Amundi
ASSET MANAGEMENT

Cross asset investment strategy

Strategy and economic research | monthly

March 2011 - N° 03

Executive summary

1 **All eyes on commodities**

1.1 The commodities shock: what impact will it have on global growth? A $10 increase in the oil price costs the global economy 0.5% in growth, while a 11% increase in food commodities subtracts 1% from global GDP. But the impact varies from country to country…
1.2 Is a new spike in commodity prices in store? The Middle East crisis is stoking fears of a run-up in oil prices to their 2008 highs. But the recent supply-side shock should not mask the key role played by demand.
1.3 "Commodity" currencies and the Dutch disease. Higher commodity prices have triggered such a sharp run-up in the currencies of commodity-exporting countries that they are beginning to hit the manufacturing sector.

2 **The ECB on the verge to hike rates, the Fed No! What impact on the yield curve and on the euro?** The ECB has just flagged a gradual increase in its rates, beginning 7 April. The German yield curve has clearly begun to flatten out. But not yet the US curve, as the Fed, which is hemmed in by its QE2 policy, cannot follow suit any time soon. Hence, for the first time ever, the ECB is preparing to shoot first, before the Fed… and that will drive the euro up.

3 **End of quantitative easing and tensions in the Middle East… the same consequences for risky assets?** The end of quantitative easing and Middle East tensions are factors that are likely to keep risky assets in check and to encourage flight to quality, in this case to government bonds. Along these same lines, look out for an increase in volatility, which is currently low.

4 **Balance sheet normalisation by US residents will curb the increase in bond yields.** The markets are concerned about the impact that the end of QE2 will have on long-term yields. However, they are overlooking the fact that domestic players are, and will remain, big potential buyers of Treasuries. The main ones being commercial banks, which will probably have to move the portion of their assets held in Treasuries back to its long-term average.

5 **Earnings season: solid reports, but signs that margins are topping out.** Several leading indicators are raising questions on market performance in this context. Historically, it has been quite premature to sell in such circumstances. Will this be the case tomorrow?

6 **Emerging equities: how will they withstand the shock?** Fears over inflation and geopolitical unrest have gotten the better of the long rally in emerging equities. In the medium and long terms emerging markets still have much going for them. In the shorter term, a shift in weightings to EMEA (Europe, Middle East and Africa) and away from Asia should mitigate the risks, given the weights of Russia (oil) and South Africa (precious metals) in this index.

7 **Sovereign debt in advanced economies: what impact will it have on emerging markets?** Fiscal austerity is now the watchword in major developed economies and is putting economic activity at risk. However, growth in many emerging economies is still closely tied to their exports to developed economies. Fears of contagion to emerging economies are therefore warranted, but only in part. The real threat there is inflation.

8 **Brisk demand bonds supports strong HY bonds supply: as a result, refinancing risk eased considerably over the next few years.** Heavy issuance volume in the last two years has mitigated refinancing risk considerably for the next three years and improved the outlook on the default cycle. While spreads have narrowed sharply, they are still attractive in Europe for the long term.

9 **Japan: is change in sovereign outlook a dangerous tipping point?** After S&P's in January, Moody's put Japan's debt on negative credit watch in late February. While the ratings agencies' concerns appear to be well-founded, their warnings come at a bad time. But on the bright side, there is no threat of a rise in inflation or bond yields.

Text sent to press on March 7, 2011

More about it

ASSET CLASS	INVESTMENT THEMES and OUTLOOK	Amundi INVESTMENT STRATEGIES
Asset allocation	• The environment remains quite favourable for risky assets, including monetary policy biases that remain highly accommodating and a bright outlook on growth. • Tactically speaking, exposure should probably be reduced because of the Middle East crisis. • Mature economy equities remain the risky asset of choice, as they are attractively priced. Equities currently epitomise this situation, with upgrades in earnings forecasts and yields expected to hit historic highs. • Emerging assets will probably continue to be penalised by inflation dynamics, which are having a hard time stabilising.	• Overweight risky asset classes. • Within risky assets, continue to shift weightings towards equities and away from investment grade credit. • Shift from UK equities to Japanese equities in an environment of increased inflation risk. • Among less risky assets, inflation-linked bonds are preferable to other bonds.
Money markets	• The ECB has flagged an initial rate hike for 7 April. We forecast three rate hikes by yearend. The ECB has no room to raise its rates more aggressively than that. Euribor rose sharply on the news. As the year goes on, the money markets will price in the tightening cycle that we see for 2012. • In the US, however, the Fed cannot begin to raise its rates until QE2 ends, perhaps abruptly, on 30 June. The Fed will probably want to wait to see the impact on long-term yields before it removes the sentence that says it will keep its rates unchanged for an extended period of time.	• The end of exceptional refinancing operations is now set, and that should push Eonia gradually back in line with the repo rate. The profile will probably not be smooth. • We expect the same thing to happen in the US, but later, probably not until summer.
Bond markets	• Normalisation in monetary policies generally comes with a flattening in the yield curve, with the short end rising more than the long one. The German yield curve is already well along in this process, spurred on by the ECB's tougher line. However, the curve's slope is still at historically high levels in the US and will only begin to flatten with a significant shift in tone from the Fed. • Food inflation is at its highest since July 2008 (+34% year-on-year in February), and this is stoking inflation in emerging economies, where food accounts for a large portion of consumer spending. • In the US, regulation and deleveraging mean that a greater portion of assets will be held in the form of Treasury bonds (in particular, by commercial banks and pension funds).	• Despite a run-up in the short-term rates of euro zone core countries, we are maintaining our bear flattening position. • Yields are likely to continue moving up this year in both the US and Germany. • Despite the rise in break-even points, inflation-linked bonds remain attractive, particularly in short segments. • The spread in short-term rates between Germany and the US is unlikely to widen much further. The 2-10-year section now has less flattening potential in the euro zone than in the US.
Credit	• The picture is still credit friendly. Key factors include low interest rates, low inflation, significant corporate deleveraging, cash accumulation, still-attractive credit spreads, very low default rates, and a the strong rebound in profits. • February confirmed January's positive start, until the very recent rise in geopolitical risk	• Stay overweight in high-yield versus investment-grade credit. • Performance should be satisfactory in 2011, but not up to the levels of the last two years.
Equities	• Risks are on the rise, but the investment cycle is still in favour of equities. • The pro-equity arguments of double-digit earnings growth, still-attractive valuations and still-accommodating monetary policies remain valid. • This inflation risk brought on by commodity prices has not thrown this scenario into doubt but could make each of its arguments a little less relevant, by slightly undermining earnings growth (which will nonetheless remain in double digits), by lowering valuations (due to a decline in the quality of growth as margins top out), and given the risk of error in monetary policy • We reiterate our pro-cyclical bias, mainly on the basis of company pricing power. We reiterate our positive view of oil & gas stocks (due to geopolitical tensions and high yields). Yield will come into its own as an investment theme.	• Overweight the US and euro zone • Constructive bias on Japan • Underweight non-euro Europe (which is subject to higher currency and inflation risks) • Don't rush to increase weightings of emerging markets (which are the most affected by the inflation risk and the most dependent on capital flows) • Continue to overweight cyclicals (which benefit the most from earnings upgrades) and energy.
Emerging markets	• Emerging economies' assets remain the most attractive, given their long-term robustness and growth prospects. That said, they may encounter some headwinds from stubborn inflationary pressures. • There is another factor of instability on top of inflation fears: the risk of outflows of non-domestic capital. As the assets are less attractive, that could trigger net capital outflows, particularly in the Middle East, which is currently suffering from serious political unrest. • Dollar-denominated debt dropped sharply before recovering in February. Emerging equities are doing no better, as they are down on the year to date.	• In the meantime, until the positive impact of the current monetary tightening begins to show up in these economies, underexposure is highly recommended to both emerging equities and debt.
Commodities	• The price of oil should remain on a rising trend as long as the current turmoil in North Africa and the Middle East persists. • The rate tightening taking place in most emerging countries particularly in China is likely to weigh on basic metals in the short term. • Gold is benefitting from the rise in risk aversion as well possibly of fears of an upswing in inflation.	• Overweight on the energy sector. • Overweight on gold stocks. • Stay long on soft commodities in a context where supplies remain very tight (risks of a food crisis).
Currency markets	• The euro continued to ride the widening in the two-year yield spread between Germany and the US, which, in turn, is linked to the ECB's new line. The euro will remain strong as long as the Fed does not shift its tone, and that could take several more months… • In European sovereign debt, the risk-return ratio remains attractive on short maturities. All eyes will be on the meetings scheduled for 11 March and then 24-25 March, at which European authorities could step up measures on economic governance and financial solidarity. This could help improve attractiveness, which could cause the euro to overshoot upward. However, a failure in the current negotiations could send the two-year German bonds back down and weaken the euro… • The dollar is likely to remain under pressure, particularly vs. Asian currencies (in countries having heavy current-accounts surpluses and inflation under control). • However, the yen is likely to be an exception. As it is overvalued, it offers little protection against a resurgence in volatility. We do not expect monetary normalisation in Japan until 2012. Yield spreads are likely to continue to play in favour of the dollar/yen.	• We prefer emerging currencies, particularly in Asia, given their connection to the gradual strengthening expected in the RMB. • Commodity-linked currencies will probably remain strong, even though they now looked overvalued (the Brazilian real, in particular). The latter continues to be supported by very attractive carry trade opportunities. • Scandinavian currencies and the dollar offer good protection against a worsening in the sovereign-debt crisis.

Introduction

The past month confirmed a number of trends or existing risk factors, but the Middle-East crisis, a complex and uncertain situation that cannot be overlooked, has blurred the overall message. One of the main lines of attack of the month concerned commodities. Like all other risky assets, commodities at first benefited from growth, demand from emerging markets and excess liquidity in the market, etc. but also, very recently and at least for some of them, from rising tensions in the Middle East. The price of Brent crude oil accordingly jumped 15% in January, returning to levels unseen since the Lehman Brothers bankruptcy and gold rose to historical highs ($1,445 an ounce on March 7) before easing slightly. In section 1, we will return to discussing soaring commodity prices, the potential impact on growth, fears that they will spiral further and the “Dutch disease” that now threatens Brazil.

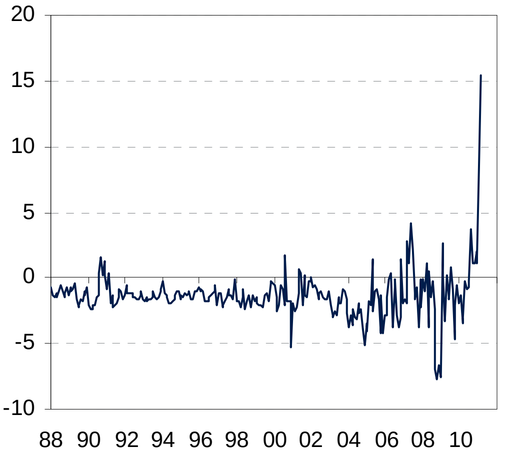
Food inflation has become a central concern, exacerbated no doubt by the unrest in the Middle East. It is difficult not to draw a link between Middle-East tensions and food inflation, as they “feed” on each other, so to say. Inflationary pressure are very real in a large number of emerging markets, whereas they are not yet really a concern in advanced economies. Admittedly, forecasts reflect higher headline inflation in 2011 and 2012 than in previous years, but the turnaround remains moderate. However, the monetary policy response diverges on both sides of the Atlantic. In the US, the Federal Reserve would tend to take into account the erosion of growth on the back of surging oil prices. Conversely, in the eurozone, the ECB fears rising inflation. In other words, recent spiking oil prices would tend to prompt the Federal Reserve to wait it out, whereas it would exacerbate normalisation of monetary policy in the eurozone. On the one hand, this may be good news insofar as it would accompany an improved financial and macroeconomic situation in the eurozone. On the other hand, since normalisation of monetary policy has been carried out in a piecemeal fashion, the price to pay will be an excessive rise in the euro…

However, the good news is that for the time being, growth remains firmly entrenched in the US (the ISM indices – manufacturing and services – rose to their highest levels since May 2004 and September 2005 respectively), underpinned further by household spending. Consumption ensures growth while investment drives growth as they say. Under these conditions, quantitative easing – as a first step towards normalisation of monetary policy in the US (see sections 2 and 3) – will seemingly end in June 2011 according to plan. This decision is widely anticipated. The Fed’s biggest challenge is its communication. We only have to recall the goals of quantitative easing: **(1)** to provide financial markets with liquidity and keep interest rates low; and **(2)** to support risky asset classes, which saw the decision as a promise to maintain low interest rates over a long period of time, a willingness to favour growth “at any price” and the possibility of investing at less risk in said “risky” assets, such as equities, debt, emerging market assets, commodities, etc. Granted, these asset classes benefited from solid fundamentals at the same time, but quantitative easing lowered risk aversion which, subsequently, implied a rise in long-term rates, despite massive treasury buybacks by the Fed. In other words, it is a paradox that the end of quantitative easing, coupled with Middle East tensions may actually turn out to be good news for the government bond market!

> *“Global inflation is picking up, but growth is holding back”*

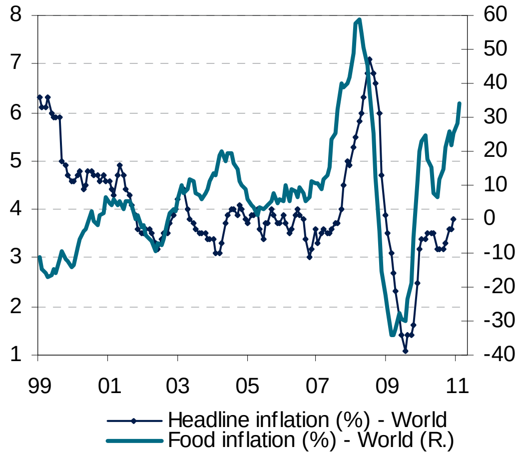
Even if geopolitical tensions are settling down rapidly and QE2 is ending, a bond crash in 2011 is unlikely, as feared by some. First of all, the Federal Reserve will adopt a prudent normalisation policy. Second of all, US citizens will probably continue to buy massive amounts Treasuries, as the portion of their assets held in Treasuries remains too low. In other words, balance-sheet rebalancing will continue to contain the rise in long-term rates in the US (see section 4).

The spread between the Brent and the WTI ($ pb) partly reflects the geopolitical risk



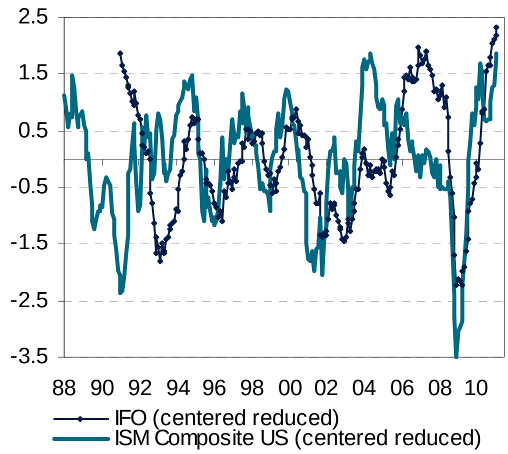
Source: Datastream, Amundi Strategy

The rise of food prices pushes up headline inflation



Source : Datastream, Amundi Strategy

Business surveys close to their peak on the both sides of the Atlantic



Source : Datastream, Amundi Strategy

In Europe, growth remains solid as well but with persistent significant divergences between countries, attributable to: **(1)** on the one hand, some countries (so-called "peripheral" countries) are forced to adopt budgetary and fiscal discipline on account of their public finances and the requirements of the countries and international organisations that came to their rescue; **(2)** on the other hand, some countries (Portugal, Ireland, or even Spain notably) need to reinvent their growth model. The lack of competiveness or a growth model based on debt and real estate ran its course and growth collapsed. These divergences are not bound to disappear rapidly.

Furthermore, the progress made by European countries to find sovereign debt crisis solutions is noteworthy. Admittedly, the solutions have yet to be adopted, but the lull in debt markets demonstrate that, at last, financial markets are starting to accept that solidarity between countries of the eurozone remains the strongest scenario. Is the lull justified or is it too optimistic? We will have an answer in late March and the ball will be in the court of European governments. It should be kept in mind that finding solutions for future debt issues is very important but finding solutions for existing debt issues is no doubt more urgent. Until now, governments have been more preoccupied with the future (what will happen after 2013) and have ignored the present. Bond holders expect the opposite in late March and are probably wrong to do so!

