



# Investment Strategy

## 12 December 2011



|                                     |    |
|-------------------------------------|----|
| <b>ASSET ALLOCATION</b> .....       | 2  |
| <b>ECONOMIC OUTLOOK</b> .....       | 3  |
| Viewpoint .....                     | 3  |
| Developed economies .....           | 4  |
| Emerging economies .....            | 5  |
| <b>BOND MARKETS</b> .....           | 6  |
| Government Bonds .....              | 6  |
| IG and HY credit .....              | 7  |
| Emerging debt.....                  | 8  |
| <b>CURRENCY MARKET</b> .....        | 9  |
| <b>EQUITY MARKETS</b> .....         | 10 |
| Developed markets .....             | 10 |
| Emerging markets.....               | 12 |
| <b>ALTERNATIVE STRATEGIES</b> ..... | 14 |
| Commodities .....                   | 14 |

### 2012: A few reasons for hope

The end of year is traditionally a time for retrospectives and forecasts for the following year. 2011 will be remembered as an extremely difficult year, marked by the deepening financial and economic crisis in the eurozone, political upheaval in the Middle East and North Africa, the Fukushima disaster, and confirmation that the US recovery is running out of steam. Against such a backdrop, and at the time of writing this, market performances do not seem as bad as might have been feared in such circumstances. The indices of the eurozone and numerous emerging countries lost about 20 percent, credit suffered, but the US stock market, commodities and on average sovereign bonds were relatively stable. Valuations that are in some cases modest (equities) and support from monetary policies, which remain highly expansionary, undoubtedly acted as dampers.

In our opinion 2012 is unlikely to start better than the final months of 2011, and we maintain very conservative allocation recommendations, like in the previous months. But, although the downside risks are constantly highlighted (and we believe they are substantial), the approach of the end-of-year festivities encourages a little wishful thinking, and we consider what are the upside risks for next year. They are obviously not in-existent in a market that is already pessimistic:

**1. An easing of the eurozone crisis** would undoubtedly be the main upside risk. Although this would not be a sufficient long-term solution, an ECB commitment to a more massive asset buying programme (whether directly in the form of quantitative easing, or indirectly by financing another organisation) could mark a turning point some time in the year. We believe this scenario is quite possible, although we do not expect it in the first quarter of 2012. A sharper decline in the euro could also boost eurozone exports and soften the looming recession.

**2. An acceleration in US growth** is not very likely either in our opinion, but technically it would not be impossible. Corporate investment remains weak, stocks are low, and residential construction is still distressed; all these segments of the economy could rebound and infuse more positive sentiment regarding growth.

**3. The emerging countries**, lastly, should in our opinion be more economically resilient than developed countries, despite the slowdown affecting them at present. It is not impossible that in 2012 markets could increasingly see them as locomotives capable of maintaining global growth permanently in positive territory. Here again, downside risks exist, but the growing weight of the emerging economies and their continuing economic vigour are factors of support that will (fortunately!) play an increasing role in global growth.

While remaining positioned to face difficult conditions, we of course hope for the best and we wish you all a Merry Christmas and a Happy New Year.



## 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. We are waiting for a window to return to emerging debt in local currency.

### Developed equity market arbitrage

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

### Emerging equity market arbitrage

- Unchanged preference for China, and to a lesser extent Russia.
- Neutral on India, Brazil, South Korea and South Africa.
- Underweight on Turkey and Taiwan.

## Recommended allocation – Investment Strategy Team

### ASSET ALLOCATION MODEL PORTFOLIO

December 2011

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

|                     | Alpha | Current weight | Previous weight |
|---------------------|-------|----------------|-----------------|
| <b>EQUITIES</b>     |       |                |                 |
| Developed Equities  | -0.10 | -0.6%          | -0.6%           |
| Emerging Equities   | 0.07  | 0.5%           | 0.2%            |
| <b>FIXED INCOME</b> |       |                |                 |
| Government Bonds    | 0.03  | 1.3%           | 2.5%            |
| Investment Grade    | -0.01 | -0.1%          | -0.9%           |
| High Yield          | 0.00  | 0.2%           | -1.2%           |
| Emerging Debt       | 0.04  | 0.2%           | 0.4%            |
| Emerging Debt Local | 0.05  | 0.3%           | 0.5%            |
| <b>COMMODITIES</b>  |       |                |                 |
| Brent Oil           | -0.04 | -0.1%          | -0.1%           |
| Base Metals         | 0.04  | 0.2%           | 0.4%            |
| Gold                | 0.43  | 2.3%           | 2.3%            |
| Agricultural        | 0.05  | 0.5%           | -0.2%           |
| Cash Euro           |       | -4.5%          | -3.3%           |
| <b>Module Total</b> |       | <b>0.0%</b>    | <b>0.0%</b>     |

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

|                     | Alpha       | Current weight | Previous weight |
|---------------------|-------------|----------------|-----------------|
| US                  | 0.00        | 0.9%           | 0.2%            |
| Canada              | -0.05       | -3.2%          | -2.0%           |
| Euroland            | -0.04       | -2.1%          | -2.8%           |
| Japan               | 0.05        | 1.3%           | 1.8%            |
| UK                  | 0.08        | 4.8%           | 4.0%            |
| Switzerland         | 0.02        | 0.6%           | 1.6%            |
| Australia           | -0.05       | -2.3%          | -2.8%           |
| <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              | 0.02        | 0.2%           | -0.5%           |
| China               | 0.27        | 1.7%           | 1.8%            |
| India               | -0.01       | -0.1%          | 0.4%            |
| South-Korea         | 0.00        | -0.1%          | 0.0%            |
| Taiwan              | -0.26       | -1.8%          | -1.7%           |
| Russia              | 0.23        | 1.0%           | 1.1%            |
| South Africa        | 0.02        | 0.3%           | -0.1%           |
| Turkey              | -0.27       | -1.2%          | -1.0%           |
| <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       | -13.0%         | -16.0%          |
| Euroland            | 0.00        | 1.8%           | 8.3%            |
| Japan               | 0.00        | 0.0%           | 0.0%            |
| UK                  | 0.13        | 11.2%          | 7.6%            |
| Switzerland         | 0.00        | 0.0%           | 0.0%            |
| <b>Module Total</b> | <b>0.00</b> | <b>0.0%</b>    | <b>0.0%</b>     |

#### PORTFOLIO STATISTICS

|                           |              |
|---------------------------|--------------|
| Target Ex-ante Volatility | <b>2.00%</b> |
| Real Ex-ante Volatility   | <b>1.03%</b> |

1-Hedged in Euro, 2-Local Currency

Source: BNPP AM





## DEVELOPED ECONOMIES

### No hope for the European economy

**Activity has already started to contract**

In the third quarter, GDP growth was 0.2% for the euro zone as a whole (like in Q2), bringing carry-over growth to 1.6% after three quarters in 2011. There are major disparities from one country to another: 0.5% and 0.4% growth in Germany and France respectively, stagnation in Spain and Italy, and contraction in Portugal and the Netherlands. The GDP components reflect the sluggishness of domestic demand, especially investment, while the outlook for industry shows a sharp slowdown in orders, for both domestic and export markets. The surveys of economic activity continued to deteriorate, pointing to a contraction in GDP by approximately 0.5% at the end of the year and probably at the start of the following year. A recession seems increasingly likely, and the latest ECB forecasts were revised downward significantly: the range of expectations is from -0.4% to 1% for 2012 (following growth ranging between 1.5% and 1.7% in 2011).

