



# Investment Strategy

## 17 January 2012.



<b>ASSET ALLOCATION</b> .....	<b>2</b>
<b>ECONOMIC OUTLOOK</b> .....	<b>3</b>
Viewpoint .....	3
Developed economies .....	4
Emerging economies .....	5
<b>BOND MARKETS</b> .....	<b>6</b>
Government Bonds .....	6
IG and HY credit .....	7
<b>CURRENCY MARKET</b> .....	<b>8</b>
<b>EQUITY MARKETS</b> .....	<b>9</b>
Developed markets .....	9
Emerging markets .....	11
<b>ALTERNATIVE STRATEGIES</b> .....	<b>13</b>
Commodities .....	13
<b>CONTACTS &amp; DISCLAIMER</b> .....	<b>14</b>

### Is the upturn sustainable?

Since the start of 2012, markets have remained in a fairly buoyant mood, marked in particular by an upward move in risky assets and a positive trend for certain intra-EMU spreads. The cause of this more favourable trend is probably a shift in the market's attention from the eurozone crisis (which dominated the second half of 2011) to other more promising subjects. These include the signs of resilience of the US economy, which in recent months confirmed that it was still positive, and the Chinese economy (the leading indicators and the latest GDP figure likewise point to a soft landing), and the easing of financial conditions in Europe due to the refinancing operations carried out by the ECB.

These factors are positive, but are not extremely surprising and are in line with our expectations. US growth has not proved higher than what the consensus of economists was already expecting a few months ago, Chinese growth is still settling in to a cruising speed that is less vigorous than before, and for most observers, including ourselves, there has never been any real doubt that the ECB would provide sufficient liquidity to the banks for their funding. This rebound can therefore also probably be seen as a "backlash" against the generally pessimistic consensus and conservative positions that have prevailed among investors for several months now.

This respite is worth enjoying, but we do not regard it as a trend turnaround, for several reasons. First, we believe that, all in all, US growth will remain limited in 2012, and it is unlikely that, as the year progresses, markets will be enthusiastic about the growth outlook in the United States given the fiscal tightening that will have to begin next year. Next, in the case of the eurozone, we consider that the economic risks are on the downside and that little has been settled. The cases of the countries which in our opinion represent a high risk of insolvency (Greece, Portugal, Ireland) have not been dealt with, there is still no new financing mechanism in place in the eurozone, the flaws of the monetary union have undergone little or no discussion, and the pro-cyclical economic policy of eurozone governments is still as threatening for growth prospects. With political deadlines coming closer (in particular the difficult negotiations on the new treaty, which was agreed to in principle in December 2011), the Greek PSI issue which seems to be at a standstill, and a sharp increase in the pace of debt refinancing in the coming weeks, it can be feared that the eurozone will become the focus of market concern again.

For these reasons, we largely maintain the cautious investment recommendations that we were already giving last December.



## ASSET ALLOCATION

### Allocation decisions

- Negative recommendation on developed equities, and neutral on emerging equities, for which we maintain a preference.
- Virtually neutral on government bonds and credit.

### Developed equity market arbitrage

- We recommend relative overexposure mainly to Switzerland and the United Kingdom (with currency hedging).
- Negative position maintained on eurozone equities.
- Neutral on Japan and Australia, underweight on Canada.

### Emerging equity market arbitrage

- Unchanged preference for China and Russia, and an improvement in our recommendation on Brazil.
- Neutral on South Korea and South Africa.
- Underweight on Turkey, India and Taiwan.

## Recommended allocation – Investment Strategy Team

### ASSET ALLOCATION MODEL PORTFOLIO

January 2012

#### MULTI-ASSET CLASS <sup>1</sup>

	Alpha	Current weight	Previous weight
<b>EQUITIES</b>			
Developed Equities	-0.07	-0.6%	-0.6%
Emerging Equities	0.06	0.3%	0.5%
<b>FIXED INCOME</b>			
Government Bonds	0.03	1.0%	1.3%
Investment Grade	0.05	1.8%	-0.1%
High Yield	0.04	0.4%	0.2%
Emerging Debt	0.00	0.0%	0.2%
Emerging Debt Local	0.00	0.0%	0.3%
<b>COMMODITIES</b>			
Brent Oil	-0.04	-0.1%	-0.1%
Base Metals	0.04	0.4%	0.2%
Gold	0.43	2.3%	2.3%
Agricultural	0.05	0.4%	0.5%
Cash Euro		-6.0%	-4.5%
<b>Module Total</b>		<b>0.0%</b>	<b>0.0%</b>

#### PORTFOLIO STATISTICS

Target Ex-ante Volatility	2.00%
Real Ex-ante Volatility	1.04%

#### EQUITY DEVELOPED COUNTRIES <sup>1</sup>

	Alpha	Current weight	Previous weight
US	0.00	-0.2%	0.9%
Canada	-0.05	-3.8%	-3.2%
Euroland	-0.03	-2.3%	-2.1%
Japan	0.00	-0.4%	1.3%
UK	0.04	5.1%	4.8%
Switzerland	0.04	1.9%	0.6%
Australia	0.00	-0.3%	-2.3%
<b>Module Total</b>	<b>0.00</b>	<b>0.0%</b>	<b>0.0%</b>

#### BOND COUNTRIES SOVEREIGN <sup>1</sup>

	Alpha	Current weight	Previous weight
US	-0.13	-13.9%	-13.0%
Euroland	0.03	3.7%	1.8%
Japan	0.00	0.0%	0.0%
UK	0.09	10.2%	11.2%
Switzerland	0.00	0.0%	0.0%
<b>Module Total</b>	<b>0.00</b>	<b>0.0%</b>	<b>0.0%</b>

#### EQUITY EMERGING COUNTRIES <sup>2</sup>

	Alpha	Current weight	Previous weight
Brazil	0.10	0.7%	0.2%
China	0.27	2.0%	1.7%
India	-0.13	-1.0%	-0.1%
South-Korea	0.00	0.0%	-0.1%
Taiwan	-0.10	-0.7%	-1.8%
Russia	0.11	0.5%	1.0%
South Africa	0.02	0.0%	0.3%
Turkey	-0.27	-1.5%	-1.2%
<b>Module Total</b>	<b>0.00</b>	<b>0.0%</b>	<b>0.0%</b>

1-Hedged in Euro, 2-Local Currency

Source: BNPP AM



## ECONOMIC OUTLOOK

### VIEWPOINT

#### United States: Do not assign too much importance to the "good" figures, nor the "bad" ones

##### Watch out for "surprises"

Since last summer, the economic surprise indices (produced by comparing the published data with the expectations of market economists) have improved significantly in the United States, and in early January they returned close to their highs of March 2011. Since then they have levelled off and will probably start to fall back because, by definition, these series have a strong mean reversion property when expectations are realigned, upward or downward. Beyond these short-term fluctuations and changes of consensus, what does the latest available economic data tell us?

