



INVESTMENT STRATEGY

June 11, 2010

June 10

ASSET ALLOCATION	2
ECONOMIC OUTLOOK.....	3
Viewpoint	3
Developed economies	4
Emerging markets	5
BOND MARKETS.....	6
Government bonds.....	6
IG and HY credit.....	7
CURRENCY MARKET	8
EQUITY MARKETS.....	9
Developed markets.....	9
Emerging markets	11
ALTERNATIVE STRATEGIES.....	13
Commodities	13
DISCLAIMER.....	14

At the crossroads

The last few weeks have seen markets grow increasingly nervous and pessimistic, with violent and sometimes bizarre reactions to economic data and policy decisions. Among all of the “noise” we must try to distinguish those issues that are truly important. The skittishness of investors may be attributed to the uncertain outlook over the coming months. Will growth continue, slow or perhaps even fall back into a double-dip recession? Will we see more systemic problems in the financial sector? Will plans to cut public spending be credible and effective? Can the euro zone stay together? According to our baseline scenario:

- Growth will slow in the developed countries and efforts to reduce budget deficits will also start to make themselves felt in 2011. We do not expect this to trigger another recession however, since several factors should still continue to support modest growth, including investment, household consumption to a lesser extent and, in the case of Europe, exports.
- Given the rescue plan implemented over the past few weeks, we currently see very little risk of a sovereign default in the euro zone or its collapse. Although this plan does not eliminate the longer-term risks it will help stabilise the situation.
- Liquidity risk in the financial sector should not be overestimated, as the ECB and other central banks will certainly do everything necessary to prevent this.

There are therefore indeed structural risks that will no doubt continue to weigh durably on risk appetite. Along with slower growth in the Western economies, these risks are likely to depress risky assets in these markets over the medium term. Nonetheless, with markets continuing to correct in May the current situation is rather complex. The global economy is growing, corporate profits are still rising and monetary policy will continue to be expansionary over the foreseeable future. Another factor is more attractive valuations for those asset classes that have declined since the beginning of the year. This is why we believe that risky asset prices are more likely to stabilise over the near term than drop sharply.

Accordingly, we have stopped avoiding risk in June and our portfolio’s risk exposure is roughly unchanged from May. We are still neutral in developed market equities and continue to prefer the US market, although we have trimmed our underweight in the euro zone. We continue to wait for a better opportunity before returning to emerging markets. In the credit market we have maintained a slightly long position in the high-yield segment. In commodities, we have edged up our exposure to gold and other metals.



ASSET ALLOCATION

Allocation decisions

- Few changes since May.
- Equities: neutral exposure to developed equities is maintained. Although we prefer emerging equities over the medium term their correlation with developed equities will mean similar exposure over the near term.
- Bonds: we still prefer high-yield debt.
- Commodities: waiting for an opportunity for oil, we still prefer gold.

Developed equity markets

- Still overweight in the US market and in the United Kingdom to a lesser extent.
- Further trimming of euro-zone underweight.
- Back to neutral in Japan.

Emerging equity markets

- Overweight in Korea and Russia.
- A bit more optimistic about China.
- Underweight in India, Brazil and South Africa.

Typical diversified model portfolio – Institutional clients

The model portfolio holdings below are measured against cash and may be transposed into any other portfolio whether benchmarked or not.

MULTI-ASSET CLASS¹

	Alpha	Current weight	Previous weight
EQUITIES			
Developed Equities	0.03	0.4%	0.2%
Emerging Equities	0.04	0.3%	0.6%
FIXED INCOME			
Government Bonds	-0.03	-1.4%	0.0%
Investment Grade	0.01	0.2%	-0.1%
High Yield	0.06	1.3%	1.7%
COMMODITIES			
Brent Oil	0.00	0.0%	0.0%
Base Metals	0.04	0.5%	0.3%
Gold	0.08	0.7%	0.5%
Agricultural	0.00	0.0%	0.0%
Cash Euro		-1.9%	-3.4%
Module Total		0.0%	0.0%

PORTFOLIO STATISTICS

Target Ex-ante Volatility	1.00%
Real Ex-ante Volatility	0.66%

1-Hedged in Euro, 2-Local Currency

EQUITIES: DEVELOPED COUNTRIES¹

	Alpha	Current weight	Previous weight
US	0.34	2.6%	2.4%
Canada	-0.06	-0.5%	-0.7%
Euroland	-0.08	-0.7%	-1.0%
Japan	0.00	-0.1%	1.2%
UK	0.09	0.7%	0.7%
Switzerland	-0.07	-0.6%	-0.9%
Australia	-0.22	-1.4%	-1.7%
Module Total	0.0	0.0%	0.00%

BOND COUNTRIES SOVEREIGN¹

	Alpha	Current weight	Previous weight
US	0.0	-1.2%	-7.0%
Euroland	0.5	9.5%	6.4%
Japan	0.0	-1.2%	-4.8%
UK	-0.5	-6.1%	-0.7%
Switzerland	0.0	-1.2%	6.1%
Module Total	0.0	0.0%	0.00%

EQUITY EMERGING COUNTRIES²

	Alpha	Current weight	Previous weight
Brazil	-0.05	-0.2%	-0.5%
China	0.05	0.3%	0.0%
India	-0.10	-0.5%	-0.5%
South-Korea	0.13	0.9%	1.2%
Taiwan	0.00	0.1%	0.3%
Russia	0.15	0.7%	0.4%
South Africa	-0.20	-1.4%	-1.1%
Turkey	0.02	0.2%	0.1%
Module Total	0.0	0.0%	0.0%



ECONOMIC OUTLOOK

Viewpoint

A more difficult environment

Sovereign debt crisis is key concern now...

