust into the torment. And it worsened with the partial failure of the German bond auction. The crisis has now affected every AAA-rated country in the eurozone, including Germany, whose sovereign debt instruments were considered to be the last safe-haven investment. In this environment, the resiliency of the euro is quite a surprise. Usually, sovereign debt crises are followed by a fall in the value of the currency of the country in trouble. The reason for this is simple: foreign investors dispose of the assets they hold in that country (whether bonds or equities). This takes place all the faster when a debt crisis takes hold of a small country (one that investors can easily do without in their portfolios) running a current external deficit. But the euro does not fit this pattern.

Euro fluctuations linked to portfolio reallocation

The single currency has a number of features that account for its unusual behaviour. The euro is simultaneously the currency of countries in the throes of crisis (peripheral countries) and the currency of countries whose debt (until recently) was a safe-haven investment (the AAA-rated countries of the eurozone, with Germany in the forefront). As the sovereign debt crisis worsened over the summer, foreign investors saw an opportunity to sell the debt they held in the peripheral countries and to buy the debt of eurozone's "reliable" countries, which ultimately left the currency's exchange rate unchanged. Furthermore, investors hold the view that if some countries are compelled to leave the eurozone, the "new eurozone", reduced to a handful of core countries (including Germany), would have substantial current external surpluses. In other words, the euro fair value would be considerably higher than it is now.

In its short history (which is still unfolding!), the euro has been subject to big swings that have had nothing to do with the fundamentals and that have caused it to move from parity with the greenback to double its value – from US\$0.83 (October 2000) to US\$1.60 (November 2008). Portfolio reallocations account for most of these foreign exchange movements.

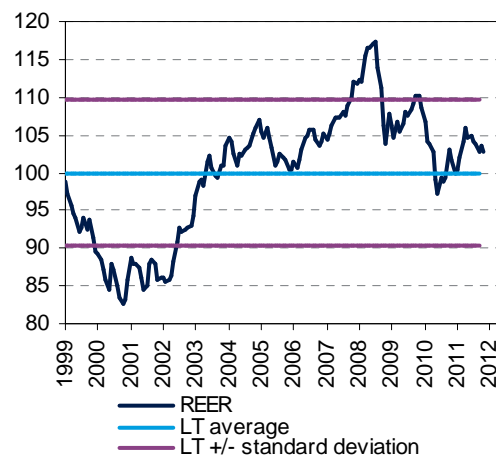
“ The euro often disconnected from fundamentals ”

Paradoxically, what was depicted by some to be a defeat for the single currency in 1999-2000 appears, with hindsight, to be the result of the European integration that was then underway (see box). The euro's jump to US\$1.60 in November 2008 and to 1.50 in October 2009 primarily stemmed from portfolio diversification by foreign investors, in particular Asian investors. Indeed, at the time we saw inflows of capital to eurozone bonds and money market securities soar in parallel with an increase in the proportion of central banks' foreign exchange reserves held in euros.

Today, despite the crisis, the eurozone continues to attract foreign investment that does not represent portfolio diversification flows. In total, net capital inflows (equities and debt) over the last 12 months totalled €335 bn, which is a key factor bolstering the euro. As strange as it may seem, the euro's resiliency over these last few months could be due to movements indicative of the disintegration of the euro: the flight to quality associated with the sovereign debt crisis could have boosted, at least until recently, the demand for German debt securities (viewed as a safe-haven investment) by foreign investors. The repatriation of capital held overseas by eurozone residents – who need to mobilise assets to reduce debt – ultimately translates into net inflows of capital to the eurozone.

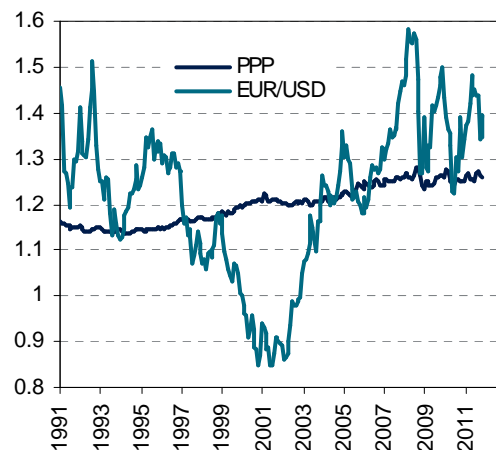
In both these cases, a temporary increase in the demand for euros that counteracted the speculative positions built by currency traders resulted. Unsurprisingly, these traders had built underweight positions on the euro. Furthermore, we note that implied EUR/USD volatility (whether six months or a year) is far above the level seen in spring 2010 (when the euro fell to \$1.20) and near its March 2009 level (when the euro was at \$1.25), which implicitly suggests that traders are attempting to hedge against a plunge in the currency. But capital flows also work the other way: a quick assessment of the correlation between the basic balance and the euro suggests that it could potentially be higher than \$1.50 today! In other words, once ongoing portfolio reallocation movements come to an end, the euro could quickly fall to levels along the lines of \$1.20 to \$1.25, i.e. close to its fair value.

Real effective exchange rate of the euro (100 = average since its creation)



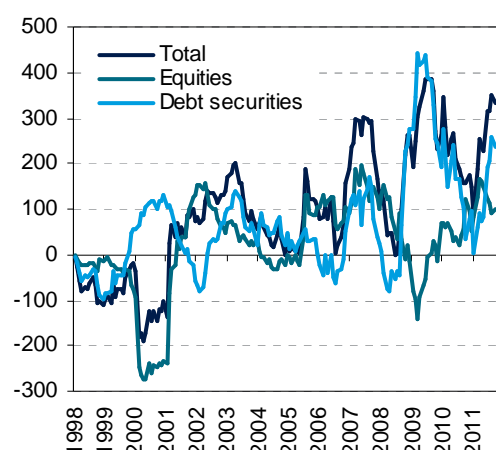
Source: Datastream, Amundi Strategy

EUR/USD vs its PPP equilibrium value



Source: Datastream, Amundi Strategy

Eurozone: Net portfolio flows (EUR bn, 12-month rolling sum)



Source: Datastream, Amundi Strategy

Has the euro become a currency that is "too big to fail"?

If the crisis worsens, would foreign investors be able to liquidate their euro-denominated holdings quickly? The answer is probably no. Admittedly, the single currency could depreciate but – barring an extreme scenario in which all the countries in the eurozone return to their national currencies – it is unlikely to collapse. The euro (like the US dollar) is in fact a currency that international investors cannot suddenly abandon because no other financial market has the capacity to quickly absorb the demand for assets which would result. In support of this diagnosis, we note that the composition of foreign exchange reserves held by major central banks has not radically changed over the last few years (see chart).

Admittedly, the dollar remains the dominant currency of the international monetary system but the Fed's propensity for money printing is prompting investors to question the status of the greenback as a reserve currency. The euro – the second global currency of importance in international trade – ended up becoming the preferred investment currency by default. But the onset of the sovereign debt crisis brought that chapter to a close. Between late 2009 and spring 2010 (the peak of the first Greek crisis), fears of the disintegration of the eurozone caused the single currency to plunge from \$1.50 to \$1.20 in the space of less than six weeks. It is worth remembering that during this period, the basic balance of the eurozone deteriorated from a surplus to a deficit representing more than 1% of GDP, a situation that is in sharp contrast with the present, where the basic balance surplus is close to 3% of GDP.

The central banks of the major emerging countries, which had diversified their assets to include the euro (among other currencies) over the last few years, would be the first victims of a drastic decline in the currency. Although the sovereign debt crisis put an end to the urge by the central banks of the emerging countries to increase their exposure to the euro, no substitute currency has been found. The relatively unchanged composition of foreign exchange reserves confirms that there is nowhere to hide in the currency universe. The yen stabilised because BoJ began fighting its appreciation in earnest. The Swiss Central Bank opted to peg its currency to the euro, which proved to be the right thing to do (the euro has been fluctuating in a narrow range of 1.20 to 1.23 francs since early September). The renminbi is still not convertible and cannot be used as a backstop by foreign investors. Other currencies (the Australian dollar, the Canadian dollar or the British pound) do not have sufficient market depth to serve as substitutes. Lastly, the price of gold has soared. Its run may not be over but, in any case, it cannot be used as a substitute for the world's major currencies.

Finally, the pressure on the euro could certainly increase in the near term, especially if the sovereign debt crisis worsens. But the sell pressure on the single currency will be presumably limited...the winds could shift any time.

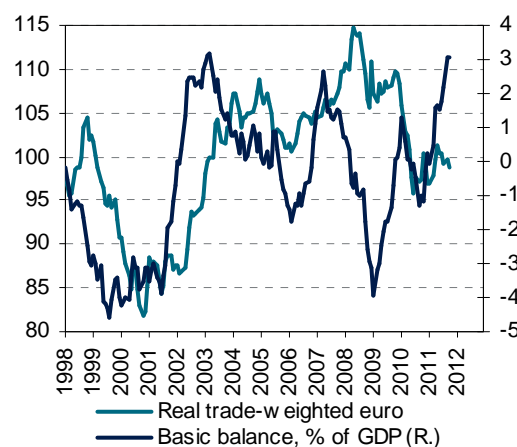
Box 3: Is a plunge in the euro/dollar below parity possible?