**Super Mario moves forward but is rather disappointing**

Following the Governing Council meeting on 8 December, Mario Draghi announced a cut in the refi rate (reduced to 1%), further bank refinancing measures with the introduction of a 3-year LTRO and an easing of the criteria applied to securities accepted as collateral for repos, including by national central banks. The reserve requirement ratio was also lowered (from 2% to 1%) to release collateral and support money-market activity. On the other hand, as was foreseeable in light of the statements made recently, the ECB does not plan to massively increase its public debt purchases and gave a reminder that governments had to make efforts. On several occasions Mario Draghi emphasised that the monetisation of deficits was contrary to the spirit of the treaties and gave a reminder that the SMP (Securities Market Programme), which represented a total of EUR 207 billion as of 2 December, was designed to ensure the satisfactory transmission of monetary policy.

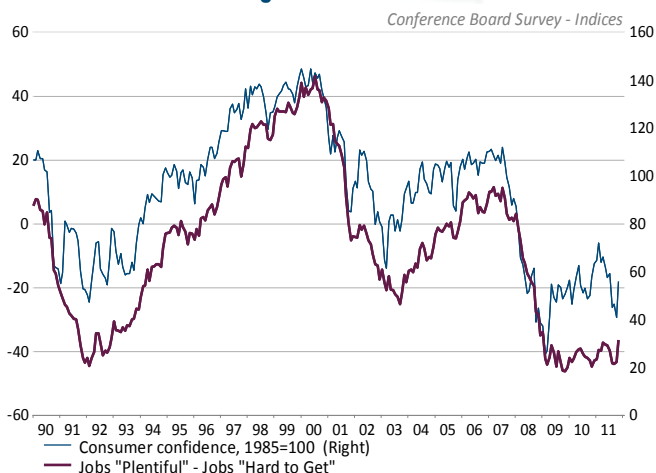
**Ever more liquidity for the banking system**

The ECB is acting to provide liquidity for European banks at a time when their recapitalisation needs have been revised upward by the European Banking Authority, which now estimates capital requirements up to June 2012 at around EUR 115 billion. On 30 November, six central banks (the Fed, the Bank of England, the Bank of Canada, the ECB, the Bank of Japan and the Swiss National Bank) announced concerted measures to increase the capacity for providing liquidity to the global financial system to reduce pressure and facilitate lending to households and companies: 50 bp cut in the rate for swap agreements designed to supply USD and establishment of swap agreements in other currencies, even though for the time being the need for liquidity has been seen only in the US dollar. International cooperation on this subject was perceived as a positive factor in that it reflects the commitment of central banks.

**Pending the next summit?**

The European summit on 8 and 9 December concluded with major commitments to institutional reform, in particular by establishing increased means of control over sound budgetary management by each of the Member States. And yet, there are still no concrete answers to the liquidity problems faced by several countries nor any precise details regarding new operating procedures for the European Financial Stability Facility. There will probably be other summits over the coming months, while there will be increasing signs of a slowdown in growth in the euro zone, with the concomitant risk that deficit reduction targets will not be met.

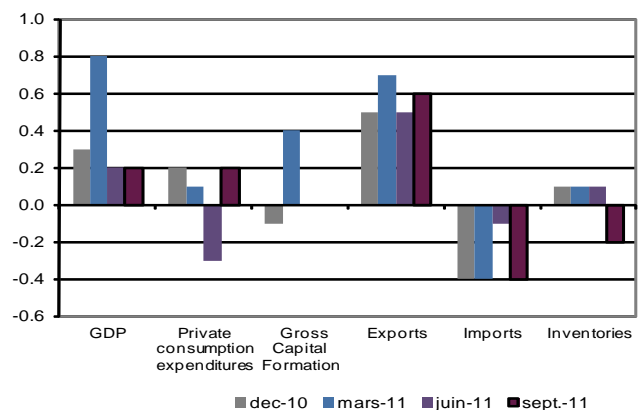
#### United States: A slight rise in consumer confidence



Source: Factset, BNPP AM

#### Euro zone: Heading for recession following modest growth

##### Eurozone: Contributions to QoQ GDP growth (in pp)



Source: Eurostat, BNPP AM



## EMERGING ECONOMIES

### Rapid deterioration of momentum

#### **Slower growth rate, monetary easing**

The growth rate of emerging economies has slowed sharply in recent months, especially in the cyclical economies and large economies such as India and Brazil. Overall, the rate of growth in industrial output has stabilised at very low levels, or has even contracted sequentially for some countries such as Taiwan.

In the short term, the outlook will deteriorate. The latest PMI surveys point to a contraction in new orders, while stocks are accumulating at a higher rate. The leading indicators for the emerging economies remain unresponsive, reflecting the weakness of developed economies, but chiefly due to monetary tightening. In general, economic growth is expected to stabilise at around 5.5% in 2012, compared with 7% in 2010.

#### **Better prospects for Asia and Latin America compared with Eastern Europe**

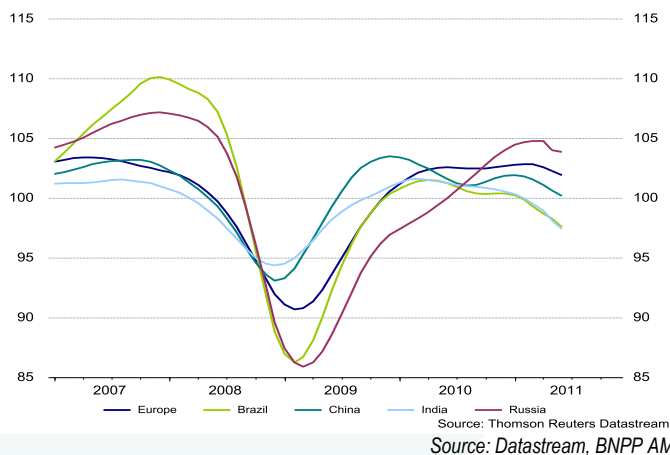
The Asia region is relatively resilient, while in Latin America and Eastern Europe there has been a more pronounced slowdown in the economic cycle. But risks are rising rapidly: the Chinese economy faces a turbulent landing but also a leadership transition, India is faced with a sharp decline of its currency and deficits that leave the government with few alternatives, while political risk is increasing in Russia.