...and for the future

The rescue plan is credible but fails to convince. Over the past few weeks concerns about European sovereign debt have captured the attention of investors and caused them to ignore some rather encouraging indicators in the United States and the emerging economies and upward revisions in earnings forecasts. Markets remain jittery, despite the announcement by European authorities of a massive rescue and stabilisation plan that should, at least in theory, ease liquidity risk. The fact that national lawmakers were quick to approve the creation of a European financial stability fund further strengthens the plan's credibility. Lastly, the ECB's decision to purchase government bonds reduces the risk of further attacks by speculators. Yet despite these factors volatility continues to be high in comparison with late April and the euro remains weak. We feel this situation reflects the growing awareness of the **increasingly structural nature of sovereign debt risk** that is the consequence of fiscal stimulus measures and the recession.

Sluggish growth ahead

Macroeconomic concerns are likely to return to the forefront as efforts to redress public finances weigh on growth. There is little chance that countries that are not under direct pressure from financial markets will begin fiscal consolidation in 2010, given upcoming elections and the time required to adjust fiscal policy. And yet some countries (most notably Germany) have already made commitments toward greater fiscal discipline as of 2011. During this transition toward less expansionary policy economic news is likely to become increasingly disappointing as the manufacturing cycle's boost to economic activity runs its course and growth slows to a modest pace. We may then expect only a very gradual improvement in the labour market that will leave the jobless rate quite high.

Risks have intensified

We maintain our scenario of slower growth over the coming quarters in the Western countries, whose economies should however continue to recover. Yet the risk of more than just a slowdown, i.e. a double-dip recession, is now probably higher. The race to cut public deficits would severely handicap growth, while recent strains in European interbank markets could reduce the supply of credit if they continue and intensify. These threats would play out against a background of steadily declining core inflation (less than 1% in Europe and the US) that has rekindled fears of deflation. Both recession and deflation (which our baseline scenario excludes) would be particularly difficult to deal with, given the limited scope for economic policy measures.

Consensus Forecasts: Growth & Inflation

	GDP y.o.y %								Inflation y.o.y %									
	2009	2010				2011				2009	2010				2011			
		M	H	L	-1M	M	H	L	-1M		M	H	L	-1M	M	H	L	-1M
<small>M= Mean; H= High; L=Low</small>																		
Developed Economies																		
USA	-2.4	3.3	3.9	2.9	[3.2]	3.1	4.4	1.9	[3.1]	-0.3	2.0	2.6	1.6	[2.1]	1.9	3.8	0.6	[1.9]
Canada	-2.6	3.3	3.7	2.5	[3.2]	3.0	3.6	2.1	[3.0]	0.3	1.9	2.1	1.6	[1.9]	2.2	2.6	1.7	[2.2]
Euro zone	-4.0	1.1	1.7	0.7	[1.2]	1.5	2.6	0.9	[1.5]	0.3	1.3	1.6	1.0	[1.2]	1.4	1.9	0.8	[1.4]
UK	-4.9	1.3	2.2	0.8	[1.3]	2.3	3.4	1.1	[2.3]	2.2	2.9	3.2	2.2	[2.7]	1.8	3.6	0.3	[1.7]
Switzerland	-1.5	1.9	2.5	0.9	[1.8]	1.9	2.8	1.2	[1.9]	-0.5	1.0	1.3	0.3	[1.0]	1.0	1.5	0.5	[1.1]
Japan	-5.2	2.4	3.2	1.7	[2.2]	1.7	2.9	0.9	[1.6]	-1.4	-1.0	-0.6	-1.4	[-1.1]	-0.2	0.4	-0.7	[-0.2]
Australia	1.3	3.2	3.8	2.6	[3.3]	3.4	4.3	2.7	[3.4]	1.8	2.8	3.4	2.4	[2.6]	2.9	3.8	2.6	[2.8]

Source: Consensus Forecasts as of 10/05/2010



ECONOMIC OUTLOOK

Developed economies

Growth has been spotty and will probably remain so

Americans consume, the Japanese export and Europeans are depressed

Although the aggregate GDP growth of the OECD countries has been positive for the past four quarters some are growing significantly faster than others. They may be divided into three groups: those where domestic demand is satisfactory or even robust (the United States and Canada), those who continue to export (Japan and Switzerland), and Europe (including the UK) where household consumption remains sluggish and imports rose in the 1st quarter. This situation is likely to continue and even intensify in the second half of the year when economic activity slows from the relatively rapid pace we have been seeing since the fourth quarter (from 0.9% then 0.7% q/q in the OECD area).