After its introduction at an exchange rate of \$1.18 on 1 January 1999, the euro fell against the dollar, hitting a historic low of \$0.83 in October 2000. While it began to appreciate in the spring of 2002, its value remained below parity with the dollar for more than three years (2000-2002). This weak phase was one during which the euro was weaker against all currencies. In light of the magnitude of the sovereign debt crisis and the risk of a plunging euro, some fear it could happen again. But the current situation is different in more than one respect.

The euro's plunge was not so much due to a lack of confidence on the part of foreign investors as it was to portfolio diversification by eurozone residents. When the euro was introduced, eurozone investors suddenly found themselves with a disproportionate percentage of securities denominated in the same currency. The keen desire to improve portfolio diversification was particularly evident in respect of equities: between 2000 and 2002, the eurozone recorded capital outflows in the form of equities along the lines of €200 billion per year!

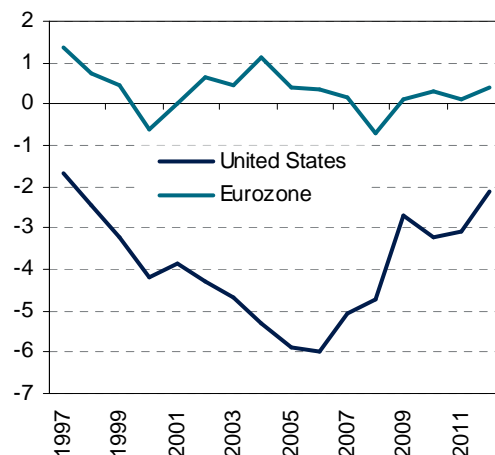
During the same period, we saw that the modest current account surplus (along the lines of 0.5% of GDP) became a deficit of almost 1.5% of GDP by the end of 2001. As to direct investment, the balance was slightly negative. The basic balance, which combines the current account with foreign direct investment (FDI) and net inflows of portfolio securities (equities and bonds), turns out to have been an accurate leading indicator of euro movements since its introduction and, in particular, to have correctly identified periods of overreaction by the European currency, whether in the form of surge or a plunge.

Eurozone: real trade-weighted euro (100=LT average) vs basic balance



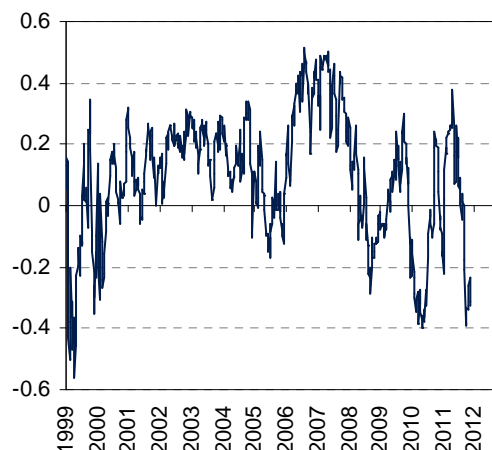
Source: Datastream, Amundi Strategy

Current account balance (as % of GDP): US vs Eurozone



Source: Datastream, Amundi Strategy

Euro: net speculative positions



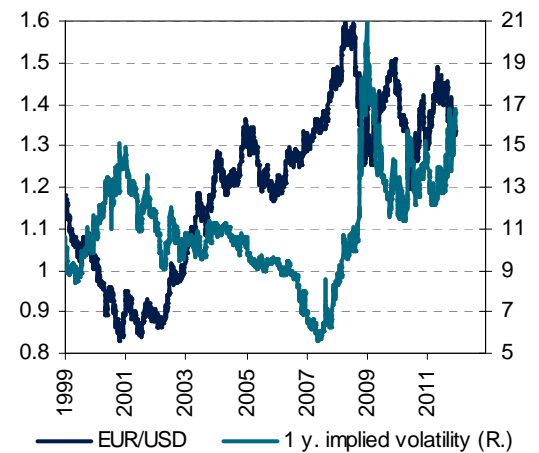
Source: Bloomberg, Amundi Strategy

When the euro hit its record low in October 2000, the enlarged basic balance of the eurozone had a deficit of nearly 5.0% of GDP while today it has a surplus of nearly 3.0% of GDP (See chart). If bonds are excluded from the basic balance calculation (with only FDI and equities included), the narrative does not fundamentally change: the basic balance improves from a deficit of 4.0% of GDP in 2000 to a surplus of 1.0% of GDP in 2011.

It is not the current account that is responsible for such large fluctuations but capital flows due to portfolio reallocation movements. In fact, the eurozone continues to have an overall current account that is close to being in balance and the massive external deficits of the peripheral countries are offset by the surpluses of the core countries.

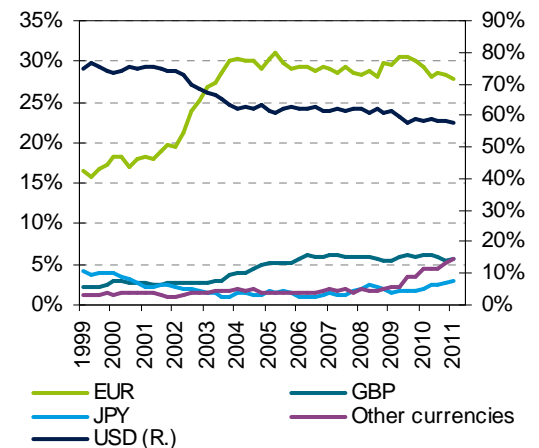
As to the dollar, the situation has completely changed. Following the increase in the Fed's balance sheet since the collapse of Lehman Brothers and the uncontrolled growth in US government debt, the greenback's status as the dominant currency of the international monetary system is in question today. The dollar's real effective exchange rate has fallen to its lowest in the last 50 years. Admittedly, the dollar continues to dominate international trade (the currency in which sales are invoiced) and – provided that the US Treasury market remains the deepest and most liquid in the world – it will continue to serve as a safe-haven investment in times of extreme risk aversion (as the collapse of Lehman Brothers shows). That being said, a sustained resurgence of the dollar against all currencies, like that observed at the end of the 1990s, cannot be ruled out. Yet another reason to hope that the euro does not descend into oblivion!

EUR/USD vs its 1y implied volatility



Source: Datastream, Amundi Strategy

Emerging economies: Composition of FX reserves (% of allocated reserves)



Source: IMF, Amundi Strategy

4 Deleveraging, but no european credit crunch yet!

The ECB published its latest bank lending survey in October. It shows a noticeable tightening of the credit standards on bank loans to non-financial corporations (and to large companies in particular) and to households (particularly for home loans).

The net tightening of credit standards on loans to SMEs rose from 3% in Q2 2011 to 14% in Q3 2011 while it rose on loans to large firms from 3% in Q2 2011 to 19% in Q3 2011. The percentage is calculated as the difference between the sum of the percentages of banks responding that the conditions were tightened and those responding that they were eased.

The tighter credit standards revealed by this survey are no surprise given the European banks' announcement that they intend to deleverage (reducing the project financing transactions mainly). In other words, they will not renew international financing lines of credit when they reach maturity (higher funding costs in foreign currencies are too prohibitive for the transactions to be profitable) and the pricing offered by credit institutions on financing, using considerable liquid assets, will increase markedly (transactions in US dollars particularly). The most recent broker reports mention a **decrease in banking assets of between €1.5 trillion and €2.5 trillion over the next two years**. Approximately €1 trillion of this has already been announced by European banks. Most of these deleveraging announcements involve assets outside the eurozone (regional refocusing of bank financing with no impact at the moment on the real economy in Europe).

The ECB survey also indicated that European banks do not expect business loan demand to pick up in the fourth quarter (19% expect an annual decrease in demand for underweight-term loans).

The same is true for credit standards on loans to households. The percentage of banks reporting a net tightening of credit standards on home loans rose to 18% in Q3 2011 versus 9% in the prior quarter. Eleven percent (11%) of European banks expect further tightening of credit standards on home loans in the fourth quarter.

This net tightening of credit standards is not yet reflected in a contraction of loan outstandings in Europe

At 30 September 2011, loans in Europe grew by +2.3% compared to 30 September 2010 (+3.2% for households and +1.3% for businesses). However, since the summer we have seen the pace of loan growth slowdown in Europe (sequential growth is now less than 1% on a quarterly basis).

Banks in England, Ireland and Spain have recorded a contraction in their loan outstandings since 2009, both for business and household loans.

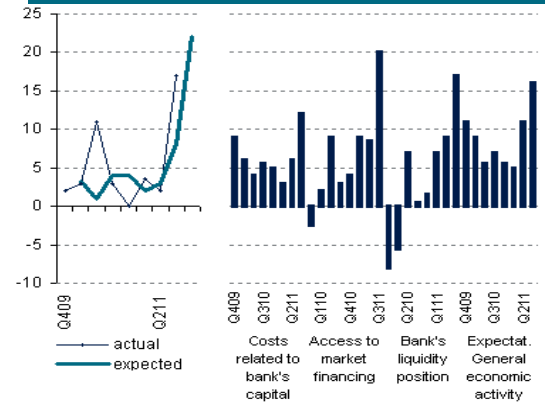
However, French and Italian banks continue to post healthy growth in outstandings (approximately +5% yoy), despite an increasingly depressed environment.

Should we expect a "credit crunch" in Europe in view of the latest ECB surveys on the net tightening of credit standards and the contraction in loan demand? The answer is no in the short term but we need to keep an eye on the quickly deteriorating trend.