The **Chinese** authorities have finally managed to reverse the trend in real estate, where prices and volumes are falling in most large cities. Investment contributes more than 50% of GDP growth, mainly via infrastructure and real estate. If real estate were to fall heavily, it would have disastrous cyclical and structural effects given its importance for public and private finances. The rapid slowdown in the economy led the PBOC to reduce its reserve ratio by 50 basis points to 21%, announcing the start of a monetary easing cycle. For 2012, the priority will be stable economic growth of around 8%, through a reduction in the reserve ratio and some fiscal stimulus.

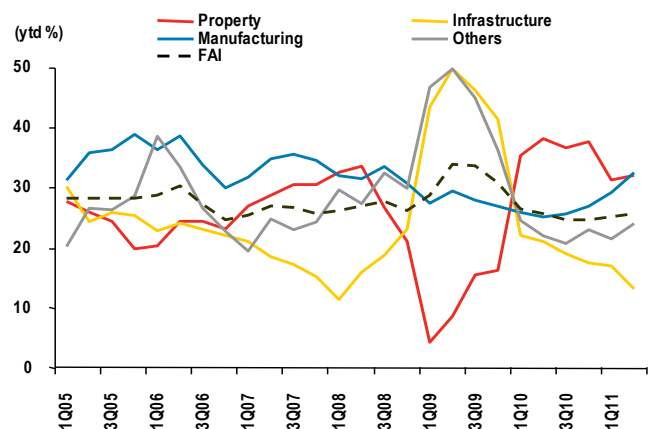
#### **India: Economic slowdown, rising deficits and currency depreciation**

The outlook for the **Indian** economy is less cheerful: persistently high inflation, a significant deterioration in industrial output, and in the current-account and budget balances as well, recurring scandals and constantly postponed reforms. The steep depreciation of the rupee should be watched closely, because India is a net importer of goods and capital. The political situation in **Russia** also requires caution. The weakened position of the current government could encourage more fiscal laxity or delay unpopular but necessary reforms. Lastly, the **Brazilian** economy is expected to slow sharply in 2012, with growth of about 3% compared with an average of 4.5% since 2004, due to the global economic situation and weak private demand.

OECD leading indicators more negative for India and Brazil



China: Falling investment, pulled down by infrastructure and real estate





## BOND MARKETS

### GOVERNMENT BONDS

#### The ECB steps up its measures for the banks but not its purchases of government bonds

From an economic viewpoint, the figures seem to be stabilising in the United States, thus alleviating fears of a double-dip recession. This only partially reassures us, because we believe that the country still needs monetary and fiscal stimulus to achieve slightly positive growth rates. President Obama's stimulus plan could boost the GDP growth rate depending on the number of proposals approved, but the underlying trend is still weak.

#### The Fed moving toward more transparent communication

The Fed, for its part, will work on its communication policies to make its monetary policy decisions even more transparent and efficient. The members of the FOMC are apparently more prepared to tie the level of key interest rates to employment or inflation rather than growth targets, and to publish more information concerning the future path of interest rates, like what has already been done by announcing that current interest-rate levels would be left unchanged until mid-2013. The scenario we look for, therefore, is one of low short-term interest rates for a long time, a very directional yield curve and long-term interest rates that will remain at low levels for the time being.

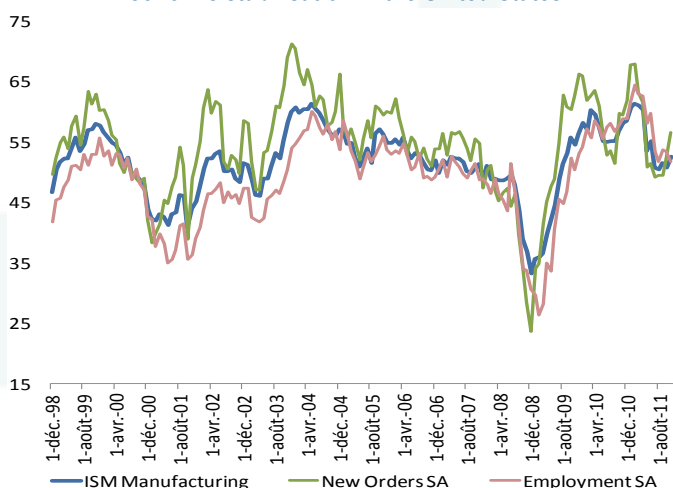
As regards Europe, we have had further important summit meetings which have confirmed the shared determination to find solutions, but which struggle to convince markets. The new government in Italy has proposed measures which in our opinion go in the right direction, but the road is still long.

#### The ECB steps up its measures to support banks

The ECB, for its part, again lowered its key interest rate by 0.25% at its last meeting. The announcement of further extraordinary measures to be adopted by the central bank was much-awaited. Regarding this, Mr Draghi announced important measures for bank funding, but also showed little flexibility concerning the programme of sovereign bond purchases in the secondary market (SMP). Regarding the first point, it was important for us to have stronger liquidity measures, in order to provide slightly more oxygen in a situation in which banks are struggling to obtain financing in the primary market. The introduction of 36-month refinancing operations, the reduction in the reserve requirement ratio and the broadening of eligible collateral exceeded our expectations, and this was a positive surprise. Regarding the SMP, on the other hand, Mario Draghi did not indicate that he intended to increase his support for governments, because it would violate treaty rules, and the same applies for any financing for the IMF intended to support Member States.

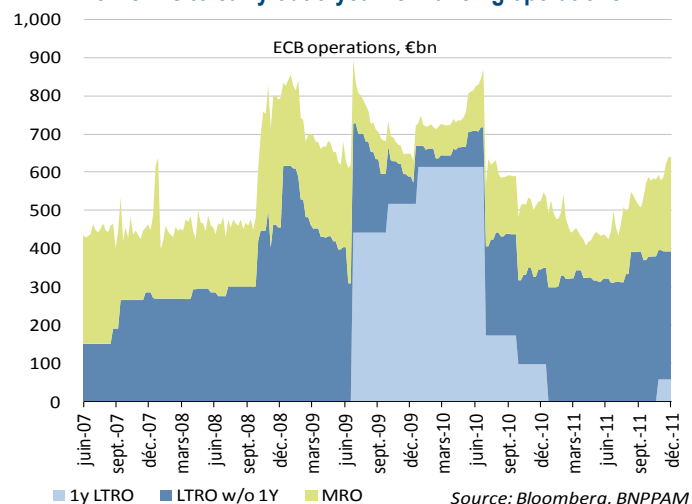
The fundamentals, monetary policy and risk aversion point to low core interest rates, but we find valuations expensive. Moreover, this does not take into account the premium to be added to remunerate country risk. Although for the time being this does not seem a worry for such yields, following the unsuccessful German auction in November we are watching this point closely.

Economic stabilisation in the United States?