Euro zone continues to lag

In the euro zone, growth forecasts are being steadily lowered, including by the ECB, which now expects only 1.2% in 2011. The euro's depreciation does not make up for the currency block's structural sovereign debt concerns, high unemployment, weak consumption and the prospect of greater fiscal discipline. Business investment in countries with strong export demand may be restricted if credit remains tight.

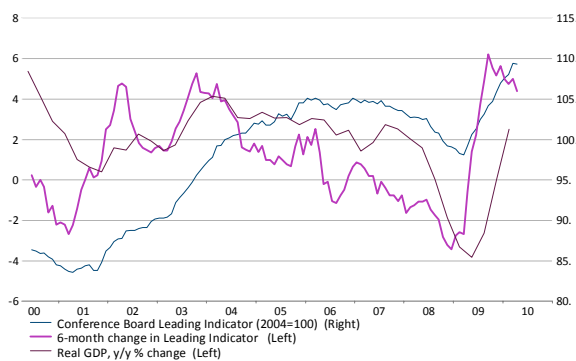
The US economy is growing but will probably slow in the second half

In the United States, although growth is gradually becoming self-sustaining it is likely to remain limited. Household consumption has been maintained by social transfers and a lower saving rate. Although wage growth is expected to accelerate over the next few months, when temporary census-related hiring is excluded the labour market's recovery has been weak. The jobless rate (9.8% in May) is not likely to decline over the near term and this could weigh on consumer confidence and spending. Judging from survey data and indicators, manufacturing activity is probably near its peak but will not collapse. Although business investment may pick up the slack relatively little is expected from SME, as is the case with job creation. Yet GDP in the 2nd quarter should benefit from investment to replace equipment and the pick-up in the housing market in April. Although this improvement may largely be attributed to favourable tax measures, housing-related spending (on durable goods, furniture, etc.) should increase. GDP growth should therefore be comparable to the annualised 3% seen in the 1st quarter and then gradually decline.

Central bankers must continue to provide support

Even though the economy has improved over the past few months it is still fragile and the Federal Reserve and the ECB should definitely maintain their highly accommodative monetary policies as financial stress returns to credit markets.

United States – weak signals of a slowdown



Euro zone – domestic demand is weak



ECONOMIC OUTLOOK

Emerging markets

Growth stops accelerating but is still robust

Growth still solid in the emerging economies

Supported by domestic demand, economic recovery in the emerging countries has been particularly strong and is likely to remain so over the coming quarters. But as we pointed out last month, Brazil and many countries in Asia have reached their growth potential and we may now expect slower growth from the emerging economies. Recent business surveys also suggest that the pace of global economic activity is likely to stabilise over the summer. Indeed, with the exception of India, emerging countries' purchasing manager indices are down substantially, although still well within expansion territory. This may mainly be attributed to fewer new orders and the global economy's adverse impact on manufacturing.

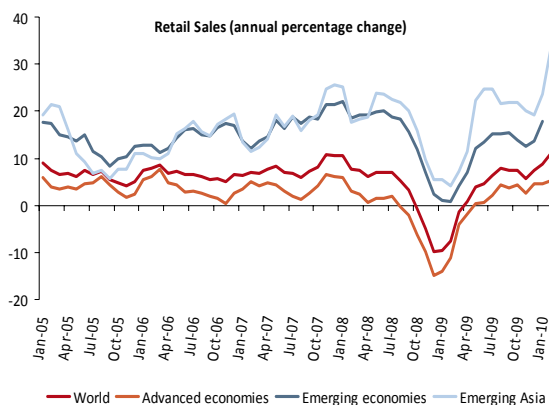
Unlike the G7 members, the emerging economies have very little debt

Although the emerging economies should be relatively unscathed by Europe's difficulties, their policy decisions must now factor in the greater risk of a slowdown in demand from their developed counterparts and in the growth of the global economy. Asia, where budgets are soundest, is in the best position to withstand contagion. Among the Eastern countries, Russia's low public and foreign debt should best enable it to weather the current crisis, which has already affected Hungary considerably. The main risk for Brazil is a fall in commodity prices.

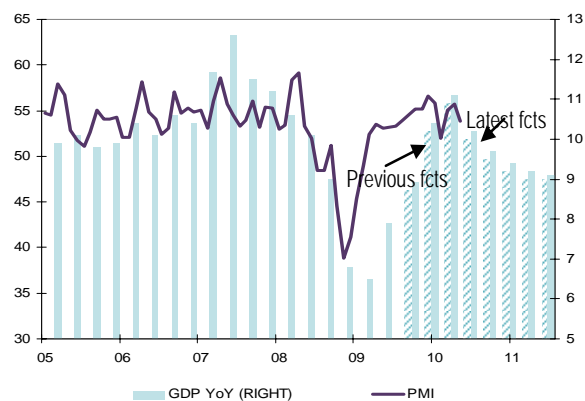
Higher wages accelerate the rebalancing of China's economy

With 11.9% GDP growth in Q1, China's economic cycle has probably peaked. Property sales have fallen sharply in the wake of new administrative measures and now cast a cloud over the construction sector, while the latest PMI index also points to a slowdown in export orders. These signals should justify a pause in monetary tightening. Chinese authorities have decided to accelerate the rebalancing of the country's economy by raising minimum wages. The sharp salary increases granted by Foxconn and Honda in response to both social and demographic factors will reverse the downward trend in wage income relative to GDP, reduce the saving rate and thereby boost household consumption's contribution to economic activity. Less dependence on foreign trade and investment is reducing the economy's cyclical volatility.