The Bank of France conducted a study on the predictive interpretations of the survey over the period from 2003 to 2009. It shows that the distribution of credit reacts negatively to tightening supply and positively to an increase in demand. With regard to business loans, an increase of 30 points in credit supply conditions historically leads to a 0.9% drop in loan growth. Similarly, a 30 point drop in loan demand leads to a 1% decline in the growth rate for loans. Although recent trends are negative both for credit supply conditions and loan demand, **we do not anticipate a future credit crunch yet, but the risks are sharply higher.**

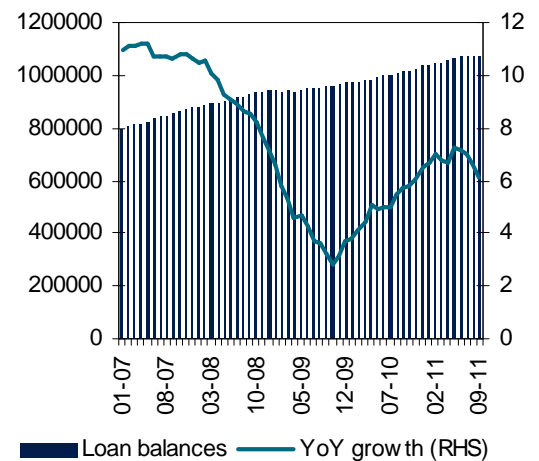
However, it makes sense to monitor the trend from these opinion surveys on the conditions for the supply and demand for credit **because they represent a very good statistical leading indicator, in the range of three quarters, with regard to trends in business and household loans.**

Decisive factors in credit supply conditions in the eurozone



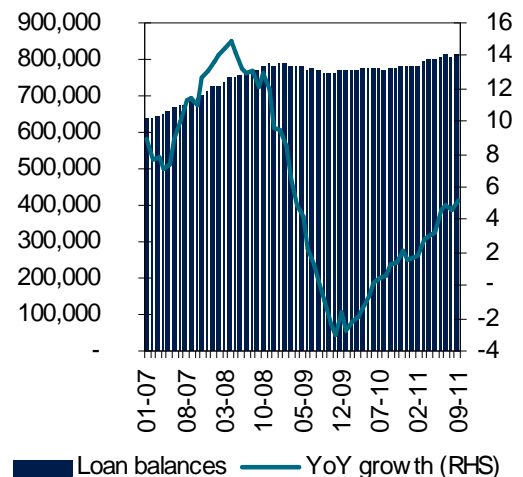
Source: ECB, Amundi Financial Analysts

Loans to households in the eurozone



Source: Amundi Financial Analysts

Loans to businesses in the eurozone



Source: Amundi Financial Analysts

5 Country effect: an analysis using risk measures

Financial asset prices have been strongly correlated since 2008. Together with the markets' extreme instability, this configuration makes active portfolio management difficult. In high-volatility phases, risk indicators such as correlation, dispersion and concentration throw helpful light on the various steps in the investment process, both in terms of active risk management within portfolios and of detecting potential alpha. We therefore review the definition and use of these variables, going on to clarify their relationship with the volatility cycle. We then illustrate them using the examples of country allocations in the eurozone and emerging markets.

Box 4: Correlation, dispersion, concentration : 3 measures to qualify risk structure

Correlation measures the degree with which securities co-move. A high degree of correlation implies less diversification potential and tends to increase overall portfolio risk. **Correlation increases when systematic risk (i.e. the risk common to all assets: growth, inflation, liquidity conditions etc.) rises relative to idiosyncratic risk (i.e. risk specific to a given asset).** If we consider the equity market, we intuitively understand that when variations in share prices are influenced mainly by macroeconomic factors rather than factors specific to those shares, prices tend to move together. If we refer to the usual parameters of multifactor risk models, where σ^2_M is systematic variance, β is the security's sensitivity to systematic risk and σ^2_ϵ is idiosyncratic variance, we establish that correlation is a function of the relationship

$$\frac{\beta^2 \sigma_M^2}{\beta^2 \sigma_M^2 + \sigma_\epsilon^2}, \text{ and therefore when } \frac{\sigma_\epsilon^2}{\beta^2 \sigma_M^2} \text{ decreases, correlation increases.}$$

Numerous studies in the early 2000s had documented a trend rise in idiosyncratic volatility relative to systematic volatility. This trend has reversed in the past five years in a context of worsening macroeconomic visibility. This means that risk models are particularly effective at measuring portfolio risk in current environment as they explain a significant part of asset volatility. And they are all the more relevant to the investment process by virtue of their ability to measure portfolios' sensitivity to the different sources of systematic risk and the correlation structure of the assets in the portfolio.

Dispersion can be interpreted as the average difference between asset returns for a given time period. We usually look at the standard deviation of monthly asset returns. Numerous research papers have demonstrated the effectiveness of this measure to detect a market's alpha potential. Dispersion helps to identify sources of opportunities (stock-picking, country, sector or asset allocation) for both tactical and strategic allocation. The higher the dispersion, the greater the potential for outperformance (and underperformance) and for alpha generation. The ability to rank relative expected returns is less relevant when dispersion is low. By the same token, it provides a useful information about the level of active risk and therefore can be particularly relevant for risk budgeting.

Correlation and dispersion are often associated with one another, based on the assumption that a high degree of dispersion is synonymous with weak correlation and vice versa. These notions cover different concepts, however. Two securities may be highly correlated but generate very different performances, reflecting differences in volatility or beta. For example, before the sharp rise in risk aversion during the summer, we saw correlations decline in emerging markets without any rebound in dispersion, as volatility was low. In contrast, during the present high-volatility phase, dispersions in Europe are climbing in parallel with correlations. **Dispersion increases with systemic and specific risk**

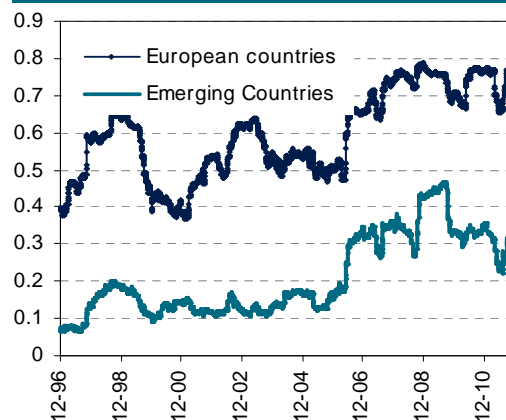
Concentration: a market is concentrated when the performance of its underlying assets may be explained by a limited number of common factors. The greater the concentration of risk, the more vulnerable and volatile the market will be and the lower the possibility for diversification between securities. It is calculated as follows: we determine the risk factors common to assets using principal component analysis. The proportion of variance explained by the first common risk factors (in terms of explanatory power) measures the risk concentration of the market.

We may complete the picture with another risk measure: **Tail dependence.** It complements correlation measures and sheds light on diversification potential and the portfolio's vulnerability in bear markets. It measures the probability that two assets A and B suffer major losses simultaneously, using the conditional probability

$$PC_t^{A,B} = \Pr(r_{A,t} \leq VaR_A^\alpha | r_{B,t} \leq VaR_B^\alpha)$$

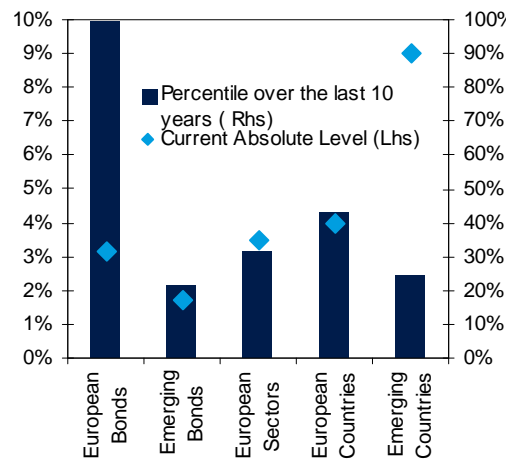
where $r_{A,t}$ and $r_{B,t}$ are the respective yields on A and B an instant t and VAR^α is their value at risk at level α .

Median correlations in Europe and emerging markets



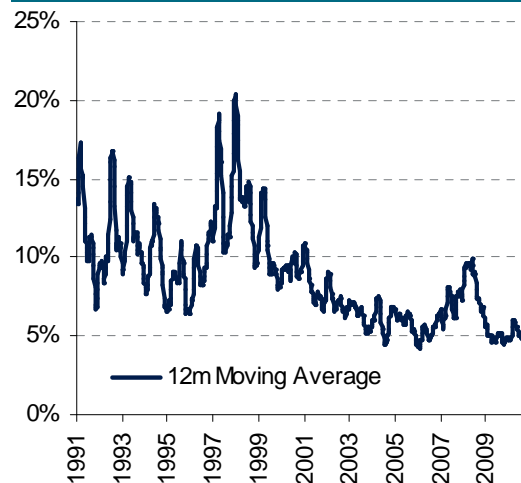
Source : Datastream, Amundi Strategy

Dispersion in Europe and emerging markets



Source : Datastream, Amundi Strategy

Country dispersion in Emerging Markets



Source : Datastream, Amundi Strategy

A high-correlation regime since 2008

Correlations have fluctuated around an historically high level since 2008 in Europe. The persistence of high correlations since 2008 is related to the volatility regime: correlations rise when volatility rises. These phenomena all stem from the same underlying factor, which is marked uncertainty over real economic growth.