##### Subdued consumption in the coming months

While comments by retailers (shops and commercial websites) pointed to a good start to holiday-season purchasing in the days following Thanksgiving, the official figures showed practically flat retail sales in December. Given this momentum, real consumer spending probably grew 2% to 2.5% at an annualised rate and is likely to remain on this trend in coming quarters. The improvement in employment is still limited and the savings rate returned to 3.5% at the end of 2011 (versus almost 6% in the summer of 2010), which leaves little margin for consumption to increase much faster than wage income. Moreover, despite the improvement in sentiment, households do not intend to purchase big-ticket items in the next six months, given that their net wealth continued to decline in the third quarter.

##### An investment lag to be caught up

Business investment is expected to remain relatively robust, mainly because the renewal of certain equipment now seems essential at a time when companies have the means to invest and when the average age of capital stock (approximately seven years) is high and will fall only after several years of investment at a rate exceeding 10%. Following increases of 14.6% in real terms in 2010 and about 10% in 2011 (affected by a slowdown at the very end of the year), investment in capital goods could gather pace again. The survey of small businesses conducted by the NFIB (*National Federation of Independent Business*) shows that 24% of SMEs plan investments in the next three to six months: this is the highest percentage in more than three years, but it is still far lower than the percentage with a normal growth rate.

##### Confidence will be key to growth

The investment and employment decisions of SME owners are of course influenced by the economic environment, but also by the political context. The election year has just started with the Republican Party primaries but, in the opinion of political analysts, so far these elections have aroused no particular enthusiasm. Moreover, the economic policy conducted by the administration is very poorly viewed by the citizens, and the uncertainties surrounding the fiscal measures for 2012 and 2013 are likely to restrict initiatives by corporate managers and rein in household buying intentions. A virtuous circle could be established if a more marked improvement in employment reassured consumers, boosted domestic demand and justified widespread hiring which, in turn, would stimulate activity. This is not our core scenario, but note that, while we can imagine such an upside risk, we do not for the time being see a major downside risk for the US economy, apart from an exogenous financial shock from Europe whose consequences could be similar to the effects of the Lehman Brothers bankruptcy.

### Consensus Forecasts: Growth & Inflation

	GDP YoY %									Inflation YoY %								
	2010	2011				2012				2010	2011				2012			
		M	H	L	-1M	M	H	L	-1M		M	H	L	-1M	M	H	L	-1M
M= Mean; H= High; L=Low																		
<b>Developed Economies</b>																		
USA	3.0	1.7	1.8	1.7	[1.8]	2.1	3.1	1.3	[2.1]	1.6	3.2	3.3	3.0	[3.2]	2.1	3.5	1.4	[2.1]
Canada	3.2	2.3	2.4	2.1	[2.3]	2.0	2.5	1.5	[2.0]	1.8	2.9	3.0	2.8	[2.9]	2.0	2.8	1.7	[2.0]
Eurozone	1.8	1.6	1.7	1.5	[1.6]	-0.1	1.0	-1.3	[0.4]	1.6	2.7	2.8	2.5	[2.7]	1.8	2.2	1.3	[1.8]
UK	1.8	0.9	1.0	0.7	[1.0]	0.7	1.8	-0.5	[1.1]	3.3	4.5	4.7	4.4	[4.5]	2.7	3.3	0.9	[2.8]
Switzerland	2.7	1.7	1.9	0.7	[1.8]	0.2	1.4	-1.1	[0.7]	0.7	0.3	0.4	0.2	[0.4]	-0.1	0.6	-0.7	[0.1]
Japan	4.5	-0.6	0.1	-0.9	[-0.4]	2.0	2.9	0.7	[2.1]	-0.7	-0.2	0.3	-0.5	[-0.3]	-0.2	0.8	-0.8	[-0.2]
Australia	2.6	1.9	2.2	1.5	[1.6]	3.5	4.5	2.5	[3.5]	2.8	3.5	3.6	3.3	[3.4]	2.8	3.6	2.3	[2.9]

Source: Consensus Forecasts as of 12/12/2011



## DEVELOPED ECONOMIES

### Eurozone: Everything is getting worse!

#### The recession is here...

January 2012 will (possibly) be remembered as the month in which the Standard & Poor's rating agency downgraded the ratings of nine European countries, notably depriving Austria and France of their Triple-A. The deterioration of the economic situation in the main countries appears more worrying than this minor incident and should not be masked by the slight rise in certain economic indices at the end of 2011. The composite index reflecting purchasing manager surveys in the manufacturing and service sectors recovered to 48.3 in December, but its average for the fourth quarter was 47.2, the lowest since mid-2009. Such a level is associated with a contraction in GDP, and the components (employment, orders) point to a continuation of this trend in early 2012. Retail sales fell sharply in November and are unlikely to find any support due to the rise in unemployment and fiscal tightening in several countries.

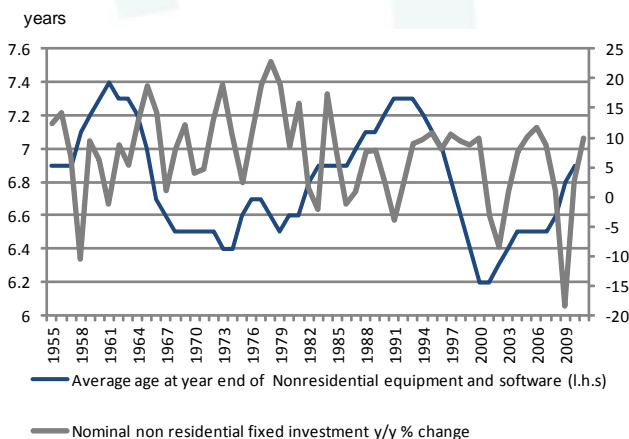
#### ... and it is everywhere

According to initial estimates, **the German economy** – still robust with 3% growth in 2011 (following 3.7% in 2010) – posted a slight contraction at the end of 2011. The IFO survey of business leaders reflects a weak outlook at the start of this year. In **France**, GDP stagnated between the third and fourth quarters following slight growth (+0.2%) in domestic demand relative to the second quarter, and survey data have been deteriorating rapidly since the summer. The debates of the presidential election campaign are likely to maintain great uncertainty regarding economic policy trends (in particular taxation) and hamper consumption. In **Italy**, where GDP contracted as of the third quarter, the prime minister announced that he would swiftly introduce structural reforms designed to increase the growth potential (0.2% in 2011 according to the OECD), while the austerity measures designed to restore a balanced budget as of 2013 will inevitably depress activity and threaten the survival of his technocrat government. The latest news from **Spain** is not encouraging: the new government has hinted that the budget deficit for 2011 far exceeds the forecasts (8% versus 6%), which could lead to further fiscal tightening if the target for 2012 (4.4%) is maintained. **Greece** and **Portugal**, which have likewise exceeded their budget deficit targets, will experience a deep recession, as shown by survey data almost as gloomy as at the time of the Great Recession. With a very slight decline in GDP expected for the eurozone in 2012 (-0.1%), we consider the consensus is still too optimistic, even though the relative resilience of the US economy and the expected renewed acceleration in emerging economies should enable Europe to avoid a drastic recession.

