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INVESTMENT PARTNERS

Investment Strategy
14 March 2012

ASSET ALLOCATION 2

ECONOMIC OUTLOOK 3

Viewpoint 3
Developed economies 4
Emerging economies 5

BOND MARKETS 6

Government bonds, IG and HY credit 6

CURRENCY MARKET 7

EQUITY MARKETS 8

Developed markets 8
Emerging markets 10

ALTERNATIVE STRATEGIES 12

Commodities 12

CONTACTS & DISCLAIMER 13

Monetary policies: stimulus or poison?

One of the factors behind the markets' rise in recent months is very likely the continuation or the adoption of increasingly accommodative monetary policies. Central banks are propping up markets, whether through interest rate cuts (in the emerging world), "extraordinary" measures (the Fed's Operation Twist, the Long Term Refinancing Operations - LTROs - of the ECB, etc.), or assurances given concerning future monetary policy trends. These factors are bolstering markets both directly and indirectly (by shoring up confidence). Some investors even regard the current configuration as an "ideal" situation, with central banks acting as an insurance policy against any risk of an economic deterioration, because such a deterioration would probably lead them to take further measures.

We believe that central banks are indeed one of the keys to understanding the current bullish environment and, for this reason among others, we maintain tactical positions which are still fairly risk-taking. However, it would perhaps be over-rash to place blind faith in the saying "don't fight the Fed", even extending it to the other central banks.

Firstly, the current good market conditions undoubtedly owe at least as much to the stabilisation of the global economic outlook as to monetary policies and liquidity. Abundant liquidity has been constantly available throughout the crisis, although this did not prevent risky asset markets from falling enduringly at certain times. Liquidity is admittedly even more plentiful at present, but it seems likely that markets would take a hit if the more positive economic sentiment that has developed in recent months were threatened. Now, on a horizon of a few months, we believe that this sentiment will deteriorate again faced with the inability of developed economies to accelerate further.

At the same time, the intervention mechanisms of the central banks also have their limits. The Federal Reserve's Operation Twist, which aims to flatten the yield curve by buying long-dated securities while selling shorter-dated securities, cannot act directly on risk premiums and hence on the total cost of credit for economic agents. The ECB's LTROs have been salutary in improving market conditions for the financial sector and for eurozone sovereign debt, in particular by stimulating purchases of public debt by the banks. However, they are not a direct answer to governments' long-term borrowing requirements nor to the need for the banking sector to shrink the size of its balance sheets, which is incompatible with a simultaneous increase in commitments to public- and private-sector borrowers.

Finally, and above all, it is clear, objectively, that the current policies in major developed countries consist of going ever further down the road of liquidity injection and low interest rates, which were, precisely, partly responsible for the crisis of recent years. Exit policies are not an issue in the short term, but this question will have to be faced in the future. Now, ultra-accommodative monetary policies become increasingly addictive over time. Do you treat an addiction by increasing the doses? The question will eventually have to be asked.

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ASSET ALLOCATION

Allocation decisions

- Neutral recommendation on developed equities and positive on emerging equities, for which we maintain a preference.
- Virtually neutral on government bonds and slightly long position in credit.

Developed equity market arbitrage

- We recommend relative overexposure mainly to Japan and the United States.
- Underweighting of Canada and Australia.

Emerging equity market arbitrage

- Preference for China and Brazil.
- Neutral on South Korea and South Africa.
- Underweight on Turkey and India.

Recommended allocation – Investment Strategy Team

ASSET ALLOCATION MODEL PORTFOLIO — March 2012

MULTI-ASSET CLASS [1]

	Alpha	Current weight	Previous weight
EQUITIES			
Developed Equities	0.04	0.4%	0.2%
Emerging Equities	0.20	1.2%	0.9%
FIXED INCOME			
Government Bonds	0.01	0.4%	-0.3%
Investment Grade	0.08	3.0%	3.2%
High Yield	0.07	1.1%	1.7%
Emerging Debt	0.00	0.0%	0.0%
Emerging Debt Local	0.00	0.0%	0.0%
COMMODITIES			
Brent Oil	-0.08	-0.3%	0.1%
Base Metals	-0.03	-0.2%	-0.2%
Gold	0.28	1.9%	1.9%
Agricultural	0.01	0.1%	-0.2%
Cash Euro		-7.5%	-7.4%
Module Total		0.0%	0.0%

PORTFOLIO STATISTICS

Target Ex-ante Volatility	2.00%
Real Ex-ante Volatility	0.94%

EQUITY DEVELOPED COUNTRIES [1]

	Alpha	Current weight	Previous weight
US	0.07	1.8%	-0.7%
Canada	-0.09	-1.7%	-3.4%
Euroland	0.04	0.9%	0.5%
Japan	0.19	2.8%	1.3%
UK	-0.03	-0.6%	5.1%
Switzerland	-0.03	-0.5%	-0.9%
Australia	-0.15	-2.7%	-1.9%
Module Total	0.00	0.0%	0.0%

BOND COUNTRIES SOVEREIGN [1]

	Alpha	Current weight	Previous weight
US	0.00	0.0%	-14.6%
Euroland	0.00	0.0%	7.1%
Japan	0.00	0.0%	0.0%
UK	0.00	0.0%	7.5%
Switzerland	0.00	0.0%	0.0%
Module Total	0.00	0.0%	0.0%

EQUITY EMERGING COUNTRIES [2]

	Alpha	Current weight	Previous weight
Brazil	0.10	1.1%	0.9%
China	0.19	2.3%	2.3%
India	-0.12	-1.4%	-1.2%
South-Korea	-0.01	-0.1%	-0.1%
Taiwan	-0.01	-0.1%	-0.1%
Russia	0.03	0.2%	0.2%
South Africa	-0.06	-0.9%	-0.8%
Turkey	-0.13	-1.1%	-1.2%
Module Total	0.00	0.0%	0.0%