EM - strong domestic growth



China - growth has peaked



BOND MARKETS

Government bonds

Guarantees fail to calm nervous investors

Europe spares nothing to stop the sovereign debt crisis

To make sure that it was taken seriously when it announced its measures to alleviate the funding difficulties of some EU members, **the European Union committed a substantial amount of funds and ensured that the ECB would play an active role.** The central bank had previously been reluctant to adopt certain unorthodox measures. Although the market's immediate and justifiable perception was that the plan was a good one, investors soon began to find other reasons to worry beyond the euro zone and its sovereign debt crisis, such as slower growth in the emerging economies, new banking regulations and macroeconomic uncertainties.

However, it is easy to find arguments to counter each of these concerns. As is often the case, the truth no doubt lies somewhere in between.

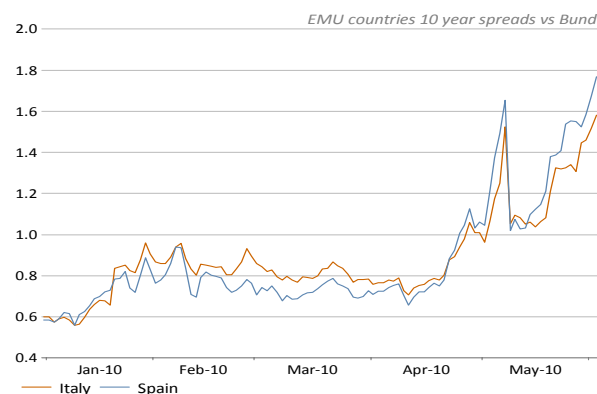
Given the sluggish growth and the long-term threat of sovereign risk, we believe **these structural concerns will be around for quite some time.** But for the time being, the measures taken should normally enable markets to breathe a bit easier, yet this has not been the case. **Bond investors thus continue to flee the riskier countries as they seek refuge in German Bunds and US Treasuries,** as may be seen by further pressure on Spanish and Italian yields.

A technical correction is possible but yields will stay low

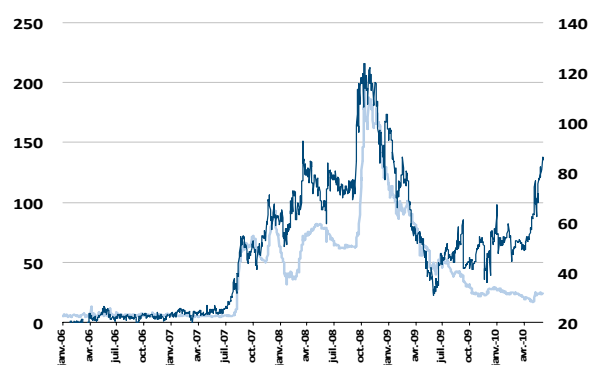
We believe this reaction is excessive. It is mainly driven by sentiment and is therefore susceptible to a sudden reversal if German and US yields "normalise" at somewhat higher levels.

Even if such a correction would mean more reasonable valuations, **we are unlikely to see any spectacular increase in yields.** Indeed, they will probably remain rather low over the next few months given the prospect of weak growth, the downward trend in core inflation and the maintenance of rock-bottom policy interest rates for the foreseeable future.

Spanish and Italian 10-year spreads over Bunds at record level



2-year German Bunds are overbought



BOND MARKETS

IG and HY credit

Worries remain despite stronger fundamentals

Since they suffer from the same fears that have lowered German and US interest rates, credit markets have also declined. The spreads of investment-grade debt issued in euros have widened, particularly on financial sector issuers. However, **since this is mainly attributable to lower benchmark interest rates there was little impact on yields** and losses were relatively modest, except of course on subordinated debt.

New issuance plunges

Concerns about certain countries and consequently certain financial institutions weighed on credit markets, not only by increasing spreads but by making it more difficult to issue new debt. With only a few exceptions, **primary market issuance has fallen sharply** and the ECB's programmes were the only means that some borrowers had to obtain short-term funds.

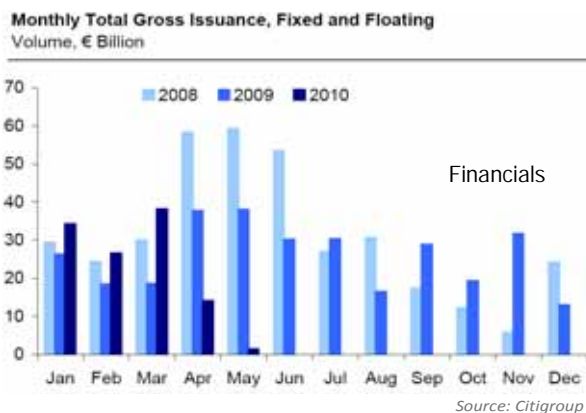
Although this has had no major impact on borrowing costs in euros, some strains were observed across the Atlantic, particularly in the form of a broader Libor-OIS spread as some European banks had difficulty in obtaining dollar funding. We believe however that these fears are exaggerated, given the size of the spread, the measures implemented to ensure liquidity and the relatively little use that has been made of the dollar funding made available by the Central Bank.