#### The ECB as the ultimate saviour?

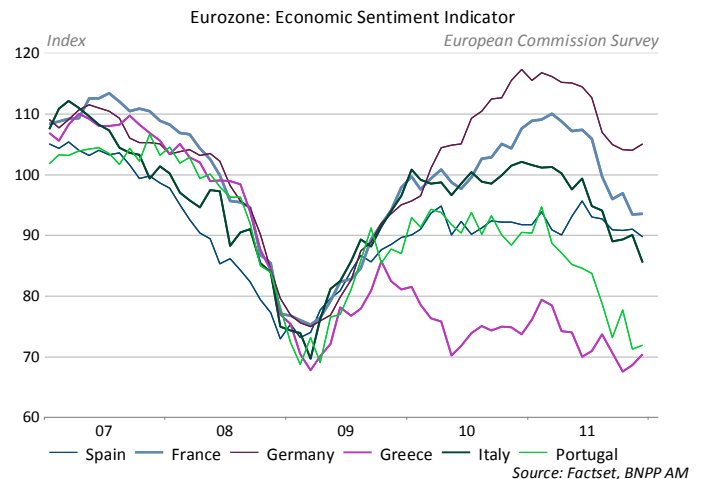
The adverse economic environment and the expected decline in inflation (2.8% in December) will enable the ECB to further lower the refi rate (reduced to 1% in December). Moreover, the ECB will probably continue to use its panoply of unconventional measures to provide liquidity to the European banking system at all costs. These operations are presented as a means to facilitate the good transmission of monetary policy and not as exceptional measures to support financial institutions or the market. The monetisation of debt via massive purchases of government bonds is not on the ECB's agenda, but could be introduced as Greece moves dangerously closer to bankruptcy.

#### United States: Investment should be robust



Source: Factset, BEA, BNPP AM

#### Marked slowdown in activity in the eurozone



Source: Factset, BNPP AM



## EMERGING ECONOMIES

### The trough of the cycle is near

**Further deterioration of economic activity, but stabilisation of the leading indicators**

The deceleration of the emerging economic cycle continues, fuelled by the deterioration in demand from the advanced economies (especially Europe) and slackening of domestic demand in the major emerging economies. Monetary tightening is starting to affect domestic consumption via the cost of credit or via a sharp deceleration in investment and real estate. The leading indicators of emerging countries still point to a continuing economic slowdown for the coming months, although the rate of deterioration has stabilised, according to opinion polls. Industrial output continues to contract in year-on-year terms. Inflation has also declined, from 6.3% to 5.3% last month, which backs up the authorities' monetary easing efforts.

Asia is slowing down, adversely affected by exports of course, but also by domestic demand which was the main engine driving the recovery. Growth prospects are still being downgraded, reflecting monetary tightening and the effects of the financial crisis on lending conditions. However, the risks of a drastic deterioration remain limited, because the authorities have the financial clout to stimulate domestic demand if necessary.

**Firming of the Chinese economy expected in the second quarter**

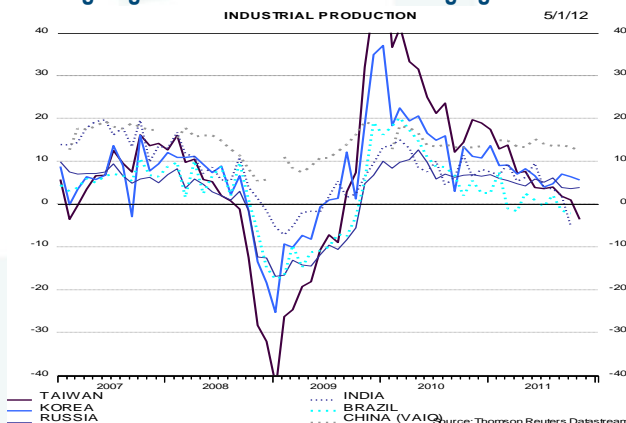
The **Chinese** economy continues to slow down but will probably reach the trough of its cycle around the end of the first quarter, before firming at the end of the year. Exports have deteriorated, SMEs are affected by the drying-up of credit, while real estate prices and transaction volumes are still falling in most of the large cities. Planned measures to stimulate the economy include an increase in new lending, a lowering of the RRR (Reserve Requirement Ratio), the launch of new infrastructure programmes, e.g. for rail transport, tax cuts to boost private consumption, and subsidies for certain real estate purchases. Some real estate developers are having to liquidate their stocks at a heavy discount, undermining the confidence of property owners, who not so long ago were still convinced that real estate was "rock-solid". A banking crisis is unlikely because the amount of lending is small relative to the value of the underlying (less than 50%). On the other hand, banks will be affected by lending to local governments, for which the collateral - and especially the income - depends heavily on real estate and land prices. The deterioration of the Chinese economy has led to a contraction in foreign exchange reserves, reflecting speculative fund outflows and an increase in Chinese investments abroad. This should reduce the upward pressure on the RMB.

**India: Political paralysis, increased deficits and currency depreciation**

The economic situation remains problematic in **India**, due to inaction by the authorities, the high level of interest rates and an adverse global environment. Moreover, highly populist measures are exacerbating the budget deficit, while the sharp depreciation of the rupee is amplifying the current-account deficit, which has become hard to finance due to the financial crisis in Europe. Against this backdrop, the government has revised its growth outlook to 7% for fiscal year 2012. The situation is improving in **Brazil**. Subsiding inflation should enable the central bank to loosen its monetary brakes and stimulate domestic demand, which is extremely dependent on consumer credit. The stabilisation of the Chinese and US economies is also positive for exports.

**Positive outlook for Brazil thanks to monetary easing**

Ongoing economic slowdown in emerging countries



Source: Datastream, BNPP AM

China: Loss of confidence in real estate



Source: Bloomberg, BNPP AM



## BOND MARKETS

### GOVERNMENT BONDS

#### The United States in better shape than Europe...

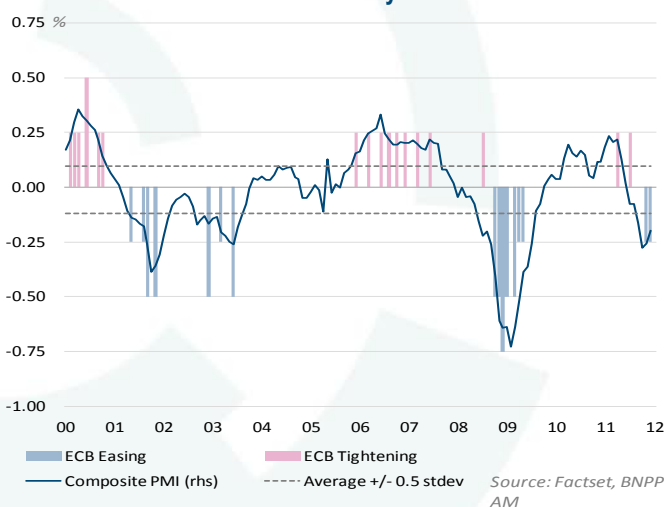
##### Confirmation of subdued but positive growth in the United States

In the United States, the latest economic figures seem to confirm the scenario of subdued but positive growth. The leading indicators remain positive and seem to have stabilised, while the job creation figures, although not very high, go nevertheless in the right direction. However, the country is not immune to further weakening, and the Fed's bias is still generally in favour of a more accommodative monetary policy, in particular to shore up the real estate sector (cf. statements along these lines made by William Dudley, Eric Rosengren and Sandra Pianalto). Meanwhile, it will start publishing its projections for the policy rate as of the January meeting. In this environment, the performance of US long-term yields raises questions. With an economy that is not brilliant but is not collapsing either, and in the wake of positive economic surprises, it might have been expected that there would be upward pressure on yields, but this has not occurred. Of course, we still do not expect yields to return to high levels anytime soon, but some reaction to the good news would have been logical. This probably reflects risk aversion, due in particular to the problems in Europe, and a "search for quality", which means that investors turn to US Treasuries despite far-from-reassuring fiscal dynamics. This is why we still prefer Gilts and Bunds to USTs.