“
Dispersion in the eurozone is returning to its early 1990s levels
”

Recent research has linked the correlation level and market and interest-rate volatility to precisely this factor. In that respect, we observe that the trend rise in correlations since 2002 that is usually explained by structural factors (globalisation) has been accompanied by a rising risk premium on equities and is a reflection of rising systematic risk (see box 4). It is worth highlighting, however that contrary to Europe, the correlations regime among Emerging countries has normalised post 2008-crisis (see 1st chart, previous page). The asymmetric profile of correlations is also illustrated on this chart by the underweight term fluctuations in correlations around this high level since 2008. Correlations are higher in bull markets than in bear markets. Because of this asymmetry, the recent crisis has had serious consequences in that it has limited international diversification in the succession of volatility spikes we have witnessed since the beginning of the sovereign debt crisis in Europe .

Market opportunities shift according to the volatility cycle

In periods of rising volatility, sector and country allocations should be favoured over stock-picking. Opportunities move towards sectors and countries because dispersion between sectors and countries increases faster than that between stocks. In these market phases, securities within a given sector or country tend to react to macroeconomic factors, and investors discriminate little on the basis of future earnings or relative valuation. This creates stock-picking opportunities that become potentially profitable once volatility normalises and correlations start to fall. VIX is a useful tool to enhance alpha focused strategies.

The rebound in the country effect in the eurozone

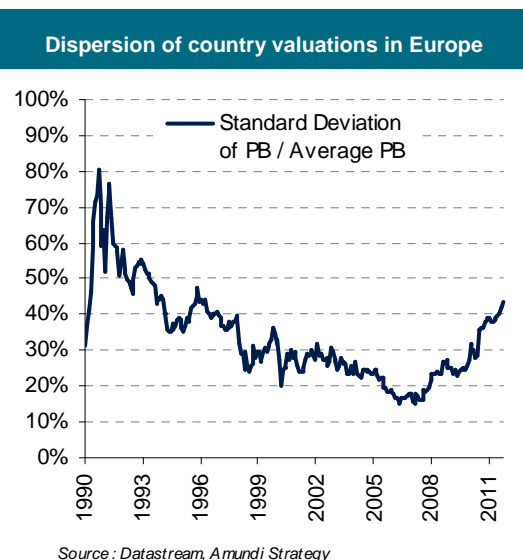
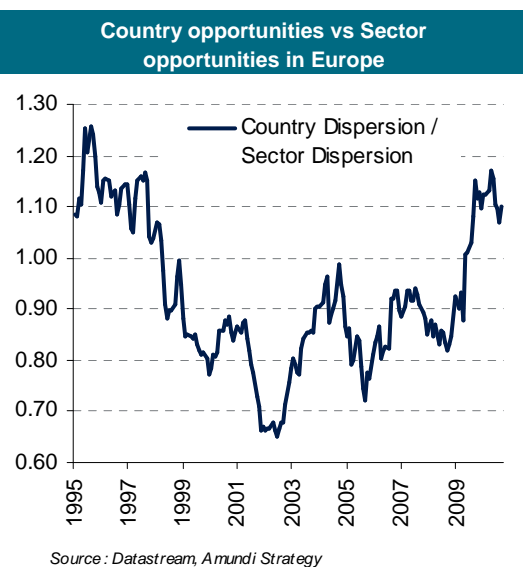
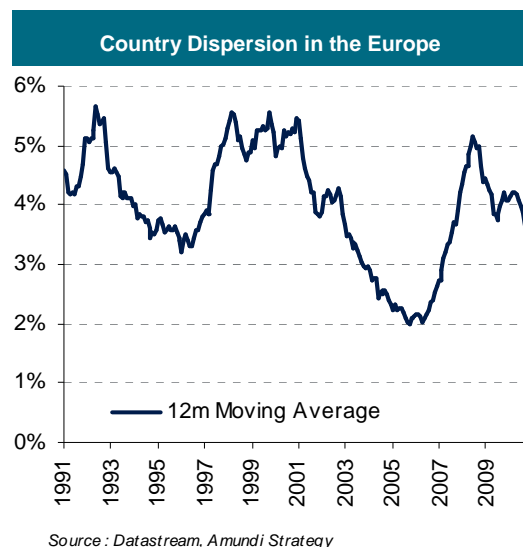
Inter-country dispersions have trended wider in the eurozone since 2008, and for the first time since the mid-1990s country dispersion is now higher than sector dispersion (see 2nd chart), while dispersion on the euro bond markets is at a record high. By way of comparison, emerging countries are trending in the opposite direction, with inter-country dispersion rather low in historical terms despite decreasing correlations since 2008.

In the eurozone, the rebound in country risk is reflected in higher valuation dispersion. Following a long period of convergence, valuations have been diverging again over the past two years. Even so, we remain well below the levels that prevailed in the early 1990s.

In the present context of heightened uncertainty, the growing importance of country risk in the eurozone is regarded above all as a portfolio risk to be managed rather than as an additional source of alpha and stock-picking.

Emerging markets still offer a great many opportunities

Although dispersion between emerging markets has been historically low since 2008, it is still high in absolute terms (2nd chart). Emerging countries allocation continue to offer very attractive opportunities. They are an attractive source of absolute returns.



6 China: a choppy but controlled domestic slowdown

A change in the growth model

In the decade spanning 2000-2009, China's GDP grew 10.3% on average each year. This performance was repeated in 2010. However, since early 2011, China's economy has been experiencing a slowdown. GDP growth fell from 9.7% to 9.1% between Q1 and Q3 2011. This decelerating growth trend is expected to continue over the next few years. The World Bank reports that the potential for growth between 2010 and 2015 will be no more than 8.4%. The Chinese government itself has set a minimum growth target of only 7% over the next five years (compared to +8% during the Eleventh Five-Year Plan). Lower Chinese growth is expected to be coupled with a change in its growth model, as set out in the Twelfth Five-Year Plan. The aim is to boost domestic consumption to offset the forecast slowdown in investment and export growth.

The rate of investment in China is now 48%. It is well above the average rate observed in OECD countries (19%) and roughly equivalent to the maximum observed in Japan and Korea during their major development phase. This rate of investment is the result of the considerable effort made during the previous development infrastructure and the boom in the construction industry. Nearly 50% of all investment in China is being made in these two sectors. Although infrastructural development is expected to continue at a solid rate thanks to the Twelfth Five-Year Plan, which provides for an aggregate outlay of CNY 15 trillion (38% of current GDP over 5 years) in this area, investment in the housing sector should taper off.

The housing market has grown by leaps and bounds over the last few years. But in China's major cities, the cost of housing has sky-rocketed and the affordability of real estate has sharply deteriorated. In Beijing and Shanghai, the purchase of 90 square meters of residential space requires, respectively, an average of 24 or 18 years of income used entirely for this purchase. The middle class is finding it harder to afford property, which is now a source of social tensions. Furthermore, the upsurge in property prices has resulted in surplus real estate inventory that has outstripped demand. Land purchases increased almost 30% in 2010; by the end of Q1 2011, this increase had accelerated to nearly 60% year-on-year. Because of higher prices, residential housing sales did not follow the same growth track.

Sales grew by "only" 8% in 2010 and by 14.3% at the end of the first half of 2011 year-on-year. As a result, the inventory of unsold housing grew by 50%, increasing to 8 months of supply in 2009 and to 12 months of supply by late September 2011.

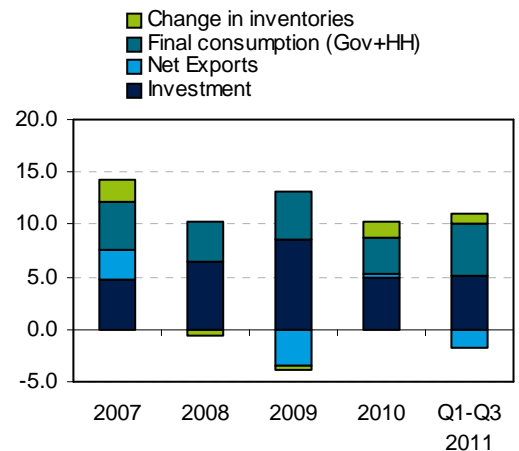
The authorities are limiting the housing prices to curb the social tensions

A negative contribution from residential investment and exports expected in 2012

The Chinese authorities have placed restrictions on the housing market mainly to contain the upward momentum in prices: demand has been rationed in thirty or so cities, the prime rate was raised by 1%, the reserve requirement upped from 15% to 21% percent and banks' prudential ratios increased. Banks exposed to systemic risk are required to raise their Tier One capital to 9.5% by 2013 while others have been ordered to increase this ratio to 8.5% by 2016.