Unsurprisingly, high-yield issues were hit harder than investment grade. Although the decline in performance relative to the recent high is not in itself alarming, **the volume of HY fund redemptions is another matter**, since fund inflows have been a very strong supporting factor.

High-yield fund redemptions remove a major support

Barring a reversal of risk aversion, it is hard to imagine investors rushing back to HY debt. However, **we prefer to maintain our overweight in the high-yield segment**, given the unlikely prospect of a relapse into recession, increasingly strong fundamentals, fewer defaults, a relatively attractive carry yield and the lack of compelling alternatives.

Primary European IG market shuts down



High-yield investment funds chalk up redemptions



CURRENCY MARKET

The euro should stop falling but a durable rebound is unlikely

More volatile euro struggles to regain ground

Rumours of intervention

The euro will be weak over the medium term

Japan's new prime minister favours a weaker yen

Will the G7 or G20 take action?

In response to recent developments in the sovereign debt crisis, the euro has dropped sharply since the end of April against the US dollar (by 9% on June 10), the yen (-12%) and a basket of currencies (-6%). Various events and rumours have weighed on Europe's currency, which benefited only momentarily from the announcement of the European stabilisation plan, falling rapidly back down after an initial surge. Germany's unilateral decision on May 18 to prohibit certain types of short sales rekindled concerns that Europe's cohesion could fall to pieces and caused the single currency to slump below 1.22 USD. The low level to which the EUR/USD rate has fallen triggered rumours of intervention that enabled the euro to recover to 1.26 on May 21. Other factors also came into play, such as the announcement by Chinese authorities that they would, contrary to rumours, continue to purchase euros to diversify their foreign reserves. The SNB's purchases on May 18 to prevent the EUR/CHF rate from falling below 1.40 and a timid increase in risk appetite also helped strengthen the euro, which is still extremely volatile however. In early June, EUR/USD fell below 1.20 as investors reacted nervously to statements by a Hungarian official.

The conditions for a near-term euro recovery are in place (European solidarity and the prospect of less risk aversion and speculation) and should prevent further weakening of the EUR/USD rate, which is now near its equilibrium value. We expect the downward trend to reappear toward the end of the year and assert itself in 2011, when greater importance is accorded to more fundamental factors, such as economic growth and monetary policy.

Expect a weaker yen by the end of year. When he was finance minister, Naoto Kan made it known that currency intervention was an option, stating that he wanted to avoid an "excessive increase" in the yen. Now that he is prime minister this is what he is likely to encourage the BoJ to do. The maintenance of highly accommodative monetary policy and the decision to provide one-year loans to banks could facilitate the revival of yen-financed carry trades, although investors will first have to regain some appetite for risk.

The levels that some currencies have reached, the high volatility and the threat that sharp fluctuations might pose to economic activity could encourage officials to normalise the currency market. Central banks certainly already have quite a bit to deal without a currency crisis. The currency game has entered a political phase that could signal the end of play.

FX Rate Forecast Summary (Major Currencies)

End of Period		2009	10-Jun-10	2Q 2010		3Q 2010		4Q 2010		1Q 2011	
				Min	Max	Min	Max	Min	Max	Min	Max
USD Block	EUR / USD	1.43	1.2057	1.20	1.30	1.20	1.30	1.20	1.25	1.15	1.20
	USD / JPY	93	91.47	90	100	95	100	100	105	100	110
	USD / CAD	1.05	1.0381	0.95	1.05	0.95	1.05	1.00	1.10	1.00	1.10
	AUD / USD	0.90	0.8340	0.85	0.90	0.82	0.87	0.82	0.87	0.85	0.90
	GBP / USD	1.61	1.4594	1.39	1.56	1.47	1.56	1.44	1.53	1.38	1.47
	USD / CHF	1.03	1.1429	1.10	1.14	1.10	1.14	1.14	1.18	1.19	1.23
EUR Block	EUR / JPY	134	110.29	113	125	119	125	123	129	118	129
	EUR / GBP	0.89	0.8262	0.80	0.90	0.80	0.85	0.80	0.85	0.80	0.85
	EUR / CHF	1.48	1.3780	1.38	1.43	1.38	1.43	1.40	1.45	1.40	1.45

Source: BNPP AM as of 10/6/2010



EQUITY MARKETS

Developed markets

Increasing risk of a downturn

A cyclical slowdown is taking shape...