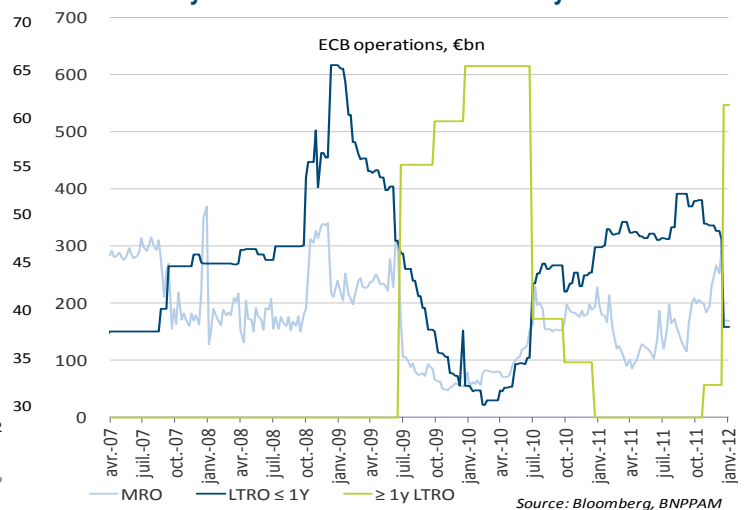
##### Coming decisions for Greece

In Europe, the latest PMI leading indicators have shown some signs of stabilisation, suggesting a pause in the economic slowdown seen in recent months. However, given the coming fiscal tightening, for the time being the risks are still on the downside. Apart from these economic aspects, the sovereign crisis is still topical. In addition to the discussions concerning fiscal consolidation and bailout mechanisms, the finalisation of the measures concerning Greece is of special importance at the start of this year. Discussions concerning private sector involvement (PSI) in the restructuring of public debt are in progress, and are proving difficult. They hinge around calculation of the haircut, the coupon on the new bonds offered in exchange, the introduction of collective action clauses, the role of the ECB and the triggering of CDS contracts. Moreover, European bond markets will be faced with a very busy issuance schedule in the first quarter, where the demand for paper is not certain. In this situation the ECB will have to remain prepared to intervene when necessary, even though its reluctance to make intensive use of the Securities Markets Programme is well known. Meanwhile, it nevertheless did a good operation with the first 3-year LTRO, which it considered positive, helping steepen the peripheral yield curves. As regards the level of its policy rates, we expect at least one further cut.

#### Interest rate cuts likely for the ECB



#### The 3-year LTRO considered a success by the ECB





## IG AND HY CREDIT

### ... and this holds for credit too

#### **Rather favourable environment in the United States**

Recent weeks confirmed that the economic environment in the United States should support credit, including the most speculative issues, but the news from Europe still gives grounds for some caution.

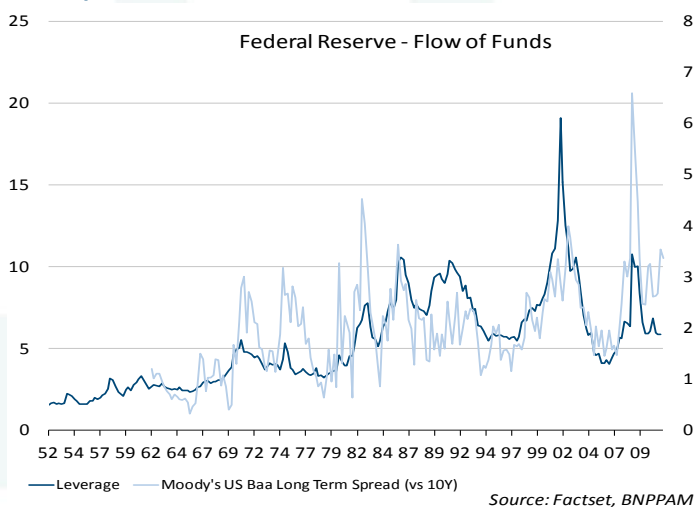
The fact that US growth is heading toward low but positive levels provides a context that should not be unfavourable for credit. Valuations there are attractive, the fundamentals are sound and the asset class is still attractive in an environment of very low underlying interest rates. Regarding more speculative credit, for the time being we see no major increase in defaults. The SGL indices, which give an indication of companies' difficulties in obtaining liquidity via internal and/or external funding, remain at low levels, which reduces the likelihood of an increase in default rates in the near future.

#### **Positive sentiment for European credit, but the structural problems should not be overlooked**

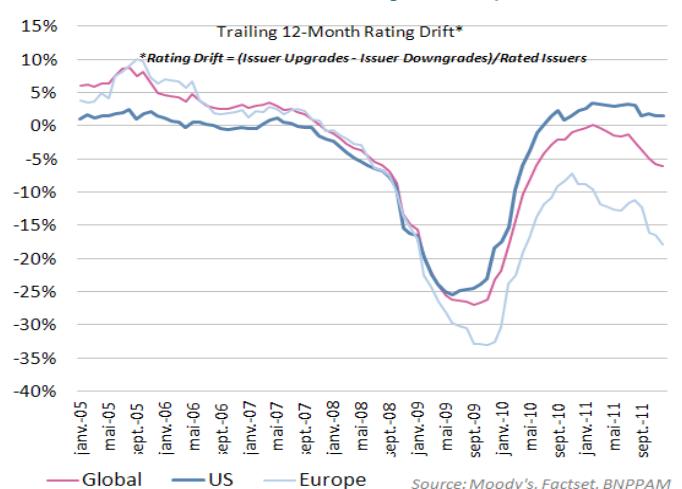
However, the market is obviously still sensitive to events in Europe, where the sovereign crisis persists and growth will face difficult times. Nevertheless, the start of this year is so far rather positive for the credit market. The ECB's 3-year LTRO helped relieve the banking sector, heavily penalised in the second half of 2011, while more positive sentiment from the peripheral government bond sector and narrowing spreads also positively impacted the credit market. This helped private issuers come into the primary market with large volumes, and in the first two weeks of the year unsecured issues exceeded those in the same period of 2011. However, this phenomenon is especially true for non-financial companies, as financial companies are still suffering from a geographic bias in favour of the core countries relative to the peripherals. Moreover, the primary market still has relatively high premia, on which the secondary market subsequently tends to align itself. In general, although this positive sentiment could last a little longer yet, one should not overlook the structural problems of the eurozone which have still not been resolved, which is why we remain somewhat cautious.