Source: Bloomberg, BNPPAM

The ECB is to carry out 3-year refinancing operations



Source: Bloomberg, BNPPAM



## IG AND HY CREDIT

### Uncertainty has not gone away in Europe

#### No increase in the default rate in sight in the United States

Although on the one hand the economic environment in the United States should help support credit, including the most speculative issues, the news from Europe is not reassuring.

US growth seems to be heading toward low but positive levels, although fiscal stimulus, the form of which is as yet uncertain, will still be needed to counter persistent fundamental weakness. In theory, this context should not be unfavourable to credit, where valuations are attractive, the fundamentals healthy and the asset class 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 the default rate in the near future.

However, the market at present unfortunately seems to be driven more by events in Europe, where the sovereign crisis remains tense. The proposals put forward by governments at the recent meetings are a step in the right direction, but uncertainty persists. European growth is heading for a difficult period, with the leading indicators pointing to another recession ahead.

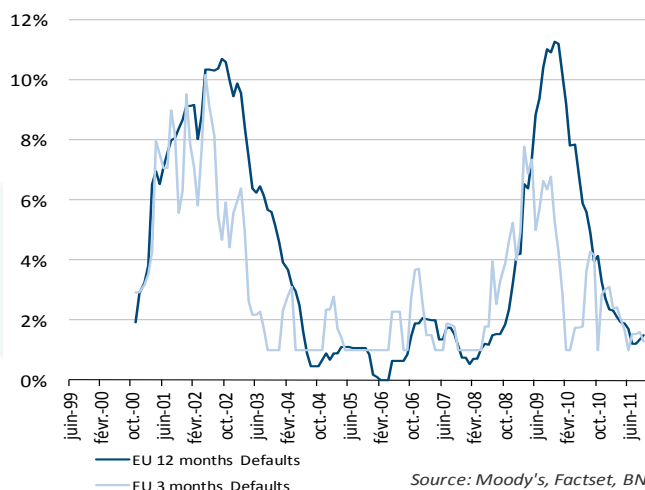
#### The ECB bailing out banks

With regard to banks, the difficulties of European governments are weighing on financial institutions which hold government debt. The consequence of this is a drying up of the primary market, which does not permit balanced funding apart from the short-term liquidity provided by the ECB. Precisely, the ECB has decided to intervene more massively to meet liquidity needs, going so far as to offer three-year refinancing operations and broadening the range of collateral eligible for such operations. These measures are certainly welcome, but do not eliminate the need for longer-term issuance, given that the plan for joint guarantees at the European level seems to be producing nothing concrete for the time being, thus justifying our scepticism concerning the announcements made.

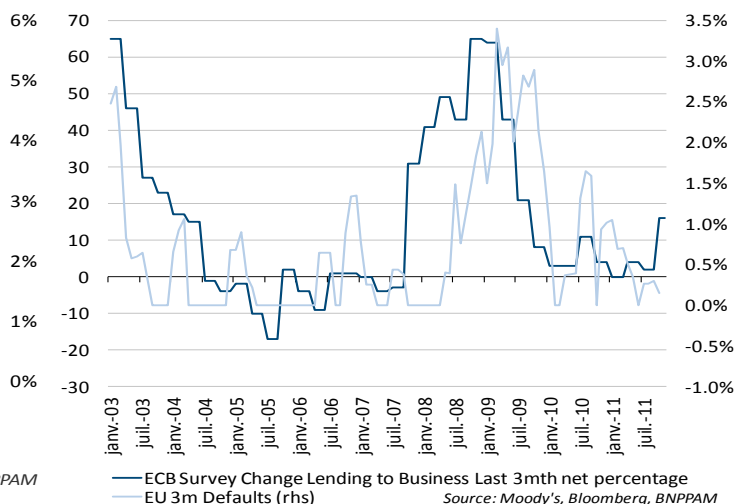
This latter point is crucial, because there is currently a deterioration in European banks' lending conditions, which indicates that their difficulty in obtaining access to the market is becoming an increasingly significant factor weighing on corporate credit. Less abundant and more expensive credit is not good for the economy and for the companies most heavily dependent on bank financing. Default rates are at very low levels, but the economic slowdown and the deterioration in lending conditions would be consistent with a slight increase in these rates, although it must also be recognised that companies are currently in better health than in 2008.

Overall, we have a generally negative tactical bias on credit, with a relative view that is more positive for the United States than for Europe.

Default rates at very low levels in Europe...



...but a deterioration in sight?





## EMERGING DEBT

### Growing divergence between emerging economies

#### Increase in the cost of protection

After a lull in October, fears of contagion of the European debt crisis led to an increase in the cost of protection against a default by the leading emerging countries (five-year sovereign CDS's). However, this increase, practically universal, was more moderate in November than in September, and was far smaller than during the 2008-2009 crisis. An easing of CDS spreads has even been seen since the end of November thanks to the adoption of reforms in some eurozone countries and discussions on the strengthening of fiscal discipline in the European Union.

#### Still cautious positions in the asset class due to global risk aversion

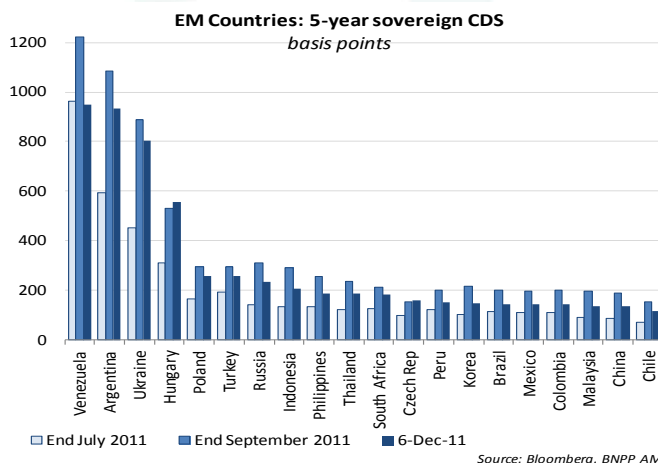
Global risk aversion, fuelled by the European crisis, therefore still largely determines the performance of this asset class, even though it offers good fundamentals, especially local debt. We maintain a **positive view on local debt expressed in local currencies**. Against a background of economic slowdown, a deceleration in inflation and monetary easing, yields on local bonds should ease further in the coming months, provided, however, that the eurozone crisis does not worsen, leading to massive capital outflows. In such a scenario (which is not our core scenario even though we do not think a solution can be found rapidly), a withdrawal from emerging assets by foreign investors could put pressure on bond yields, as was the case, briefly, in November and in 2008-2009. However, the situation is very different from one country to another, **the EMEA region being the most vulnerable**, due to its greater exposure, both in trade and financial terms, to the eurozone. Central banks' responses to their worsening economic outlooks and their weakening currencies will therefore probably continue to diverge in the coming months. In the EMEA, their priority is to tame the inflationary pressures resulting from the depreciation of their currencies, whereas in Asia and Latin America further cuts in key rates are expected in the coming months to help stimulate the economy.

