BNP PARIBAS
INVESTMENT PARTNERS

INVESTMENT STRATEGY

July 13, 2010

July 10

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Financial markets get used to weak growth

We believe there are two things that are particularly noteworthy regarding the recent behaviour of financial markets, which continue to see large swings in the prices of risky assets.

The first is a phase of readjustment as investors gradually realise that they should expect slower growth in the developed countries, as a result of deleveraging, the end or reversal of fiscal stimulus, and the fading away of cyclical growth drivers such as inventories. The combination of these factors should mean weaker growth in the developed economies for some time. However, a double-dip back into recession is not part of our baseline scenario, nor do we even believe that growth will be just above zero. Although there is of course a risk that when economies slow they could fall back into recession, we believe that the current situation calls for a more subtle analysis. After all, there are significant positive growth factors: firms need to reinvest (since capital spending has fallen well below the level required to replace production capacity) and private consumption should continue to grow, albeit weakly. The dwindling expectation of a stronger cyclical recovery, which marked the first few months of the year, was therefore justified. We believe this phase of adjustment is still underway, since economic consensus forecasts have yet to be revised downward and turns in leading indicators have historically resulted in a longer period of market turbulence than what we have witnessed so far (see page 9).

The second noteworthy trend is the "rebalancing of pessimism" between the developed economies. The second quarter of 2010 was marked by investor concern for the euro zone's difficulties, which include sovereign debt risk in the peripheral countries, anaemic growth and the "governance gap". These issues have weighed heavily on the euro and on European asset prices and we may now expect a swing back in the opposite direction. Although the euro zone's position is of course still far from enviable compared to the rest of the world, the other developed economies are also faced with the problem of slow growth over the medium to long term and weak public finances. It is not that investors are now more optimistic about the euro zone, but rather that markets are returning to a more balanced position, which moreover explains much of the rebound in the euro/dollar rate. Regarding the latter we believe it will continue to vary within its current range of 1.20 to 1.30 over the coming months and probably not fall back until next year. As far as equities are concerned, we further increased our exposure to the euro zone, which was heavily underweight three months ago and is now back to neutral.

Our medium-term bias remains cautious on the riskier assets of the developed economies, to which we continue to prefer those of the emerging countries, as we have explained in previous issues of our *Investment Strategy*. Nonetheless, we will not be significantly reducing our risk exposure in July since we see two supports for investor sentiment over the near term: second quarter earnings reports and the publication of the results of the European bank stress tests.

BNP PARIBAS
INVESTMENT PARTNERS

ASSET ALLOCATION

Allocation decisions

- Few changes to our portfolio since June.
- Equities: neutral exposure to developed equities is maintained. Although we prefer emerging equities over the medium term, their correlation with developed equities limits their absolute return potential in the near term.
- Bonds: we still prefer high-yield debt.
- Commodities: waiting for an opportunity for oil, back to neutral in metals and we still prefer gold.

Developed equity markets

- Still overweight in the US market and in the United Kingdom to a lesser extent.
- Back from underweight to neutral in the euro zone.
- Underweight in Switzerland, Canada and Australia.

Emerging equity markets

- Overweight in Korea, and in China to a lesser extent.
- Underweight in India, Brazil and South Africa.
- Neutral in Russia, Taiwan and Turkey.

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.

ASSET ALLOCATION MODEL PORTFOLIO

MULTI-ASSET CLASS[1]

	Alpha	Current weight	Previous weight
EQUITIES			
Developed Equities	0.00	0.0%	0.4%
Emerging Equities	0.04	0.3%	0.3%
FIXED INCOME			
Government Bonds	-0.01	-0.7%	-1.4%
Investment Grade	0.01	0.2%	0.2%
High Yield	0.12	2.5%	1.3%
COMMODITIES			
Brent Oil	0.01	0.1%	0.0%
Base Metals	0.00	0.0%	0.5%
Gold	0.08	0.6%	0.7%
Agricultural	0.00	0.0%	0.0%
Cash Euro		-2.8%	-1.9%
Module Total		0.0%	0.0%