... and will cause disappointment just as doubts about the sustainability of growth intensify

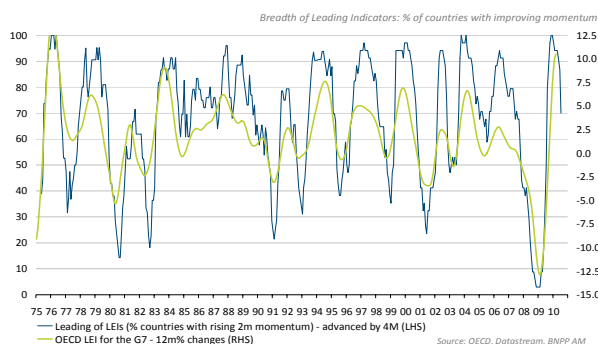
The very buoyant conditions in equity markets have been deteriorating over the past few weeks. The leading global economic indicators that we monitor have confirmed their downward trend and consequently our scenario of slower global growth in the second half of the year. However, we do not expect the global economy to fall back into recession, given the resilience of US economic activity made possible by still favourable fiscal policy in 2010, and above all the robust growth of the emerging countries. Furthermore, monetary conditions will continue to be particularly favourable in the advanced economies over the next few quarters. The cyclical slowdown now taking shape will not in itself prevent equity prices from rising. **Nonetheless, the imminent decline in GDP growth**, which has yet to be confirmed by the most recent economic data, will occur in an environment that is particularly unfavourable and stressful for equity markets.

Recent strains on the sovereign debt of some countries indeed remind us that the repercussions of the subprime crisis are still making themselves felt in the form of tighter credit markets, accelerated fiscal tightening and diminished confidence that will continue to weigh on global growth for several years.

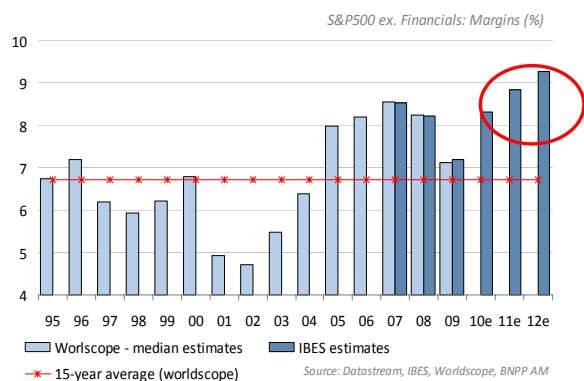
This resurgence of doubt as to the sustainability of growth will be exacerbated by the **"cyclical" disappointments that we may expect very soon**. The extremely favourable ratio of positive surprises for both economic news and corporate earnings is therefore likely to reverse trend very shortly. This will revive concerns of a more structural nature about global growth, in light of the considerable imbalances that remain in the global economy, not least of which are household and public debt.

Since news flow is very likely to be disappointing and often plays a greater role in near and medium-term market performance than fundamentals themselves, **we expect it to become an increasingly negative factor over the coming months**. For the time being, the earnings growth trend is still quite positive and the second-quarter earnings season could even still be surprisingly strong.

Leading indicators have reversed already



Profit margin forecasts are very (over?) optimistic



EQUITY MARKETS

Developed markets

Highly favourable earnings forecasts are at risk

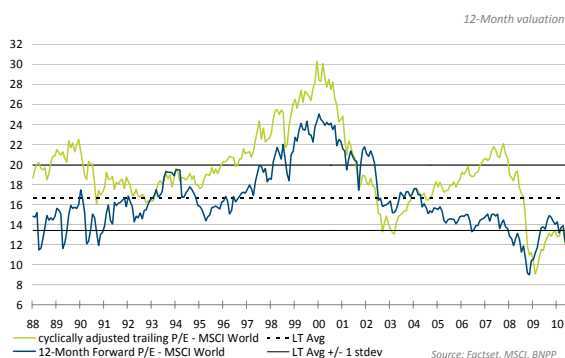
However, earnings growth will have some headwinds to face. To begin with, fiscal tightening is likely to gradually weigh on sales as the potential to further increase profit margins steadily diminishes. Furthermore, **financial sector earnings will probably suffer from recent market developments and their negative impact on funding conditions.** Given these factors, current forecasts of sales and earnings growth, and the profit margins they imply, seem quite optimistic. In addition, the momentum of upward earnings forecast revisions is at an historically high level. This trend could therefore quite easily reverse over the coming months and disappoint investors, which poses an additional and major threat to equities.

With this in mind, the currently attractive level of valuations (which are particularly compelling when based on forward 12-month P/E) should be considered with caution. Furthermore, given the increasingly uncertain outlook for growth and the resurgence of fears of near-term deflation and long-term inflation, valuations are likely to play a lesser role in investment decisions. **We therefore have a cautious medium-term outlook on equities, although a technical rebound may be expected in the short run.**