#### Downward pressure on currencies

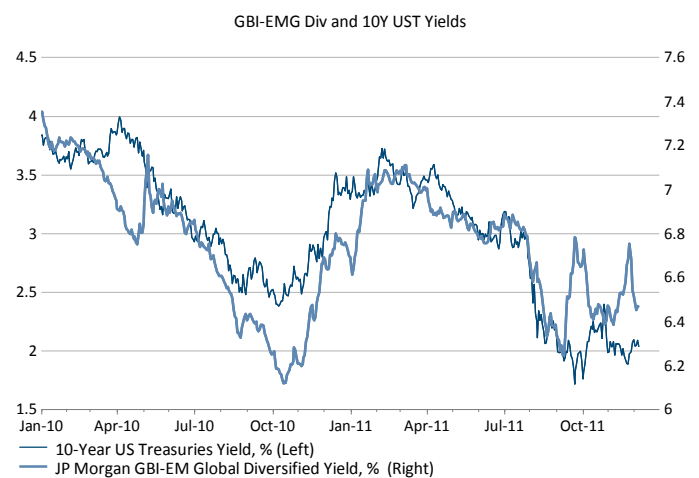
In this economic context, and given high risk aversion, **downward pressure on emerging currencies** will probably persist despite less strained valuations than at the start of the year and a still very attractive short-term interest rate differential. We therefore recommend a neutral exposure to emerging debt for international investors unhedged against currency risk, because the performances of local bonds could be offset by currency depreciation.

For several months now, the performance of **external debt** has been driven mainly by global factors, with the rally in US bonds largely compensating for the widening spreads on emerging sovereigns. Over the coming months, the performance of this asset class will probably be limited by further widening of spreads due to the economic slowdown, while the performance based on the underlying US bonds seems limited, since yields are already very low.

### Risks of contagion: Broad-based increase in the cost of protection



### Local bonds: Yields of more than 6%





## CURRENCY MARKET

### The European sovereign crisis is negative for the single currency

#### The US dollar as a safe haven

The sharp rise in **the euro** (above 1.42) following the European summit of 26 October was only short-lived. While November was marked by further sharp falls in stock markets, the US dollar profited from its status as a safe haven currency, coming back toward 1.32 at the end of the month before being slightly weakened by the renewed interest for risky assets and then, on 30 November, by the central banks' decision on dollar swap agreements. In early December, it was around EUR 1.33. In the past month, the US dollar has in fact appreciated against most G10 currencies, except the Canadian dollar and the yen, which remained practically stable. Against a basket of currencies (trade-weighted exchange rate calculations by the Bank of England), the US dollar rose 1.8% from end October to early December, and also appreciated against many emerging currencies. Volatility in currency markets has remained high in recent weeks, reflecting the lack of a clear-cut scenario regarding both the future of the eurozone and the economic outlook in the United States.

#### Toward a weakening of the euro

In the short term, given that there are massive speculative positions against the euro, any news perceived as a political breakthrough in the discussions between European governments seems likely to cause a rebound in the euro. In the medium term, however, we still foresee a decline in the euro against the US dollar due to the major growth gap between the United States, where growth is resilient, and the euro zone, heading into recession. Further cuts in the ECB's key rates expected in early 2012 could have a similar effect, especially if the ECB decides to lower its main policy rate well below 1%, going beyond the current expectations of a stabilisation at 0.75%. Despite the continuation of a very accommodative monetary policy in the United States, possibly with further quantitative easing measures, the EUR/USD exchange rate is likely to go below 1.30 in 2012.

#### The yen remains strong

The massive intervention (JPY 9 091 billion) in the foreign exchange market conducted by the Bank of Japan at the end of October was unable to reverse the trend of the **USD/JPY** exchange rate, which has stabilised above 77. The Japanese authorities suggest that they will continue to watch any appreciation of their currency closely, but a massive weakening seems unlikely at present, since the yen remains a safe haven currency. However, the BoJ's monetary policy remains very accommodative, and further quantitative easing measures, such as the increased purchases of securities (especially JGB's) decided on at end October, could be taken, which would weigh on the currency.

#### Currencies affected by the European problems

The currencies traditionally related to commodities and, more generally, global growth, continue to move in line with fluctuations in risk appetite. In this group, the Swedish krona could suffer from the country's close economic ties with the eurozone, where demand is set to weaken. Similarly, the **USD/CHF** exchange rate could return above 1 in the second half of 2012. Although Swiss business leaders' lobbying of the SNB to raise its threshold for intervention on the EUR/CHF exchange rate (set at 1.20 in September) has little chance of succeeding in the short term, it could cause a depreciation of the franc. This move would take place not only against the euro but also against the US dollar, the two aspects (fall of the CHF against the euro and of the EUR against the USD) being cumulative.

### FX Rate Forecast Summary (Major Currencies)

| End of Period |           | 2010 | 02-Dec-11 | 4Q 2011 |      | 1Q 2012 |      | 2Q 2012 |      | 3Q 2012 |      |
|---------------|-----------|------|-----------|---------|------|---------|------|---------|------|---------|------|
|               |           |      |           | Min     | Max  | Min     | Max  | Min     | Max  | Min     | Max  |
| USD Block     | EUR / USD | 1.34 | 1.3484    | 1.25    | 1.35 | 1.20    | 1.30 | 1.20    | 1.30 | 1.20    | 1.30 |
|               | USD / JPY | 81   | 77.85     | 75      | 85   | 77      | 87   | 80      | 90   | 80      | 90   |
|               | USD / CAD | 0.99 | 1.0118    | 0.97    | 1.07 | 0.97    | 1.07 | 0.95    | 1.05 | 0.95    | 1.05 |
|               | AUD / USD | 1.03 | 1.0261    | 0.90    | 1.00 | 0.95    | 1.05 | 0.95    | 1.05 | 0.95    | 1.05 |
|               | GBP / USD | 1.57 | 1.5695    | 1.44    | 1.63 | 1.39    | 1.56 | 1.39    | 1.56 | 1.39    | 1.56 |
|               | USD / CHF | 0.93 | 0.9161    | 0.92    | 1.00 | 0.96    | 1.04 | 0.96    | 1.04 | 1.00    | 1.08 |
| EUR Block     | EUR / JPY | 109  | 104.96    | 98      | 111  | 96      | 109  | 100     | 113  | 100     | 113  |
|               | EUR / GBP | 0.86 | 0.8591    | 0.80    | 0.90 | 0.80    | 0.90 | 0.80    | 0.90 | 0.80    | 0.90 |
|               | EUR / CHF | 1.25 | 1.2352    | 1.20    | 1.30 | 1.20    | 1.30 | 1.20    | 1.30 | 1.25    | 1.35 |

Source: BNPP AM as of 2/12/2011



## EQUITY MARKETS

### DEVELOPED MARKETS

#### It is too soon yet to abandon our cautious bias

##### *The global slowdown continues but the United States is resilient*

The ongoing deterioration of economic conditions worldwide — except for the United States which is showing remarkable resilience — remains a major concern for investors. In the United States, the rates of positive surprises in reported macroeconomic figures have continued to rebound in recent weeks, and are now at extremely high levels. As a result, this indicator is near a peak and will therefore be less and less favourable to equity markets in the coming months, especially since the slowdown in the global economy will continue to hold back the US economy.