PORTFOLIO STATISTICS

Target Ex-ante Volatility	1.00%
Real Ex-ante Volatility	0.64%

1-Hedged in Euro, 2-Local Currency

EQUITIES: DEVELOPED COUNTRIES[1]

	Alpha	Current weight	Previous weight
US	0.17	1.9%	2.6%
Canada	-0.06	-0.7%	-0.5%
Euroland	0.02	0.1%	-0.7%
Japan	0.00	-0.1%	-0.1%
UK	0.08	1.0%	0.7%
Switzerland	-0.02	-0.3%	-0.6%
Australia	-0.19	-2.0%	-1.4%
Module Total	0.00	0.0%	0.00%

BOND COUNTRIES SOVEREIGN[1]

	Alpha	Current weight	Previous weight
US	0.26	5.2%	-1.2%
Euroland	0.21	5.9%	9.5%
Japan	-0.16	-4.3%	-1.2%
UK	-0.31	-5.8%	-6.1%
Switzerland	0.00	-1.0%	-1.2%
Module Total	0.00	0.0%	0.00%

EQUITY EMERGING COUNTRIES[2]

	Alpha	Current weight	Previous weight
Brazil	-0.05	-0.4%	-0.2%
China	0.05	0.4%	0.3%
India	-0.05	-0.4%	-0.5%
South-Korea	0.13	1.2%	0.9%
Taiwan	0.00	0.1%	0.1%
Russia	0.05	0.3%	0.7%
South Africa	-0.15	-1.5%	-1.4%
Turkey	0.02	0.2%	0.2%
Module Total	0.00	0.0%	0.0%

ECONOMIC OUTLOOK

Viewpoint

US economy is a growing concern for investors

US growth is slowing

Job market improvement is modest

Recovery loses steam. As is often the case, US economic news has set the tone for most of the advanced economies, leaving the impression that growth is slowing sharply. The most closely watched indicators released early in the month were indeed disappointing: the ISM manufacturing index fell 3.5 points to 56.2 in June, its lowest level so far this year, and a net total of 125,000 jobs were lost that month. Although the latter can mostly be explained by the ending of the temporary census-taking jobs, which was expected, private employment is having a hard time recovering. Although the pace of job creation (an average of 100,000 jobs created a month since January) is similar to that observed after the recessions of 1990-91 and 2001, the job destruction this time was massive. Since payrolls are a lagging indicator of economic recovery they should gradually improve over the coming months. However, any improvement in the jobless rate will be slow. The decrease from 9.7% to 9.5% in June is the result of labour force shrinkage that is probably attributable to the growing ranks of the "discouraged jobless". The Senate's failure to pass the Emergency Unemployment Compensation bill that extends unemployment benefits could mean the end of payments for two million people in July and for four million by October and thus reduce consumer spending by 0.2% to 0.4% over the coming quarters, unless Congress quickly comes to an agreement.

Structural problems persist

Fiscal policy will provide less support but tightening will not be brutal.

Growth forecasts are lowered. These factors, along with a further slump in the housing market as the tax credit come to an end, have led most economists to revise their growth forecasts downward. Since these revisions were made early this month (and therefore do not appear in the table below) their publication by leading US brokers could disappoint investors. The Obama administration has so far made few concrete commitments toward its objective of reducing the budget deficit from 10.3% of GDP for the current fiscal year, which ends in September, to 8.9% for fiscal 2011. Although President Obama mooted the creation of a commission to eliminate the primary deficit, no deadline has been set for this. The plan to freeze "discretionary" spending for three years only covers 30% of total budget expenditures. Although the upcoming mid-term elections in November are likely to postpone fiscal discipline, fiscal policy measures should not be expected to provide significant stimulus as was the case in the 1st half of 2010. Furthermore, states and communities have already begun to cut back on their spending, which shaved 0.3 pp off GDP growth in the 4th quarter of 2009 and 0.5 pp in the first. **But does this mean we can expect a double-dip back into recession?**