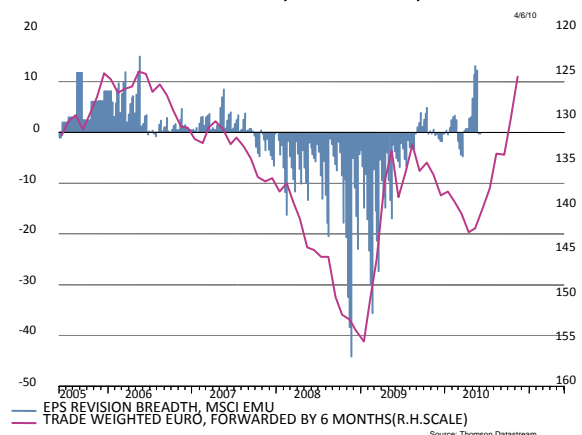
We prefer the United States

The main change in our geographic allocation this month is a shift from overweight to neutral in the Japanese market, where economic and political uncertainties offset the positive earnings revision trend and relatively attractive valuations. We remain overweight in US equities given the high level of risk aversion and the still favourable near-term outlook for earnings, despite the dollar's appreciation. We have maintained a slightly overweight position in British equities in view of UK monetary policy measures and their very compelling relative valuations. However, the pound's strong appreciation against the euro and uncertainties about the new budget plan limit our enthusiasm. We have once again trimmed our underweight in euro-zone equities to account for the favourable impact of the euro's decline on exports and repatriated earnings. Yet this market remains handicapped by the region's structural challenges, concerns about bank exposure to peripheral countries and the implementation of fiscal austerity despite the current recovery's fragility.

Valuations are attractive, if you believe EPS forecasts



The weaker euro's positive impact on EPS



EQUITY MARKETS

Emerging markets

Superior performance with lower beta

Leading indicators suggest no reversal for a few months

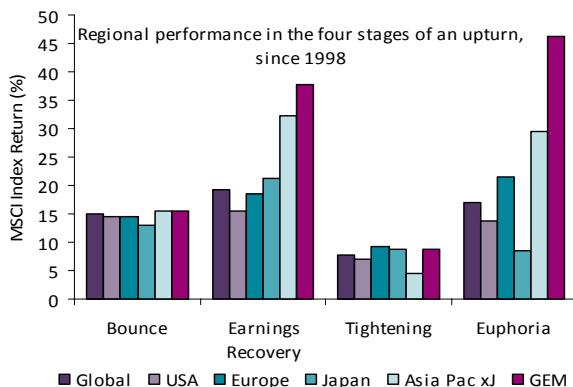
Leading indicators continue to decline. This has been the trend since fall 2009 and it will continue for a few more months. The tightening of monetary policy, which is just underway in Brazil, India and many other countries, is likely to continue. However, the sluggishness of the global economy (further weakened by the sovereign debt crisis) reduces the threat of runaway inflation and therefore of the increase in market volatility normally observed during periods of rising interest rates. Other indicators are also unfavourable, such as the semiconductor cycle and the ratio of inventories to shipments.

Lastly, the normalisation of China's economy from excessive growth to high growth will not be good for commodities and this could throw a damper on such markets as Brazil, Russia and India, to a lesser extent. The sharp drop in the Australian dollar clearly reflects this outlook.

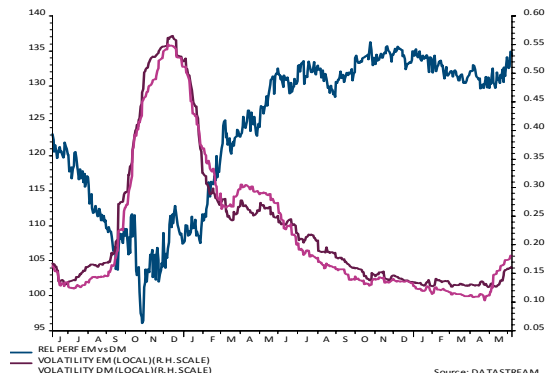
Outperformance and low beta

The performance of the emerging equity markets has historically been strongly correlated with the global economy, the Federal Reserve's monetary policy and investment fund flows. This explains their high betas and the extreme swings in emerging indices during times of financial crisis in comparison with developed market indices. Yet the opposite has strangely been the case since Europe's sovereign debt crisis, with emerging markets outperforming developed by 4.3% (in local currency terms), despite their current monetary tightening. The relative volatility of emerging markets versus developed has even decreased. Furthermore, the dollar's appreciation in response to heightened risk aversion did not weigh on emerging equity prices as expected. If this trend continues, it will be tempting to conclude that emerging markets offer superior growth and a lower beta, which is an ideal combination for any portfolio. This is not yet the case however in terms of absolute performance, since many risks still lie ahead, such as the decline of Chinese leading indicators and further monetary tightening. We do not expect the market trend to clearly start reversing before one or two quarters, when leading indicators hit bottom.

Higher rates, weak performance



EM – outperformance with less risk



EQUITY MARKETS

Emerging markets

Does peak stress = a low point?

From a technical standpoint, emerging indices are once again sitting on a major support level. Stress indicators also peaked in late May, which confirms the near-term bull trend. As for valuations, the combination of the upward trend in earnings forecast revisions and recent market corrections have brought valuation multiples well below their historical averages. Lastly, we should keep in mind that emerging markets' firms are less indebted than their counterparts in the developed economies, which further enhances their appeal.