1-Hedged in Euro, 2-Local Currency

Source: BNPP AM

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ECONOMIC OUTLOOK

VIEWPOINT

More encouraging statistics in the United States, but growth will remain modest

A generally satisfactory jobs report

In February, the US economy once again created more jobs than expected (227,000 versus 210,000 expected), and the results for the preceding months were revised upward. Monthly job creations have averaged 245,000 in the past three months, but only 188,000 in the past twelve months. The improvement is modest and, moreover, may have been artificially boosted by seasonal adjustments that were less relevant due to an extremely mild winter. Another more fundamental factor makes us cautious regarding this improvement. A fall in the number of jobless claims generally goes hand-in-hand with a rise in household confidence. Now, jobless claims are at their lowest level since March 2008 (around 350,000), whereas the confidence indices have only just regained the level that prevailed a year ago (about 71 versus 100, just before the slide into recession). Consumers remain cautious regarding the improvement in employment, which, moreover, is not accompanied by any pronounced pickup in hourly wages. The increase in employment and hours worked is reflected by approximately 4.5% nominal growth in wage income. Inflation is around 3%, so that the margin for growth in real consumer spending is limited,

Doubts persist

especially since the recent rise in oil prices (and the accompanying rise in gasoline prices to around USD 3.80 per gallon, the highest level since mid-2011 and not very far from the record of more than USD 4 dollars in July 2008) is likely to weigh on purchasing power (and confidence). According to the initial indications regarding retail sales, real growth in consumer spending in the first quarter is unlikely to exceed 2% at an annualised rate.

Among the figures considered encouraging published in recent weeks, the ISM Index in the non-manufacturing sector continued to progress (exceeding 57, its highest level in one year), whereas the ISM for the manufacturing sector declined slightly. Due to the importance of the service sector in major economies, the composite indicators built based on these surveys show, for February, an acceleration in activity in the United States, and also in the rest of the world given the weight of the US economy. The non-manufacturing ISM has seldom been an accurate predictor of the cycle in recent years. Moreover, sentiment of small and medium-sized business owners (75% in the non-manufacturing sector) remains weak, which suggests that fears persist. Growth, also adversely affected by deleveraging, will remain subdued.

The Fed still accommodative

In January, when the Fed had recently stated that it would keep rates exceptionally low at least until the end of 2014, its chairman specified that further QE measures would be taken if necessary to ensure a more robust economic recovery. He did not repeat this expression during his hearings before Congress on 29 February and 1 March. However, we do not consider this omission as a policy inflection suggesting that QE has ended. The intrinsic weakness of growth since the start of the recovery justifies a very cautious approach. Indeed, following the Federal Open Market Committee (FOMC) meeting of 13 March, the Fed reiterated its outlook for "moderate" growth, noting the recent fall in the unemployment rate but considering it still "elevated". It still thinks that the housing market remains "depressed". The meeting of 24 and 25 April will be followed by a press conference which will give Ben Bernanke an opportunity to clarify his monetary policy intentions two months before the end of Operation Twist.

Consensus Forecasts: Growth & Inflation

	GDP YoY %									Inflation YoY %								
	2011	2012				2013				2011	2012				2013			
M= Mean; H= High; L=Low		M	H	L	-1M	M	H	L	-1M		M	H	L	-1M	M	H	L	-1M
Developed Economies																		
USA	1.7	**2.2**	2.8	1.8	[2.2]	**2.5**	3.5	1.4	[2.5]	3.2	**2.0**	2.9	1.1	[1.9]	**2.0**	4.0	0.5	[1.9]
Canada	2.3	**2.0**	2.4	1.5	[2.0]	**2.3**	2.9	1.0	[2.3]	2.9	**1.9**	2.5	1.3	[2.0]	**2.0**	2.5	1.4	[2.0]
Eurozone	1.5	**-0.3**	0.6	-1.5	-[0.3]	**0.9**	1.7	-0.4	[1.0]	2.7	**2.0**	2.2	1.8	[1.9]	**1.7**	2.7	1.3	[1.7]
UK	0.9	**0.5**	1.5	-0.5	[0.5]	**1.8**	2.5	0.5	[1.8]	4.5	**2.6**	3.2	2.1	[2.7]	**2.0**	3.5	0.7	[2.0]
Switzerland	1.7	**0.2**	0.7	-1.1	[0.2]	**1.4**	1.9	0.5	[1.3]	0.2	**-0.3**	0.4	-1.0	-[0.3]	**0.7**	2.0	-0.5	[0.7]
Japan	-0.9	**1.8**	3.7	1.0	[1.9]	**1.4**	2.3	0.5	[1.4]	-0.3	**-0.3**	0.1	-0.8	-[0.2]	**0.0**	0.4	-0.6	[0.0]
Australia	2.0	**3.3**	4.0	2.5	[3.4]	**3.3**	3.7	2.7	[3.3]	3.4	**2.5**	3.1	2.0	[2.8]	**3.0**	3.6	2.6	[3.1]

Source: Consensus Forecasts as of 13/02/2012

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DEVELOPED ECONOMIES

Slowdown in the eurozone

The European Commission foresees a recession…

For the eurozone as a whole, GDP contracted by 0.3% in the fourth quarter of 2011 following two quarters of very weak growth (only +0.1%). Moreover, the trend for the components is worrying, with a fall in private consumption (-0.4%) and investment (-0.7%, following two less marked declines). The external contribution was positive due to a larger fall in imports than in exports. Except for two consecutive quarters during which the contribution from stocks was negative (-0.2 pp), the dynamic seems to be unfavourable for the coming months. The stabilisation of activity shown by surveys of purchasing managers and industry will probably not suffice to lend stimulus to European economies. In this environment, the latest European Commission forecasts (interim report in February) point to a "slight recession" for 2012 with an average contraction of 0.3% of GDP (versus 0.8% growth still foreseen last autumn). The ECB has also revised its growth expectations downward and now looks for GDP growth of between -0.5% and 0.3% in 2012 and between 0% and 2.2% in 2013. These official figures are similar to the consensus of private forecasters, who consider that in 2013 growth (+0.9%) will remain slightly below its potential.