Consensus Forecasts: Growth & Inflation

	GDP y.o.y %									Inflation y.o.y %								
	2009	2010				2011				2009	2010				2011			
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	-2.4	**3.3**	3.6	2.8	[3.3]	**3.1**	4.1	1.9	[3.1]	-0.3	**1.7**	2.3	1.3	[2.0]	**1.7**	3.0	0.4	[1.9]
Canada	-2.6	**3.5**	3.8	3.0	[3.3]	**2.9**	3.5	2.1	[3.0]	0.3	**1.9**	2.1	1.6	[1.9]	**2.2**	2.6	1.8	[2.2]
Euro zone	-4.1	**1.1**	1.7	0.7	[1.1]	**1.4**	2.2	0.8	[1.5]	0.3	**1.4**	1.7	1.0	[1.3]	**1.5**	2.1	0.8	[1.4]
UK	-4.9	**1.3**	2.2	0.8	[1.3]	**2.3**	3.2	1.1	[2.3]	2.2	**3.1**	3.5	2.7	[2.9]	**1.9**	3.4	0.3	[1.8]
Switzerland	-1.5	**2.0**	2.5	0.9	[1.9]	**1.9**	2.5	1.2	[1.9]	-0.5	**1.0**	1.3	0.8	[1.0]	**1.1**	1.8	0.7	[1.0]
Japan	-5.2	**3.2**	3.6	2.7	[2.4]	**1.7**	3.1	0.7	[1.7]	-1.4	**-1.0**	-0.7	-1.4	-[1.0]	**-0.2**	0.5	-0.9	-[0.2]
Australia	1.3	**3.0**	3.8	2.6	[3.2]	**3.4**	4.1	2.5	[3.4]	1.8	**3.1**	3.5	2.8	[2.8]	**3.0**	3.6	2.6	[2.9]

Source: Consensus Forecasts as of 14/06/2010

ECONOMIC OUTLOOK

Developed economies

Tougher times ahead but no replay of recession

Double-dip risk has increased but is still improbable

US growth will be modest but self-sustaining

The current slowdown reflects the transition between the upswing out of the recession, when the inventory cycle boosted growth (although not as much as in previous recovery cycles considering the 2009 recession's severity) and the coming phase during which US GDP may be expected to grow in line with final domestic demand, at an annual rate of about 2.5%. Durable goods orders and business surveys suggest that investment could accelerate. Even a small improvement in employment will increase household income and therefore consumer spending, there is little chance that the saving rate will increase substantially from its current level (4% in May). Household and business confidence are critical to this scenario and must be strong enough to prevent self-fulfilling prophecies that recession will return, especially when it comes to the outlook for employment.

The euro-zone economy is still export-dependent

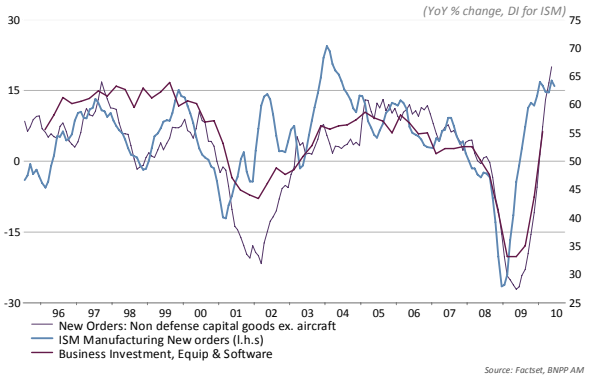
Japanese domestic demand will soften

Confidence in the economy will also be crucial in the **euro zone**. Some survey results have already weakened in response to debt concerns in Greece and Spain. The ZEW index, which measures the confidence of German financial analysts and investors and is highly responsive to financial news, thus fell significantly in June, while remaining however above its long-term average. The IFO index, which gives a better idea of how manufacturers see the outlook for business, rose slightly overall but its expectations components subsided. The euro's 15% depreciation in effective exchange rate terms since last fall continues to underpin manufacturer confidence, which the euro's recent recovery failed to perturb. After 0.2% growth in the 1st quarter, manufacturing activity probably picked up in April and May but has been stable since. It could start to slow in the second half of the year, particularly if fiscal consolidation gets quickly underway. **Japan's economy**, which was surprisingly strong early in the year, should start slowing and may also be hampered by the new shift in economic policy, which will mean less support for household consumption.