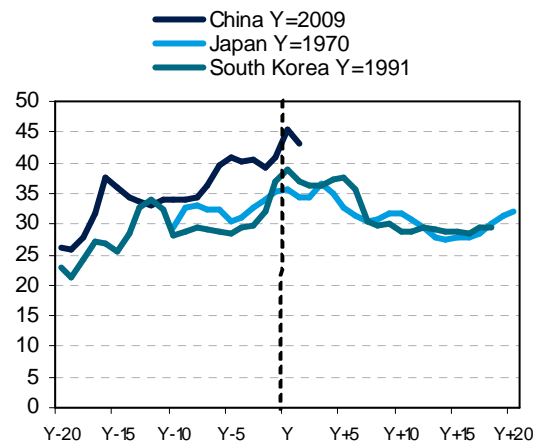
The construction industry has been reeling from the effects of these measures since summer 2011. Land purchases fell off to +7.2% year-on-year at the end of Q3 2011 and year-on-year growth in housing starts slumped from +32% in August to just +2.2% in October. This set of statistics empirically reflects a strong correlation with housing investment. Housing investment is expected to make a negative contribution to growth in Q4 2011 and in H1 2012 before inventories get back in line with their historic average. However, the impact should be softened by the construction of public housing as set out in the next Five-Year Plan. The plan provides for the construction of 36 million residential units to house 144 million people, namely 20% of the urban population. In view of these elements and recent trends in housing supply and demand, we predict that real estate construction will contract by at least 5% to remedy the observed imbalances.

Contributions to GDP growth, %



Source: IMF, NBS, Amundi Strategy

Investment rate (GFCF/GDP, %)



Source: World Bank, Amundi Strategy

Property sector: land area purchased and floor of space sold, yoy, %



Source: Bloomberg, Amundi Strategy

This means a negative contribution to growth of less than 0.5% given its GDP weighting (approximately 10%). The scale of the correction will largely depend on whether or not restrictions on demand are lifted.

Besides real estate, foreign trade is expected to make a negative contribution to growth over the next few quarters due to falling world demand associated with the sovereign debt crisis in the developed countries. During the first three quarters of 2011, the contribution to GDP growth from the balance of trade was negative, amounting to -0.5%. The magnitude of the slowdown in global demand naturally depends on whether or not the crisis in Europe spreads to other parts of the world. If recession is confined only to the eurozone and if growth in the global economy remains in the neighborhood of 3% as our core scenario predicts, the impact should be limited (contribution to growth from net exports around -0.5%) since the eurozone accounts for only 15% of China's exports. On the other hand, if the crisis in Europe worsens and leads to worldwide recession, the impact will be more pronounced. Growth in net exports of Chinese goods fell from +8.3 to -10.7% in 2009 (the trade balance led to a negative contribution to growth of -2.2%) as world economic growth declined to -0.7%.

The domestic consumption as a new engine of growth

The Chinese Twelfth Five-Year Plan aims at developing international demand and investment growth drivers by stimulating consumer demand. As of now, a pick-up in consumption in China seems likely. The nominal disposable income of urban and rural households has increased on average by 9.7% and 8.9%, respectively, over the last five years. Minimum wages climbed by 22.9% in 2010. The Chinese authorities should continue this trend as they guarantee an increase in real wages of 7% on average over the next five years in the Five Year Plan (measures to support SMEs are also planned because they are the most vulnerable to rising production costs).

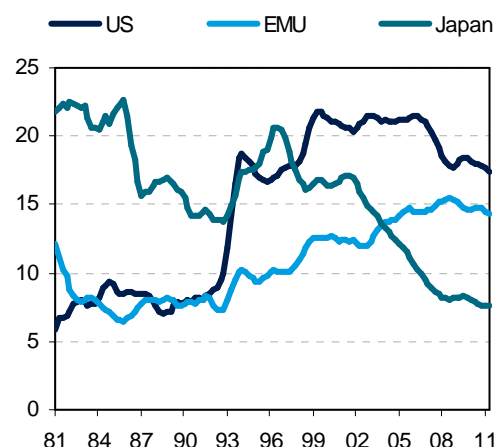
Increases in real wages should ease in the underweight-term due to continuing deflation. The annual Consumer Price Index fell from 6.5% to 5.5% between July and October due to base effects on the food component (which accounts for 30% of the CPI).

“ Consumption is a growth engine that China will boost ”

Base effects should continue to be felt the coming months, and inflation in China is expected to fall to 4% by the end of 2011. This will lead to an increase in real household income since, at the same time, the leading indicators on employment show no signs of contraction. To boost consumption, the Chinese authorities plan to strengthen the welfare benefits. Their goal is to increase the consumption share in GDP from 37% to 40%, which looks credible in these conditions.

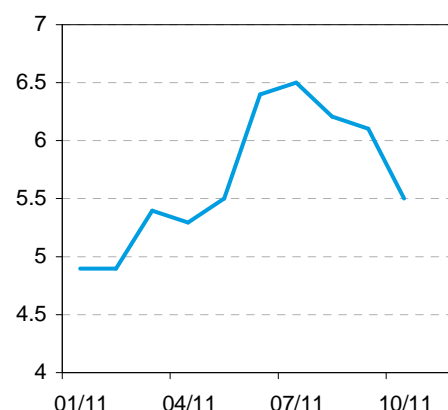
Transforming an economic model is impossible without upheaval. China must clear the housing market surplus and manage the financial position of its banks and local governments (see box). Furthermore, China needs to make a substantial effort to increase spending on infrastructure. In addition, China has the financial means and the potential for growth, via consumer spending, to continue its current growth phase at a solid rate. Barring a major shock to global growth, Chinese growth is expected to gradually drop off but still exceed 8% in 2012.

China exports to G3, % of total exports, 4-Q moving average



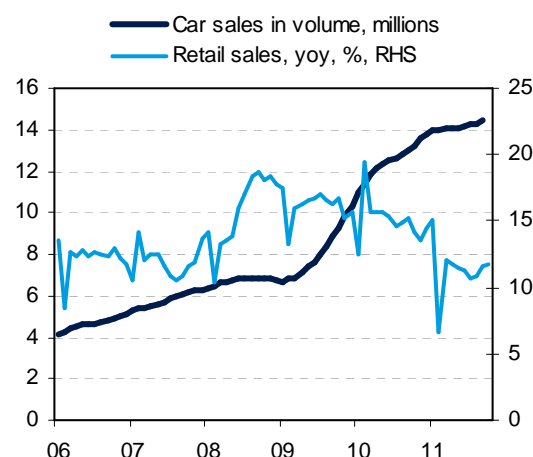
Source: Datastream, Amundi Strategy

China: Consumer Price Index, yoy



Source: Datastream, Amundi Strategy

China: retail and car sales



Source: Bloomberg, Amundi Strategy

Box 5: Chinese banks – a recent IMF assessment (*)

The Chinese economy has grown by an average of 10% annually since 1978. Alongside this impressive performance, the government has introduced major reforms to the financial sector, including a bank recapitalisation programme, a prudential regulation system and a series of other changes to the interest rate formation mechanism. But despite these significant advances, the financial sector is still underdeveloped. Thin capital markets made it hard for small and mid-sized firms to raise financing, thus hampering the development of truly liquid and sophisticated hedging products. For example, China's bond market is undiversified – it is made up chiefly of government securities – and its capitalisation is around 50% of GDP, some \$2.9 trillion. By comparison, its US counterpart is worth 2.5 times America's GDP, or more than \$36 trillion. Owing to the lack of depth of Chinese capital markets, investment flows focus on a handful of segments in the quest for yield, which leads to a greater risk of bubbles. There are strong doubts that the real estate market can avoid risk in the near future.

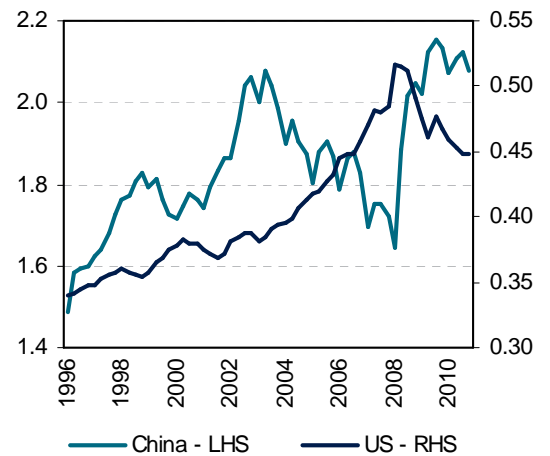
This forthcoming maturity phase puts banks in a commanding position in terms of financial intermediation. According to the IMF, nearly two-thirds – specifically, 63% – of the assets deposited with Chinese banks are held by the four largest institutions: China Construction Bank, Industrial and Commercial Bank of China, Bank of China and Agricultural Bank of China. All four have balance sheets equivalent to some 25% of Chinese GDP, or around \$1.5 trillion. Moreover, as the major shareholder, the Chinese state continues to use the banking system as a monetary policy instrument. The 2008 stimulus plan was implemented through bank credit. To compensate for this key economic role, the authorities have imposed stringent credit controls, including interest rate targets and quantitative lending targets.

The risk of falling property prices has highlighted distortions resulting from current inefficiencies. At first glance, China's commercial banks have little exposure to real estate, which accounts for 20% of total lending (RMB 11,400 billion, or \$1,790 billion). However their actual exposure is probably much greater. The Chinese banking system relies heavily on mortgage or collateralised loans, which make up an estimated 30-40% of the total. Most of the assets posted as collateral are properties. The current unease stems from the distortions created by credit controls, which have prompted banks to rely on off-balance sheet financing and distribute structured credit products (see "China don't we have to worry about banks" p.29 – Issue 11, November 2011).