> *Historical month for Europe? Beware of the ides of March!*

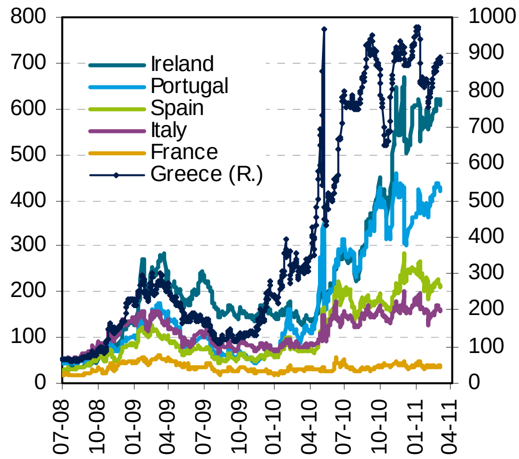
Moreover, expectations should not run too high on the March announcements. First of all, because the inclusion of the infamous collective action clauses (CAC) in bonds contracts is unlikely to diminish the financing costs for governments. It is the first time that a device of this nature will be deployed in a monetary union, where an adjustment using currencies is impossible by definition. Under these conditions, there is no guarantee that government bond yields will not remain too high in view of fundamentals, rendering interest expenses unsustainable. It is up to private creditors to correctly assess the risk incurred.

But the cost of financing of government bonds threatens to grow, if consolidation plans are not deemed credible by investors. It will take time for these to get used to the new climate. And it is highly probable that, given the uncertainty, they require – at least at first – risk premiums that are too hefty for governments in difficulty. March will be full of announcements. Expectations for a sudden improvement in peripheral debt appear to be too soon in our opinion. On the other hand, if as we expect "the worst is behind us", the ECB will be able to take advantage of the lull to raise rates sooner than expected. In his speech on March 3, Mr. Trichet implicitly indicated an initial increase in rates on 7 April. The ECB will shoot first, before the Fed, for the first time in its history (see section 2).

In another vein, it was important to identify the channels for transmission between the austerity imposed by the deterioration in the sovereign debt of advanced economies and growth of emerging markets. One of the most visible risks may be a real appreciation of their currencies, without a major prior impact on growth (section 7).

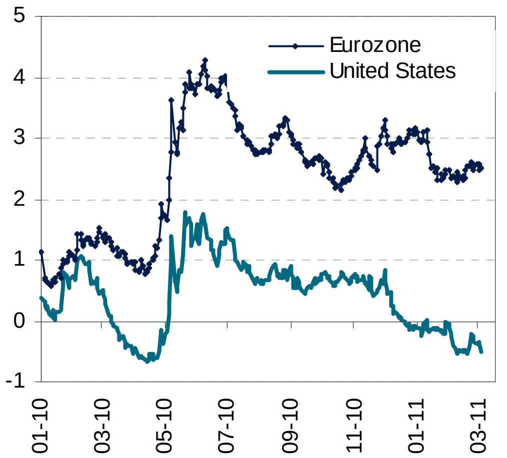
The good news is the fact that "risky asset" markets are holding up rather well. Only the long rally in emerging markets will have not withstood inflation fears and geopolitical risks partly associated with the recent period (section 6). It is another story for Japan, whose economy is less likely to be affected by inflationary pressure and interest rates cannot rise for the time being (section 9). Last, our financial stress measures in the US and eurozone have barely climbed on events in the Middle East. Despite the slight correction, equity markets remain underpinned by the strength of earnings (section 5), as well as High Yield bonds, a sector for which supply and demand conditions remain upbeat (section 8). Ultimately, if oil prices stop increasing, we anticipate these trends to persist but at a more modest pace. In sum, we should not be overly optimistic or pessimistic.

Sovereign spreads with Germany (10y)



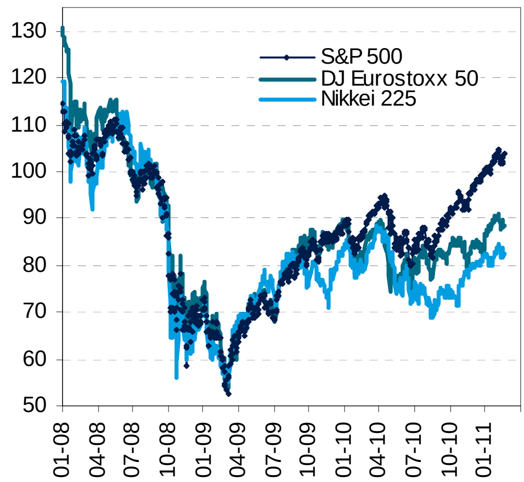
Source: Datastream, Amundi Strategy

Financial stress: Eurozone vs United States



Source: Datastream, Amundi Strategy

G3 equities market (100 = 1 Sep. 2008)



Source : Datastream, Amundi Strategy

1.1 Commodity price shock: what impact will it have on global growth?

The emerging world is dynamic, productive capacity is saturated, central banks are injecting even more liquidity, and now geopolitical troubles have erupted – and all these factors have sent commodity prices soaring over the past year. There may be many effects on the economy.

A tax on global growth

In accounting terms, a rise in commodity prices implies a revenue transfer from import-oriented economies to producer countries. But the consequences of such a transfer are not neutral. Blanchard [1] shows that oil shocks have had a highly recessionary impact over the last 40 years, because the commodity price curtails consumers' buying power and corporate margins and thus behaves like a tax on the vast majority of global final demand. According to our calculations, on the planetary scale, the oil bill represents 4.6% of GDP.

A $10/bbl price rise thus costs 0.5% of global growth**.** In the same vein, regarding the weight of food components in consumer price indices worldwide, an 11% increase in prices of food commodities could imply a 1% reduction in global GDP. Important as these figures are in weighing up economic consequences, they must naturally be interpreted with care, because many countries administer or modulate market prices (through floating-rate taxes and the like) to limit their effects on domestic demand. Further, these ratios are easy enough to read and plug into calculations, but they mask the economic interactions. We need to consult general equilibrium models to get the full picture. And beyond estimated averages, it is important to sort out the effects on particular countries.

> *A $10/bbl price rise thus costs 0.5% of global growth*

A weighty impact on US consumption

An oil price rise has a larger impact on the economy of the USA than Europe, because the US uses oil more intensively. In 2009, oil consumption represented 3.6% of US GDP, compared with 2.3% for the European Union. The impact may be even greater because of exchange rates, as at present.

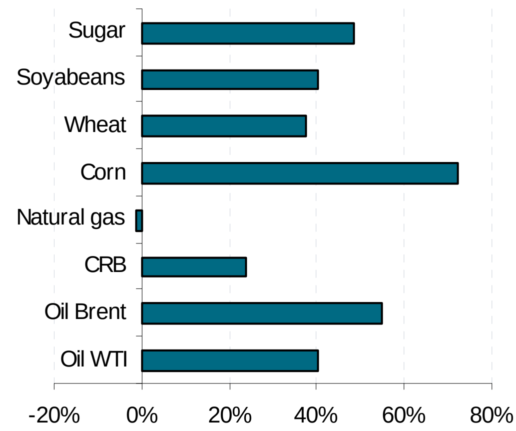
In the US, a 10% increase in petrol prices raises the total oil bill by $40 billion and reduces consumers' buying power by 0.4%. Over the past six months, prices for WTI and Brent crude have leapt by 39.8% and 52.1% respectively, sending pump prices up 22.3% (from $2.70 to $3.30 per gallon). If petrol prices stay at the current level, the US consumer will lose 0.9% in buying power. The effects of the tax package passed in December will be more than halved. When the tax-cut deal was announced, the consensus revised its consumption growth forecast up +0.5% (from 2.7% to 3.2%). But now the risk is clearly of a downside correction trimming the estimate to slightly below 3%. The final impact will largely depend on wage trends, i.e. acceleration of job creations and second-round effects on wages in the months ahead. Typically, the impact of an oil shock on growth peaks 12 months after the shock and lasts for 24 months (Blanchard and Gali [1] and Sill [2]). In any event, under current conditions, even though GDP growth estimates need to be adjusted slightly downward, the US economic picture remains favourable overall.

> *The US consumer will lose 0.9% in buying power*

[1] The Macroeconomic Effects of Oil Shocks: Why are the 2000s So Different from the 1970s? Blanchard, Gali – NBER Working Paper 2007

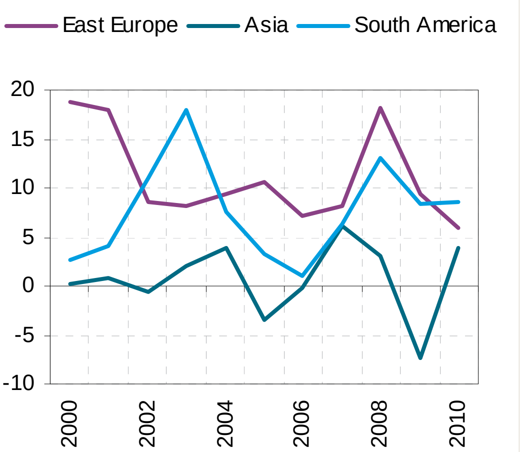
[2] The Macroeconomics of Oil Shocks; K. Sill – Federal Reserve Bank of Philadelphia Business Review Q1 2007

Change in commodity prices (6 months)



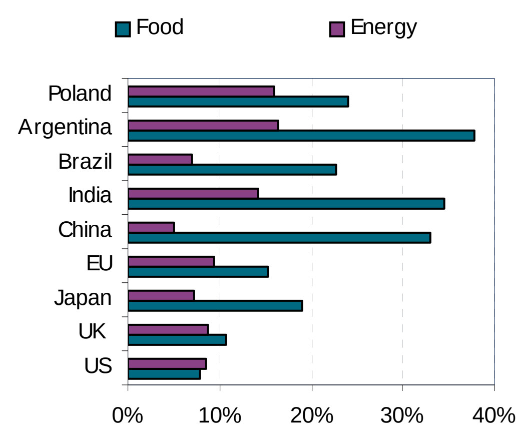
Sources: Datastream, Amundi Strategy

CPI food and beverage



Source: Datastream, OECD, Amundi Strategy

Weights in CPI



Source: OECD, IMF, National statistical institutions, Amundi Strategy

The shock makes emerging countries even more disparate

The term "emerging" takes in ever more disparate countries, in terms of their growth and economic importance. A durable commodity price shock can magnify these differences. First of all, the effects on the country's current-account balance are diametrically opposed, depending on whether or not the country is a commodity producer/exporter. Second, consumption varies considerably, as seen in the weights and fluctuations in the food and energy components of consumer price indices (see graphs). Over a period of one year, the food and beverage CPI rose by around 6% on average in Eastern Europe compared with around 4% in Asia and 8.5% in South America. These figures indicate that a price rise for food commodities has more impact on domestic demand in South America than in Eastern Europe or Asia.

Finally, the commodity shock may lead to geographical rotation. Global growth estimates may need to be revised slightly downward, but for the time being our central scenario of durable recovery is not challenged. However, the shock may encourage central banks to change their exit strategies.

Box 1: Monetary policy and core inflation: when the Fed and ECB disagree…

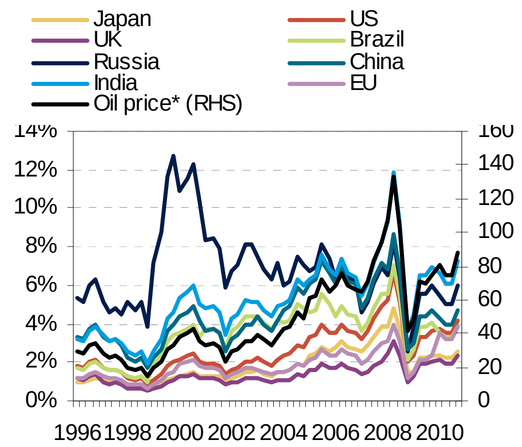
We generally define core inflation as a rise in the Consumer Price Index less food and energy. Often central banks prefer to use this adjusted index to gauge underlying pressures on prices in determining their monetary policy. This tradition is due to the fact that, in the past, price fluctuations in food and energy often turned out to be volatile but not indicative of a trend, with their impact on the price index dissipating over time. Stripping out temporary fluctuations provides a more accurate picture of underlying inflationary pressures.

Distinguishing temporary fluctuations from persistent trends in price changes is key. As tightening monetary policy on account of temporary price increases would be counterproductive. On the other hand, not taking account the upward trend in energy prices may lead to underestimating "actual" core inflation, insofar as sooner or later producers will factor in energy prices into their selling prices and salaries will eventually rise.

The debate on the good measure of core inflation recently took centre stage once again, owing to divergent interpretations on both sides of the Atlantic. Accordingly, for the Federal Reserve's members, excluding food and energy from the calculation correctly captures core inflation. The limited level of inflation excluding food and energy in the US (+1.0% over one year in January) and ongoing rampant unemployment have led them to believe that inflationary expectations will not slip. Whereas ECB members consider that core inflation is underestimated in doing so.

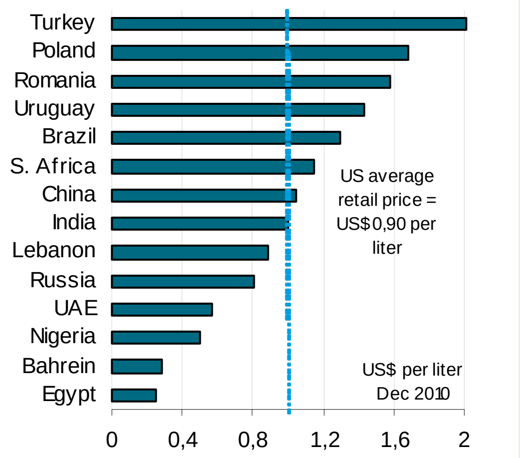
The implications for monetary policy may be massive, especially when energy prices rise sharply. In the US, the recent rise in oil prices, to the extent that it is the result of the Middle-East crisis, will tend to be interpreted as a temporary supply shock more likely to hamper growth than boost core inflation. Accordingly, pressure on overall inflation will not be deemed as a factor that is likely to speed up normalisation of monetary policy. In fact, the exact opposite is true. Conversely, within the ECB, monetary authorities will tend to worry about inflationary pressure that may ensue at the present time. Diverging conclusions that are likely to have implications for monetary policy, with the ECB once again having to be more restrictive than the Federal Reserve and could lead it to tighten its monetary policy before its US counterpart—which would not be a bad idea for once.

Oil burden, by country
% of GDP



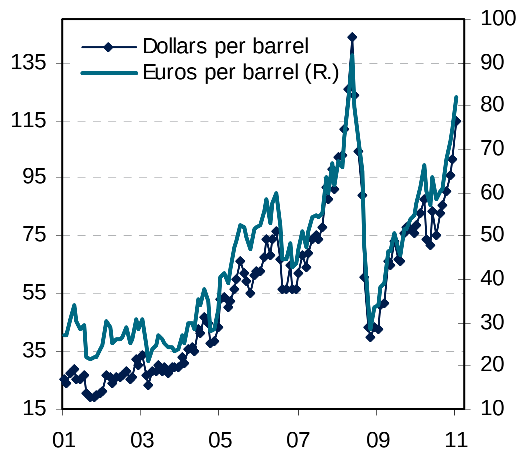
* Real prices, Q4 09 = 100
Source: Datastream, Amundi Strategy

Average retail gasoline and diesel price



Sources: Amundi Strategy

The oil price in euros is close to its peak!



Source: Datastream, Amundi Strategy

1.2 Another 2008-style commodities flare-up?

Commodity prices have been in an almost uninterrupted bullish trend since January 2009. The only hesitant moments were at the peak of Europe's sovereign debt crisis, in May 2010. Ever since, a divergence has opened up between prices for basic materials and crude oil. Basic materials have returned to their highs, but crude prices have continued to fluctuate around $80/bbl, far from the stratospheric levels of 2008. The winds of revolt sweeping through the Middle East and North Africa are stirring up fears that prices may return to those earlier peak levels. Understandably, current anxiety in part reflects the possibility of the first partial supply disruption for hydrocarbons since the Iraq conflict erupted in 2002. This is not the best time for these tensions to surface. Emerging economies are already grappling with inflation in food commodities, and are not welcoming imported inflation via oil prices. And the oil price rise hits emerging economies every bit as hard as mature ones. The risk is that the world's main central banks carry out synchronised monetary tightening under these conditions.