We still maintain a more positive view for credit in the United States than in Europe.

### Top-down fundamentals in the United States still sound



### Deterioration of ratings in Europe





## CURRENCY MARKET

### The EUR/USD exchange rate settles below 1.30

#### *The growth gap and the sovereign crisis are weighing on the euro*

The EUR/USD exchange rate was around 1.34 in early December, but the USD appreciated fairly sharply after 12 December, bringing the exchange rate rapidly below 1.28 on 6 January, a level around which it has fluctuated since. This move reflects a **decline of the euro**: against a basket of currencies, the single currency lost 2.3% from mid-December to mid-January, returning to its lowest level since mid-2005 (based on the trade-weighted exchange rate calculated by the Bank of England). In recent weeks, the euro suffered from concerns over the sovereign crisis (conclusions of the summit of heads of state and government on 8 and 9 December considered unconvincing, alarmist comments by the rating agencies) and the 13 January downgrade of the ratings of nine European countries by Standard & Poor's. Although the sovereign crisis seems out of its acute phase, worries persist, especially concerning a possible Greek bankruptcy and the major bond auctions (Italy, Spain, etc.) scheduled for the first quarter of 2012. Although the initial bond issues for the year were generally well absorbed, the euro did not benefit from this, which indicates that there are still worries about this issue. The economic situation is also likely to depress the currency: the recession in the eurozone has begun, and this will probably lead the ECB to further ease its monetary policy. Conversely, the improving figures in the United States point to modest but very real growth in the US economy, providing support for the US dollar. In this environment, and apart from possible short-term corrections which could result from an unwinding of very significant speculative positions, **we expect a further decline in the EUR/USD exchange rate**. For the same reasons (accommodative monetary policy and weak economic prospects), the **pound sterling**, which recently benefited from the euro's difficulties, will probably lose ground against the US dollar in 2012.

#### *The yen stabilises*

The **USD/JPY** exchange rate remained relatively stable around 78 in December, before falling at the very end of the year below 77 despite very cautious comments by the Japanese authorities on the economic situation, with in particular a downward revision of the projections of the Bank of Japan, which now expects growth to stagnate until the spring of 2012. The threshold of 75 is viewed by market participants as the level from which the BoJ triggers its intervention in the currency market, and should therefore form a floor for the exchange rate. Conversely, the "defensive" nature of the Japanese currency limits the possibility of a rapid depreciation in the current, still turbulent context.

#### *The Swiss franc still under control*

The resignation of Philipp Hildebrand, chairman of the Swiss National Bank, following a conflict of interests related to transactions performed by his wife, will not lead to any change in the central bank's exchange rate policy. The floor of 1.20 for the **EUR/CHF** exchange rate should continue to be defended, even though the euro fell back below 1.21 Swiss francs at mid-January.

The overall economic scenario is in theory not negative for those currencies whose performance is traditionally linked to that of **commodity** prices, but a clearer resurgence of risk appetite will be needed before they could appreciate. The Norwegian krone and Swedish krona are hurt by their closeness to the eurozone.

### FX Rate Forecast Summary (Major Currencies)

End of Period		2011	13-Jan-12	1Q 2012		2Q 2012		3Q 2012		4Q 2012	
				Min	Max	Min	Max	Min	Max	Min	Max
USD Block	EUR / USD	1.30	1.2797	1.20	1.30	1.15	1.25	1.15	1.25	1.15	1.25
	USD / JPY	77	76.76	75	80	75	80	77	87	77	87
	USD / CAD	1.02	1.0206	0.97	1.07	0.95	1.05	0.95	1.05	0.95	1.05
	AUD / USD	1.03	1.0310	0.95	1.05	0.97	1.07	0.97	1.07	0.97	1.07
	GBP / USD	1.55	1.5319	1.44	1.62	1.33	1.50	1.33	1.50	1.33	1.50
	USD / CHF	0.94	0.9460	0.96	1.04	1.00	1.08	1.04	1.13	1.04	1.13
EUR Block	EUR / JPY	100	98.22	94	100	90	96	92	104	92	104
	EUR / GBP	0.84	0.8354	0.77	0.87	0.80	0.90	0.80	0.90	0.80	0.90
	EUR / CHF	1.21	1.2106	1.20	1.30	1.20	1.30	1.25	1.35	1.25	1.35

Source: BNPP AM as of 13/1/2012



## EQUITY MARKETS

### DEVELOPED MARKETS

#### Despite the recent cyclical improvements, structural constraints continue to weigh very heavily

##### *Ongoing cyclical improvement at the global level*

The ongoing cyclical improvement in global economic activity indicators (PMI) has supported risky assets, especially equities. However, it is still too soon to foresee a permanent improvement when the fundamental problems persist, especially in the eurozone. The pro-cyclical fiscal consolidation measures that are currently being adopted in Europe and will be stepped up further during the year will continue to hold back growth that is already weak and vulnerable. Moreover, the surprise rates of surprises on recently published macroeconomic data have reached all-time highs, especially in the United States, and are logically expected to become less and less favourable to equity markets in the coming months.

##### *Increasingly active central banks...*

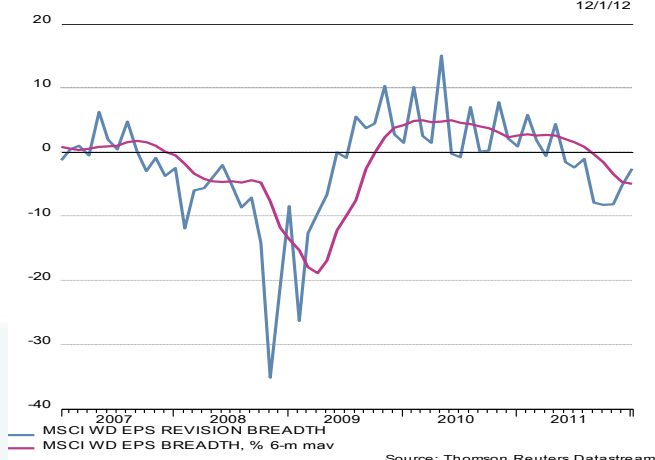
Despite very positive yield curves and low real interest rates, financial conditions remain tight due to high risk aversion. The monetary policies of the major central banks will therefore remain extremely accommodative. For the time being, although it is not carrying out quantitative easing strictly speaking (vetoed by Germany and the proponents of strict monetary orthodoxy in the eurozone), the ECB is trying to inject liquidity into the economy via the banking system. Its wager is that by providing banks with unlimited liquidity at very low interest rates, they will take advantage of this to buy sovereign debt and will lend to companies and households. So far the results are limited, but the process is still very recent. The regulatory constraints which are leading banks in particular to reduce the size of their balance sheets and their risky exposures are a considerable impediment to the success of this operation, although it at least helps overcome the liquidity problems (short-term funding) currently faced by the banks.