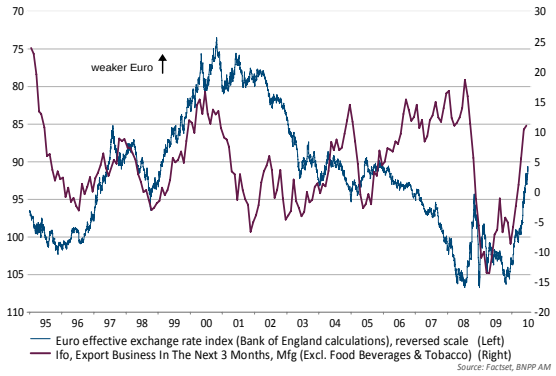
Central banks are increasingly pragmatic

Monetary policies will remain accommodative. The Federal Reserve could start raising its fed funds rate (at 0.25% since December 2008) toward the end of the 2nd quarter of 2011, mainly to preserve its credibility and provided that neither the European sovereign debt crisis nor the current slowdown gets any worse. The ECB is likely to continue its purchases of government bonds, which began in May, and to supply more liquidity to banks, as it did early this month when its 12-month refinancing operation launched in June 2009 expired. Given Europe's sluggish growth and low inflation, the central bank may be expected to raise its policy rates after the Fed.

USA – business investment is strong



Germany – weak euro supports confidence



ECONOMIC OUTLOOK

Emerging markets

Strong growth and widespread normalisation of monetary policies

Pause in recovery is welcome after strong rebound

After reaching their peak growth levels last fall, the leading economic indicators of the emerging countries continue to decelerate, but at a slower pace, and should stabilize this fall. In the case of India, the leading indicator has even flattened sooner than expected, suggesting that growth will stabilize at a high level. The US economy's weakness and the euro zone's fragility seem to be having little impact on recovery in the emerging economies, since exports are still robust and macroeconomic fundamentals are still quite strong. GDP growth in the emerging countries is likely to exceed 6.3% and 6% in 2010 and 2011 respectively, in line with the trend growth rate. But since near-term growth is clearly too strong (for example, Singapore's GDP surged 23% q/q) and potentially inflationary, further normalisation of monetary policy could be justified in most emerging economies.

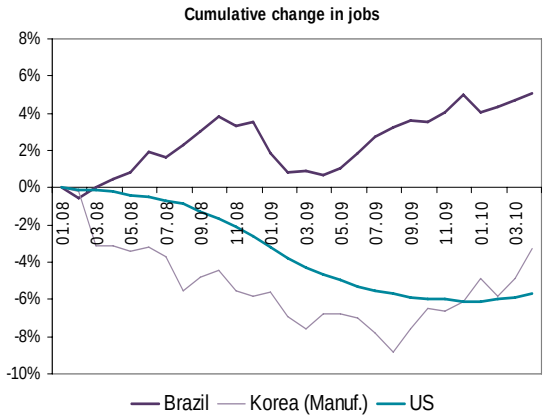
Interest rates in emerging economies normalise, while Brazil overheats

Brazil's recovery is exceptionally robust, boosting employment by over 5% since mid-2009, which should enable a rebound in household consumption. We expect GDP to rise over 7% in 2010, a rate seldom seen. The recovery's strength and its overheating of the economy will probably mean more monetary tightening. The situation is similar in India, where the economy is going full steam while real interest rates are still at historically low levels. Korea is also starting to bring its interest rates back to more normal levels, with an unexpected 25 bp rise in its policy rate in response to the robustness of the country's export-driven recovery, as private consumption begins to take over.