In this environment, the crucial question is how much the current price trajectories reflect fundamentals of global growth. The answer depends on where current marginal demand is strongest – namely, in China.

> *The market focuses its worries on supply*

By straightforward investigation we can readily see that a crude oil price in the neighbourhood of $120/bbl and a copper price above $9,000/tonne are consistent with the past decade's growth in China's oil and copper imports, respectively 17% and 8% annually. However, in the near term, we must also factor in the tricky questions of supply that are of vital importance for these two commodities (see box 2 on copper supply constraints). Given that average volatility of both commodities is around 30%, a copper price above its psychological threshold of $10,000/tonne does not appear at all excessive, nor do crude prices again flirting with $150/bbl.

Box 2: Copper at historical highs, supply constraint remains an issue

LME copper hit a record high of $10,190/t in February 2011 (vs $7483/t in 2010 on average and compared to a marginal cost of $4800/t) on a lower-than-expected Chinese CPI and strong data on China's imports (refined copper up 6% m/m in January). China accounts for 38% of global copper consumption and 50% of incremental demand for the next 5 years.

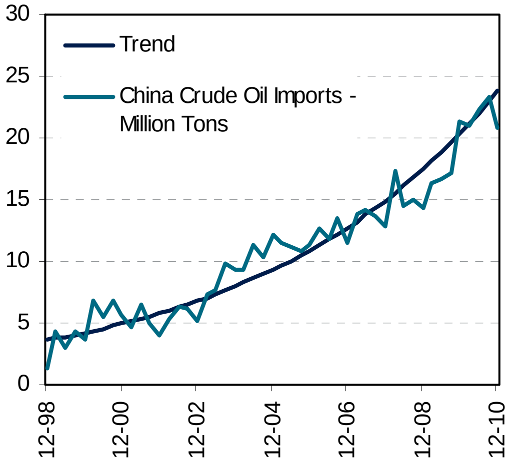
This elevated price reflects a tight physical market with a deficit expected to last until 2012 at least. The current price level has also been supported by financial investment in commodities via a commodity index fund (total value ~$250bn at end 2010, of which close to 7% invested in copper) and physically backed ETFs, forecast to absorb 60% of LME inventories if all of them are launched.

The challenge to supply growth will be a key driver of copper prices in the short and medium term as production growth will be constrained. This view has solidified following five years of underperformance relative to plan, resulting from myriad supply disruptions representing 560kt/y since 2002 or 4% of global production.

A continued strong copper price environment is driving expansion activity and substitution, so over the long term the price will not remain at current levels, since more production capacity will be added from Africa (Congo, Zambia), Latin America (Chile, Peru, Brazil and Mexico) and Asia (Mongolia). Market consensus expects copper prices to hit a peak in Q4 11 at $10,000/t on average over the quarter (average 2011 $9700/t), followed by $9800/t on average in 2012 and to decline in 2014 to $8190/T. In the short term, the price will remain volatile due to continued worries about inflation, further monetary tightening in China and its impact on final demand.

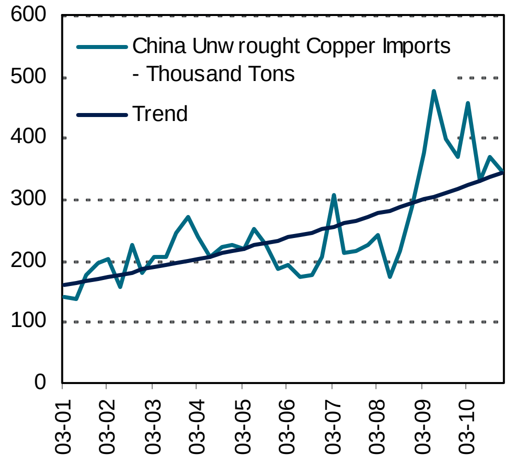
However, we must be careful how we use historical trends, for two reasons. In the first place, it is always dangerous to base an argument on trends when it is really a matter of a change in the growth regime, as in the case of China. Second, the supply-demand aspects are only critical in determining average prices over the long term. These factors may vie with others to explain the short-term volatility of commodity prices. In fact, what sets commodities apart is essentially a duality. At one and the same time, they are utilitarian industrial goods and real assets linked to a broad spectrum of other assets, from futures contracts of various maturities to sector companies' shares. This singular property gives

Trend of Chinese crude oil imports



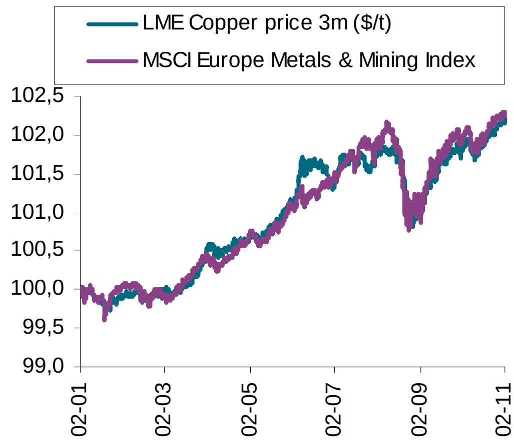
Source: Bloomberg, Amundi strategy

Trend of Chinese copper imports



Source: Bloomberg, Amundi strategy

Performance Metals & Mining Index vs LME copper price (rebased to 100: 02/2001)



Source: Datastream, Amundi Equity Research them a special status: that of assets whose prices are particularly sensitive to the growth outlook as well as inflation. This property may be used with care to estimate the equilibrium value of a commodity such as oil. In the absence of known future cash flows associated with holding an asset such as a commodity futures contract, an equilibrium price is always difficult to pinpoint [1].

By exploring the relationship between commodity prices and global money supply, approximated by the total foreign reserves, it is possible to identify an equilibrium relationship: the two series' movements follow correlated trends. One could argue that the explanation resides in the accumulation of reserves by commodity-exporting countries, except for the fact that emerging Asia is accumulating foreign currency reserves at a much faster clip. China is the economy that typifies this currency strategy.

This connection between oil price fluctuations and global money supply is symptomatic of a completely different phenomenon: the scarcity of assets that provide a hedge against inflation in emerging economies. Certain investors, particularly in emerging economies, have no alternative but to rely on commodity-linked assets to hedge against domestic inflation risk.

> *"Other factors must be weighted – liquidity conditions, for example"*

Are we dealing with a devillish mechanism in which rising commodity prices feed surplus demand motivated by inflation hedging? Fortunately, no. Central banks in emerging economies are the only powers that today have the power to choke off global inflation risk. Their currency stability strategy makes it incumbent upon them to arbitrate, either in favour of capital flows or more specifically domestic objectives, such as fighting inflation. On this front, central banks certainly appear to have chosen to refocus on the second option. China's Premier Wen Jiabao recently announced that in the Chinese government's forthcoming five-year plan for 2011-2015, the annual growth objective is set at 7% compared with 7.5% for 2008-2010. This is an example of the mindset of policymakers in these economies: domestic factors will definitively trump external ones.

[1] Ordinarily, this is done by stating that the current price is equal to the present value of the sum of all future cash flows.

Box 3: Price difference between Brent and WTI

The price difference between for Brent crude quoted in London and West Texas Intermediate (WTI) quoted in New York has a fairly simple explanation, namely that two products differ intrinsically in quality. The better-quality WTI has commanded an average $1.20/bbl more than Brent since 1987. However, wide gaps exist during some periods. Recently the difference reached an all-time high of $16.20, well above its historical average.

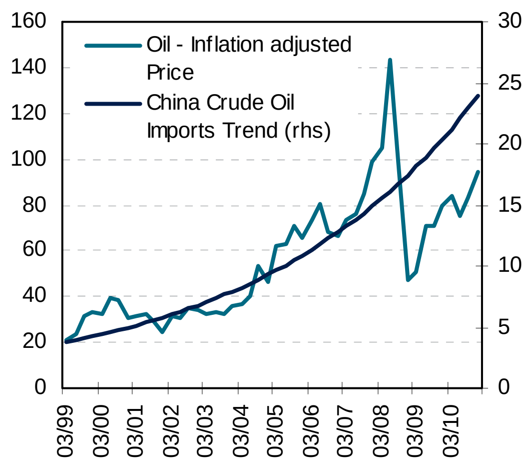
As shown in the 1st graph, the main explanation for this difference in the quotes is the level of oil stocks in Cushing, Oklahoma. Cushing is the largest US oil terminal, the distribution point for oil arriving in the USA from the Gulf of Mexico. The higher the number of barrels stocked there, the more Brent appreciates against WTI.

Larger stocks mainly reflect a rise in output following the opening of two new pipelines linking the Gulf of Mexico to the Midwestern states. As the 2nd graph page 9 indicates, WTI production has clearly been on the rise since 2008, but production of Brent has fallen continuously since the early 2000s.

US oil consumption forecasts, proxied by the number of new vehicle registrations lagged five months, seem to have stalled and be moving sideways. An increase in the number of newly registered vehicles would boost oil consumption and thus trim the Cushing stocks.

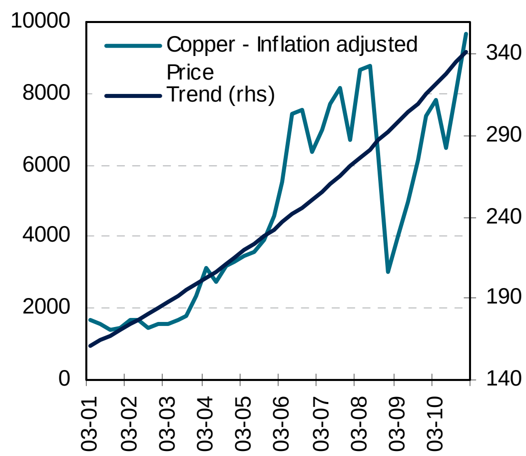
Automobile registrations rose in December, indicating that Cushing oil stocks should start to dwindle in April 2011. At the same time, the price difference between WTI and Brent should return to normal levels.

Oil Price and Oil Chinese Import Trend



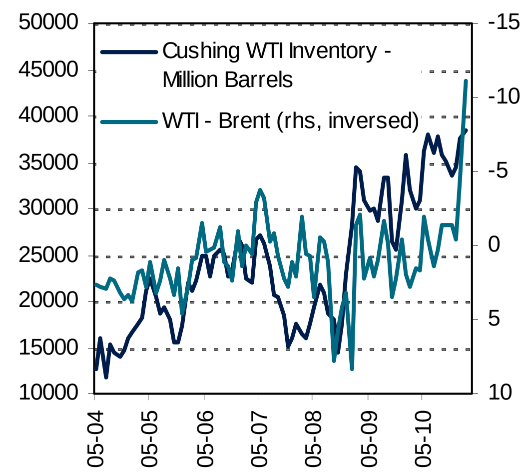
Source: Bloomberg, Amundi strategy

Copper Price and Copper Chinese Import Trend



Source: Bloomberg, Amundi strategy

Cushing WTI inventory and Price Difference between WTI-Brent



Source: Datastream, Amundi strategy

Box 4: The gas bubble deflates, slowly

The "gas bubble" that began with sliding spot prices in mid-2008 started when a crisis-induced drop in gas demand met a jump in available supply, especially of liquefied natural gas (LNG) and unconventional gas.

Despite some delays in bringing new LNG supplies online, global production capacity rose nearly 30% in 2009-2010 and should increase by another 8% in 2011.

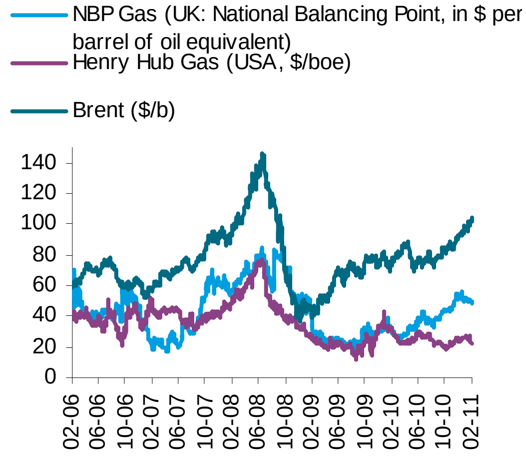
So-called "unconventional" gas is divided into three categories: "tight gas" (poor-quality gas from traditional sources), coalbed methane (CBM) or coalbed gas, and shale gas, which is a truly new type. Shale gas is found in "parent rock" that has formed gas pockets through its maturation process. Thus, the gas has not migrated. It is developed using advanced drilling techniques that require large quantities of pressurised water to fracture the parent rock. These reserves have long been known to exist, but only recent technical progress has made their large-scale development possible.

In the US, shale gas production has undergone a veritable explosion. Shale gas accounted for 42% of US production in 2007, and should approach two-thirds by 2020. In combination with conventional gas, this production is enough to make the US practically self-sufficient for several decades. The US market is likely to remain in a substantial surplus at least through 2011, keeping downward pressure on spot natural gas prices. The current price of less than $4/MMBtu (Henry Hub reference contract) corresponds to an energy-equivalent oil price (Brent) around $22/bbl., less than one-fourth of parity with the market.

Europe's situation is very different. There is less potential for unconventional gas development. Europe imports a large volume of LNG and will import even more in future, because increases in gas imports via pipelines from Russia will not be enough to keep up with increasing consumption and the decline in North Sea production. In recent months, European spot gas prices have recovered. They have had support from stronger demand, slowing LNG imports and a rather surprising discipline on the part of major producers (Gazprom and Statoil, as well as Qatar). Spot prices are now around $8.4/MMBtu, on an energy-equivalent basis close to 50% of the Brent price. The medium-term outlook remains very favourable for global natural gas demand, with support from growing electricity demand and the specific advantages of this form of energy in terms of costs and environmental constraints.

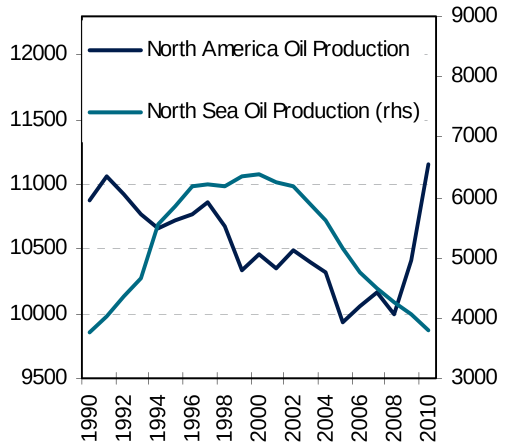
There is reason to expect the gas bubble to decline gradually in the years ahead. Trends in spot prices should begin to pick up in 2012.