In other regions, and especially in the eurozone, conditions remain difficult; the slowdown is continuing and will be exacerbated by fiscal austerity measures that will gather momentum in all the countries in the zone. Any major solution to ward off this crisis will be long and hard to implement due to institutional and governance constraints specific to the eurozone, but also because it will be impeded by weak growth prospects.

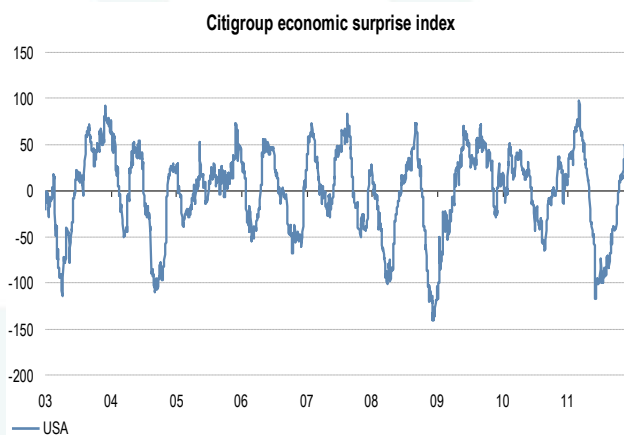
##### *Central banks will continue their efforts to prevent a tightening of financing conditions*

In these circumstances, the major central banks, increasingly including the ECB, will continue to conduct extremely accommodative monetary policies, in order to support economic activity in general, but also the liquidity of the banking system, to prevent a credit crunch.

Until now, despite this hostile environment, corporate earnings have remained resilient, but the outlook is darkening. Although analysts' expectations concerning the rate of earnings growth have been revised downward, they are still too ambitious, in our opinion. The consensus expects a sharp slowdown in revenue growth, which seems perfectly consistent with a low growth environment. However, the same consensus still looks for significant growth in margins, which we consider far too optimistic given that margins are already at extremely high levels and that operating leverage will be far less favourable in a context of slowing sales. Accordingly, despite a temporary improvement seen in recent weeks, the trend of earnings projection revisions should remain negative, and this will continue to weigh on equity markets.

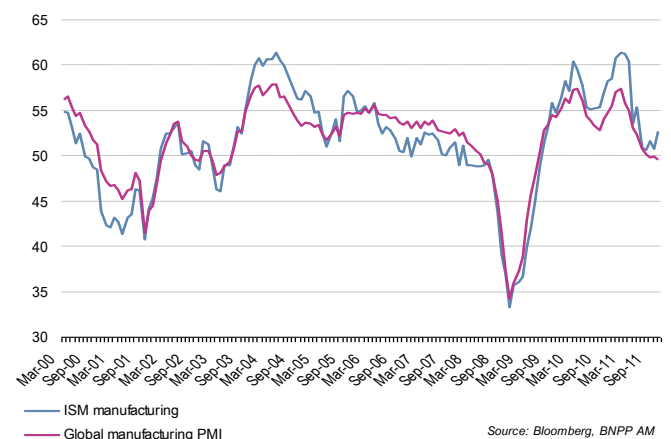
Market valuations that seem favourable should therefore be viewed in perspective and, in our opinion, do not yet constitute an argument to buy markets. The PERs based on analysts' forward earnings expectations for the next 12 months, which may seem at attractive levels, should therefore be treated with caution

#### United States: Positive surprises in economic reports already at a peak



Source: Bloomberg, BNPP AM

#### Global slowdown in the manufacturing sector despite the US rebound



Source: Bloomberg, BNPP AM



## DEVELOPED MARKETS

**Sentiment indicators not as pessimistic as the situation could suggest**

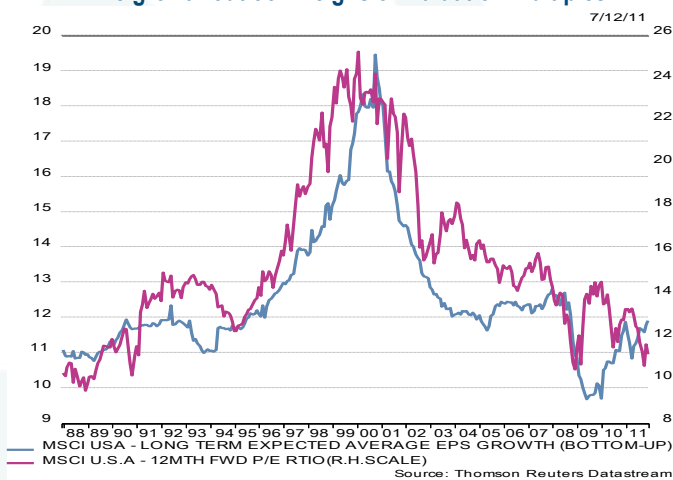
as long as the trend of earnings projection revisions remains negative. Moreover, when valuation indicators are analysed over very long periods, e.g. by applying the cyclically adjusted P/E ratio, it can be seen that markets are far from being as attractive as that. The only valuation indicator still clearly positive for equities is the comparison with fixed-income products, corporate bonds and government bonds.

We believe that stock market volatility will probably remain high. In this context, technical and sentiment indicators play a predominant role. Although, objectively, there are still high risks, equity investor sentiment indicators reflect a certain caution but are a very long way from the panic levels that would constitute an unambiguous support for markets. Moreover, for the time being the trend indicators are still sending a clearly bearish message. In the very short term, seasonality and extremely short speculative positions are the most significant factors of support for markets.

In relative terms, we still prefer the **UK market**. With a low valuation, it should continue to benefit from the Bank of England's extremely accommodative monetary policy and weak sterling. We also continue to prefer the **Japanese market**. This market offers valuations that are extremely attractive in both relative and absolute terms, and we still expect a gradual depreciation of the yen. We maintain a slightly positive bias on the **Swiss market**, which benefits from a relative weakening of the franc and higher visibility regarding the market trend, but also defensive qualities which offset its exposure to the eurozone and a valuation that is still high. We remain neutral on **US equities**. Their defensive nature in an environment of high risk aversion is still an advantage, but relative earnings revisions are less favourable than in recent months and valuation levels are stretched. We remain cautious on the **Australian market**. The cycle of interest rate cuts underway is a very positive factor, but this is likely to remain limited, whereas the fall in commodity prices and the global slowdown will probably remain a negative. We prefer to maintain a cautious attitude to **eurozone markets**. Although they are still very attractive on a relative valuation basis, and recent euro weakening could favourably impact negative earnings revisions, the risks related to the sovereign crisis and the likelihood of a recession still prevent us from adopting a more positive bias. Recent institutional changes and ECB involvement are a step in the right direction to solve the sovereign crisis, but we believe they are still too limited by comparison with the risks overhanging the zone. Lastly, there is no change in our position on the **Canadian market**, which is still very expensive and vulnerable to the fall in commodity prices.