The IMF, in cooperation with the Chinese banking regulator, has carried out stress tests on 17 banks. The results highlight several strengths but leave a few questions unanswered. On the plus side, none of the banks has a capital adequacy ratio (CAR) below 8%. A 30% fall in real estate prices would lower CARs by an average of 1/4 percentage point. Capital reserves are substantial. More broadly, if the assets of the four main banks were to depreciate by 15% in case of a shock, only two of the 17 banks of the sample would see their CARs fall below the 8% threshold. Interest rate risk seems to be manageable and is not among the most likely risks, given that the central bank is poised to ease. Exchange rate risk is simply non-existent because it is borne almost entirely by the central bank. Nevertheless, there are two thorny issues. The first is that banks depend heavily on the domestic interbank market even though their deposits are stable and cheap (interest rates on term deposits are capped). The second issue is more worrying. The tests were conducted with limited data, particularly for off-balance sheet activities. This hinders effective analysis of risks in this area.

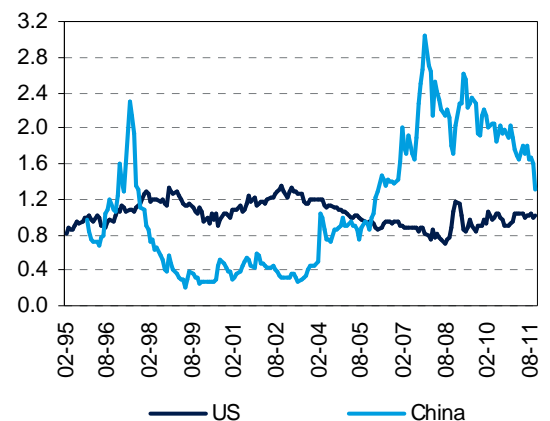
(*)IMF Country Report No11/321 November 2011 "People's Republic of China: Financial Stability Assessment"

Ratio of loan stock to GDP



Source: Bloomberg, Amundi Strategy

Banks – Price-to-Book Ratio



Source: Datastream, Amundi Strategy

7 Energy: Improving fundamentals despite skepticism

Oil prices have trended downwards since early May, due to fears of a negative impact on demand due to slowdown in GDP growth. Nevertheless, ongoing market tightness has maintained oil prices at relatively high levels so far, and we think that this situation is likely to continue.

As the Brent price has been in backwardation since early 2011, the Nymex WTI forward curve has flipped from co tango into backwardation recently (end October), emphasizing that the spot worldwide oil market is really tight. This move is very significant, as the front-end of the WTI forward curve had been in contango since 2008. Historically, in such circumstances, the WTI forward curve has tended to remain in backwardation for a significant period of time, and prices have tended to stay at high levels.

The global worldwide oil demand has been very resilient so far despite a significant deterioration of the macro environment. The International Energy Agency has slightly reduced its demand forecast over the last few months, but they haven't noticed any significant demand destruction yet. On the Base Case macro scenario (worldwide GDP up 3.9% in 2012), the worldwide demand should increase by around 1.3 mb/d (or +1.5%) versus 2011. Even on the lower base scenario (worldwide GDP up only 2.6% in 2012), the worldwide oil demand would remain slightly positive (+0.3%)

On the supply side, the non-OPEC supply has been revised down again by the IEA during the last few months, due to persistent weather and political related shut-ins in North America, the North Sea, and Latin America. The non-OPEC supply is now expected to increase only marginally in 2011 (+0.3%). Expectations for next year are more encouraging (+1.1 mb/d to 53.8 mb/d, or +2.0%). The Libyan oil production has ramped up on a faster track than initially anticipated. But reaching the pre-conflict level of 1.5 – 1.6 mb/d could take 18 months.

Regarding OPEC, the crude oil supply was slightly up recently, and the theoretical spare capacity stands currently at about 3.6 mb/d. The effective spare capacity can be estimated at only 2.8 mb/d, excluding the heavy oil crude from Saudi Arabia. This emphasises clearly that the oil market is currently tight, with only 3% to 4% of spare capacity worldwide.

The worldwide oil market has been under-supplied since 2010, and remains so for the time being. The balance between world demand and total supply has been negative, putting pressure on the global stocks levels. This situation is likely to improve next year, but only marginally. In the medium term, The OPEC spare capacity is expected to increase within 2015, but only at a relatively low pace.

“ The worldwide oil market has been under-supplied since 2010, and remains so for the time being ”

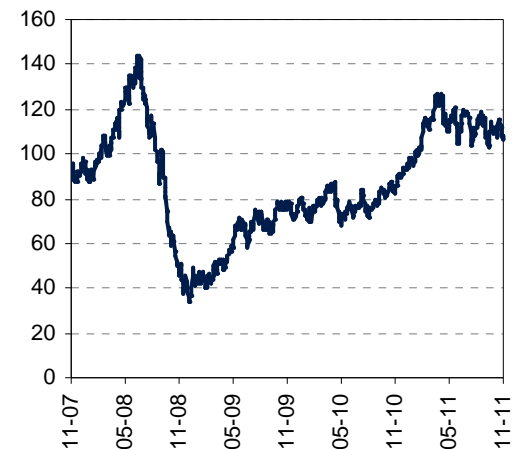
The recent dislocation between Brent and WTI prices can be explained by a combination of inflexible pipeline systems, a lack of capacity for transportation crude oil and products out of the US Midwest, as well as a surge in deliveries of both Canadian and US domestic crude from new shale plays. The spread between Brent and WTI has reduced significantly recently, but it is likely to persist for a while, probably for at least for 1 – 2 years.

Replacement Reserves Rates have improved significantly in 2010, and companies have delivered good numbers three years in a row. Production volumes outlook seem now better on average for the next few years. On top of that, balance sheets remain strong, and we see a good visibility on dividends.

On the oil services, fundamentals remain globally very positive, supported by a combination of different parameters: strong commitment of OPEC to underpin oil prices above US\$90/bbl, the vast majority of projects to be sanctioned are economic at less than US\$80/bbl, and strong balance sheet of most of integrated companies. The outlook for Offshore Construction is bright, with order intake holding up and an extremely attractive pipeline of large new orders coming to award.

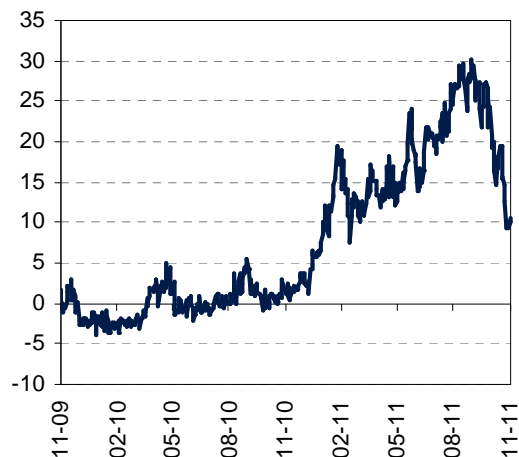
For all those reasons, we maintain very positive view on the energy sector.

Brent 1 month forward



Source: Datastream, Amundi Financial Analysts

Brent – WTI spread



Source: Datastream, Amundi Financial Analysts

Energy performance vs MSCI Europe



Source: Datastream, Amundi Financial Analysts

8 Is a third round of Quantitative Easing needed for oil?

Is the price of oil still cyclical?

Until the end of the summer and as signs of an impending economic slowdown in developed countries grew, global demand for oil was moving in the right direction (See "Energy: improving fundamentals despite scepticism"). Amidst this environment, the price of oil remained high. Since then, a looming recession in the eurozone and a slowdown in emerging markets argue, all things being equal, for lower oil prices.

However, the price of oil has become less cyclical than in the past. Throughout the economic cycles of the past thirty years, the price of a barrel of oil tended to act as an automatic countercyclical stabiliser. When the economy was growing, potential overheating was moderated by higher oil prices and, conversely, when the economy was slowing down, lower oil prices played a role in stimulating the global economy. But the flood of liquidity worldwide has severed the mechanical link between the price of oil and the physical balance of supply and demand.

This raft of liquidity could increase again with the resumption of financial asset purchase programmes (*Quantitative Easing or QE*) for the third time since 2008. This possibility was raised by several members of the Fed although, for the moment, there has been no official statement. Whatever the assets to be bought, purchases would be made by creating money, which would increase liquidity. The correlation between the periods of financial asset purchases and higher oil prices is obvious (Chart 1). However, correlation is not causation.

How does QE affect the price of oil?

From a theoretical standpoint, two transmission channels account for the link between liquidity and the price of oil:

- A flood of liquidity increases expectations of inflation and lowers real interest rates. The aim is to revive growth and, hence, oil consumption.
- Greater liquidity drives down the dollar and investors hedge their positions by buying assets that are delivered in dollars such as oil or gold. Moreover, there is a strong correlation in the long run between the real effective dollar exchange rate, which has fallen to a fifty-year low, and the price of oil (Chart 2).

What impact did the various QE measures have on oil?

The first QE programme in March 2009 took the markets by surprise and oil jumped 24% in the first month. Subsequently, the price of oil continued to rise until the end of the asset buying programme in March 2010. During this period, the price of Brent per barrel increased 57%.