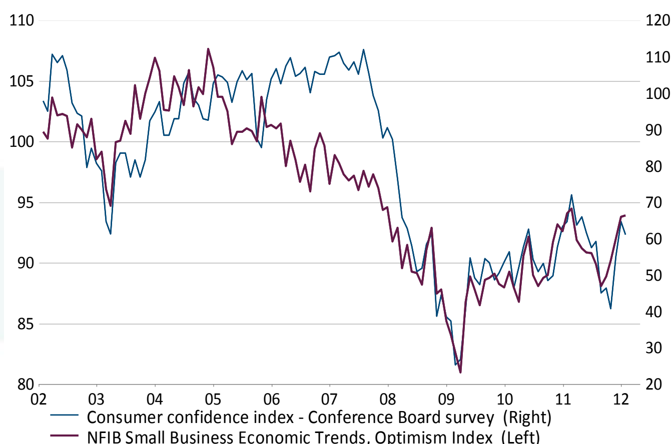
…and the ECB too

Major differences between economies

Our widely shared scenario of a **limited recession** this year will probably give rise to the eternal debates about a "technical" recession (i.e. two consecutive quarters of contraction in GDP according to the standard usually adopted by market economists), or the possibility of the eurozone "escaping" recession precisely by avoiding this sequence. This quibbling will in no way change the fragile situation of European economies accompanied by rising unemployment and a fall in household confidence, or the great difficulties faced by major countries such as Spain and Italy (28% of eurozone GDP between the two of them). Italy's GDP contracted by 0.7% between the third and fourth quarters of 2011 and posted a year-on-year decline of 0.4% at the end of 2011 due to a fall in domestic demand. In Spain, the quarter-on-quarter contraction in GDP was limited (-0.3%), but domestic demand is in free fall (removing 2.9 pp from GDP) and the unemployment rate is close to 23%. Although the eurozone as a whole can give an illusion, mainly because of Germany, the major difficulties faced by most of its member countries will probably foster some scepticism. Moreover, restrictive fiscal measures will increasingly weigh on activity. The Spanish government has stated that, because of the budget deficit overrun in 2011 (-8.5%) and the current recession, the target of 4.4% for 2012 which had been agreed with the European authorities will probably not be reached. On 12 March, the Eurogroup authorised Spain to target a 5.3% deficit this year, but demands a return to 3% in 2013. This difficulty in meeting ambitious targets − when the economic situation is still poor − is likely to revive tension between European partners. Although, through its two 3-year refinancing operations for the banks (LTROs), the ECB has apparently managed to "extinguish" the sovereign crisis in the short term, the longer-term difficulties on the road to greater fiscal integration could revive worries.

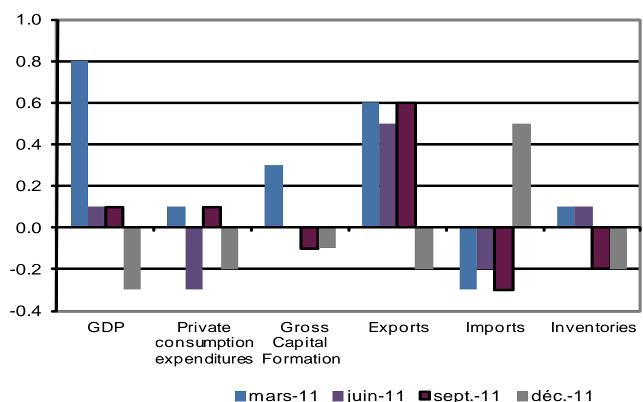
Restrictive fiscal policies are still on the agenda

United States: Caution among households and small businesses



Source: Factset, BNPP AM

Eurozone: Breakdown of GDP



Source: Eurostat, BNPP AM

EMERGING ECONOMIES

Economic momentum has stabilised, but watch out for oil prices

Economic activity has stabilised

Economic activity has stabilised in emerging countries. China's industrial output is modest based on historical comparisons, but subsiding inflation is making the central bank's work easier. The economies of Northern Asia are enjoying a rebound in exports and new orders, and an improvement in sentiment. Latin America remains solid due to further monetary easing, which is boosting consumer confidence. Improved visibility regarding the European crisis is having a positive impact on Eastern Europe.

The leading indicators have remained on a positive trend since October 2011 and point to an acceleration of economic activity in the second quarter. The PMI opinion surveys are in moderate expansion mode in most emerging countries, sustained mainly by the pickup in new orders. However, the employment and inventory components are disappointing.

The risk of contagion from the eurozone is behind us, but watch out for oil prices

Further monetary policy easing in emerging countries, which is increasingly widespread, is threatened by the resurgence of inflation. The oil price has rebounded by 8% since the start of the year, and by more than 35% since the lows of October 2011. This is especially problematic for Asian countries, which are poor in resources but heavily dependent on the manufacturing sector. Oil imports in Asia currently represent 12% of GDP, versus 13% in 2008. The oil price has a negative impact on the current-account balance (Turkey) or inflation (Asia in general), and jeopardises central banks' monetary policies. This is the case for Indonesia and India, where energy is heavily subsidised.

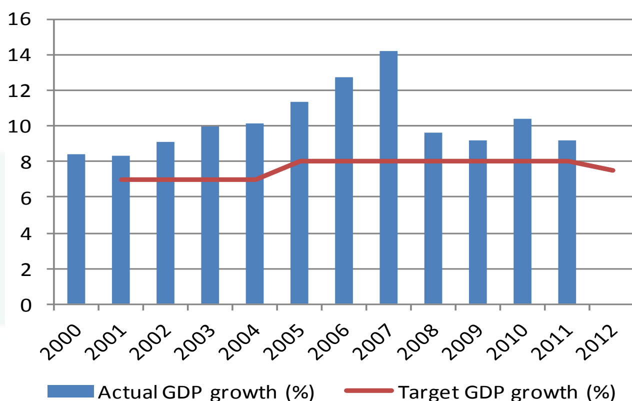
Lower Chinese growth, but of better quality

China has lowered its GDP growth target from 8% to 7.5% for 2012, which is well below actual growth in the past ten years. By setting a moderate target, the central government hopes to lower local authorities' expectations, which will make it possible to better curb inflation and will facilitate a rebalancing of the economy. Without the two key growth engines of infrastructure and real estate, the Chinese economy will not be able to repeat its performances of the past two years. Capital investment will remain very modest, while the huge stock of unsold apartments and downward pressure on real estate prices will continue to hold back construction volumes. In the end, the contribution of the trade balance will be zero or even negative, given the weakness of external demand and efforts to boost domestic demand. However, we think that Chinese GDP should nevertheless achieve growth of around 8% in 2012, thanks to monetary and fiscal stimulus.