**Give priority to the UK and Japanese markets**

**The growth outlook weighs on valuation multiples**



**Eurozone equities: Attractive relative valuation but far from the lows**





## EMERGING MARKETS

### Monetary easing points to growth in the multiples

**Valuation close to crisis levels.  
High probability of a positive  
performance 12 months out**

The valuation of emerging markets (PBV, PER) has returned to historical lows, close to those of the previous crises in 2003 and 2009. However, the earnings revisions trend will remain negative until the leading indicators have stabilised, i.e. not until at least the end of the first quarter of 2012. Domestic consumption remains moderate, while subdued demand from developed markets is expected to adversely affect exports.

However, 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. Lastly, subsiding inflation is allowing central banks to gradually abandon their restrictive policy, thereby releasing 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 2012, combined fiscal and monetary stimulus and an increase in bank lending quotas should support growth in the multiples.

**Little decorrelation of stock  
markets in the event of high risk  
aversion**

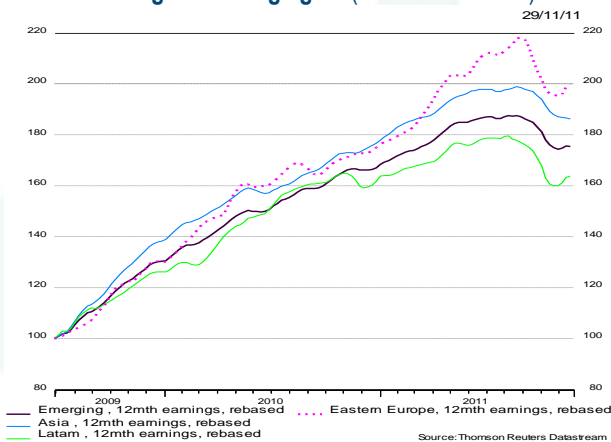
In the near term, lack of visibility and risk aversion continue to affect emerging stock markets, which will probably move in line with developed markets, even though their fundamentals are better. This is especially the case for the return on equity (ROE), highly favourable to emerging markets compared with developed markets since 2001, and a powerful discriminating factor of outperformance. In this context, we still give priority to stock markets with sound domestic fundamentals and relatively unexposed to the global cycle. Unfavourable risk perception also limits the upside potential of emerging currencies against the dollar, and could even cause some of them to fall. It is interesting to note that RMB/USD futures contracts discount a decline in the yuan!

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

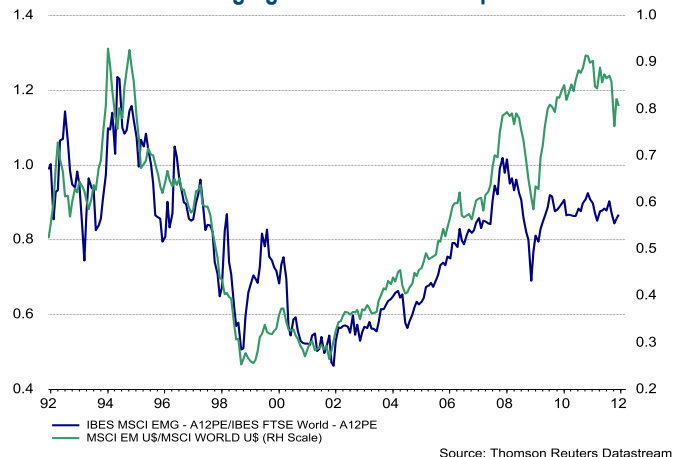
We remain overweight on **China**. The economic momentum is slowing rapidly, as shown by the PMI Index for November, which slipped from 50.4 to 49, and the contraction in property prices. This challenges the soft landing scenario, and the ability of the Chinese authorities to stimulate the economy in a depressed environment. The central bank has reversed its monetary policy and now gives priority to stable growth of around 8%. It reduced the reserve ratio by 50 bp for the first time since February 2009, and other fiscal measures will follow. Against this backdrop, valuation multiples, which are at very low levels, should ease and facilitate an upward trend in the indices.

We maintain our positive bias on **Russia**. Until now Russia was well supported by oil prices on an uptrend and plentiful liquidity. Positive factors include: stable inflation, a growing current account surplus, rising private consumption, and in November Russia joined the World Trade Organization. Moreover, Russian equities are among the least expensive in the world, which is partially justified by state control and especially by the increased political risks following the elections (thus adding a lot of volatility to the market). The risk would be that of seeing the new authority take a nationalistic path, raise oil prices, reduce the speed of privatisations or adopt a lax fiscal policy.

**Earnings are rising again (30/06/2009 = 100)**



**Valuation of emerging markets vs. developed markets**





## EMERGING MARKETS

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

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

We return to neutral/positive for **Brazil**. Domestic demand should benefit from policy stimulus, because the central bank started monetary easing at the end of August. Inflation continues to slow down. The PMI Index has risen from 46.5 to 48.7. Valuation multiples have fallen to lows near those of the 2008 crisis and earnings expectations are modest, while the country enjoys monetary and fiscal flexibility which enables it to avoid the worst of the global economic slowdown, and lower earnings growth. In the future, exports are likely to suffer from the slowdown in foreign demand and from the still overvalued real.

We remain neutral on **South Korea** due to the cyclical nature of the economy, more exposed to the uncertainties coming from developed markets, and having a high relative performance. The latest PMI figure of 47.5 reflects the impact of the global slowdown, but what is most worrying is the sluggishness of domestic demand, which represents a threat for growth. Inflation is still a concern, but the central bank is unlikely to raise its policy rates, fearing a weaker global economy. On the contrary, interest rate cuts are likely. Moreover, valuations are attractive, but earnings prospects are limited.