Gas prices vs. Oil price



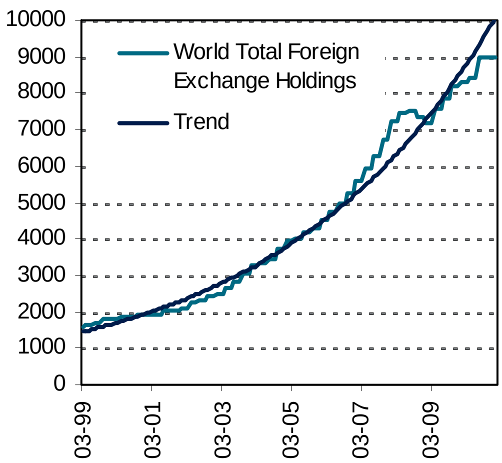
Source: Datastream, Amundi Equity Research

Crude Oil Production – Thousand barrels daily



Source: BP Statistical Review, Amundi strategy

World Foreign Exchange Reserves – Billions of USD



Source: Datastream, Bloomberg, Amundi strategy

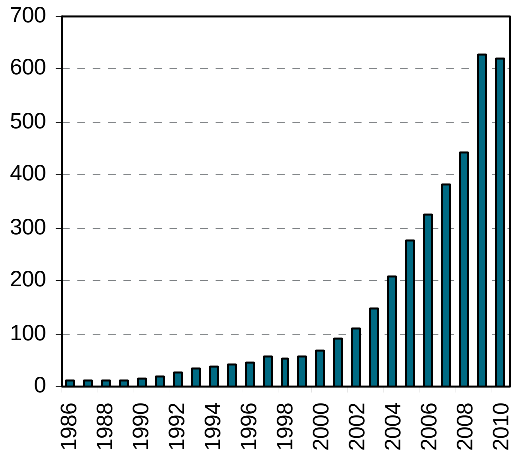
1.3 Commodity currencies and the Dutch disease

The impact of rising prices for commodities such as iron, coal, oil and gold, etc. is not confined to faster inflation. The currency exchange rates of commodity exporting countries are also directly affected, since export revenues automatically increase and rising demand for the currency causes it to appreciate. Theoretically, if the commodity price rise is structural, it brings about a lasting increase in the terms of trade (the ratio of a country's export prices to its import prices), which warrants a rise in the currency's equilibrium value. This is what happened in the 2000s, when demand for commodities intensified. For example, China's imports of iron ore and coal for steel production accelerated sharply (see 1st graph). The link between commodity prices and exporting countries' currencies therefore strengthened considerably over the last decade (see graph 2). The market plunge in late 2008 led to a simultaneous fall in prices for oil, metals and so-called commodity currencies such as the Australian, New Zealand and Canadian dollars and the Brazilian real. But since then, commodity prices have rebounded briskly on steadily strengthening Asian demand. More recently, the global liquidity surplus has lifted prices even higher (see section 3). Prices for metals such as tin and copper have soared past their record 2008 levels. This has put severe pressure on commodity-exporters' currencies, hence their steep appreciation (the Australian and New Zealand dollars have risen by around 55% against the US dollar since March 2009).

Could it be that the "Dutch disease" is threatening commodity exporters such as Australia, Brazil and New Zealand? The term denotes the negative effects of commodity-induced currency appreciation on manufacturing. The rising currency inflicts real damage on traditional industries' price competitiveness: local firms can import capital goods more cheaply but can no longer export them. These sectors face potentially heavy job losses. Clearly, the "Dutch disease" has already infected some countries. In Australia and Brazil, manufacturing export volumes are still about 20% lower than their pre-recession levels. In contrast, commodity export volumes were scarcely affected by the crisis and continue to climb (see graph 3). However, the two countries' governments reacted very differently – rightly so, because manufactured goods make up the bulk of Brazil's exports (more than 70% by value until 2007) whereas they have never accounted for more than 30% of Australia's exports over the last two decades. The real's very strong appreciation starting in 2007 dealt a severe blow to the Brazilian manufacturing sector, which at the start of 2011 represented barely 50% of exports by value. Employment in the sector has not even recovered to pre-crisis levels, unlike in the mining sector. At this point, it seems that Brazil's authorities are seeking to limit currency appreciation mainly through taxes on portfolio investments abroad. On the other hand, Australia seems unfazed about the run-up in its currency. In fact, the central bank welcomes it as an effective weapon against inflation.

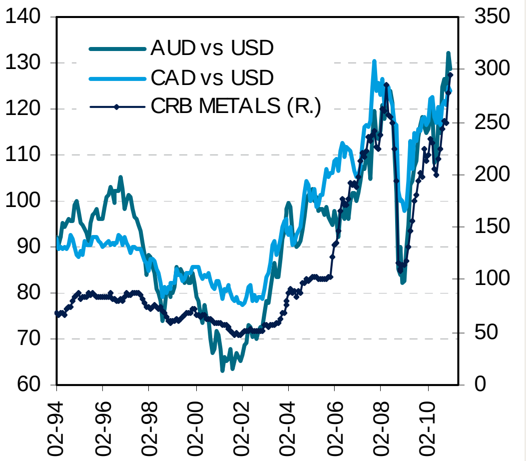
The recent oil price rise naturally prompts questions about the future course of commodity prices. Interestingly, metals prices did not join in the rally. Current oil prices do not reflect a demand shock, but rather the fear that the crisis in Libya and the Middle East will disrupt supply. If this movement continues, however, it may threaten emerging countries' growth, potentially causing demand for other commodities to fall. In short, this is not a good time to bet on further appreciation in these currencies. Our valuation models indicate that they are slightly overvalued at current commodity price levels.

China: iron ore imports (in millions tons)



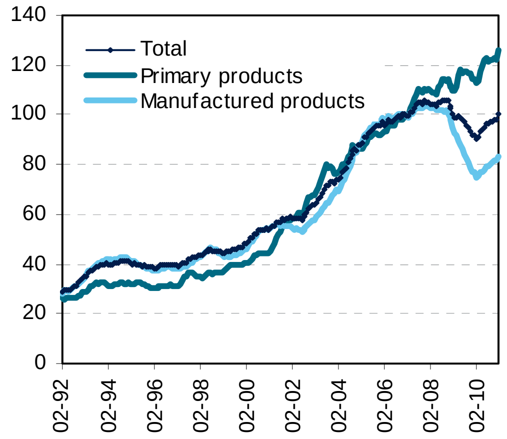
Source: Datastream, Amundi Strategy

Commodity currencies and metals price (basis 100 in January 2005)



Source: Datastream, Amundi Strategy

Brazilian exports in volume (basis 100 in 2006)



Source: Datastream, Amundi Strategy

2 The ECB on the verge to hike rates, the Fed No! What impact on the yield curve and on the euro?

Against all expectations, the ECB just “pre-announced” an imminent rate hike. In its 3 March communiqué, the ECB President called for “strong vigilance” on the inflation risk. This wording is not neutral. When Jean-Claude Trichet uses such phrasing, he is signalling to the market that the ECB intends to raise its key rates the following month. This announcement follows on the harder line taken by ECB members since January. However, the timing surprised the markets, as not all the conditions were satisfied.

So why? By doing so, the ECB seeks to regain control and to refocus on its main mandate, the price stability. The objective is to anchor inflation expectations amidst a run-up in commodity prices. In 2010, the ECB was in a way held hostage by the dissensions of Eurozone countries and had to stray from its strict mandate in order to deal with market tensions induced by the sovereign debt crisis. Those days are over.

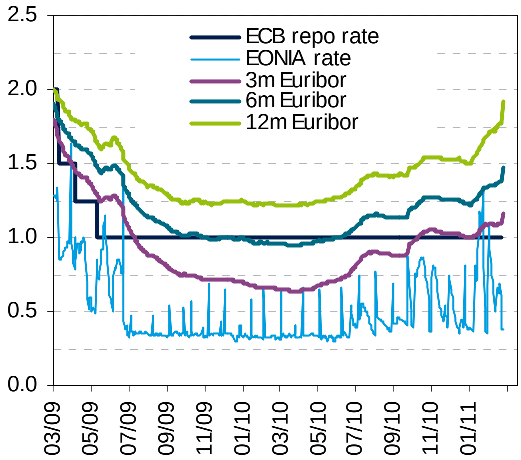
Is Europe facing an inflation threat? It is true that it is accelerating but there is no cause for alarm. The ECB raised its inflation projections for 2011 and 2012 from +1.8% and +1.5% to +2.3% and +1.7%. But these forecasts are based on the assumption that the oil price remains constant at $100 per barrel (that is to say 15 % below the current level). According to the ECB staff’s projections, inflation is likely to exceed its target in 2011 but then fall back towards it. The labour market remains weak in many countries and wages are thus unlikely to rise. In other words, the emergence of knock-on effects from rising commodity prices is not on the agenda and core inflation is therefore likely to remain under control. Moreover, M3 trends would not seem to suggest that credit aggregates are out of control. With respect to these criteria, the ECB might therefore seem to be acting prematurely. However, keep in mind that the ECB rather monitors headline inflation than core inflation (see Box 1). The recent surge in oil price may encourage the ECB to advance the timing. Most importantly, by flagging a rate hike in early March, the ECB is putting pressure on European governments to achieve credible and sustained solutions for the future of Europe. From this point of view, the European Council meetings of 11 and 24-25 March will play a key role (see box 5). With less turbulence in sovereign debt markets, the ECB implicitly reminds its doctrine: fiscal and governance issues should not be addressed by a monetary solution in the long run...

That being said, the ECB stays pragmatic. At the same time, to keep money-market interest rates somewhat in check, the ECB has announced that it will keep its full-allotment refinancing in place until 29 June and that rates will be raised only gradually. Because of persistent difficulties on the fiscal and banking fronts, the ECB cannot hike rates aggressively. This is all the more true that growth remains close to its potential, and that, as a result, the output gap remains wide.

And there is no doubt that the ECB will display pragmatism if fiscal stability mechanism talks were to fail. In order to maintain financial stability, the ECB would postpone the flagged rate hike without losing its inflation-fighting credentials as it has just showed the market how determined it is in this area. However, if significant progress were made on fiscal policy and if the global economy did better than expected, the ECB would certainly be proud to have, this time, showed the way to the other main central banks. Meanwhile, the careful statement of Jean-Claude Trichet mentioning that the ECB was not undertaking a tightening cycle aims at reassuring the markets by suggesting that rate hikes will be spread out over time ... With key rates at 1%, it is hard to imagine that the ECB is in a mere fine-tuning mode: an isolated rate hike would be meaningless. Recall that the ECB President said the same thing in December 2005, before a 200bp tightening cycle that lasted 18 months.

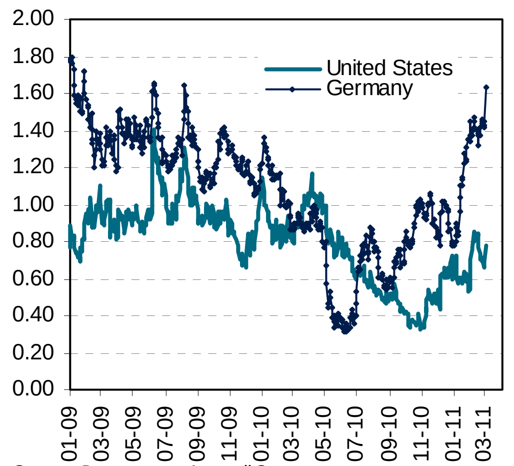
> *“Above all, the ECB is seeking to take the lead and make governments face their responsibilities head on”*

Money market rates on the rise in Europe



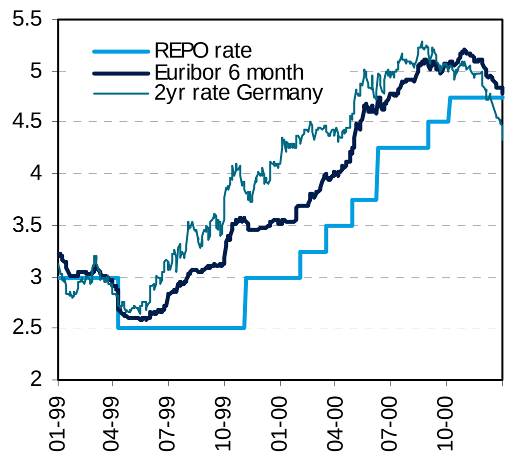
Source : Datastream, Amundi Strategy

Rapid rise of short term bond yields in core Eurozone countries



Source: Datastream, Amundi Strategy

ECB tightening cycle: 1999-2000



Source: Datastream, Amundi Strategy

Against this backdrop, we now anticipate that the ECB will raise rates by 25bp three times before the end of 2011, with the first hike most likely on April 7. The Bank of England should follow the ECB but we continue to expect the Fed to maintain the status quo about the Fed funds this year.

But monetary policy normalisation does not only refer to when central banks raise their key rates. Attention should also be paid to unconventional measures taken by central banks. And on this front, the Fed has been much more proactive than the ECB, with outright purchases of Treasuries (QE2). The table below outlines the different phases that will lead to full monetary policy normalisation on the both sides of the Atlantic.

In the case of the Fed, this means ending the QE2 programme without creating a financial shock. Once this phase is over, the Fed will be able to normalise policy by hiking rates. The last phase will be to cleanse the Fed's "toxic" balance sheet of the second-rate assets that the bank had to buy in order to provide banks with much needed liquidity. It is more than likely that the Fed will take its time with this phase. It would be hard to imagine that the Fed would suddenly sell these assets, as it could lead to a sharp rise in interest rates. For the ECB, normalisation will be easier because it did not resort to QE.

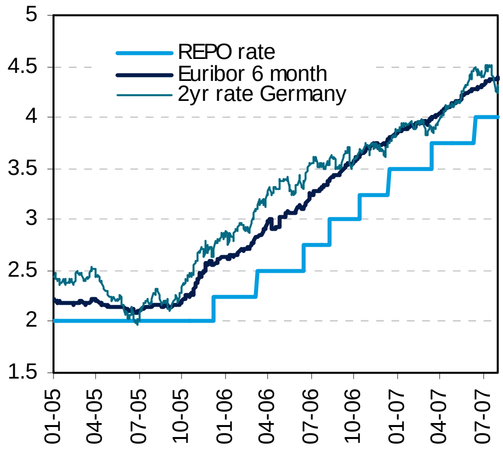
The major constraint will undoubtedly be the sovereign debt crisis. Once this is under control, it will be possible to raise interest rates. The ECB typically likes to prepare the markets for normalisation by releasing increasingly "hawkish" statements in the run-up to it. During each of the last (and only) two cycles of monetary tightening, the ECB's key rate was increased by 225bp. To implement this increase, a one-year monetary tightening cycle was needed in 1999-2000 and an 18-month cycle over 2005-2007 (+200bp in 18 months, followed by an isolated 25bp rate hike in July 2008). Each time, the impact was quite clear on the slope of the yield curve (as measured by the spread between the 10y and the 2y bond yields): it flattened (with a stronger increase in short-term rates than in long-term rates), the first time by 150bp and the second time by 180bp. But the key question is not the movement of the curve but the timing of such movement. Yield curve shifts, both flattening and steepening, often move in fits and starts and are plagued by violent corrections – this could also be the case today.

However, there are several key principles that provide insight into how the yield curve reacts:

(1) The yield curve always flattens during cycles of monetary policy tightening if such cycles are significant; **(2)** The more the central bank lays the groundwork for rate hikes, the earlier the flattening; thus, flattening precedes the actual monetary tightening; **(3)** The longer the monetary policy's status quo phase, the greater the likelihood that curve flattening will precede monetary policy tightening. From 2005 to 2007, the curve had begun to flatten practically two years ahead of the first rate hike. In 1999, however, rate hikes and flattening were simultaneous. In the first case, the status quo had lasted two and a half years...in the second case, it was rather short-lived (less than one year); **(4)** The more effectively the central bank communicates with the markets, the more the curve flattening translates into a short-term interest rate hike with lower volatility. **(5)** If communication is deficient and/or the long-term interest rates are deemed too low, a rise in long-term rates will accompany the flattening. However, in 1994, the Fed was unable to avoid a bond market crash and an increase in volatility. **(6)** The longer central banks wait before tightening the money supply, the more likely the markets are to consider the move to be late. When central banks get "behind the curve", it is not uncommon to see long-term interest rates rise faster and more sharply than short-term rates.

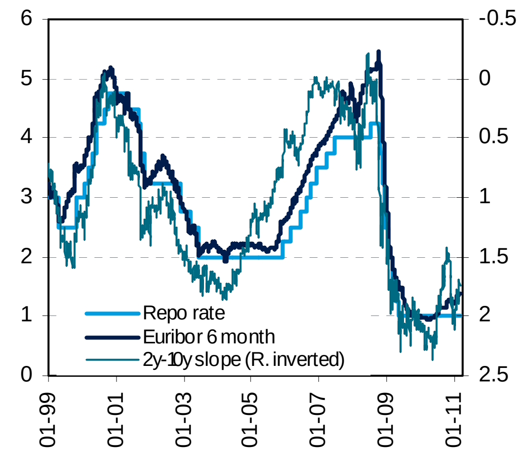
	Fed	ECB	Where / When ?
1st phase	End of Quantitative Easing / Hawkish Communication	More « hawkish » communication / 1st rate hike	Fed: Spring/ Summer 2011 ECB: Now / 1st rate hike on 7 April
2nd phase	Interest rate hikes	"tightening" cycle	Fed: Q1 2012? ECB: +75bp by the end of 2011
3rd phase	Cleansing the balance sheet	-	Fed: very gradually, smoothly, and belatedly

ECB tightening cycle: 2005-2007



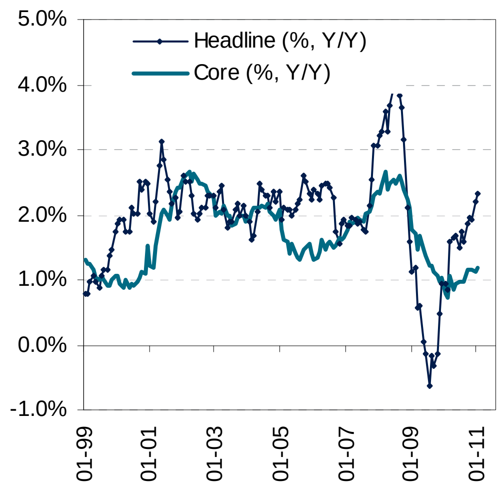
Source: Datastream, Amundi Strategy

Bear flattening during monetary normalizations



Source: Datastream, Amundi Strategy

Eurozone: Headline vs Core inflation



Source: Eurostat, Amundi Strategy

The bear flattening process has already started in Germany, and we believe that such a move will occur in the US in the coming months, more probably in the second half of the year, after the end of the QE2 programme.