Brazil and India: Falling inflation and monetary easing

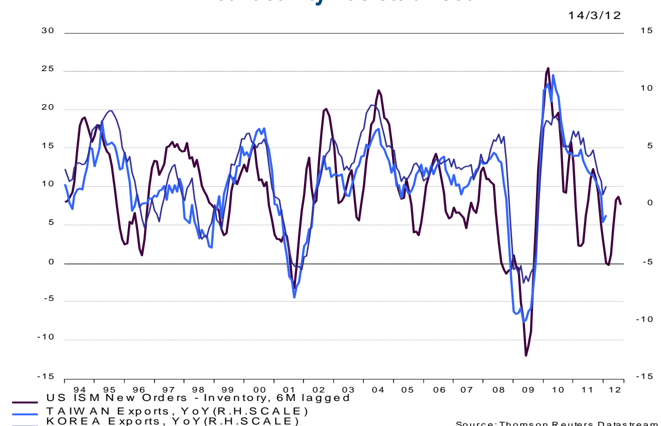
Inflation **in India** has fallen sharply, allowing the central bank to lower its reserve ratio twice since the start of the year. However, the trend in oil prices could threaten this expansionary policy. The recent state assembly elections weakened the ruling party and will have an even greater effect on prospects of reform. Consumer confidence continues to strengthen in **Brazil**, where real interest rates are at an all-time low, due to a very accommodative monetary policy. In response to this stimulus, growth is expected to accelerate in the second half.

China: Real growth systematically higher than targeted growth



Source: Datastream, BNPP AM

Real activity has stabilised



Source: Datastream, BNPP AM

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BOND MARKETS

GOVERNMENT BONDS, IG AND HY CREDIT

Plentiful liquidity beneficial for all…

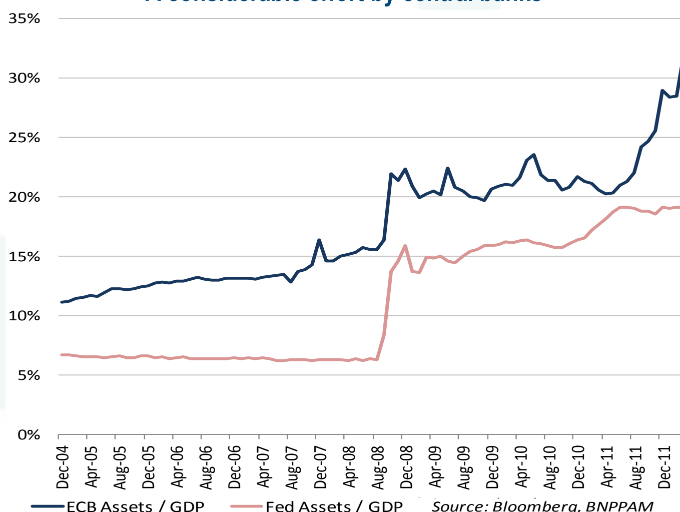
Greek debt restructuring (PSI) and the ECB's second long-term refinancing operation (LTRO) were the two factors focusing investor attention in recent weeks. Regarding Private Sector Involvement (PSI), the agreement reached with private investors has reduced the risk of a disorderly default in the short term, but Greece's problems are nevertheless not solved. For its part, the ECB's three-year LTRO succeeded in providing a total of EUR 530 billion in funding for 800 banks. In this context, it is important to emphasise that, despite the positive performance of risky assets, yields in the core countries did not move up. We need look no further than the fact that the German Bund yield ended the month of February unchanged, while the yield on the 10-year Italian BTP eased by 50 basis points and credit spreads narrowed while equity markets were in positive territory. The economic environment and monetary policies are largely to thank for this. In the United States we still foresee positive but sluggish growth this year, while numerous question marks remain concerning 2013, following the US presidential elections. Regarding monetary policy, it is no surprise that it will remain accommodative for a long time. Recent news suggests to us that subsequent quantitative easing measures, not necessarily imminent, could take the form of another Operation Twist (with the Fed selling short-dated paper and buying long-dated paper) or sterilised quantitative easing (QE). In Europe, the recent stabilisation of the PMI leading indicators does not point to a significant upturn in the economy, and growth will remain very weak. The ECB, for its part, will want to take time to properly assess the effects of the two recent LTROs before considering the advisability of undertaking further operations of the same type. A cut in the key interest rate seems less likely for the time being, given the upside risks for inflation mentioned by Mario Draghi. Moreover, the ECB staff has revised upward its inflation forecasts for this year and the next (to 2.4% and 1.6% respectively, versus 2% and 1.5% previously). All this still leads us to believe that, even if they were to trend upward, core yields would not increase significantly.

Core yields still directionless

More buoyant credit market in the short term, but medium-term issues persist in Europe

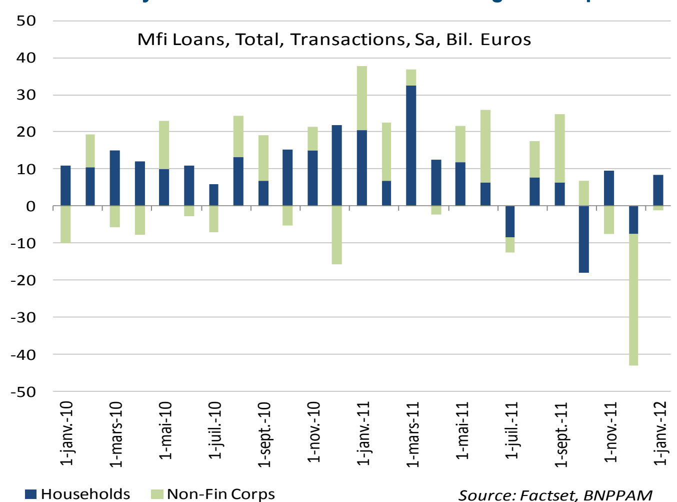
In credit markets, very fortunately the January figures for lending to households and companies in Europe did not confirm the significant fall seen last December. And although the ECB's LTROs have not led to an automatic increase in lending to the private sector, they have nevertheless been able to alleviate pressure on the banking sector for the time being. The credit market will probably continue to benefit from this environment of plentiful liquidity, but that said, it should not be forgotten that the situation in Europe is definitely not settled, and there are still medium-term issues related to the crisis and the fiscal effort.