“ The different rounds of QE increased the price of oil by an average of 55% ”

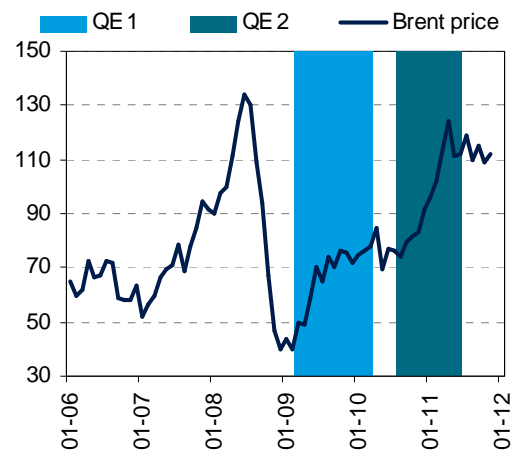
During the second round of QE, announced in August 2010 during the Jackson Hole Conference and ending in June 2011, the price per barrel for oil increased 52%, finally settling around \$112 per barrel. Therefore, on average, the two rounds of massive purchases by the Fed resulted in a 55% increase in the price of a barrel of oil.

In the interval between these two rounds of QE, the price of oil fell 10%. At the end of the second round, it fell 6%.

The flood of liquidity produced an upswing in the price of a barrel of oil and in commodities across the board. If a third round of Quantitative Easing is rolled, it will drive oil higher.

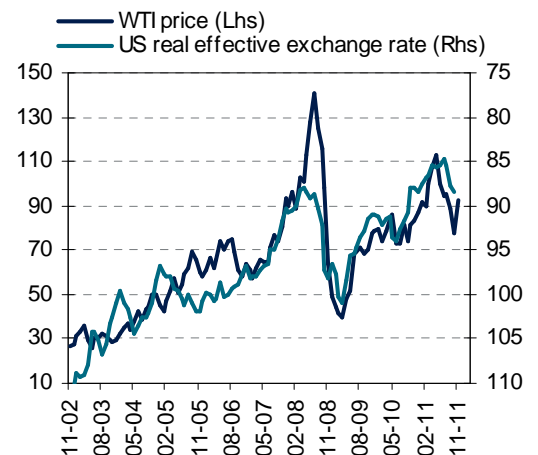
Under these circumstances, the threat of a sharper than expected slowdown in the economy would have a limited impact on the price of oil per barrel. On the one hand, that is good news for commodity equities and for commodities themselves. On the other, it will further diminish oil's stabilising role, which we have seen in action during other recessions over the past 30 years.

Effect of QE on the price of Brent



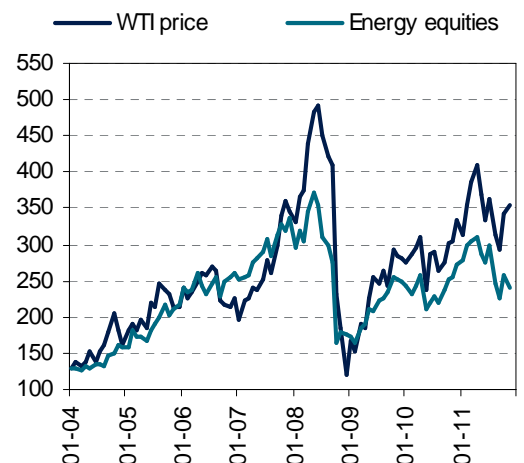
Source: Datastream, Amundi Strategy

Correlation between WTI and the US dollar



Source: Datastream, Amundi Strategy

Correlation between the price of WTI and energy sector equities



Source: Datastream, Amundi Strategy

9 Hope for equities is based more on reflation than on profits

The profit cycle is ripe. Margins are at their highest. Global growth is undermined by the European crisis. Are equity markets doomed to decline, even collapse as in 2008? Uncertainty is at its peak. There is still a path to an optimal solution, if the European crisis is quickly solved, but the road is becoming narrower. Hopes may be found in reflation rather than profit.

In terms of profits, the best that we can expect is resilience

As illustrated in the first chart, margins have begun to settle generally as in 2008, except the US. Will they be able to come to the rescue of low sales growth? The reasons for high margins are well-known: 1) commodity prices are falling year-on-year 2) Listed companies' balance sheets are solid, enabling them to resist the rising cost of credit. 3) The cost of labour, which represents the bulk of expenses, should remain under control. But companies have spent some of their room for manoeuvre; as the second graph shows, the share of profits in US GDP is at its highest, while employment (unemployment rate using an inverted scale) is at its lowest. Under these conditions, we can bet on resistant margins, but it is unlikely there will be a further general increase.

In addition, positive or neutral growth of European earnings historically requires more than 3% global growth. This remains credible assuming that growth in the US and so-called "emerging" countries offsets an "isolated" recession in Europe. This logic has its limits, of course, if Europe fails to halt contagion quickly. Thus, we expect growth in profits to be stable at best in 2012. Conclusion: do not expect corporate profits to be the driver of equity markets.

Hope therefore rests on possible reflation

Indeed, when inflation is no longer a threat and if economic growth is at risk, central banks ease monetary policy. Which favours risky assets.

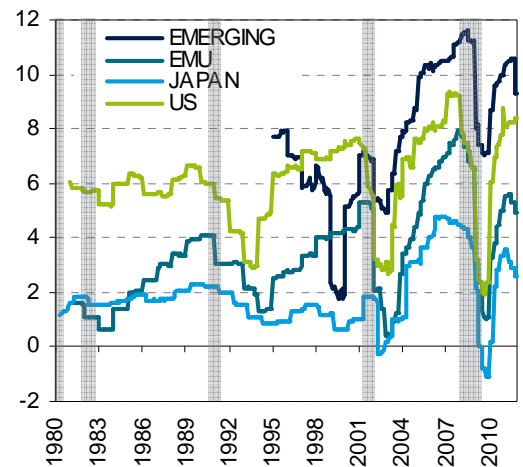
“ Are the central banks up to the task? ”

The question is, of course, first and foremost on Europe; the ECB is now seen by markets as "the" ultimate solution to the crisis in Europe. The question also applies to the United States where lack of budget agreement in the "Super Committee" has increased the likelihood of intervention by the Fed. Finally, in China, where the risk of inflation has dissipated, authorities have just taken action. Resynchronisation of the world's monetary policies gives weight to this factor.

The third graph shows the MSCI BRIC's reaction to China's monetary policy. The index corrected by the end of Chinese tightening of monetary policy in both 2008 and 2011, which is fairly standard. In contrast, markets react positively in general when relaxation accelerates. In 2008 for example, it was not until October, whereas the first drop in China's RRR (Reserve Requirement Ratio) began in September. Caution is therefore appropriate, even if the cut of the RRR in China is clearly a good news, which confirms our preference for Emerging markets. Though there is urgent need for central banks to take action, there is no urgency for investors to anticipate this action.

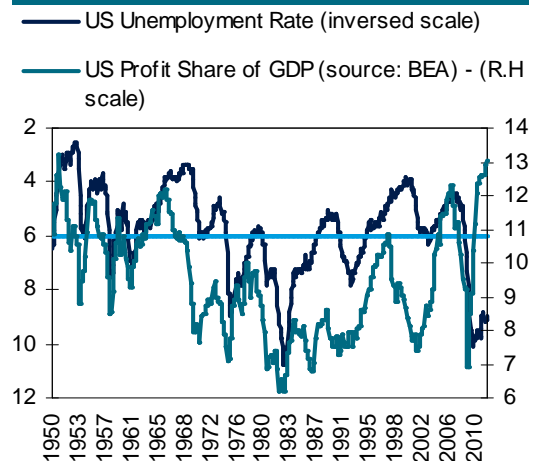
It is also possible that a new phase of stress is necessary for the ECB, which everyone is watching, to act. Time is not on its side. At this point, there is still hope that another 2008 can be averted, for which we are increasingly dependent on central banks.

Net profit margins at height of cycle



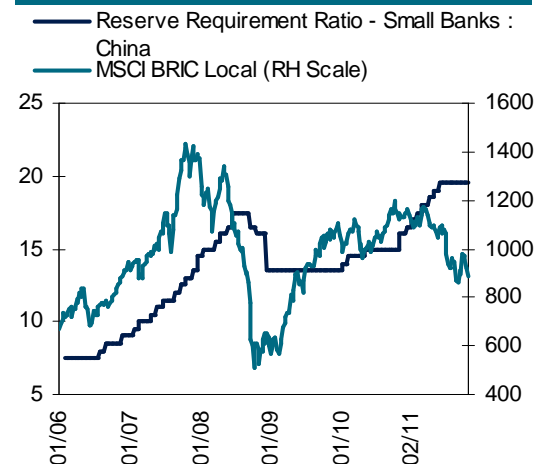
Source: Datastream, Amundi Strategy

The share of profits in US GDP is at a peak... and so is unemployment



Source: Datastream, Amundi Strategy

Chinese Reserve Requirement Ratio and MSCI BRIC



Source: Datastream, Amundi Strategy

10 Q3 2011 Earnings season: net decline in margins in Europe

In **Europe**, the Q3 2011 publication season has been characterised by a continuing rise in revenues (graph 1: +6% over 12 months and -2% sequentially) but a decline in earnings (graph 2: -12% over 12 months and -19% sequentially). This represents a sharp brake in the virtually uninterrupted recovery in earnings observed since the low point in Q4 2008.

In the **United States**, the trend has remained much more positive with a further rise in sales (+10%) and profits (+16%), a better trend of pleasant surprises than in Europe and modest revisions in recent months.