Monetary policies conducted on both sides of the Atlantic are likely to have a significant impact on the euro against the dollar. We note a significant correlation between the 2-year bond yield spread (between Germany and the US) and the EUR/USD exchange rate. The spread on 2-year yields has reached its highest level since January 2009 (100bp). Today, even though the ECB will begin normalising its monetary policy before the Federal Reserve , we believe that it will probably raise its rates very progressively. Therefore, it is highly unlikely that the delay in monetary cycles warrants an overshooting of the euro against the dollar.

> *The ECB and the Fed are not on the same wavelength when it comes to the risks resulting from global excess liquidity*

That said, it is worth bearing in mind that if Europe makes enough progress in its economic governance and financial solidarity in upcoming weeks, some investors may find the risk/return profile of some peripheral debts with short-term maturities appealing. As a reminder, the euro's sharp rise against the dollar in late 2009 –with the euro climbing above $1.50 – was not attributable to the interest rate spread between Germany and the US (which had remained somewhat stable, below 50bp for 2-year rates) but because of foreign investors' appetite for Eurozone debt securities. Portfolio diversification was a priority at that time, particularly in Asia, but this was before the Eurozone sovereign debt crisis. It remains to be seen whether or not such an appetite shown by foreign investors is still possible. For that reason, their reaction will be closely monitored at the long-awaited summit slated for March 24-25 (see box 5).

Box 5: March, fateful month for announcements

No formal agreement has been presented yet regarding the guidelines for the operation of the ESM – the European Stability Mechanism which will take over from the EFSF as of mid-2013. However, on February 15, Eurogroup President, Jean-Claude Juncker, stated that European Governments had reached an agreement to double the European mechanism's effective lending capacity. As a reminder, although in theory this fund can lend out up to €440 billion, its effective lending capacity is no more than €250 billion (total guarantees provided by AAA-rated countries). This amount is deemed to be insufficient if major peripheral countries such as Spain end up no longer being able to access the capital markets as of this date. The inclusion of collective action clauses (CACs) in bond contracts as of June 30, 2013 will be insufficient for a country to slowly restructure its debt, because it will be several years before debt backed by CACs represents a substantial portion of outstanding Government bonds. In order to allay concerns, Government leaders have already committed to increase the new fund's effective lending capacity to €500 billion, plus the IMF's contribution, which will be added to this amount. The specific structure of the new fund will be developed and ratified during the March 24-25 summit. Details on the nature of the CACs are also expected at this time.

11 March: European Council special meeting on the Eurozone crisis. Following the invitation by Herman Van Rompuy, the President of the European Council, the heads of state or government of the Euro.

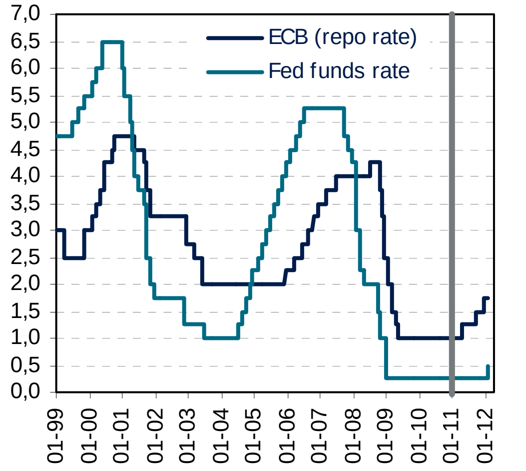
14/15 March: Eurogroup/ECOFIN. The regular monthly European finance ministers meetings. Work on the EFSF/EFSM reforms will continue.

By the 15 March: Moody's will announce whether it will downgrade Spain. Note that currently Moody's rating for Spain is one notch above that of Italy.

By the 21 March: Moody's will announce whether it will downgrade Portugal.

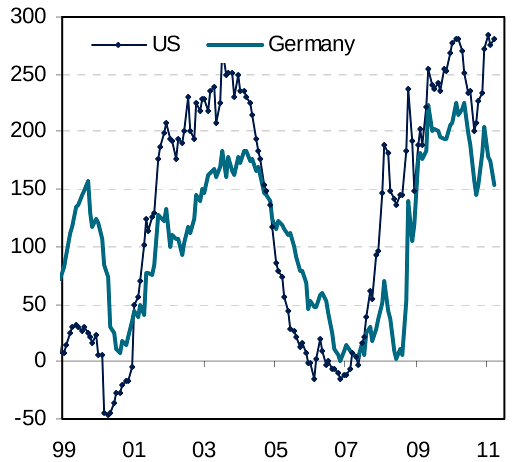
24/25 March: European Council quarterly summit meeting: An extension of the scope of the EFSF/EFSM are widely expected.

The ECB will hike rates before the Fed for the first time in its history



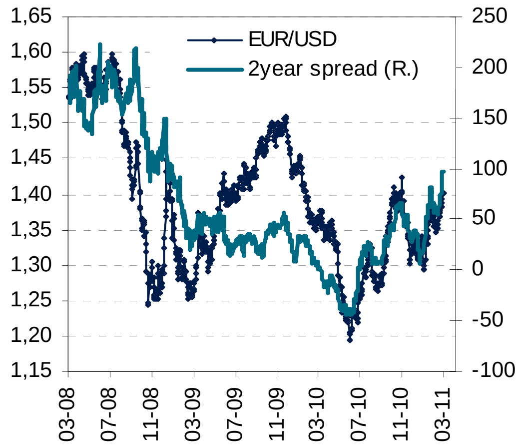
Source: Datastream, Amundi Strategy

Slope of the US yield curve (10y-2y)



Source: Datastream, Amundi Strategy

The EUR/USD pushed by the interest rate differential



Source : Datastream, Amundi Strategy

3 End of quantitative easing and tensions in the Middle East… the same consequences for risky assets?

Risky asset classes (equity, credit, emerging markets, commodities) benefited significantly from a number of factors: better fundamentals, in part tied to the economic recovery, but also due to the excess liquidity tied to the maintenance of low interest rates and the implementation of unorthodox monetary policy measures, mainly in the US. Overall, these markets benefited from solid capital flows—so solid that despite large purchases of government bonds, long rates were nonetheless pushed upwards. In effect, capital deserted the bond market (low yields) and headed towards risky asset classes. The latter offered higher returns (recovery of profits, generally better than expected results, credit spread levels, attractiveness of emerging markets, etc.), and comfort in continuing low interest rates.

The first two graphs clearly demonstrate the significant growth in the prices of these assets, partly justified by the low risk aversion created by liquidity conditions. The third graph shows the point at which the Fed's support (securities purchases) was insufficient to counter the impact of economic growth and the flow of capital towards risky assets.

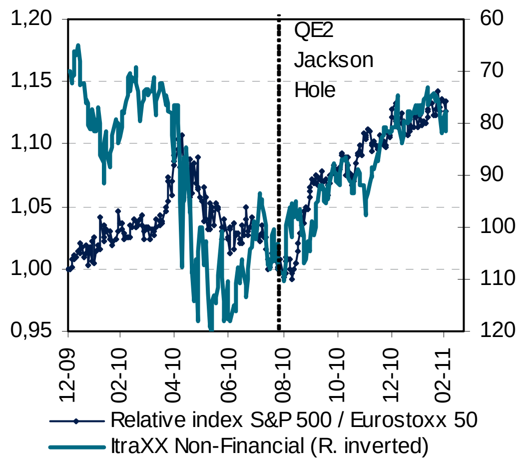
Nonetheless, two changes of course should be noted from now on:

- On one hand, it is a near certainty that US quantitative easing will end in June 2011. Risky asset classes will thus lose an important support factor;

- On the other, tensions in the Middle East have caused risk aversion to rise in a relatively low-volatility environment. Risky asset classes paused, but it is wise to distinguish commodities (energy in particular) from equity or credit, two classes that will likely suffer in this uncertain climate, especially in regards to emerging markets, some of which are suffering already from a steep increase in inflation, which is beginning to cause concern. The 2nd graph clearly shows the impact of geopolitical tensions on the price of oil (Brent in this case), and the lack of impact on metal prices.

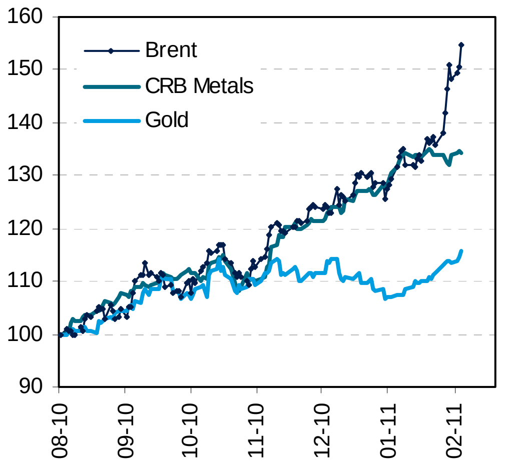
Overall, the end of quantitative easing and tensions in the Middle East have the potential to hamper growth in risky assets (except oil), and to favour a flight to quality, in this case government bonds. Meanwhile, we should expect a rise in volatility, which appears to be quite low at the moment.

Risky assets and QE2



Source: Datastream, Amundi Strategy

Price of oil, gold and metals (basis 100 Jackson Hole conference 2010)



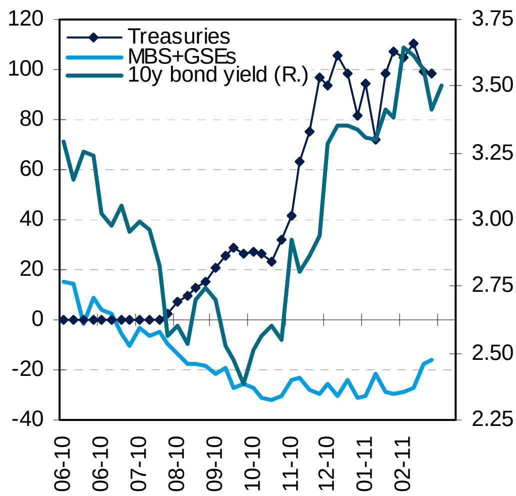
Source: Datastream, Amundi Strategy

4 Balance sheet normalisation by US residents will curb the increase in bond yields

With the monetary normalisation that is underway in the US, some observers are once again beginning to worry about a bond crash on that side of the Atlantic, akin to that which occurred in 1994. It is not the incredible rise in key rates that worries them, but – in the context of high budget deficits – investors' lack of appetite for long term government debt at interest rates considered to be too low.

Worries have become so acute that despite the massive purchases of Treasuries by the Fed as part of its QE2 programme, interest rates have increased dramatically across the Atlantic since last summer (see 3rd graph). According to our calculations, if we exclude the purchases of Treasuries associated with reinvestments in maturing MBS, the Fed has completed little more than 40% of its purchasing programme of $600 billion which expires

Purchases of Treasuries (4-week rolling sum) vs 10y bond yield



Source: Datastream, Amundi Strategy

at the end of June 2011. In these conditions, the threat is not immediate but it is only natural to question the capacity to absorb the supply of Treasuries from the second half of the year onward. The federal budget deficit projected by the US Congress will be $1.48 trillion in 2011, (9.8% of GDP), after $1.294 trillion in 2010 (8.9% of GDP). When the Fed ends its Treasuries purchasing, the question will be whether investors (domestic and foreign) are willing to absorb the flux of new issues at current interest rates.

In 2010, foreign investors (mostly Asian central banks) continued to buy a significant share of new Treasury bill issues (around 50%). But some investors – watching as China has significantly slowed its Treasuries purchasing despite a record trade surplus with the US – worry that demand is drying up. However, observers are wrongly focused only on foreign demand by omitting the role played by the current portfolio balancing by domestic players in the US. At the national level, households purchased nearly 20% of new issues in 2010 and the financial sector, more than 30% (two thirds of which were by banks and private pension funds). This situation is playing out despite an increase in household saving but also a more prudent budgeting strategy by all residents.

As such, at the end of 2010, US households thus already returned to the average allocation observed between 1985 and 2010 (with 2.4% of their assets held in Treasuries after the 2008 low point of 0.8%). And from now on the financial sector could be the most important source of demand. Commercial banks, insurance companies and pension funds still hold (in reference to all of their assets) a much lower supply of Treasuries than the long-term average. Over the last decade, the financial sector – looking for better yields – lowered its exposure to government bonds. Among commercial banks on their own, for example, the development of regulation will lead to adopting a much more prudent attitude. Treasuries represented less than 2% of their assets in 2010, versus an average of 4.6% over the last 25 years and 12.3% over the last 50 years. A return to the long term historic average (12.3%) would mean potential purchases of more than $1.5 trillion, more than a year's worth of issues! In applying the same rule to households, they will still be able to acquire around $500 billion (see table below).

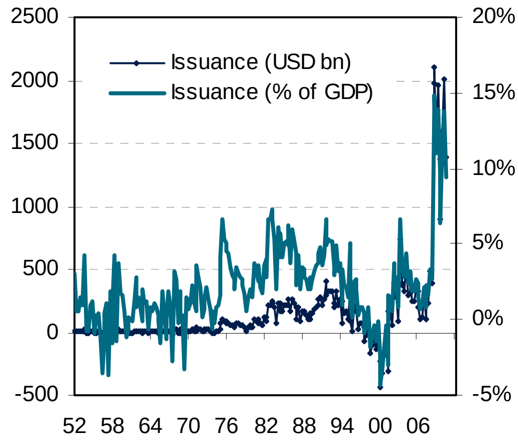
Scenarios for balance sheet normalisation by agents of US residents

	Total Assets ($ bn)	Treasuries (% of total assets)			Potential purchase of (*) Treasuries ($ bn)	
	Q3.10	1952-2009	1985-2009	2010	Back to 1985-2009	Back to 1952-2009
Households	45 682	3,4%	2,4%	2,4%	0	460
Commercial Banks	14 580	12,3%	4,6%	1,9%	385	1,515
Insurance Companies	6 459	6,3%	5,9%	3,9%	127	153
Total	**66 721**		-	-	**512**	**2,129**

(*) Purchases that would "normalize" balance sheets (i.e. that would bring the allocation back to long-term averages).

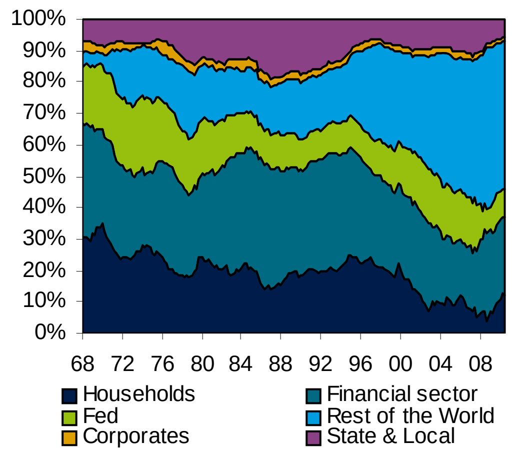
Source: Flow of Funds (Fed), Amundi Strategy

Net issuance of US Treasuries



Source : Datastream, Amundi Strategy

US Treasuries: Outstanding by sector



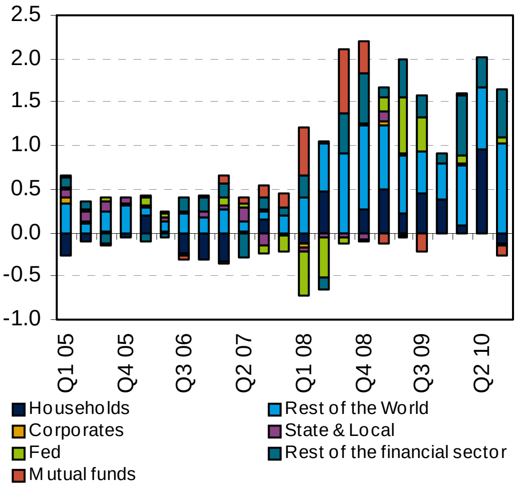
Source: Datastream, Flow of Funds and Amundi Strategy

This does not rule out the possibility of monetary normalisation being accompanied by upward pressure on long-term interest rates. Beyond a certain level, though (probably between 4% and 5%), the risk/return profile would probably seem very attractive in the eyes of many investors. In other words, the portfolio rebalancing by residents appears to offer a solid position against a brutal rise in long-term rates, at least for 2012 and 2013.