A considerable effort by central banks



Source: Bloomberg, BNPPAM

January better than December for lending in Europe



Source: Factset, BNPPAM

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CURRENCY MARKET

Shilly-shallying on foreign exchange markets

The EUR/USD trend is still by no means clear

In recent weeks, the **EUR/USD exchange rate** has moved in a range between 1.30 and 1.35, changing direction at the end of February when a slightly less pessimistic speech on the US economy by the Fed chairman suggested that a QE3 was no longer on the agenda. The euro, which had returned to around 1.35 (the highest level since early December 2011) after the further agreement reached on Greece following the Eurogroup summit of 20 February, then headed downward again below 1.31 on 14 March. The US dollar benefited from rather encouraging economic data, while the euro's decline was limited by the "success" of the plan for the exchange of Greek debt held by private creditors (the PSI), which made possible the adoption of a further bailout plan for Greece, allowing the country to get past the debt repayment date of 20 March, when EUR 14.5 billion of debt fell due. The EUR/USD exchange rate seems to be pulled in different directions by these various factors: short-term relief regarding eurozone sovereign problems on the one hand, and improved economic momentum in the United States on the other hand. Moreover, although the plentiful liquidity provided by the ECB for the European banking system under the 3-year LTROs staves off systemic risk, it does not solve the structural problems related to the sovereign crisis and the economic situation is very poor. In this environment, we continue to believe that **the euro will probably weaken further against the US dollar** in the coming months and we maintain an exchange rate target of 1.20. Speculative positions against the euro have declined in recent weeks but remain significant, and this may explain the single currency's relative resilience until now.

The yen continues to weaken gradually

On 14 February the Bank of Japan announced an increase in its programme of asset purchases (+10,000 billion yen to buy JGBs) and an inflation target (1%, whereas actual prices in February were down 0.2% year-on-year). The effect on the **USD/JPY exchange rate** was significant: a breakout above the 79.50 threshold at the end of February enabled an uptrend to become established, bringing the exchange rate to around 83 by mid-March. In one month, the yen accordingly lost 5.2% against the US dollar, returning to the level prevailing in April 2011. More effectively than through direct intervention in the market, the BoJ seems to have managed to move the exchange rate away from the 76–78 range in which it had moved since August. This trend is expected to continue in the coming months, probably at a slower pace given that speculative positions in the yen are no longer significant.

Watch out for excesses on commodity-related currencies

The **Australian and Canadian dollars** have remained at high levels against the US dollar since the start of the year and on a trade-weighted basis (i.e. against a basket of currencies reflecting the importance of various trade partners) they have posted rises of 4.5% and 3% respectively since the end of 2011. A slight correction occurred in March, just like on the Norwegian krone which had profited greatly from the rise in oil prices. This nervousness surrounding the "commodity currencies" could persist in coming weeks, since there are huge speculative positions. Any turnaround in sentiment toward lower risk appetite and/or doubts concerning the global economy could lead to a rapid correction of the prior rise, in particular for the Australian dollar, especially since the RBA seems concerned about the level of the currency. A monetary policy decision due to this factor alone is unlikely, however, and the key intervention rate was maintained at 4.25% in early March.

FX Rate Forecast Summary (Major Currencies)

End of Period		2011	01-Mar-12	1Q 2012		2Q 2012		3Q 2012		4Q 2012	
				Min	Max	Min	Max	Min	Max	Min	Max
USD Block	EUR / USD	1.30	1.3340	1.20	1.30	1.15	1.25	1.15	1.25	1.15	1.25
	USD / JPY	77	81.12	75	85	75	85	77	87	77	87
	USD / CAD	1.02	0.9880	0.97	1.07	0.95	1.05	0.95	1.05	0.95	1.05
	AUD / USD	1.03	1.0765	0.95	1.05	0.97	1.07	0.97	1.07	0.97	1.07
	GBP / USD	1.55	1.5934	1.44	1.62	1.33	1.50	1.33	1.50	1.33	1.50
	USD / CHF	0.94	0.9035	0.96	1.04	1.00	1.08	1.04	1.13	1.04	1.13
EUR Block	EUR / JPY	100	108.21	94	106	90	102	92	104	92	104
	EUR / GBP	0.84	0.8372	0.77	0.87	0.80	0.90	0.80	0.90	0.80	0.90
	EUR / CHF	1.21	1.2052	1.20	1.30	1.20	1.30	1.25	1.35	1.25	1.35

Source: BNPP AM as of 1/3/2012

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EQUITY MARKETS

DEVELOPED MARKETS

Conditions still favourable, but the window of opportunity is gradually closing again

Increasingly accommodative monetary and financial conditions…

The equity market rebound continued in recent weeks, boosted by the ongoing improvement in monetary and financial conditions but also by more positive macroeconomic reports, especially in the United States. The extremely accommodative monetary policy pursued by all the major central banks in developed countries − and the easing process underway in the major emerging countries − are directly shoring up risky assets by providing liquidity. In Europe, the success of the ECB's LTRO has also attenuated systemic fears by reducing the risks of banking sector paralysis. This operation also achieved its second goal, which was to push down the cost of government borrowing in eurozone countries. While it seems, therefore, that a liquidity crisis could now be avoided, the underlying problems relating to the solvency of certain countries and the level of their government debt are nevertheless far from solved; the potential consequences remain worrying.