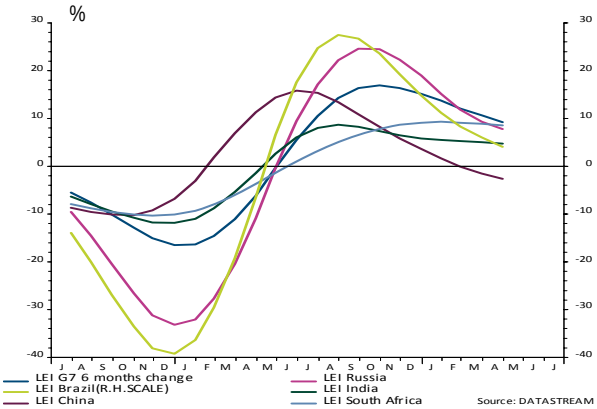
Chinese business cycle reaches a turning point, the property market cools and tightening will ease

Monetary tightening in China has finally succeeded in cooling down property prices and in slowing construction activity and investment, thus reducing the threat of inflation. Banks have cut back sharply on lending and discontinued some types of loans, while local authorities have been brought back into line. As a result economists are starting to lower their growth forecasts for 2010. We expect monetary policy to be eased toward the end of the year by increasing lending quotas, which should boost mortgage loans and property sales. This will probably coincide with a bottom in China's leading indicators and equity markets.

Job creation in the emerging economies



Leading indicators slow



BOND MARKETS

Government bonds

From the sovereign debt crisis to concerns about the economy

Although the word "double-dip" is back, we don't see one yet

As investors began to worry about the fate of the European Union and were concentrating on the various actions that governments were taking, yield spreads between the EU's core and peripheral countries were widening and yields were easing in the United States and the United Kingdom, but for different reasons. The prospect of a slip back into recession, which had been dismissed in light of the recovery's apparent solidity, came back to haunt investors. Although we still believe this scenario is unlikely there is certainly little chance of a significant increase in yields given the slower economic growth expected over the coming months.

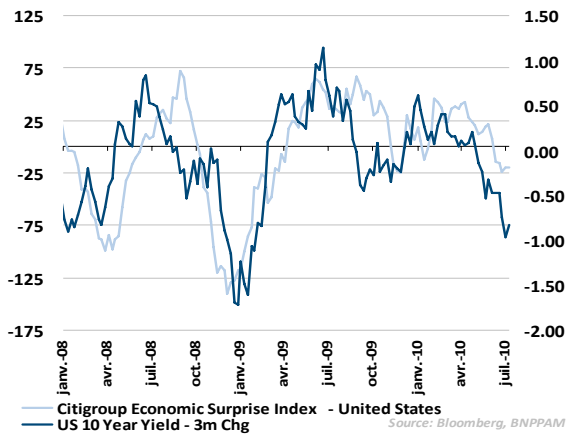
This has been our opinion for some time now, yet we are still rather wary of the low levels to which yields have sunk. Although the steady decrease in core inflation and the extension of loose monetary policy by central banks do justify low yields, we still believe that current bond prices assume excessively weak growth and inflation expectations.

As for risk aversion, it will continue to fluctuate as structural problems persist. The fiscal tightening that some countries are planning will still have to prove itself and this will take time. The financial sector's soundness continues to be a major concern, even though the volume of the ECB's last three-month auction suggests that banks do not need as much liquidity. The truth is that there are still large discrepancies between banks in the various countries.