##### *Less negative earnings revisions but the long-term trend has not yet been inverted*

The fourth-quarter earnings reporting season is currently getting under way. Following numerous corporate profit warnings, expectations are at relatively low levels, which considerably limits the risk of disappointments for this quarter. Longer-term, however, we consider the consensus of earnings growth expectations still very optimistic. While analysts, correctly in our opinion, look for a pronounced slowdown in sales growth, at the same time they expect a further rise in margins from the extremely high current levels. In our opinion, therefore, there is still potential for a further downward adjustment of earnings expectations which will probably continue to hold back the markets' rise. Moreover, the slope of the balance of earnings revisions smoothed over six months is still slightly negative at the global level, even though it is improving. If this indicator were to turn around to the upside again (i.e. fewer and fewer negative revisions), it would be a very positive signal for markets. We are not there yet, but are keeping a very close watch on its movements.

**MSCI World: Balance (breadth) of earnings revisions**

12/1/12



Source: Datastream, BNPP AM

#### Earnings growth expected by the analysts' consensus: Slowdown in sales growth, rise in margins

MSCI WORLD	2011e	2012e	2013e
EPS growth expectations	9.7%	10.7%	11.9%
Sales growth expectations	7.6%	3.5%	4.2%
Net margin level (EPS/sales)	7.7%	8.2%	8.8%

Source : Datastream, I/B/E/S, BNPP AM



## DEVELOPED MARKETS

### *It is too soon yet to focus on valuations*

Moreover, we still think that it is too soon yet to use valuation criteria as a buy signal. The risks that continue to overhang earnings revisions put into perspective the apparent attractiveness of forward PERs. Moreover, structural constraints on the economy and lack of visibility limit the potential for a rise in valuation multiples. The only valuation indicator clearly positive for equities remains the comparison with fixed-income products, corporate bonds and government bonds.

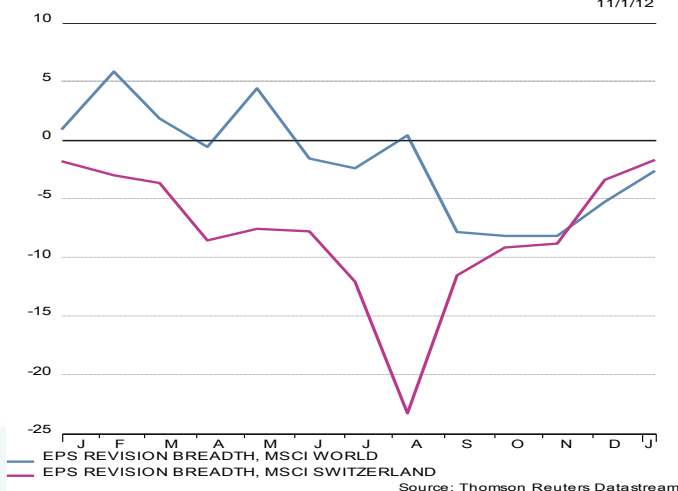
In technical terms, the long-term market trend indicators have recovered sharply in the wake of the stock market rebound, but they do not yet send a formal Buy message. Furthermore, sentiment indicators have improved sharply in recent weeks and therefore, from a contrarian viewpoint, no longer provide support for the markets.

### *Reduction in exposure to Japanese equities to neutral*

In our geographic allocation, we reduce our exposure to **Japanese** equities to neutral. Despite valuations that are still extremely attractive in both relative and absolute terms, this market is penalised by the persisting firmness of the yen and by a weaker-than-expected economic recovery following the Fukushima tragedy. Following months of outperformance, we also reduce our exposure to **US** equities to neutral. Although they should continue to benefit from an extremely favourable monetary and fiscal policy in relative terms, and from high risk aversion, certain factors of support are diminishing. Earnings revisions are deteriorating in relative terms, and this trend could continue as a result of the appreciation of the US dollar and earnings growth expectations, especially regarding margins, that are still too optimistic in our opinion. Moreover, valuations are starting to become slightly stretched. Conversely, we raise our exposure to **Australian** equities to neutral. The monetary easing underway, although limited, is providing welcome support for the financial sector, which represents almost half of this market, and this is reflected in particular by an improvement in the rate of earnings revisions for the market as a whole. This offsets the market's heavy exposure to Chinese growth and commodity prices. We still favour the **Swiss** market for its defensive qualities and an earnings revision momentum that is still positive in the wake of the recent weakening of the franc, since these factors offset valuations that are still high. We also remain overweight in **UK** equities, despite a valuation that is now less favourable. The persistence of an extremely accommodative monetary policy against a backdrop of rapidly slowing inflation in 2012 will provide strong support for this market. For the time being we remain cautious on **eurozone** markets, despite their valuation and the fall of the euro, due, in particular, to a busy schedule of sovereign and corporate bond issuance in the near term. Lastly, we remain underweight in **Canadian** equities, which are still expensive and heavily dependent on commodity prices.

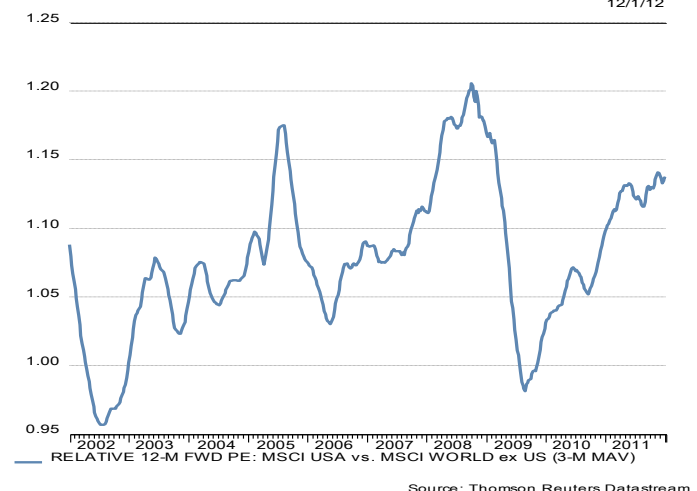
**Swiss market: Major improvement in earnings revisions**

11/1/12



**US market: Increasingly stretched relative valuation**

12/1/12





**EMERGING MARKETS**

**Falling interest rates, rising stock markets**

**Positive inflection of the leading indicators for emerging stock markets**

The valuation of emerging markets (PBV, PER) is close to historical lows, similar to those of the previous crises in 2003 and 2009. Following a steep decline, the trend in earnings revisions seems to be stabilising, corroborating the signs of an inflection in the leading indicators, expressed in terms of half-year and annualised growth. It is also in line with the prospects of a stabilisation in economic activity in emerging countries in the second quarter, following a long period of deceleration, even though domestic consumption remains subdued.

Historical research shows that, at current market levels, there is a high probability that emerging equities will deliver a positive performance in the following 12 months. The steep underperformance of emerging markets relative to developed markets (-10% in 2011) can be explained by risk aversion, and by a generally restrictive monetary cycle in emerging countries. The phenomenon is amplified by the predominant role of passive investment funds (the two largest emerging equity ETFs alone account for USD 80 billion!), greatly limiting the role of fundamentals in differentiating between markets.