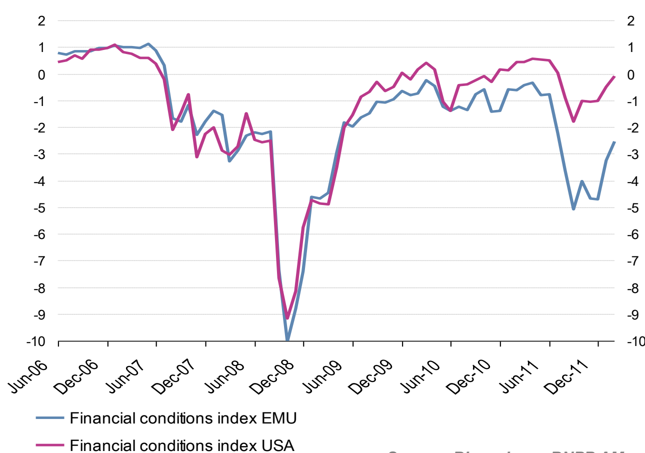
… but cyclical and structural risks persist

Apart from execution problems and the political risks involved, the fiscal austerity programmes which are currently being implemented, and which have not yet come into full swing in Europe, are expected to hold back global growth for an extended period. The recent cyclical improvement in the United States is, in our opinion, not sufficient to spark off a virtuous cycle of high growth. We still think that this improvement is mainly due to the extension of fiscal stimulus measures which are likely to be cancelled, at least partially, following the US presidential election.

In this environment, and following the recent rebound, it is obviously legitimate to ask oneself what is the market's base scenario. The earnings revisions ratio is currently re-accelerating upward, which is of course very good news and a very important factor of support for the markets. However, given the constraints on global growth that we have just mentioned and the already high level of expected earnings growth, this trend will be very hard to sustain.

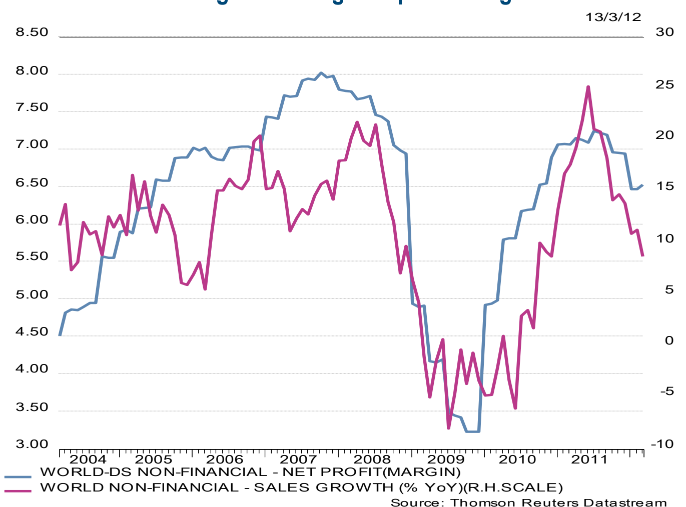
We do not find the revenue growth expectations expressed by the consensus of bottom-up analysts excessive, because they factor in a significant slowdown. On the other hand, we are still cautious regarding the expectation of further growth in margins from their high current levels even when sales growth will slow sharply. We therefore believe that the 12% earnings growth expected for the global market (MSCI WORLD) in the coming 12 months is still too optimistic.

Marked improvement in financial conditions



Source: Bloomberg, BNPP AM

Slowing sales weigh on profit margins



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DEVELOPED MARKETS

On the whole, valuations no longer provide support

From a valuation viewpoint, markets are not yet expensive, but at current prices, on the whole, they no longer allow for a cushion against a further bout of fever which could result from a resurgence of sovereign risk or disappointments regarding macroeconomic reports. The very high level of the rate of surprise on macroeconomic reports in recent weeks also suggests that the market has now already priced in a lot of good news. The bar is now placed very high if this criterion of the improvement in macroeconomic conditions is to continue to underpin market valuations. At present, the only valuation criterion extremely favourable to equities remains the risk premium relative to government bonds and corporate bonds, although it can partly be explained by proactive central bank measures to maintain the yield curves at historically low levels.

The sentiment indicators give grounds for caution

Despite the sharp rise in share prices, institutional investors generally remain under-invested in equities, which remains a factor of support for the market, especially since the trend indicators are sending out buy signals. However, the sentiment indicators have continued to improve in the wake of the rally. Although all the indicators are not yet at extreme levels, and hence worrying from a contrarian viewpoint, private investor sentiment now reflects a certain exuberance. Moreover, even though the market is now in over-bought territory, the VIX (which measures implicitly expected volatility for the US market) has fallen back to its post-Lehman lows, a level which has always been followed by marked corrections during this period.

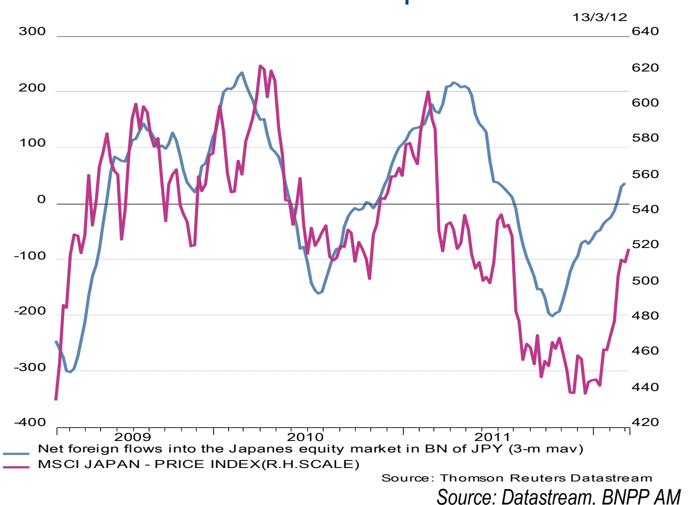
Continued overweighting of Japan

From a geographic allocation viewpoint, we maintain our overweight position in the **Japanese** market. Apart from valuations that are still extremely low in both relative and absolute terms, the sharp fall of the yen in recent weeks is supporting earnings revisions, and foreign investment flows remain positive. We raise our exposure to **US** equities to a slightly positive bias. Despite slightly stretched relative valuations, the defensive nature of this market and a favourable growth differential are still major factors of support. We remain neutral on **eurozone** markets. Apart from their very undemanding valuation and a fall in risk aversion which favours them in the short term, the fundamental problems remain and give grounds for some vigilance. We reduce our exposure to the **UK** market to neutral, since monetary policy there is becoming relatively less favourable. We maintain a slight underexposure to **Australian** equities. The RBA's monetary policy remains restrictive by comparison with global monetary policy and the slowdown in emerging countries continues to weigh on earnings revisions. These factors more than offset the attractive valuations. Finally, we maintain our underexposure to **Canadian** equities, which are still very expensive while earnings revisions remain negative.