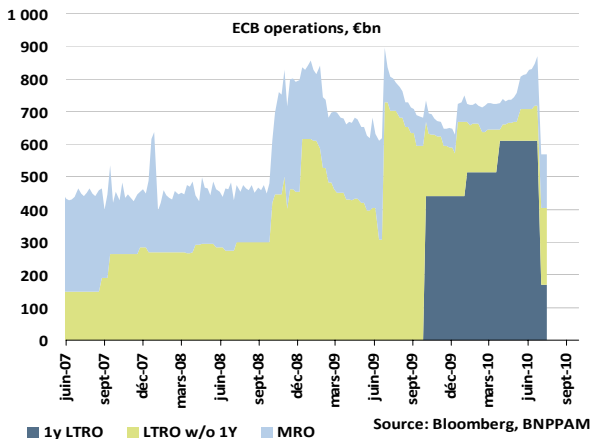
All eyes turn to stress tests

Now that the ECB has completed its 12-month refinancing operation markets are waiting to see whether or not European banks will pass their stress tests. How effective these tests are will depend on how well they address investor concerns and in particular potential losses on government debt. But these tests are no panacea since it will take some time for the crisis to unwind.

Lower yields and economic surprises



Banks ask for less ECB liquidity



BOND MARKETS

IG and HY credit

Fears and fundamentals

The credit market picked up in June after a rather chaotic month of May. But a closer look reveals that the situation is still complex.

Many fears remain in the financial sector...

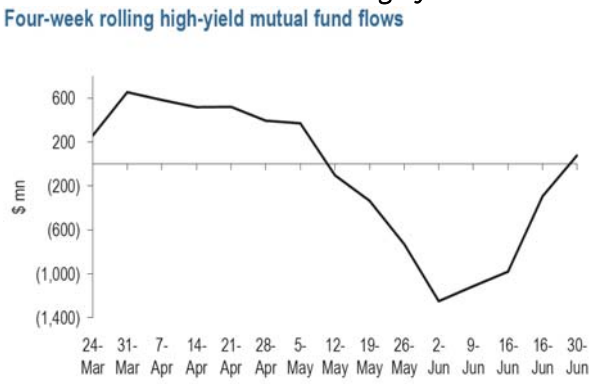
In the US investment grade market the widening of spreads was more than offset by the decline of benchmark yields. This is less true for Europe, since the behaviour of some issues, particular in the financial sector, depended substantially on the country of origin and its situation. And although the results of the ECB's three-month refinancing operation did calm investor fears somewhat, some banks are still having great difficulty in obtaining funds in either the primary or the interbank market. Although the stress tests will make it easier to assess the condition of these banks, solutions will then have to be made available to those in difficulty.

In the high yield world things are gradually improving. As the worries that made investors lose sleep in May dissipate, they are returning to high yield debt and firms can once again find buyers in the primary market. We think this is good news since it confirms that investors are still willing to venture into HY in a highly uncertain environment. Why? No doubt because spreads are likely to remain wide and carry trades will continue to offer attractive returns, provided that economies do not relapse into recession.

...while fundamentals strengthen for other firms

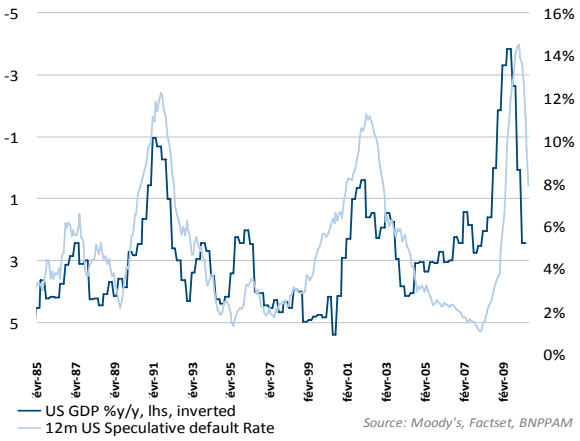
Growth, albeit modest, along with stronger corporate fundamentals will certainly help underpin credit markets. However, this support is threatened by the uncertainty hovering over the economic outlook, sovereign debt concerns and the soundness of the financial system. We therefore expect credit to continue to be volatile, as investors remain jittery.