The earnings decline in Europe was largely expected. Since the start of the general stock market crash of July 7th, against the backdrop of downgraded economic prospects and a resurgence of the sovereign debt crisis, analysts have significantly reduced their forecasts (a cumulative -11% from 7 July to 25 November in Europe for 2011 and -12% for 2012, including -11% and -15% in the eurozone). And they now expect “no more” than +3% growth in earnings in Europe for 2011 (-3% in the eurozone) and 10% next year (same for the eurozone).

However, past experience shows that:

1/ profits in Europe are unlikely to prove resilient if global growth were to fall below the 3% mark

2/ a recession, even isolated, in Europe would result in an undoubted decline in profits. This is why, even if the rate of “net pleasant surprises” has ultimately proved to be better than in Q2 (graph 3), this has not had an effect on the market. Investors are now much more focused on developments in the eurozone crisis and the worsening recession to come, which are likely to continue to fuel the downgrading of earnings forecasts.

The other lesson from this results season is a particularly sharp decline in margins. These have returned to Q4 2009 levels and the decline does not concern a particular sector but can be observed in 7 out of 10 industries.

“ Sharp decline in margins in the majority of sectors ”

Only Discretionary Consumption (saved until now by the auto sector), Staple Consumption and Health Care have managed to prove the exception to the rule, whereas Financials obviously, but also Telecoms, Capital Goods and Basic Products have been hard hit.

In the absence of wage inflation, **this margin squeeze**, which easily transcends the particular case of the financial sector, **seems primarily attributable to three phenomena:**

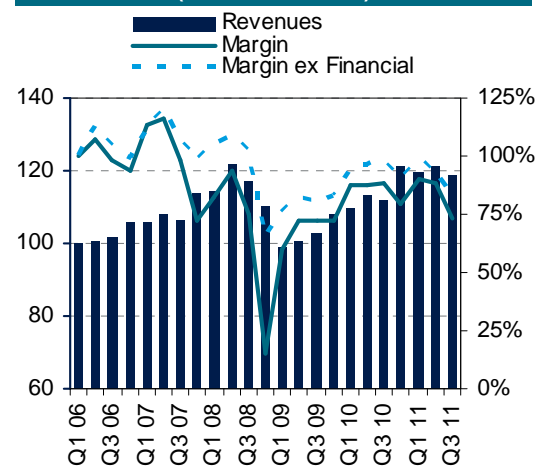
1/ the exhaustion of the effects of the cost-cutting plans which followed the 2008/2009 crisis,

2/ the differed effect of the commodity rebound (+24% over 12 months for the CRB industrial index, +25% for copper, +49% for Brent, etc.) which makes inputs more expensive,

3/ as well as the euro effect (+10% vs. the \$ over 12 months), which is penalising exporters.

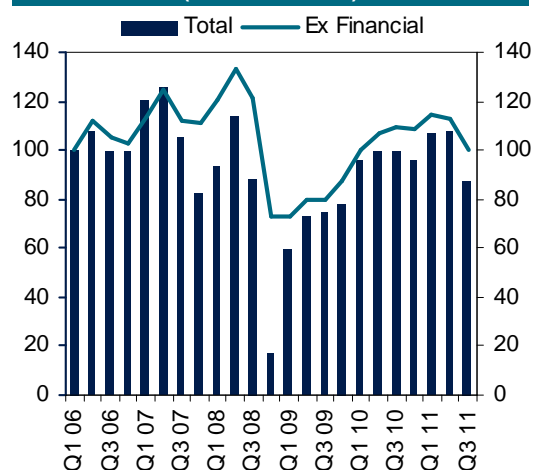
With inelastic selling prices due to the sluggishness of the economy and international competition, all this has resulted in a decline in pricing power and inevitable pressure on margins.

European quarterly revenues proxy (index 100 = Q1.06)



Source: UBS, Datastream, Amundi Strategy

European quarterly earnings proxy (index 100 Q1 06)



Source: UBS, Datastream, Amundi Strategy

What will happen over the next six months?

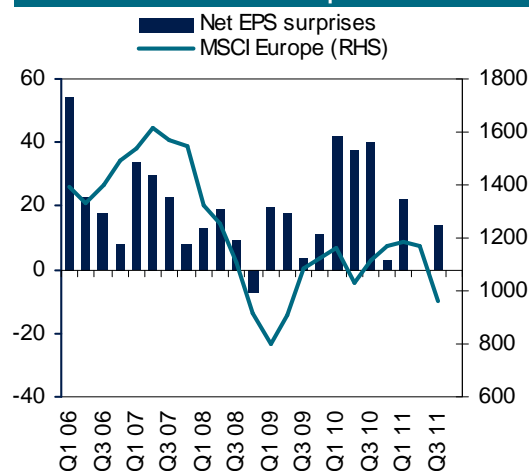
On the positive side, commodities and the euro have already begun to experience a reversal (-18% for the CRB index sequentially in Q3 and -12% in Q4 at end-November, and -2% and -4% for the euro). However, the erosion of sales and the ongoing deterioration in pricing power are likely to continue to have an adverse effect.

This deterioration in current earnings is also likely to be compounded by a rise in restructuring costs. Despite more favourable base effects in terms of commodities and the exchange rate, profit downgrades therefore look set to continue.

“ Profit downgrades look set to continue ”

For the eurozone, which constitutes the epicentre of the crisis, 2012 earnings growth is likely to be at best between 0% and +5% vs. +9% commonly expected. However, if a more severe recession scenario were to materialise, earnings could decline within a range from -10% to -15%.

Net positive earnings surprise & MSCI Europe



Source: Bloomberg, UBS, Datastream, Amundi Strategy

| Q3 2011 Europe | Sales | | EPS | | Q3 2011 USA | Sales | | EPS | |
|------------------------|-----------|------------|-------------|------------|------------------------|------------|------------|------------|------------|
| | YoY | Beat | YoY | Beat | | YoY | Beat | YoY | Beat |
| Consumer Discretionary | 13% | 71% | 65% | 63% | Consumer Discretionary | 11% | 60% | 18% | 68% |
| Consumer Staples | 3% | 56% | 4% | 26% | Consumer Staples | 11% | 58% | 7% | 65% |
| Energy | 28% | 59% | 16% | 50% | Energy | 23% | 60% | 56% | 71% |
| Financials | -8% | 46% | -38% | 38% | Financials | 1% | 51% | 0% | 64% |
| Health Care | 7% | 42% | 13% | 63% | Health Care | 7% | 71% | 7% | 82% |
| Industrials | 3% | 47% | -12% | 42% | Industrials | 9% | 67% | 17% | 83% |
| Information Technology | 4% | 57% | -6% | 53% | Information Technology | 11% | 68% | 16% | 85% |
| Materials | 9% | 56% | -7% | 53% | Materials | 15% | 53% | 31% | 73% |
| Telecom Services | 1% | 36% | -60% | 56% | Telecom Services | 6% | 38% | 17% | 38% |
| Utilities | -9% | 45% | -20% | 50% | Utilities | 2% | 21% | 5% | 76% |
| Europe | 6% | 51% | -12% | 47% | USA | 10% | 58% | 16% | 73% |

Source: Bloomberg, Amundi Strategy

Cross asset investment strategy

Strategy and economic research



Contributors

Editor

Philippe Ithurbide - Head of Research, Analysis and Strategy

+33 1 76 33 46 57

Deputy-Editor

Didier Borowski - Head of Strategy and Economic Research - Paris

Contributors

Marc-Ali Ben Abdallah - Equity Strategy and Global Allocation - Paris

Sergio Bertoncini - Credit Strategy - Milan

Didier Borowski

Rémy Lambinet - Strategy and Economic Research

Delphine Georges - Equity Strategy and Global Allocation - Paris

Philippe Ithurbide

Eric Mijot - Head of Equity Strategy and Global Allocation - Paris

Florian Roger - Head of Macroeconomics - Paris

Stéphane Taillepiéd - Head of Equity Analysis - Paris

Emmanuel Martin - Equity Analysis - Paris

Xiaofei Ma - Strategy and Economic Research - Paris

Thomas Lapeyre - Equity Analysis - Paris

Ibra Wane - Equity Strategy - Paris

DISCLAIMER

Chief editor: Pascal Blanqué

Editor: Philippe Ithurbide

This document may not be reproduced, fully or partly, or communicated to third parties without our authorisation.

Published by Amundi a joint stock company (société anonyme) with a registered capital of 584 710 755 euros. An investment management company approved by the French Securities Authority (Autorité des Marchés Financiers - "AMF") under No.GP04000036. Registered office: 90, boulevard Pasteur 75015 Paris - France. 437 574 452 RCS Paris.

The information contained in this document is not intended for distribution or use by any person or entity in a country or jurisdiction where such distribution or use would be contrary to legal and regulatory provisions, or which would require Amundi and its affiliated companies to comply with the registration procedures of said countries.

All of the products and services may not be registered or authorized in all countries or available to all clients. The data and information in this document is provided solely for information purposes. None of the information contained in this document constitutes an offer or appeal by any member of the Group Amundi to provide investment advice or services or to buy and sell financial instruments.

The information contained in this document is based on sources that we deem to be reliable, but we cannot guarantee that it is exact, complete, valid or relevant, nor should it be considered as such for any purpose whatsoever.