**The resurgence of risk appetite and falling interest rates support a rise in multiples**

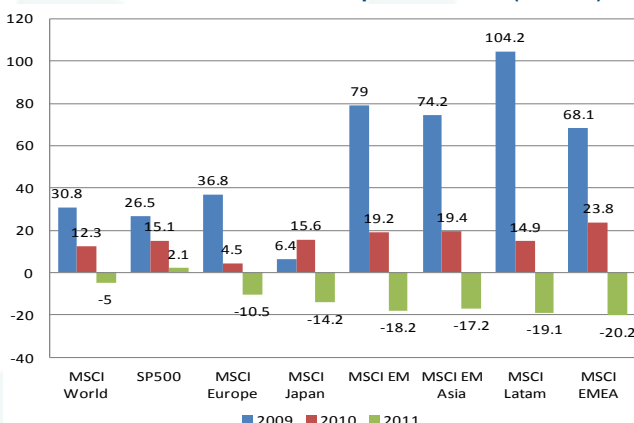
However, risk appetite seems to be returning, while subsiding inflation is allowing central banks to gradually abandon their restrictive policy, thereby easing the pressure squeezing valuation multiples. This explains the fall in the Chinese market's PER since November 2009, and its stabilisation since the appearance of signs of monetary easing in the past two months. In the coming months, combined fiscal and monetary stimulus and an increase in bank lending quotas should support a rise in the Chinese market's multiples.

In the near term, lack of visibility will continue to affect emerging stock markets, which will probably move in line with developed markets, even though their economic fundamentals are better. In this context, we give priority to stock markets with sound domestic fundamentals that are relatively unexposed to the global cycle. We are still avoiding markets suffering from imbalances, such as Turkey and India, but we have become more positive given the steep underperformance of these two markets in recent months.

**China: Monetary and fiscal easing positive for stock markets**

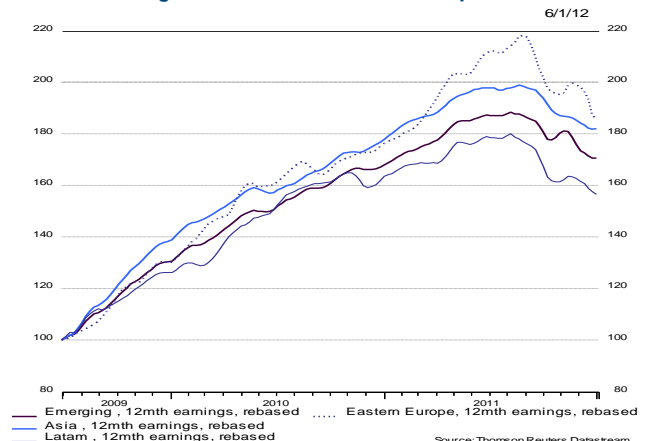
We remain overweight on **China**. The economic cycle continues to decelerate, slowed by foreign demand and by the decline of investment in infrastructure and construction. The correction in real estate prices will not only affect consumer confidence but also the financial situation of many local governments. However, the outlook is improving. Monetary aggregates are increasing again, the PMI has returned to expansion mode, inflation is slowing, and the authorities are focusing on moderate but stable growth. Further reductions in the RRR rates, increases in loan quotas and other fiscal plans will be implemented. Against this backdrop, valuation multiples, which are at a very low level of 9x, should ease and bolster the upward trend in the indices.

**Different fundamentals, same performances (USD, %)**



Source: Bloomberg, BNPP AM

**Earnings revisions: Glimmers of hope in Asia**



Source: Thomson Reuters Datastream  
Source: Datastream, BNPP AM



## EMERGING MARKETS

### Positive bias for domestic markets, negative bias for cyclical markets

#### **Brazil: Monetary and fiscal flexibility and falling inflation should support the market**

We increase our overweight position on **Brazil**. Inflation and producer prices continue to decline. The outlooks for employment and the trade balance are positive and should benefit fully from monetary policy easing and fiscal measures. Valuation multiples are at a similar level to those at the time of the 2008 crisis, but earnings growth expectations are modest. Monetary easing and the stabilisation of the economy are extremely positive factors for the Bovespa index.

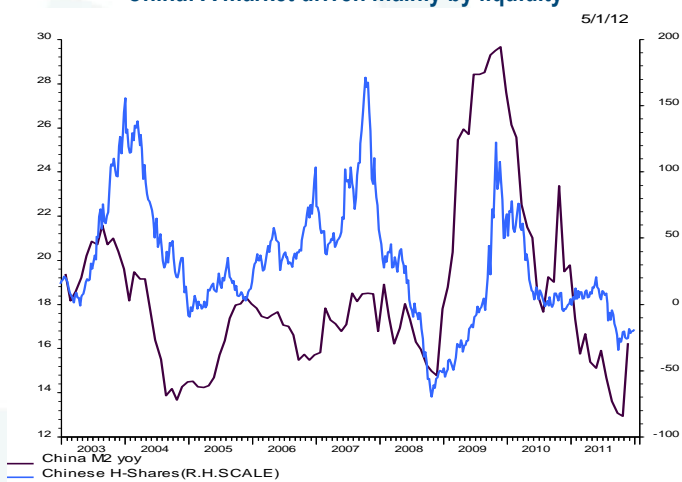
We reduce our positive bias on **Russia**, which until now has been well supported by oil prices and offers protection against a possible geopolitical crisis in the Middle East. Russian equity valuations are at historical lows, partly justified by the political premium before the elections. The risk would be that of seeing the new authority take a more populist direction, increasing the budget even further by taking a bigger bite from energy revenues.

We reduced **South Korea** to neutral last month, due to export weakness. South Korea is one of the rare economies showing a deterioration in the PMI indicators, which can be explained by the low level of new orders, but the authorities plan to launch a fiscal plan in the coming months, while the central bank could start monetary easing to stimulate growth, even though the inflation rate is still high. We reduce our negative bias on **Taiwan**. The market is a source of liquidity for fund managers when there is high risk aversion or volatility. However, the re-election of the incumbent president Ma Ying-Jeou, of the KMT party favourable to closer ties with mainland China, should remove a great deal of uncertainty and encourage investors to return. Finally, the Taiwan stock market is a good proxy for the Nasdaq, and should stay on an uptrend in the event of a recovery in the US economy and the technology sector.