Investors return to high yield



Sources: J.P. Morgan; AMG Data Services

Default rates continue to decline



Source: Moody's, Factset, BNPPAM

CURRENCY MARKET

Everyone is watching the dollar

Fears of a "double-dip" weigh on USD over near term

The euro zone's growth gap and yield differential will start to weaken the euro in 2011

Euro stops slide against US dollar for now. After the EUR/USD rate slipped below 1.19 on June 7 in the wake of concerns about sovereign debt, particularly in Spain, the correction that we had been waiting for came. Initially, the euro's appreciation was rather shaky but then became more solid in response to technical and then more fundamental factors. A disappointing IMS survey and US jobs report in early July revived fears that the US economy would fall back into recession and postponed expectations of monetary tightening by the Fed. This situation, which pushed the euro up to 1.26 dollar, could last throughout the summer, albeit with some volatility and without invalidating the longer-term trend.

The yen is still likely to slip, but not much for now

The maintenance of still highly accommodative monetary policy and the austerity measures that lie ahead (such as fears of a higher value-added tax) will tend to weaken the yen, particularly against the currencies of the strongest G10 economies. Although Japanese authorities are probably not satisfied with the yen's current levels against the dollar (about 87) and the euro (which hit a low of less than 108 yens in late June) their communication about this situation has not always been clear. The political uncertainty resulting from the senatorial elections of July 11 that deprived the DPJ of its majority is likely to further weaken the yen.

Greater yuan flexibility...

... may revive interest in the "commodity" currencies

The PBoC's decision to loosen up its foreign-exchange regime, which was announced on June 19 just a few days before the G20 summit in Toronto, confirms the political significance of the USD/CNY rate. This decision puts an end to the yuan's pegging to the dollar at about 6.82, which was decided in November 2008 to help Chinese exporters weather the global economic slowdown. The PBoC is returning to the system implemented in July 2005 which allows the yuan to fluctuate against a basket of currencies and to appreciate gradually. Under this regime it rose 19% against the dollar from July 2005 to July 2008, disregarding the initial 2% revaluation. For the time being, the yuan has posted a modest gain of only 0.8% from late May to July 9 and this should continue to be the case, since even though Chinese authorities are seeking to reorient economic activity and growth toward domestic demand, they will be careful not to rush things. Still, this decision could facilitate the appreciation of some emerging currencies and currencies traditionally linked to commodities, such as CAD, AUD and NOK. In addition to the renewed confidence in emerging country demand, investors will be paying attention to the prices of these currencies and to monetary policies, two things that should be good for the Canadian dollar and the Norwegian krona.

FX Rate Forecast Summary (Major Currencies)

End of Period		2009	07-Jul-10	3Q 2010		4Q 2010		1Q 2011		2Q 2011	
				Min	Max	Min	Max	Min	Max	Min	Max
USD Block	EUR / USD	1.43	1.2648	1.20	1.30	1.20	1.25	1.15	1.20	1.10	1.15
	USD / JPY	93	87.43	87	95	95	100	95	100	100	105
	USD / CAD	1.05	1.0500	0.95	1.05	0.95	1.05	0.95	1.05	1.00	1.10
	AUD / USD	0.90	0.8543	0.82	0.87	0.82	0.87	0.85	0.90	0.85	0.90
	GBP / USD	1.61	1.5219	1.47	1.56	1.44	1.53	1.38	1.47	1.37	1.46
	USD / CHF	1.03	1.0575	1.06	1.10	1.07	1.11	1.11	1.15	1.16	1.21
EUR Block	EUR / JPY	134	110.57	109	119	116	123	112	118	113	118
	EUR / GBP	0.89	0.8310	0.80	0.85	0.80	0.85	0.80	0.85	0.77	0.82
	EUR / CHF	1.48	1.3375	1.30	1.35	1.28	1.33	1.30	1.35	1.32	1.37

Source: BNPP AM as of 7/7/2010

EQUITY MARKETS

Developed markets

Shaky summer: neutrality maintained

Slower growth but 'double dip'

Fears about the banking system's soundness—of euro zone banks in particular given their exposure to European sovereign debt—and about the severity of the global economic slowdown have spread over the past few weeks causing some investors to fear a relapse into recession. These worries were fuelled by the deterioration of leading indicators, particularly in China and the United States, just as some central banks (mostly in the emerging countries) are starting to raise their policy interest rates.