However, in the longer term, once the recovery is consolidated, households will have cleaned up their balance sheets and other residents will expect them to hold a "sufficient" amount of Treasuries. For their part, foreign central banks will inevitably diversify their foreign exchange reserves to the benefit of currencies other than the dollar. On this horizon, the US federal deficit must therefore be much lower than it is today. Considering the CBO's projections (deficit as a percentage of GDP down 4.1% between 2012 and 2016, down 3.6% between 2012 and 2021), the chances are good that US government bonds will offer a higher structural risk premium than in the past to attract investors, which, even more than inflationary pressures, will have the effect of rooting the economic recovery and dissipating excess capacity.

On the whole, we now understand the will of US authorities to immediately reassure investors in terms of the sustainability of federal debt. For in regard to public finances, as in any other matter, there is no "free lunch" and, to put a spin on Keynes, in the long run we're not *all* dead.

Net purchases of US Treasuries (USD trillion)



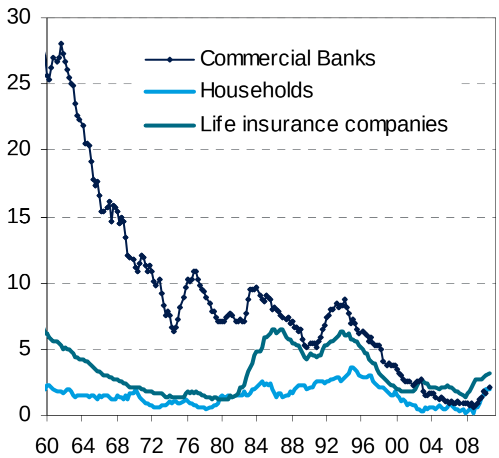
Source: Datastream, Amundi Strategy

US Treasuries: Outstanding by sector

	1952-2009	1985-2009	90-05	2010 (Q2-Q3)
Households	22,4%	16,1%	17,6%	12,3%
Rest of the World	17,3%	28,1%	27,7%	47,0%
Corporates	3,5%	2,0%	2,0%	1,2%
State & Local	9,5%	11,6%	10,5%	5,8%
Fed	14,2%	12,3%	12,7%	9,0%
Commercial Banking	15,3%	6,6%	6,5%	3,2%
Insurance companies	4,4%	5,0%	5,2%	2,8%
Private and public pension funds	6,8%	10,0%	9,7%	8,5%
Mutual funds	3,1%	6,3%	6,4%	7,7%
Others	3,4%	1,8%	1,6%	2,6%
Financial sector	**33,1%**	**29,8%**	**29,5%**	**24,7%**
Total	**100,0%**	**100,0%**	**100,0%**	**100,0%**

Source: Datastream, Amundi Strategy

US Treasuries (% of total assets)



Source: Datastream, Amundi Strategy

5 Earnings season: solid reports, but signs that margins are topping out

The earnings season began in mid-January, and within a month 43% of European and 81% of US companies had reported. This gives us a good overview of the fourth quarter and 2010 as a whole.

Earnings for 2010 bounced smartly off their 2009 lows, leaping +36% in Europe and +45% in the US. But whereas in 2009, companies basically cut costs, in 2010, the improving economy made the takeoff even more dramatic. The better conditions boosted sales by +14% in Europe and +10% in the US. Further, in Q4 2010, earnings gained +18% in Europe and +37% in the US (1st graph), with positive surprises 59% of the time in Europe and 69% in the US. However, a closer look at the earnings season reveals two factors that temper this overall positive impression.

First of all, in Europe, for the third successive quarter, momentum of positive surprises in earnings relative to sales has decelerated (2nd graph). This suggests that the trend of margin growth is flattening. Three factors may shed light on this phenomenon: 1/ a negative currency effect for some exporters, given appreciation of more than 10% in the Swedish krona and Swiss franc since end-2009, 2/ less favourable fixed-cost comparisons, and 3/ sharply rising commodity prices. Concerning the base effect, Q4 2010 is a more difficult comparison because earnings for the comparable quarter in 2009) skyrocketed by +182% in Europe and +94% in the USA thanks to a sharp rebound in activity along with all-out war on costs.

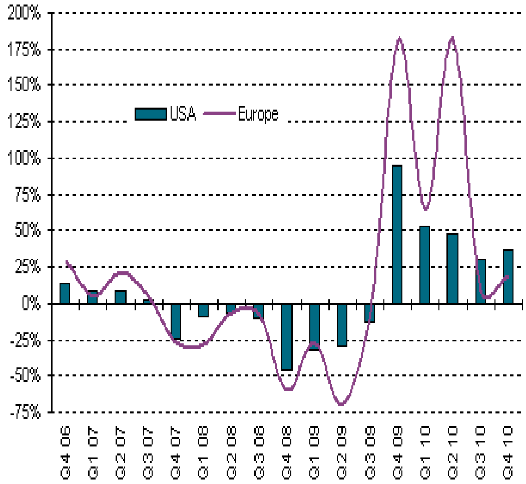
Second, this earnings season has thus far generated very little momentum for estimate revisions. From mid-January to mid-February, revisions to the MSCI Europe (statistically negligible) and MSCI US (+0.2%) indices were marginal. In other words, whilst there are still many positive surprises, they are on a smaller scale. But this movement masks interesting local disparities. In Western Europe, a gap is evident between Germany (+1.4%), where the economy continues to be very buoyant, and peripheral countries, where downward earnings revisions continue (Portugal -1.1%, Italy -0.3%, Spain -1.1%, Ireland -7.2%).

These preliminary signs lead us to ask whether margins are starting to level off, and how the market will react to these circumstances. Net margins for the S&P500 are nearly back to their 2006-2007 highs (3rd graph). Yet analysts continue to expect margins to improve over the next two years. This is technically possible, even with rising commodity prices, provided wages stay under control. Moreover, the increasing proportion of US companies' profits coming from abroad from 15% in 2006-2007 to nearly 25% in 2010 could propel margins past the previous limits. In any event, the high base for comparison and rising commodity prices mean that the potential for margin appreciation is, if not exhausted, at least largely used up.

Margins in the US market peaked in 1965, 1997 and 2006. However, during the 12 and 24 months following each peak, the SP&500 continued to climb. In other words, selling near the peak would not have been the right decision. The reason is that each peak corresponded to sustained growth in subsequent months, with a positive effect on earnings, although margins hit a plateau. Will the same pattern unfold this time? In fact, conditions are not completely identical, because this time margins peaked just a few quarters after exit from recession – thanks to cost cutting – rather than after several years of recovery. The question of whether the recovery can endure and broaden thus remains. The central scenario is that growth will spread to employment and boost buying power, putting pressure on margins, but the market will accommodate this via multiple expansion. The alternative and clearly less favourable scenario is that both growth and wages plateau, limiting both profit growth and multiple expansion.

> *"Less than two years after the trough of the crisis, margins have already rebounded to new highs"*

Quarterly earnings (12-month variation)

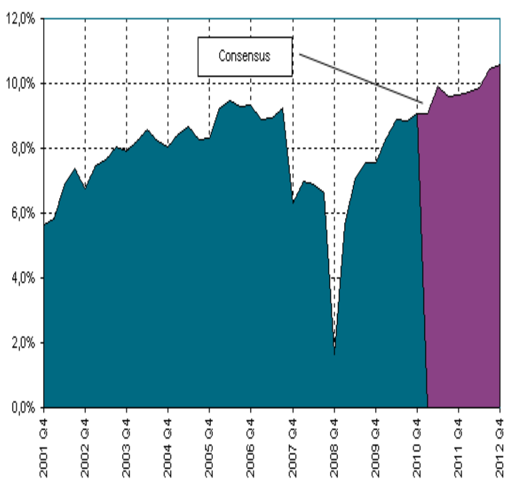


Source: Bloomberg, Amundi Strategy

Europe: Revenues surprises less Earning surprises (in %)

Source: Bloomberg, Amundi Strategy

US quarterly profit margins's and consensus forecasts



Source: Bloomberg, Amundi Strategy

Box 6: 2010 earnings: cyclicals and energy stocks lead the rally

In Europe, where sales are growing at an average 14%, three sectors stand out: consumer discretionary (+15%) and materials (+18%) are both highly cyclical, and energy (+26%) was boosted by the oil price rebound. Trailing the field are the traditionally "defensive" sectors, such as healthcare (+5%), utilities (+3%) and telecoms (-1%), which held up better in 2009 but marked time in 2010. Earnings jumped an average of 36%, and here again, cyclical sectors stood out with increases ranging from 67% for industrials to 515% for consumer discretionary. None of the above three "defensive" sectors achieved a gain of more than 10%, and telecoms saw both sales and earnings slide. Although the most cyclical sectors lead the field for sales and earnings growth, the outcome for positive surprises is less clear-cut. In addition to cyclical sectors such as materials (chemicals and paper), consumer discretionary (automobiles, consumer durables, consumer services and media) and technology (software and semiconductors), some other sectors performed well, especially consumer staples (food retailing, food/beverages/tobacco) where 67% of firms produced positive earnings surprises. Moreover, industrials, energy and financials produced a mixed picture in terms of positive surprises. Aside from sector-specific factors, the earnings rebound in many cases falls short of the rise in sales. This confirms that the margin improvement is running out of steam (see main article).

In the USA, where sales growth averaged 10%, materials (+19%) and energy (+24%) rank at the top, as they do in Europe. However, consumer discretionary stocks (+9%) did not perform as well as in Europe, and IT did much better (+15%). But the real surprise came from no defensive sector, healthcare, where sales rebounded 12% in 2010 compared with just 5% in Europe. In earnings, up an average of 44%, the increase is mostly in cyclical sectors such as materials (+104%), consumer discretionary (+73%) and IT (+57%). We also note that US earnings gains far outpaced Europe's in energy (owing to the BP syndrome in Europe) and financials (sovereign debt crisis). And as in Europe, earnings slid in the telecoms sector.

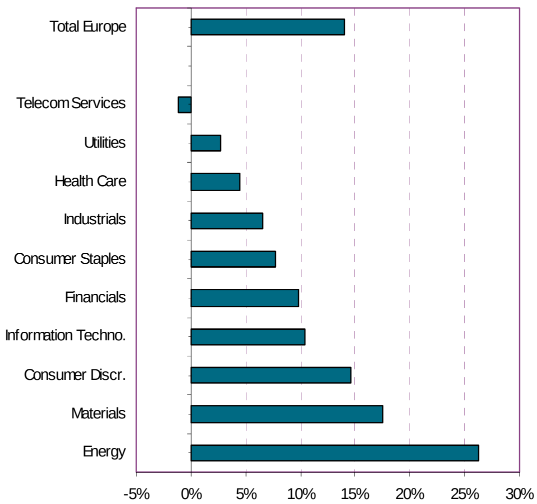
Annual publications by sector in the USA (S&P500)

USA S&P500	Growth		Positive Surprises		% reported
	Earnings	Sales	Earnings	Sales	
Energy	65%	24%	63%	63%	80%
Materials	104%	19%	68%	60%	93%
Industry	27%	5%	78%	68%	87%
Conso. Discretionary	73%	9%	80%	83%	57%
Consumer Staples	8%	3%	53%	53%	83%
Health Care	14%	12%	82%	76%	93%
Financials	112%	4%	66%	70%	94%
Information Technology	57%	15%	68%	76%	88%
Telecom	-6%	1%	50%	50%	67%
Utilities	9%	4%	45%	40%	59%
Total	**44%**	**10%**	**69%**	**68%**	**81%**

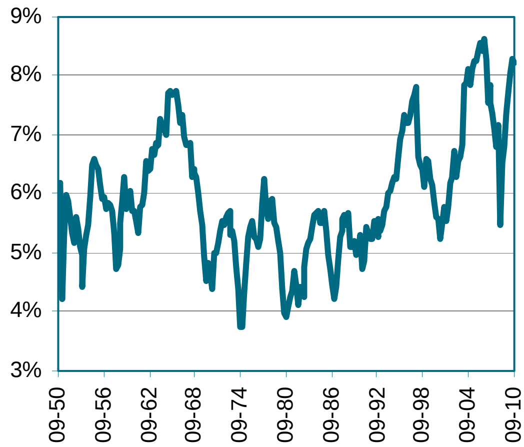
Annual publications by sector in Europe (Stoxx Europe)

Stoxx Europe	Growth		Surprises Positives		% reported
	Earnings	Sales	Earnings	Sales	
Energy	28%	26%	53%	60%	47%
Materials	100%	18%	69%	62%	55%
Industry	67%	7%	47%	65%	36%
Conso. Discretionary	515%	15%	85%	77%	42%
Consumer Staples	21%	8%	67%	53%	47%
Health Care	5%	5%	57%	52%	62%
Financials	25%	10%	53%	70%	38%
Information Technology	69%	10%	69%	92%	59%
Telecom	-2%	-1%	57%	43%	39%
Utilities	8%	3%	60%	80%	19%
Total	**36%**	**14%**	**61%**	**66%**	**43%**

Sales growth by sector in 2010

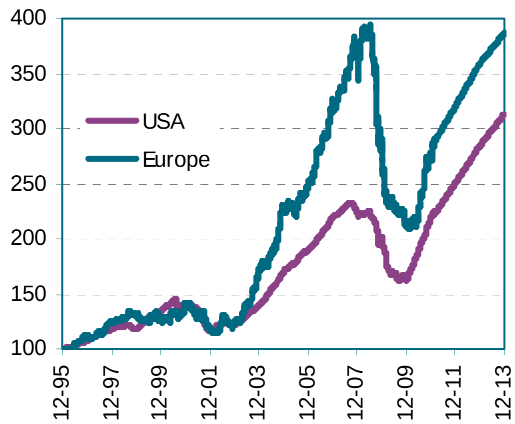


Profit Share of US GDP post-tax



Source:BEA, Nomura

Earnings index: basis 100 in 1995



Source:Factset, Amundi Strategy

Box 7: European companies are less and less European

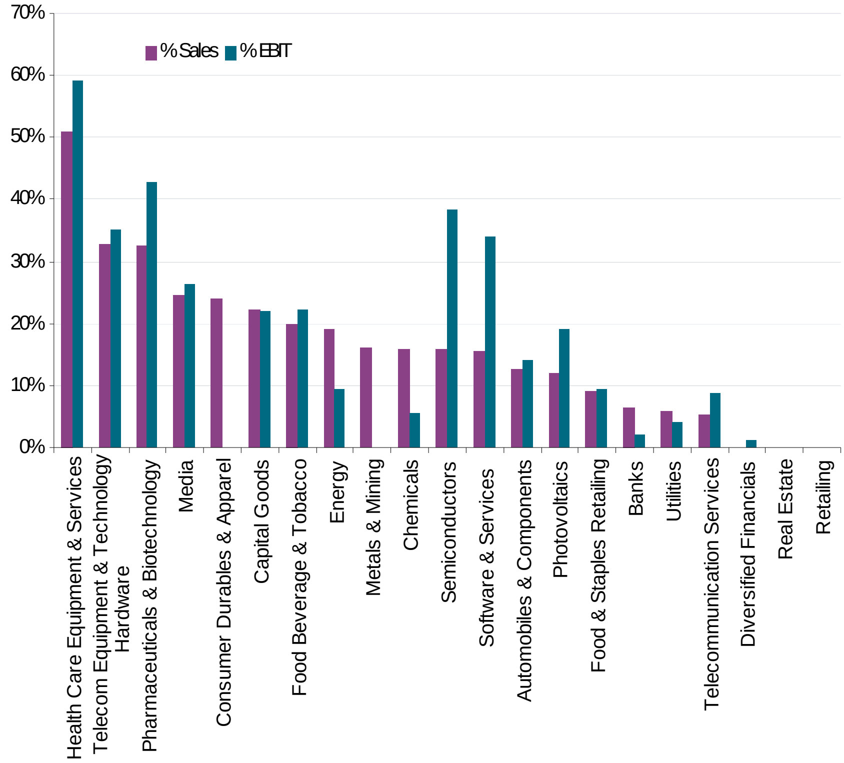
Following recent upgrades in US macroeconomic forecasts, we set out to determine: i) European companies' exposure to the US market by sector of activity; and ii) the contribution of US activities to their operating income. We based ourselves on coverage by our financial analysts (who cover more than 90% of the market cap of MSCI Europe indexes) and came to the following conclusions:

- European companies are heavily present on the US market, where they generate a total of 15% of their revenues. This figure is: i) higher in the healthcare (medical equipment and pharmaceuticals) and technology (telecom equipment) sectors; and ii) lower in consumer goods (food and non-food retailing) and finance (banks and financial institutions);
- European companies generate 15% of their total EBIT in the US. This figure is: i) significantly higher in the technology (semiconductors, software and IT services) and medical equipment sectors; and ii) lower in commodities (chemicals and energy) and financials (banks).