VIX: Back to the sensitive region

Source: Datastream, BNPP AM

Favourable flows for the Japanese market



Source: Datastream, BNPP AM

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EMERGING MARKETS

Upward trend intact

Trend still well supported by the economic cycle and liquidity

The upward trend of emerging stock markets remains intact, fuelled by expectations of a pickup in the economic cycle and by the plentiful liquidity maintained by central banks. The OECD's leading indicators reached a bottom last November and have since then begun an upward move in line with stock markets. Historically, this phase is likely to last a few more months, characterised by a resurgence of risk appetite and a focus on "high-beta" assets, which explains the extreme correlation between emerging and developed stock markets.

Fund flows clearly reflect this search for "beta". The rise of emerging indices has been driven mainly by ETFs, although flows to Asia have been more selective and generated via non-index funds. On the other hand, profit taking in recent weeks has been achieved exclusively by the sale of ETFs, which indicates that the current trend is driven by the fundamentals and that the recent decline is purely a technical correction.

The relative performance of emerging stock markets has displayed a remarkable cyclical behaviour in recent months and confirms the idea that economic fundamentals have a moderate discriminating power over relative performance expectations. The indices posting the best performances during the past three months (Indonesia, Brazil and China) are starting to show signs of weakening momentum, while the lagging indices (Taiwan, India and Turkey) have taken over, despite diverging economic cycles and less favourable economic fundamentals.

Neutral from a valuation stance, but earnings are on an uptrend again

The valuation multiples of emerging stock markets are still below their historical trend, and still trade at a large discount to developed stock markets. Curiously, the volatility of emerging markets (12%) is less than that of developed markets (13%). The last two years of (slight) underperformance of emerging markets relative to developed markets are justified by the rising inflation which triggered a cycle of monetary tightening, and by the weakness of the developed economies. If the pickup in the economic cycle continues, the earnings growth rate in emerging markets has probably bottomed out, and earnings revisions should also start to stabilise. The combined impact of disinflation and monetary easing reduces the risk premium and justifies rising multiples, thus ensuring a continuation of the uptrend.

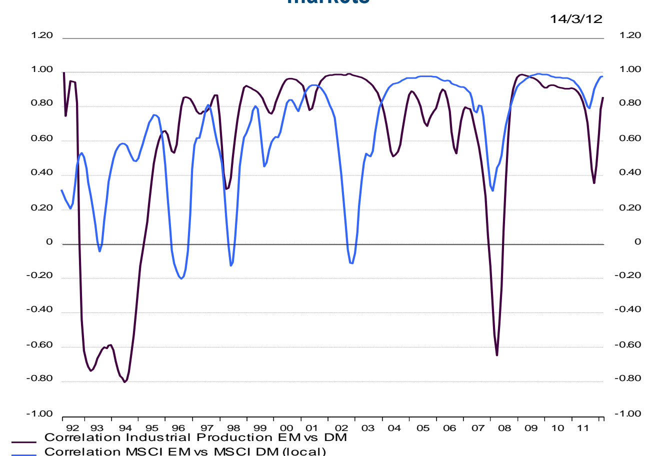
Asia still buoyed by interest rate cuts, but watch out for inflation

In Asia, our model based on the differential between Asian interest rates and Fed rates still points to a preference for Asia. However, the signal is becoming less clear-cut due to rising energy and commodity prices which could negatively impact inflation and put an end to the cycle of monetary policy easing. The sentiment model shows a very high level of optimism, which is a signal for caution from a contrarian approach.

The trend is still positive

Source: Datastream, BNPP AM

Almost perfect correlation between emerging and developed markets



Source: Datastream, BNPP AM

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EMERGING MARKETS

Back to the fundamentals, following the sharp rebound in "beta"

China: Reduction of our exposure following strong outperformance

We reduced our exposure on **Chinese equities** (H-shares) last month because the market was clearly over-bought after the rebound of more than 40% from the October low. Moreover, the catalysts needed to fuel the rise have become scarcer, while the Chinese authorities have given priority to a cautious policy so long as inflation and property risks have not been fully eliminated. But it seems that inflation will soon be tamed, while the trend in real estate prices is starting to affect the behaviour of some consumers, and this should encourage the government to release its monetary and fiscal brakes. Nevertheless, China offers a very attractive valuation, and it remains one of our favourite markets.

Positive bias on Russia and Taiwan. South Korean market threatened by the yen

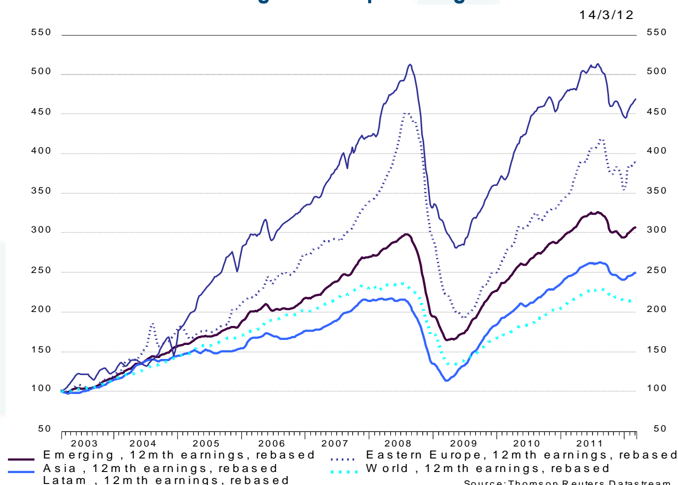
We remain neutral on **Russia**, which has until now been well supported by energy prices. Russian equities are still among the least expensive in the world, and are even more so following the oil price rally. Although the election of Vladimir Putin surprised no one, the event is positive, because it removes a major uncertainty from the market. Moreover, Putin's election programme looks to promote foreign investment, by combatting corruption. And this is good for business. We maintain our overweight position on **Brazil**, but its valuation has become expensive. Subsiding inflation has enabled the central bank to speed up the pace of cuts in its policy rate, bringing real interest rates down to an all-time low, which should stimulate private consumption. The stabilisation of its leading trade partner, China, is also positive.