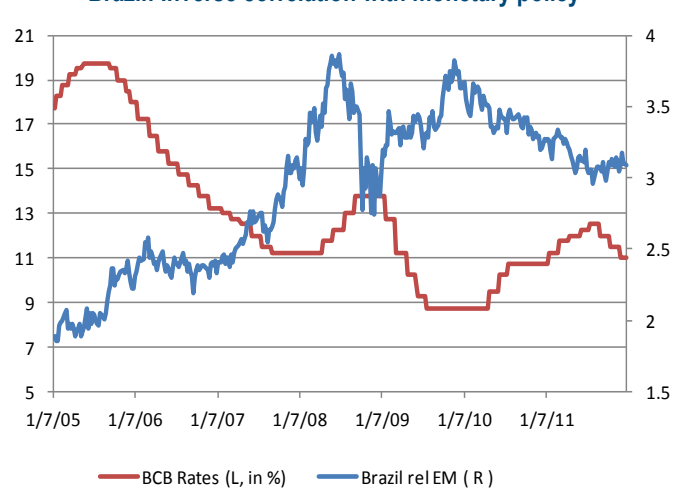
#### **Caution regarding the Indian and Turkish markets due to large deficits**

We remain cautious on **India**, even though the Sensex index lost 37% in 2011 in USD terms, bringing the valuation down to an acceptable level of 12 times earnings, and earnings revisions have stabilised. The depreciation of the rupee, persistently high inflation and the budget and trade balance deficits are major risks. In particular, the political system seems paralysed, delaying the reforms that are so necessary for the economy. The bias on **Turkey** is still negative. Inflation is trending upward, driven by the effects of the recent tax increases and by food prices, and is likely to make the current policy of interest rate cuts more complicated. This, combined with a current-account deficit amounting to 10% of GDP, and 60% financed by European banks, will probably put more pressure on the currency.

**China: A market driven mainly by liquidity**



**Brazil: Inverse correlation with monetary policy**





## ALTERNATIVE STRATEGIES

### COMMODITIES

#### We maintain our preference for gold

##### **Geopolitical tension masks less favourable fundamentals for oil**

The increasing tension between Iran and the United States, and in particular concerns regarding a risk of a shutdown of the Strait of Hormuz, and disturbances in Nigeria, enabled **crude** prices to stay at high levels, with the barrel of Brent remaining above USD 110. However, unlike last spring, the tense geopolitical context is not accompanied by tightening oil fundamentals. The two components of US oil demand, demand for gasoline and that for medium distillates (such as fuel oil and diesel fuel), have declined from last year's levels. While the milder-than-average winter temperatures may have had an impact, the trend has clearly been to a slowdown in oil demand in developed economies for some months now. Moreover, crude oil production remains firm, with a new 3-year peak for OPEC output in December. Accordingly, barring an acceleration in global growth or a major geopolitical event, petroleum product stocks are expected to increase in the coming months. We prefer to **remain neutral on oil**.

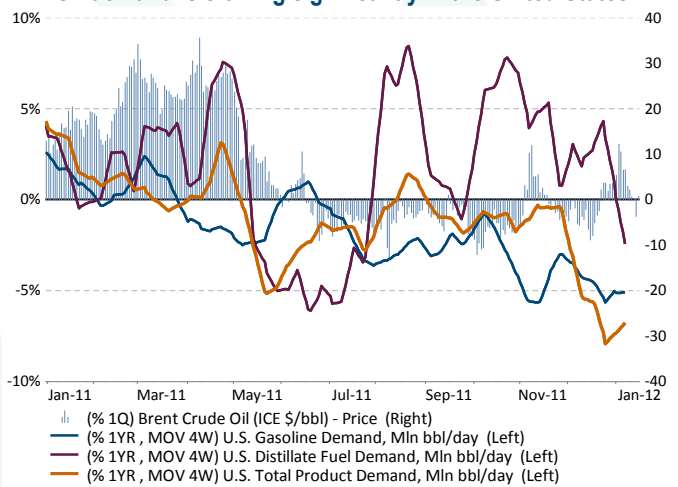
The markets for **base metals** had a little respite in recent weeks due to the publication of reassuring manufacturing activity indices in the United States and China. Moreover, Chinese metal imports seem to be still very firm, especially for copper. However, concerns about global growth in the coming months are still weighing on prices, as attested by the relative divergence between copper prices and equity indices. All in all, while the relative valuations may seem interesting, our cautious economic scenario leads us to **stay neutral on base metals**.

##### **Investor appetite for gold should remain firm in 2012**

**Gold** prices fell heavily in December, losing as much as USD 200 per ounce, from USD 1750 to USD 1550, before picking up since the start of the new year. The strength of the US dollar and the weakness of physical demand, especially in India, negatively affected the metal, but we believe that end-of-year rebalancing of commodities indices and investors' portfolios also had a significant impact, making gold vulnerable to a correction. To the extent that the effects of the rebalancing should fade away and given that we think that investor appetite for the metal will remain high in the coming quarters, **we remain positive on gold**.

**Grain** markets recovered in December, but the respite was short-lived, as the publication by the US Department of Agriculture of the monthly report on supply and demand caused a further fall in prices. Indeed, this document reported an increase in global cereal production and a downward revision of US exports. Following the recent correction, we consider the risks evenly balanced. **We are neutral on grains**.

**Oil demand is slowing significantly in the United States**



**Copper has been lagging the S&P 500 since September**





## CONTACTS & DISCLAIMER

The charts in this document were updated in January 2012, unless otherwise specified. BNPP IP is the source as of 17 January 2012 for all data commented in this document unless otherwise specified.

### Equipe Stratégie :

Vincent Treulet

Nathalie Benatia

Antonio Bertone

Charles Cresteil

Guillaume Hollier-Larousse

Dong-Sinh Ngo

Dominique Schulthess

### Investment Specialist:

Joost van Leenders

---

This material is issued and has been prepared by BNP Paribas Asset Management S.A.S. ("BNPP AM")\* a member of BNP Paribas Investment Partners (BNPP IP)\*\*.

This material is produced for information purposes only and does not constitute:

1. an offer to buy nor a solicitation to sell, nor shall it form the basis of or be relied upon in connection with any contract or commitment whatsoever or
2. any investment advice.

Opinions included in this material constitute the judgment of BNPP AM at the time specified and may be subject to change without notice. BNPP AM is not obliged to update or alter the information or opinions contained within this material. Investors should consult their own legal and tax advisors in respect of legal, accounting, domicile and tax advice prior to investing in the Financial Instrument(s) in order to make an independent determination of the suitability and consequences of an investment therein, if permitted. Please note that different types of investments, if contained within this material, involve varying degrees of risk and there can be no assurance that any specific investment may either be suitable, appropriate or profitable for a client or prospective client's investment portfolio.

Given the economic and market risks, there can be no assurance that any investment strategy or strategies mentioned herein will achieve its/their investment objectives. Returns may be affected by, amongst other things, investment strategies or objectives of the Financial Instrument(s) and material market and economic conditions, including interest rates, market terms and general market conditions. The different strategies applied to the Financial Instruments may have a significant effect on the results portrayed in this material. The value of an investment account may decline as well as rise. Investors may not get back the amount they originally invested.

The performance data, as applicable, reflected in this material, do not take into account the commissions, costs incurred on the issue and redemption and taxes.

\*BNPP AM is an investment manager registered with the "Autorité des marchés financiers" in France under number 96-02, a simplified joint stock company with a capital of 64,931,168 euros with its registered office at 1, boulevard Haussmann 75009 Paris, France, RCS Paris 319 378 832. [www.bnpparibas-am.com](http://www.bnpparibas-am.com).]

\*\* "BNP Paribas Investment Partners" is the global brand name of the BNP Paribas group's asset management services. The individual asset management entities within BNP Paribas Investment Partners if specified herein, are specified for information only and do not necessarily carry on business in your jurisdiction. For further information, please contact your locally licensed Investment Partner.