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Fundamental analysis is once again a driver for valuations

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After much procrastination, various announcement effects and surprising political developments, media coverage of the euro-zone crisis has reached a boiling point. Questions concerning the handling of this crisis, which has had a significant impact on global equity prices and market volatility, are still in the spotlight. In this environment it is difficult to see clearly even a few days ahead and try to anticipate what markets will do over the near term. We believe it is more useful to look beyond these considerations and examine the economic fundamentals that have enabled both European and US equity markets to rebound rather vigorously, by 10% to 15% from their recent lows.

This October has been an historic month for Wall Street, with the Dow Jones index posting its best monthly performance since October 2002 and the S&P500 index up 11% for its highest monthly gain since December 1991. This performance shows that Americans, who are less concerned about the political issues than the Europeans, have been paying attention to some fairly reassuring economic fundamentals. The first of these is the GDP growth rate, which rose at an annualized rate of 2.5% in the third quarter of 2011, driven mainly by domestic demand and especially household consumption despite a negative contribution from inventories. Given the various supporting factors observed, it is very likely that growth in the fourth quarter will be similar and thus eliminate the risk of a double-dip recession for the US economy, as many market participants had recently been fearing. This GDP growth enabled 70% of US companies to post better-than-expected earnings for the third quarter, increasing by 18% compared to last year.

The second positive factor in October were the emerging countries, whose economic indicators have strengthened and dispelled fears of a marked slowing of their economies. This is the case for example of China, where inflation is easing and which could like Brazil loosen its monetary policy, albeit by lowering reserve requirements instead of interest rates. This trend has lifted the emerging markets, enabling most of them to outperform over the recent period.

Despite political turbulence, the euro-zone markets have also improved. Although their performance may seem surprising, their macroeconomic data also suggest that economic conditions are improving. Household consumption is steady and economic research institutes, which were expecting vehicle registrations in France to decline by 8% in 2011, are now less pessimistic. As for the ECB, it has acknowledged the severity of the euro-zone crisis and lowered its main policy rate to 1.25%. Although this easing of monetary policy should be good for the region's growth, Europe's situation is still delicate and continues to raise the question of events in Greece and their potential repercussions on the rest of the euro-zone. We have always said that Greece in itself is not a significant factor, since the financial consequences of its decision to keep or abandon the euro would be more or less equivalent for the euro-zone and bearable. The real issue with which the region's governments must grapple is the prospect of contagion to Italy, the current focal point of the euro-zone crisis. We believe this risk can be contained if EU authorities succeed in finding an orderly solution to the Greek crisis, with the support of the European Central Bank and the European Financial Stability Fund (EFSF). Moreover, the Brussels summit last October 26 does suggest that some progress has been made on the issue of aid for Greece, although much remains to be determined. The summit also focused attention on two additional measures: the recapitalization of euro-zone banks and the expansion of the EFSF. Regarding this first point, many banks have announced that by June 2012 they will have raised their capital adequacy ratio to 9% by shrinking their balance sheets, increasing retained earnings and cutting costs (particularly bonuses) thereby boosting their profits. Judging from these announcements, investors' concerns that banks will not be able to recapitalize sufficiently seems to be exaggerated. Regarding the expansion of the

European Financial Stability Fund, it will be increased to € 1,000 billion to enable it to meet the needs of such countries as Spain and Italy, although the practical details are still somewhat vague. Lastly, the most recent political developments in Greece and Italy are encouraging and tend to give credibility to fiscal consolidation policies.

Investment Strategy

The rebound in equity markets was mainly driven by cyclical stocks, which fell most sharply over the summer and are the first to benefit from positive economic data. In bond markets, we observed high volatility in October and upward pressure on euro-zone yields. The Italian spreads reached an historical high and the French ones are higher than the German spreads for about 150 basis points, the highest level since the euro-zone's creation. Against this background, Ireland, which is not threatened by contagion, saw its yields continue to decline in response to encouraging macroeconomic data. Credit markets have also been very volatile with the current situation having substantial repercussions on the financial bonds and other corporate bonds of the peripheral countries. In terms of strategy, we currently see no point in reacting to market events on a day-to-day basis and trying to anticipate market fluctuations. We prefer to adopt a longer term strategy for our portfolios, based on such fundamental factors as global economic growth, declining price indices and strong corporate earnings, which tend to be encouraging. In light of these factors, we believe that equity markets are still attractive, even though investors must deal with uncomfortably high volatility.