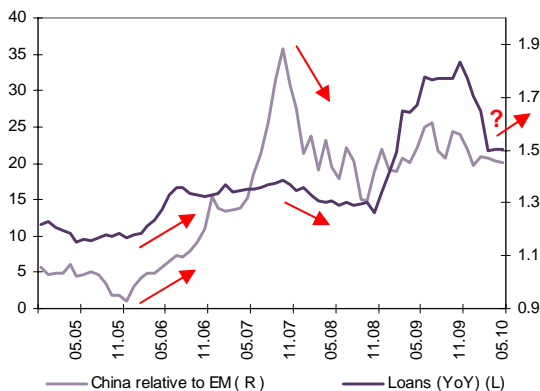
After a massive inflow of funds in 2009, the increase in risk aversion will reduce investments in emerging markets to more modest levels this year. Unsurprisingly, only the EMEA region enjoys a net inflow so far this year, with indiscriminating global EM funds, such as ETFs, responsible for most of the demand.

Back to a slight overweight in China

We are back up to a slight overweight in China. Property sales have plunged in reaction to the drastic measures adopted in mid-April. The 40% drop in transactions over one month could cause officials to suspend monetary tightening to prevent a self-sustaining decline in the market that could hurt consumer confidence. The most recent figures already show an encouraging stabilisation of bank lending and M1 money supply growth. Exports are also surprisingly strong, suggesting that China's economy is showing good resilience in the depressed global environment. The first major emerging equity market to start consolidating in the summer of 2009, China's could also be the first to revive. This at least seems to be what Chinese authorities believe since they still plan to go ahead this summer with the Agricultural Bank of China's IPO, which is poised to be one of the largest ever. Technical factors are compelling and portfolios have too much cash.

Although economic and financial conditions are still attractive, we are reducing our exposure to Korea in light of the heightened geopolitical risk. We are maintaining a very small underweight in Brazil in response to monetary tightening, even though positive earnings revisions have reduced valuations to more normal levels. Despite India's long-term structural appeal given its huge potential domestic demand, we are cautious about this market since it is still too expensive over the near term and monetary tightening has just begun.

China – a strong link between lending and performance



Brazil – valuations are back to neutral



ALTERNATIVE STRATEGIES

Commodities

Caution advised. We still prefer gold.

Beyond the crisis, fundamentals should lead the recovery of cyclical commodities

Investment demand should continue to support gold

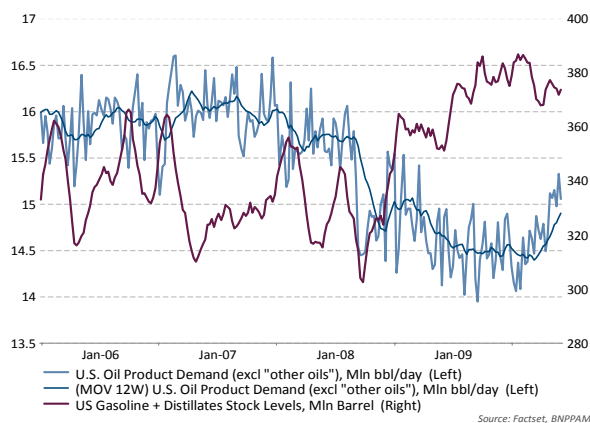
As **crude oil** plunged over the past few weeks the demand for oil products in the US began to show encouraging signs of recovery. The US Department of Energy's weekly figures show an increase in demand for fuel and intermediate distillates, to levels not seen since March 2009. This pickup in demand is quite welcome, since the rebound in oil prices over the past few months has encouraged a rise in production and thereby jeopardized the reduction of stocks. If this stronger demand is confirmed over the next few months we may see the beginning of inventory normalisation. Over the near term however there are still many risk factors, not least of which are economic conditions, and we prefer to wait before we increase our exposure. **We therefore remain neutral.**

We have maintained a slight overweight in base metals, since near-term fundamentals are still positive, with physical demand solid and prices close to production cost. A more favourable risk environment could encourage the market to refocus on fundamentals and enable prices to recover.

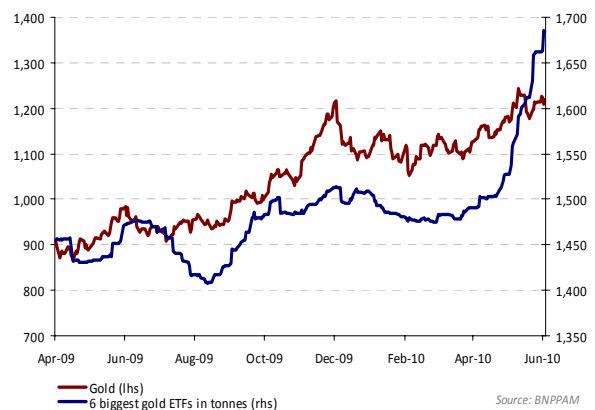
As was the case last month, **gold** enjoyed massive investment inflows in May. Investors thus held over 2,000 metric tons of physical gold via ETFs. Therefore, even though the high price of gold is reducing its demand for jewellery, high risk aversion and favourable monetary policies should maintain the investment demand and the price of gold. **We are maintaining our overweight** in gold.

We are still neutral on grains. With good weather conditions during the US planting season, high stock levels and sluggish global demand, there seems little upside potential barring a major climate event. The dollar's strength also continues to weigh on export demand.

Oil - demand is rising but stocks are high



Gold - investment flows accelerate



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