In the short term (2011-2012), we should see "excess profitability" by European companies' US businesses (due to the projected growth gap between the US and Europe over the period in question), with US activities generating more than 15% of their EBIT. In the longer term (probably in 2012 or 2013), European companies will generate more than 50% of their operating profits outside Europe (30% in emerging markets and 15% in the US in 2010). This could give European companies a new stock-market status, as it might be enough to temper the negative view that most investors (mainly from English-speaking countries) have of European companies.

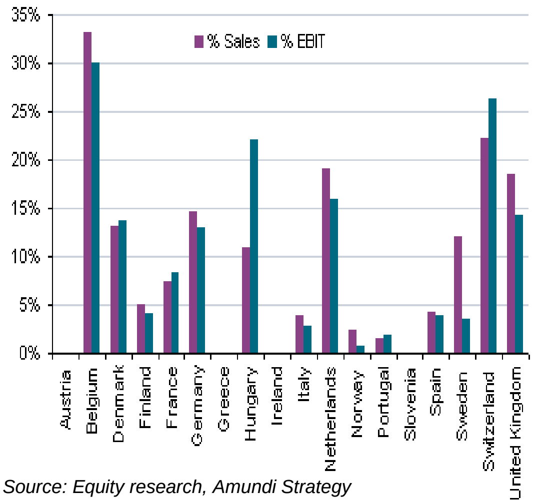
Companies with the heaviest US exposure are from the Benelux (retailers), Switzerland (pharmaceuticals and medical equipment) and the UK (pharmaceuticals and capital goods). More generally, Southern European companies (including French ones), with their heavy financial sector biases, have a much smaller footprint in the US than northern European companies, which are weighted more towards industry.

European Sectors - Exposure to US (% of total)



Source: Equity research, Amundi Strategy

European Countries - Exposure to US (% of total)



Source: Equity research, Amundi Strategy

Sales exposure to US Market Cap weighted	
Top 5	
1	Health Care Equipment & Services
2	Telecom Equipment & Technology Hardware
3	Pharmaceuticals & Biotechnology
4	Software & Services
5	Media
Bottom 5	
18	Telecommunication Services
19	Real Estate
20	Retailing
21	Banks
22	Diversified Financial

6 Emerging equities: how will they withstand the shock?

Emerging-country inflation is rising, monetary policy is tightening in response, and questions about growth momentum are cropping up – all putting pressure on emerging markets. The North Africa and Middle East world's spreading unrest and oil prices' flare-up have sowed doubt, leading to a swift pullback in emerging markets and a massive reversal of flows. Is patience the best course? Are there alternatives? At this crucial juncture, we provide concrete answers to investors' legitimate questions.

For the medium term, there are at least three good reasons to continue to choose emerging markets over developed countries: their higher growth rates, their financial soundness and their valuations. In growth terms, for more than 30 years emerging markets have surpassed developed ones. But this phenomenon has accelerated dramatically since 2000. The gap in GDP growth between emerging countries and the G7 widened from around 1% annually from 1980 to 1999 to 4% from 2000 to 2007. Then 2008 marked a turning point. Since that time, emerging markets have further amplified their advance, whereas in earlier crisis periods, they were the first to feel the pain. Beyond detailed explanations, the very reason for these countries' emergence is their newfound industrial heft. Their production now represents nearly half of the global total (1st graph). As to their financial soundness, the contrast is even more striking. Deficits and debts have migrated to the North, whilst surpluses and foreign exchange reserves are in the South. Finally, valuations make emerging markets very affordable. Their 2011 P/E is only 11.3x, and in relative terms, not even the most expensive, Asia and Latin America, sell at a premium to the MSCI World (2nd graph). Thus, many factors continue to favour emerging markets, and not least that they remain under-represented in portfolios relative to their economic significance.

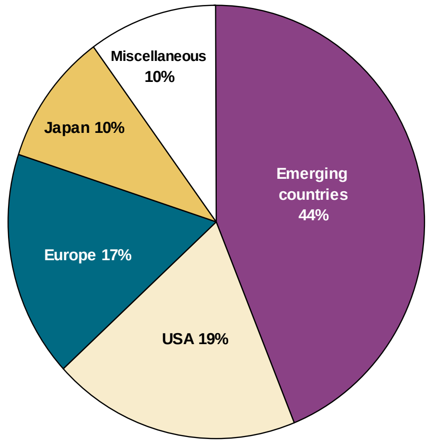
But the much greater concern at the moment is inflation, not to mention the resurgence of country risk. That was what interrupted their rise for several weeks; investors are afraid of inflation getting too strong, because that would sooner or later lead to tightening actions, which could disrupt growth momentum. Besides, rising interest rates tend to weigh on the numerator of the P/E ratio.

> *Paradoxically, the Middle East crisis favours the EMEA*

Fundamentally, emerging markets are usually judged by their growth rates and their degree of autonomy from the major Western economies. On this basis, Brazil scores higher than Mexico. Currently, however, it is important to pay close attention to inflation as well as geopolitical risk. The differential between nominal GDP growth and long-term interest rates provides a quick-and-dirty way to see which countries have the most accommodative policy mix and thus risk overheating. On this basis emerging Asia tops the list, as it is vulnerable to inflation and also highly dependent on commodities.

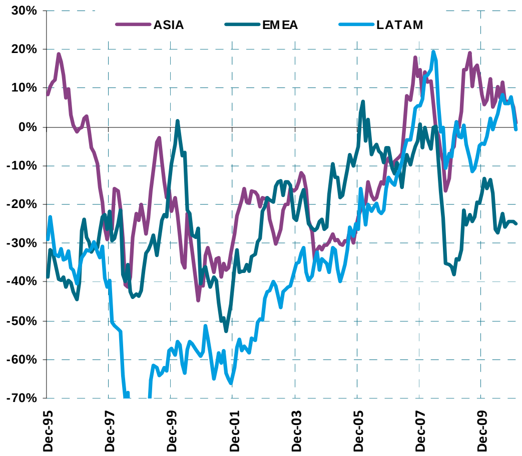
On the other hand, the EMEA region is looking more attractive. First of all, it is less vulnerable than other emerging areas to food price inflation, because per capita GDP is both higher and more autonomous. Second, EMEA markets traditionally sell for less than other emerging markets (2nd graph) because of their dependence on slow-growing Western Europe, but they have new catalysts in the soothing of sovereign credit fears and the German economy's good performance. Last but not the least, Russia and South Africa dominate the EMEA index with 76% of its capitalisation, compared with less than 11% for North Africa and the Middle East (3rd graph). Paradoxically, the Gulf region's concerns may help EMEA, given Russia's major role as an oil supplier and South Africa's in precious minerals. This analysis appears to be corroborated by greater flows into EMEA equities. Whilst other emerging markets seem to be losing their way, these are forging ahead. A reflex which is all the more understandable than in the past, the MSCI EMEA index has consistently outperformed during periods when oil prices are rising sharply (outperforming the MSCI World by 7% on average during the eight quarters of double-digit oil price increases since 2007).

Global industrial output



Source : World Trade Database

Premium / Discount vs MSCI World



Source: Datastream, Amundi Strategy

MSCI EMEA Index Weighting	
Emerging Europe	**49,6%**
Ukraine	0,1%
Czech Republic	1,9%
Hungary	2,2%
Poland	8,7%
Russia	36,7%
Sub-saharan Africa	**39,4%**
South Africa	39,4%
North Africa - Middle East	**10,9%**
Morocco	0,9%
Egypt	2,0%
Turkey	8,0%
Total	**100,0%**

Source: Factset, Amundi Strategy

7 Sovereign debt in advanced economies: what impact will it have on emerging markets?

The sharp deterioration in the financial situation of a number of advanced economies has raised fears about its repercussions on emerging markets. Budgetary rigour has become a necessary evil and presents serious risks to the economy. Moreover, growth in a number of emerging markets continues to be closely tied to exports to advanced economies. Fears of a knock-on effect in emerging markets are therefore justified but only in part.

First of all, it is worth noting that some large emerging markets' growth models no longer rely exclusively on price competitiveness and their exports, but increasingly on domestic demand. This is notably the case for Brazil and China. In other words, emerging market growth is becoming gradually more autonomous and a drop in activity in advanced economies "hurts" less than before.

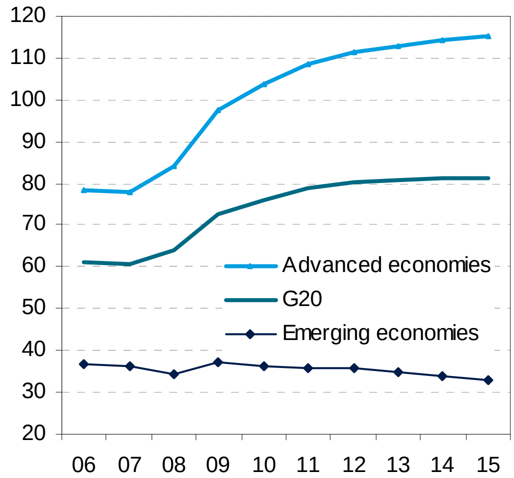
Moreover, the impact of the upcoming budgetary adjustment on the growth of the most advanced economies may not be as bad as some feared. It is clear that eurozone peripheral countries, for example, will be affected by budget austerity that they are forced to accept because of the state of their public finances or has been imposed on them by other international organisations that came to their rescue. However, the force of the austerity plans is currently being offset by the growth recovery throughout the industrialised world, with the US, Germany and Japan leading the way. Admittedly, growth is now levelling off, but not so much as to put a damper on things.

Last, this will depend on how far are emerging fixed-income markets able to "keep out" of rate hikes in advanced economies. A simple comparison of emerging markets and advanced markets tips significantly in favour of the former: obvious fiscal discipline, rather impressive public debt ratios, exchange reserves reflecting a current account surplus for these countries, upward revisions to ratings by rating agencies, robust growth, solid currencies, etc. In sum, all of these factors point to emerging markets' better state of health.

The last question mark concerns the ability of these countries to face a sharp rise in their currencies. In view of the current environment, there is a high chance of a real appreciation of their currencies (due to higher inflation than in advanced economies) rather than the nominal appreciation long-awaited by brokers.

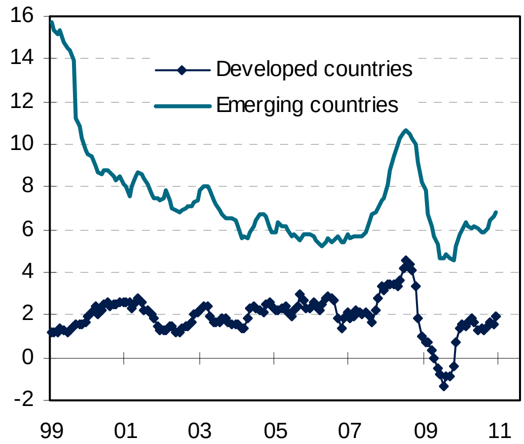
The "splendid isolation" that emerging markets have demonstrated so far may come to an end, not because of fiscal discipline in advanced economies, but rather on account of higher domestic inflation, the end of quantitative easing, which has significantly underpinned risky asset classes since last summer, and the rise in risk aversion brought on by the Middle-East crisis.

Public debts (% of GDP): Lower in emerging economies than in developed economies



Source: IMF, Amundi Strategy

Higher inflation in emerging economies than in developed economies



Source: Datastream, Amundi Strategy

8 Brisk demand bonds supports strong HY bonds supply: as a result, refinancing risk eased considerably over the next few years

Inflows into HY bonds and leveraged loans remain brisk

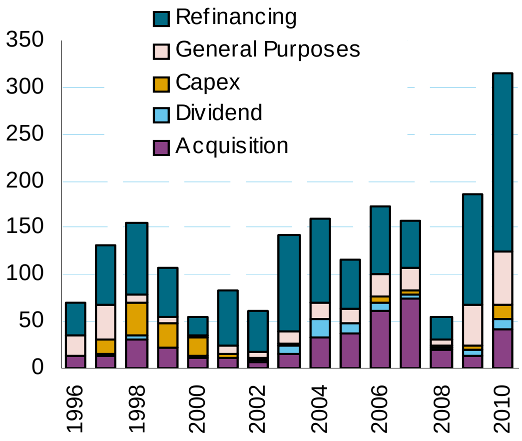
The search for yield and improved demand for risky assets together with a stronger economic picture and supportive micro signals are all factors supporting healthy investment inflows into HY credit. This trend is captured by figures of investment inflows into US mutual funds, reported in table below. After a relatively flat H1, last year saw a strong acceleration in retail inflows into US HY bond funds in H2, thanks to a cumulated figure equal to USD 12 bn. 2011 started even on a stronger note, already totalling USD 7 bn inflows as of February 9th, corresponding to 58% of H2-2010 total inflows. Interestingly, loan funds also posted a record inflow of USD 9 bn in these first few weeks of the year, compared to a total figure of 10.5 bn for H2-2010 and 6.5 bn for H1-2010. The acceleration of inflows into HY bonds and levered loan products has gone hand in hand with a reasonable slowdown of inflows into Investment Grade bonds over the same period. In fact, high grade funds saw inflows slowing from USD 70 bn in H1-2010 to USD 57 bn in H2-2010: year to date inflows into IG funds totalled only USD 5 bn, around 9% of H2-2010 flows.

US mutual fund flows, in US$ bn

	(a) 2009	(b) H1 2010	(c) H2 2010	(d) YTD as of 9/2	(d) / (c) in %
All Taxable Debt	368	164	100	30	30%
EM Debt	4	7	7	2	31%
Loans	5	7	11	9	86%
IG Bonds	180	71	58	5	9%
HY Bonds	33	1	12	7	58%
Equities	-11	32	38	43	113%
Money Markets	-514	-452	39	-57	

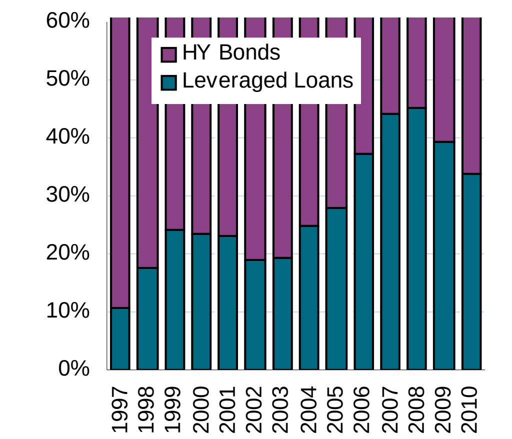
Source: AMG, Amundi Strategy

Global HY new issue use of proceeds distribution (by principal amount, in US$ bn)



source: BoA ML, Amundi Strategy

Leveraged loans as a percentage of total speculative grade finance market



source: BoA ML, Amundi

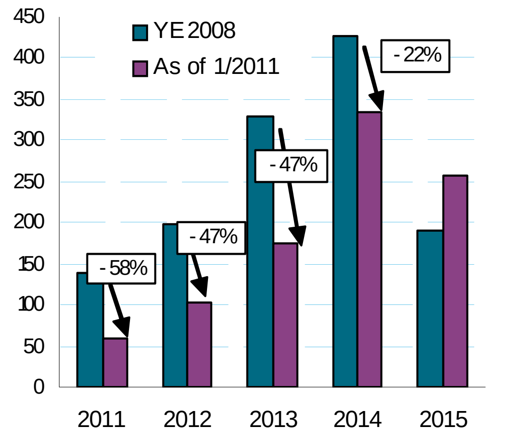
Supply keeps pace with strong demand

The first two months of the year have seen supply maintaining the sustained path of new issuance recorded in previous months. January's USD 34 bn of new HY global bonds represents the fourth month in a row in excess of USD 30 bn, if December's USD 24 bn figure is excluded given the lower activity level generally recorded at the end of the year. Furthermore and according to the stronger demand we referred to in the previous section, institutional leveraged loan primary market was back to its strongest activity of the last few years.