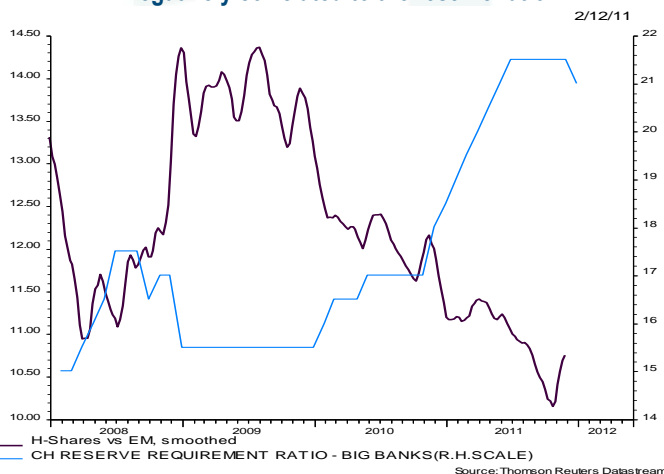
Still a strong negative bias for **Taiwan**, because the economy is highly cyclical and exposed to Europe. The significant earnings downgrades reflect weaker foreign demand and a slowdown in cyclical sectors such as information technologies. The slowdown in production confirms the repercussions of foreign demand. Moreover, next month's elections have increased market volatility. Investors are likely to adopt a defensive attitude due to concern over a victory of the DPP, a party that is against closer ties with mainland China. In addition, valuations are not yet attractive.

#### **Caution on the Indian market**

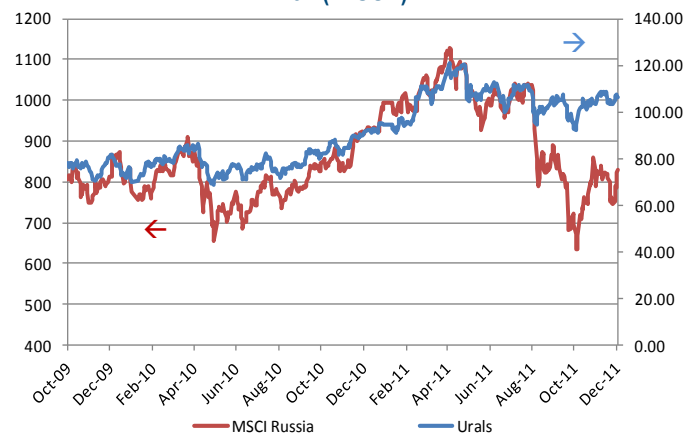
We choose to become more cautious on **India**. There are increasing signs of a slowdown, with the latest GDP figures showing growth of only 6.9% due to the lagged effects of monetary tightening. The PMI Index contracted from 52 to 51 (especially in the manufacturing sector), reflecting the low level of new orders. In October, the trade deficit amounted to USD 19.6 billion, a record level. Also, the latest failure to bring about retail trade reform has undermined the government's credibility.

The bias on **Turkey** remains negative. Inflation is still trending upward, driven by the effects of the recent tax increases, and by inflationary pressure on the supply side (especially for food prices). This, combined with a still large current-account deficit, will probably put more pressure on the currency and lead the central bank to step up its monetary tightening. Furthermore, earnings revisions are to the downside and valuations are unattractive. Lastly, Turkey is the market in our universe most exposed to the European sovereign debt crisis, and thus depends heavily on the banks.

#### The performance of Chinese equities relative to the universe is negatively correlated to the reserve ratio



#### The Russian market is correlated to the price of Russian crude oil (in USD)





## ALTERNATIVE STRATEGIES

### COMMODITIES

#### Still a preference for gold. Neutral on other commodities

**Growing pressure in oil markets remains likely in the medium term if a recession is avoided**

The price of **Brent** has remained relatively stable in recent weeks, at around USD 110, moving in line with risk appetite and the level of the US dollar. In a context of slowing economic growth worldwide, oil demand is likely to grow more slowly, at a time when oil production is being resumed in Libya. This should help attenuate pressure on oil markets in the short term, and could depress prices. However, certain factors limit the downside risks for oil prices. First, oil stocks remain low in OECD countries by comparison with the average levels of recent years, and it would seem that this is also the case in India and China. Moreover, geopolitical stress remains high in the Middle East, justifying the persistence of a "geopolitical premium" in prices. Lastly, if oil prices were to fall sharply, OPEC could decide to reduce its production. Therefore, while we remain positive in the medium term on the fundamentals of oil, we **prefer to stay neutral on oil** for the coming months.

**Base metals** markets again had a mixed performance in November, against a backdrop of further economic slowdown in Europe and concerns about the industrial sector in China. Indeed, while markets were quick to factor the worsening economic outlook for Europe into forecasts for industrial metals demand, the firmness of Chinese demand for copper was the main factor of support, limiting price declines. Although we remain confident in the Chinese economy, the risks have increased. **We remain neutral on base metals.**

**Gold** prices remained volatile in November, in line with risky assets. After climbing to USD 1 800 per ounce, the price of gold corrected to USD 1 680 before rebounding toward USD 1 740. The World Gold Council's report on demand for the metal in Q3 underscored the good health of investment demand, especially in Europe. Moreover, the persisting investor appetite for gold is confirmed by the fact that the assets of gold ETFs reached a new record in November. However, the WGC report also notes a slowdown in Indian demand, for both jewellery and investment, probably as a consequence of the record price levels and high volatility. To the extent that we think that investor appetite for the metal should remain high in the coming quarters, **we remain positive on gold**, but prices could correct if investment demand were to wane.

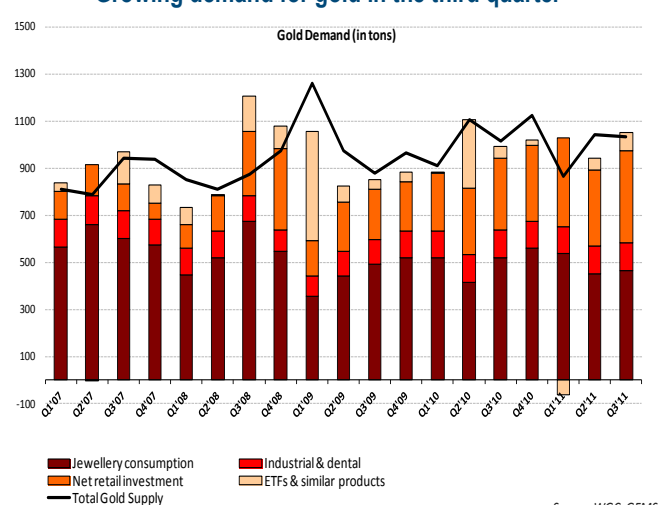
**Cereals** markets remained weak in November. US dollar strengthening and weak export demand weighed on prices. However, speculative positions in cereals are now neutral overall, and this could limit the downside risks from current levels. **We are neutral on cereals.**

**Investment remains the growth engine for gold demand**

The Chinese PMI weighs on metal prices



Growing demand for gold in the third quarter





## CONTACTS & DISCLAIMER

The charts in this document were updated in December 2011, unless otherwise specified. BNPP IP is the source as of 12 December 2011 for all data commented in this document unless otherwise specified.

### Strategy Team:

Vincent Treulet

Nathalie Benatia

Antonio Bertone

Charles Cresteil

Jenna Dessart

Sophie Fournier

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.