We are neutral to cautious on **South Korea**, due to export weakness and uncertainties arising from the developed economies, but especially after the 12% weakening of the yen against the Korean won, since Japan is South Korea's main competitor. The market could be boosted by a return to favour of cyclical markets provided that global economic indicators continue to improve. We are positive on **Taiwan**. The economy is highly cyclical and exposed to developed markets. The outlook for US technology stocks remains positive and the Taiex Index still offers a high catch-up potential relative to the Nasdaq Index, the correlation with which is historically very high. Earnings and profit margins are on an uptrend, provided that energy and commodity prices do not soar.

Reduction in the negative bias on Turkey and India, because of an improvement in the fundamentals and subsiding inflation

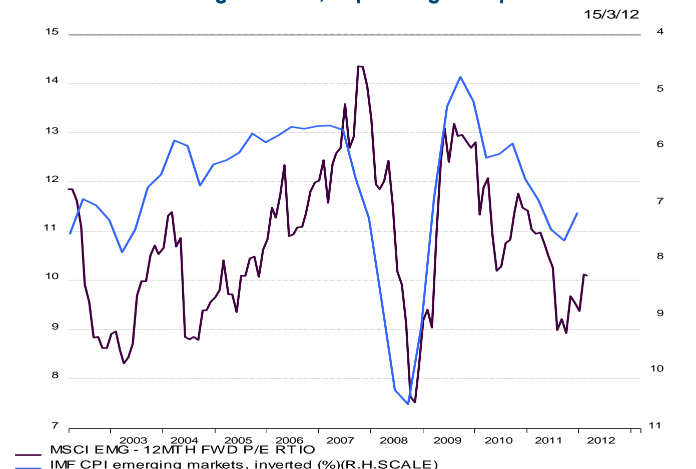
We remain cautious on **India**, justifying our bias by the political paralysis and the unfavourable fundamentals. The defeat of the incumbent party in the recent state assembly elections merely aggravates the problem, although the acceleration of monetary easing should provide a positive underpinning for the market in the short term. Earnings revisions have bottomed out, but valuations are no longer so attractive following the recent rebound. We continue to reduce our negative bias on **Turkey**. The fundamentals have improved, with a slight decline in inflation, which had reached a three-year high, and a resurgence in business sentiment. The financing of the current-account balance, mainly by European banks, remains our main concern. European bank stress seems to be evolving positively, thereby reducing the pressure on Turkish assets.

Earnings on an uptrend again



Source: Datastream, BNPP AM

Falling inflation, expanding multiples



Source: Datastream, BNPP AM

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ALTERNATIVE STRATEGIES

COMMODITIES

Still a preference for gold

A supply shock rather than a demand shock

The fear of worsening tension with Iran and the continued optimism regarding the macroeconomic situation in the United States propelled **crude** prices above $120 per barrel and to record levels in euro terms. The theory of a "demand shock" combined with a "supply shock" accordingly led investors to return massively to oil markets. However, for the time being nothing in recent oil statistics confirms the hypothesis of an acceleration of oil demand in developed countries, and the current price level could be a further factor pressuring the growth in energy consumption. Therefore, while we believe that oil demand will probably increase gradually over the coming years, we consider the risks are evenly balanced in the short term, especially since the second quarter is usually that in which global oil demand is lowest. Moreover, the possibility of a another crude release from strategic stocks cannot be ruled out if tension were to persist in oil markets, since OECD countries will want to avoid jeopardising the recent improvement in the economic situation (especially in a presidential election year in the United States). We therefore prefer to remain cautious and are **neutral on oil**.

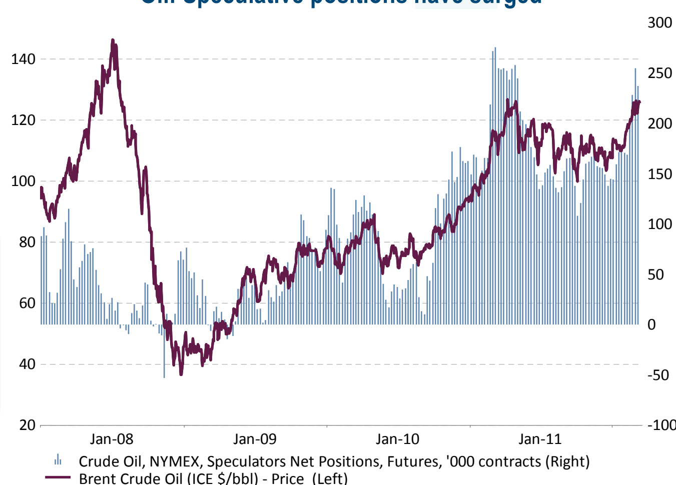
Base metal prices have stabilized following the sharp rebound in January. The PMI indices of manufacturing activity have remained moderately positive, but metals markets are waiting to see how demand for metals in China will evolve after the Chinese New Year. For example, although Chinese copper imports have remained strong, the sharp increase in domestic stocks points to more moderate imports. We **remain neutral on base metals**.

Investor appetite for gold should remain firm in 2012

Following a positive start to the year, **gold** prices have been volatile in recent weeks, experiencing a $100 correction in a single session, probably due to profit taking. While such "technical corrections" are normal – and even healthy – the scale of these moves suggests that when tactical investors reduce their positions, physical demand is not strong enough to take over the baton. Therefore, while we continue to believe that investor appetite for the metal is likely to remain high in the coming quarters, we think that price volatility will persist. **We are positive on gold**.

Grain markets rose while forecasts for soya bean and maize crops in South America were revised downward. However, although South American crop yields are likely to be an important factor in the short term – especially since grain stocks are low – the relative weakness of export demand and forecasts of a record crop in the United States limit the upside potential. **We are neutral on cereals**.

Oil: Speculative positions have surged



Source: Factset, BNPPAM

Copper: The fall in LME stocks offset by rising stocks in China

Source: Factset, BNPPAM

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CONTACTS & DISCLAIMER

The charts in this document were updated in February 2012, unless otherwise specified. BNPP IP is the source as of 14 February 2012 for all data commented in this document unless otherwise specified.

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