> *"Strong issuance considerably reduced financing risk over the next three years"*

2011's strong start comes after two record years for HY bond issuance. In 2009 and 2010, powerful technical factors strongly contributed to a dramatic tightening in HY debt risk premium, and subsequently to a remarkable compression in speculative grade companies' refinancing costs. But that's not the whole story: thanks to a remarkable demand, companies issued amazing volumes of debt, mainly in the bond segment. The 1st graph shows the incredible acceleration in total volumes of new debt issued in 2009 and 2010 and, at the same time, underlines that around USD 300 bn out of a total record figure of USD 500 bn were used for refinancing purposes. Only a small proportion of new issues were due for re-leveraging purposes, contrary to the mid-2000s.

US HY bond and loan maturities (in US$ bn)

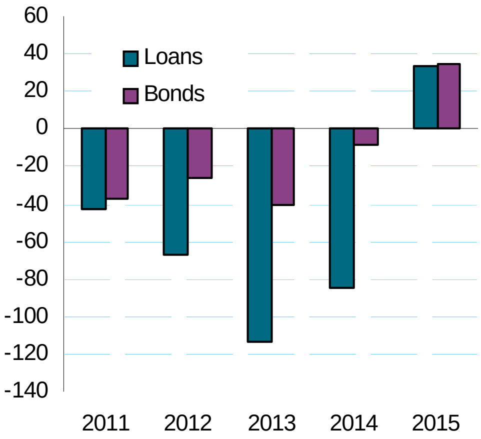


source: BoA ML, Amundi

The last two years' strong issuance has considerably reduced refinancing risk over the next three years, improving the picture on the expected default cycle

The maturity schedule for HY bonds and loans has been one of the major mid- to long-term concerns for speculative grade investors over the past years. The last cycle saw a record issuance of leveraged loans under particularly stretched conditions during the final years of the credit bubble, namely in 2006 and 2007. As shows the 2nd graph page 22, in 2007, leveraged loans or the "new HY bonds" reached a record 40% of the total speculative grade market, with most leveraged deals maturing between 2012 and 2014. The last graph page 22 shows a remarkable concentration of debt maturing in these few years, as of end 2008: the 1st graph opposite also shows to what extent funding perspectives have strongly improved over the last two years. In 2011 and 2012, around USD 160 bn in debt will come due, adding loans to maturing bonds. This cumulated volume only represents 60% of 2010 refinancing volumes. The graph shows how refinancing needs have been reduced by 58% for 2011 and by 47% for both 2012 and 2013. The latter still looks manageable, while 2014 is clearly more challenging than the next three years, not only given the huge volumes maturing but also the high leverage at which these deals had been issued. The above considerations provide an important factor behind a more benign default outlook for the asset class over 2011 and the following years, all other "economic factors" being equal.

Change in US HY loans and bond maturities over the last two years (in USD Bln)



source: BoA ML, Amundi

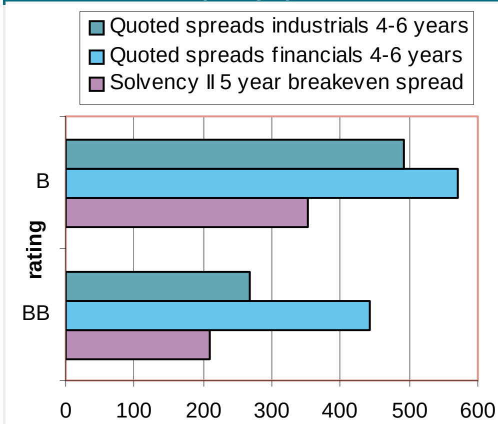
Box 8: Treatment of high-yield bonds under Solvency II

Solvency II, the new directive that sets capital requirements for European insurers, will take effect in January 2013. Previously, insurers' regulatory capital was based on a flat-rate calculation, independent of asset allocation. A new feature of Solvency II is that the Solvency Capital Requirement (SCR) is based on a detailed map of effective risk exposures (i.e. VaR of 99.5% over one year). The imperfect correlation of risks is taken into account so that the total capital requirement is less than the sum of its parts. For market risk, the regulator states that the SCR must be calculated on the basis of a stress scenario specific to each asset class. Thus the new requirement is closely linked to the insurer's asset allocation.

For corporate bonds, the SCR is calculated by applying a rating-dependent stress scenario to the spread. A bond's SCR is determined by multiplying the stress scenario by the bond's duration. However, duration is capped and floored (from 1 to 8 for bonds rated B, and 10 years for BB). The result is then adjusted using a factor that depends on the insurer's specific situation, in particular the interaction of credit risk with the other sources of risk through correlations, and the insurer's target solvency ratio (which is often greater than 1). The cost of capital is then obtained by multiplying the SCR by the insurer's desired profitability as measured by return on equity. Because of the duration-based formula, the cost of capital is an increasing function of bonds average life. In addition to calculate the average capital needed over a given bond's entire remaining life under a buy-and-hold scenario, it must be remembered that duration will decline gradually over the holding period until the bond matures.

It looks tempting to compare the annualised cost of capital under Solvency II with the spread, which, under the buy-and-hold scenario often used by insurers, is a significant factor in the expected return on credit bonds. But for high-yield bonds, the spread also includes a non-trivial component that offsets probable losses due to defaults. This component should be added to the cost of capital to obtain a breakeven spread that is comparable with the market spreads on bonds. Factoring in an annual default probability consistent with an economic scenario of moderate recovery (1.3% for a BB rating and 2.2% for B), a 60% loss given default and an ROE of 10%, the market spreads on high-yield bonds as quoted on 15 February (median spreads on the Amundi bond universe corresponding to each rating and maturity bucket for each (see 2nd graph) are generally higher than the breakeven spreads.

Comparison between market quoted spreads and breakeven Solvency II spreads for Europe high yield bonds



Source: Amundi Quant research and referential

9 Japan: Is change in sovereign outlook a dangerous tipping point?

Following S&P's first downgrade in 9 years last month, Moody's reduced the outlook for Japanese sovereign debt to negative. However, investors heavily bought JGBs thereafter rather than penalising with higher premiums. Does this reflect unrest in the MENA region and a subsequent plunge in equity prices, or the market's conviction that funding difficulties are inexistent? Maybe both are right. This article probes the latter subject more deeply and reaffirms that rating agencies are pointing towards the right issue but at the wrong time. As a consequence, we believe the Japanese bond market is unlikely to be battered by any possible downgrade. On the contrary, reluctance in business investment and scant hope for real wage growth should keep consumer prices, and thus bond yields, in check.

Foregone conclusion: The downward revision of the sovereign outlook is not necessarily a disaster, nor is it out-of-blue. Nobody feels comfort when outstanding public debt soars to twice the size of a €4.3 trillion economy. Moody's apprehends heavier indebtedness amid an ageing population and declining household saving could lead to a catastrophe in the long run. Nevertheless, The 1st graph contrasts public sector debt and private sector saving. Households have lost the ability to accumulate financial assets since the BOJ completely erased interest on savings deposits in 2001. Hesitancy to increase housing investment barely keeps the sector's net financial position in surplus, despite the continuous decline in disposable income. Meanwhile non-financial corporations, to everyone's surprise, have maintained net saving status for years. This unfamiliar landscape to most non-Japanese investors mirrors an extremely cautious attitude towards capital expenditure amid corporate restructuring. The amount of business investment has been falling short of their cash flow [1] since 1995.

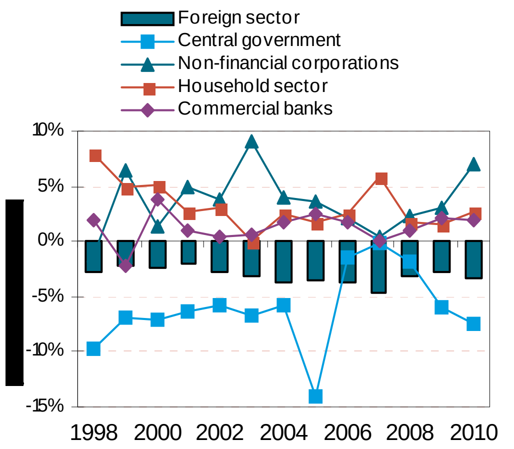
> *Ratings agencies are placing blame for the current difficulties, but at the wrong time*

Companies hesitantly resumed capex in 2010 even though their pre-tax earnings sprang up by 60%. Consequently capex ultimately fell below depreciation and the scope of corporate net saving ballooned. Likewise, banks boosted profits as lower credit costs and active market transactions completely offset shrinking margins. The government has tried to offset lacklustre private sector business through a slew of economic packages and bank rescues, allowing public debt to climb. Apart from household saving, of which Moody's is aware, gross saving in the private sector, combined with a resurgence of external claims, namely current account surplus, should well finance public obligation.

A pinch of salt: The question is how companies and households will behave this year. On the corporate front, better-than-expected earnings results should facilitate replacement and reinforcement of plant and equipment. Also, the surprising recovery in exports, primarily driven by a surge in automobiles and parts, will encourage manufacturers. However, one quarter is required to outline plans and place orders, with several more quarters needed for delivery and installation. Rather, private capital formation is expected to decline, at least in the first half of this year [2].

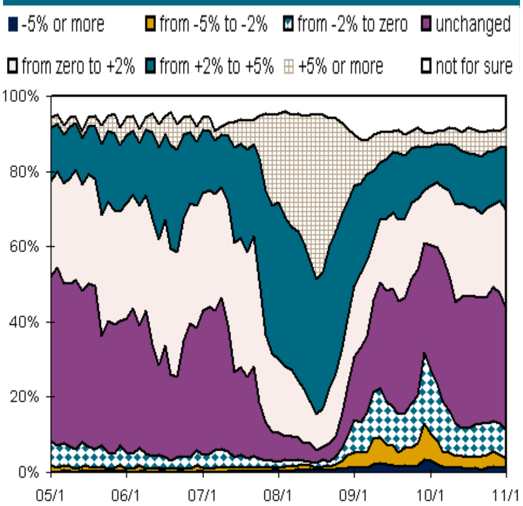
While implications from corporate activities to interest rates are rather simple, scanning consumers' minds is complicated. The 2nd graph demonstrates that, over the last couple of months, an increasing proportion of households now expect consumer prices to firm up over the next 12 months. The weighted average of 1-year Inflation expectations is now

Net saving y sectors



Source : Flow of Funds, SNA, Amundi Japan

Landscape of inflation expectation by households



Source: Consumer Survey, Amundi Japan

[1] Cash flow in this context means net profits plus depreciation

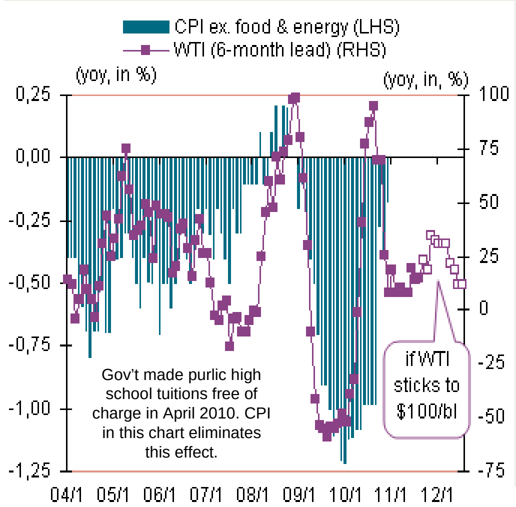
[2] Machinery orders showed a 3-month consecutive downward streak to last November, followed by a miniscule rebound in December. Projections for the Jan.-Mar. quarter remain unexciting.

standing at 1.0%, compared to close to zero a year earlier. Consumers are reacting sharply to the recent hike in the price of petrol and groceries. A higher inflation expectation tends to boost interest rates from time to time, with one important caveat. The key issue here is whether the household sector packs sufficient purchasing power to overcome inflation. In 2010, scheduled monthly earnings turned positive for the first time in five years. This, coupled with increased overtime hours worked and bonus payments pushed up nominal labour cash earnings by 1.8% in June 2010. However, stagnant industrial production on the back of the higher yen trimmed nominal wage growth to 0.1% YOY in December.

The combination of virtually no wage growth and higher inflationary psychology will not bode well for austerity. The graph opposite reveals an interesting aspect. While it is true that stronger commodity prices affect core CPI with a certain time lag, the extent of the rise in the latter appears disproportionally small. Frequently quoted is the fact that more than half of the core CPI component is dominated by services, which is inflexible to changes in commodity prices. However, another plausible explanation is that households without substantial purchasing power are forced to sacrifice consumption of other goods and services when the price of petrol and food jumps. Against this backdrop, dispersal of upward pressure on prices from upstream to downstream is somehow intercepted by the deteriorating supply-demand situation in major core CPI items.

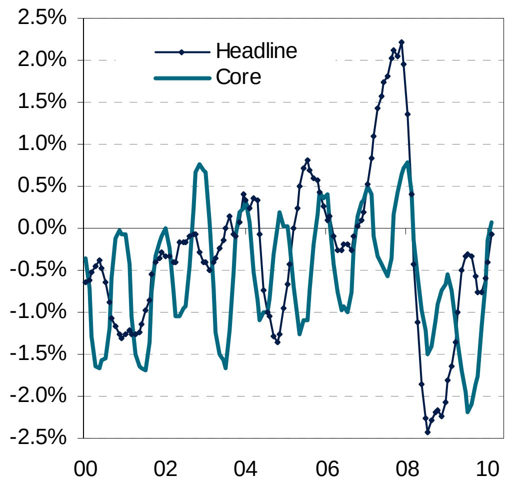
A sharp rise in upstream prices, before wages and salaries increase sufficiently to prevent households' real purchasing power being eroded, would drag down private demand rather than accelerating inflation. Ample reserves in the private sector help the government to fund procurement. In this circumstance, the bellwether 10-year JGB yield is likely to fall as low as 1.1% before bouncing back to 1.5% within a 12-month horizon.

Energy price and core CPI



Source : Nymex & Statistics Bureau, Amundi Japan

Japan: Headline vs Core inflation (6m/6m at annual rate)



Source: Datastream, Amundi Strategy

Cross asset investment strategy

Strategy and economic research

Contributors

Editor
Philippe Ithurbide - Head of Research, Analysis and Strategy

Contributors
Pauline Abadie - Equity Analysis - Paris
Sergio Bertoncini - Credit Strategy - Milan
Marc-Ali Ben Abdallah - Global allocation Strategy - Paris
Didier Borowski - Head of Strategy and economic research - Paris
Richard Butler - Head of Credit Analysis - Paris
Bastien Drut - FX & Fixed Income Strategy - Paris
Philippe Ithurbide
Delphine Georges - Global allocation Strategy - Paris
Sylvie de Laguiche – Head of Quant research - Paris
Rémy Lambinet - Global allocation Strategy - Paris
Laureline Martin - Equity analysis - Paris
Emmanuel Martin - Equity analysis - Paris
Eric Mijot - Head of Equity Strategy – Paris
Anne-Charlotte Paret - Macroeconomics - Paris
Florian Roger - Head of Macroeconomics - Paris
Stéphane Taillepied - Head of Equity analysis - Paris
Ibra Wane - Equity Strategy - Paris
Akio Yoshino - Equity Research and Strategy - Tokyo