Although the risk that the global economy may fall back into recession cannot be ruled out, we see small probability of this given the strength of many emerging economies, the magnitude of the measures implemented over the past few years and monetary policies that will continue to remain accommodative for quite some time in the major developed countries. We are maintaining our scenario of slower growth starting in the second half of 2010 and beyond. This however will not prevent equity markets from posting gains given the abundance of liquidity and the level of valuations, which are reasonable and even attractive considering that 12 months forward P/E ratios and P/BV ratios are below their long-term averages. However, our medium-term outlook for equities is cautious in consideration of the structural challenges that will have to be faced over the coming years and the lack of a strong catalyst as investors question the sustainability of economic growth and earnings.

More transparency ahead for banks...

Two major events early this summer could however support markets over the near term: the publication of European Bank stress tests and the release of second-quarter earnings reports.

-The completion of stress tests coordinated at the European level shows that EU countries are committed to resolving the crisis of confidence in the banking sector and is a major step towards more transparency, less uncertainty and therefore less risk aversion. The clarification of the assumptions used to make these tests has also contributed to the pickup in equity markets over the last few days. Under the supervision of the CEBS[1], 91 European banks representing 65% of total banking assets must test their ability to withstand an economic crisis and/or a Member State's default on its debt.

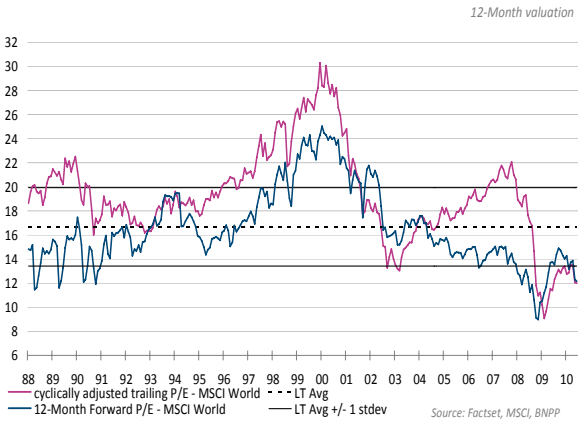
ISM and equity performance

Equity performance when the ISM manufacturing peak

Date		ISM manuf		Performances of the S&P 500					
Peak	Trough	Peak	Trough	1m before	1m after	3m after	4m after	6m after	12m after
Mar-66	Apr-67	65.7	42.8	2.7%	2.6%	-4.6%	-5.8%	-13.8%	2.2%
Nov-68	Nov-70	58.1	39.7	-4.2%	-4.2%	-9.4%	-6.3%	-4.5%	-13.4%
Jan-73	Jan-75	72.1	30.7	1.9%	-3.6%	-7.6%	-8.6%	-5.7%	-16.2%
Feb-76	Nov-76	61.5	51.7	1.2%	2.3%	0.5%	4.6%	2.4%	0.1%
Jul-78	May-80	62.2	29.4	-4.5%	3.5%	-4.9%	-5.3%	1.1%	3.2%
Nov-80	May-82	58.2	35.5	-10.1%	-3.7%	-6.6%	-4.4%	-5.6%	-10.1%
Dec-83	May-85	69.9	47.1	0.9%	-1.2%	-3.5%	-3.0%	-7.1%	0.8%
Dec-87	Jan-91	61.0	39.2	-7.1%	3.7%	4.1%	5.4%	10.3%	12.0%
Oct-94	Jan-96	59.4	45.5	-2.3%	-4.2%	-1.1%	2.9%	8.6%	23.1%
Jul-97	Dec-98	57.7	46.8	-7.1%	-5.5%	-5.5%	-5.1%	0.3%	2.9%
Nov-99	Oct-01	58.1	40.8	-1.9%	5.4%	-1.6%	7.1%	2.4%	-5.3%
Jun-02	Apr-03	53.6	46.1	7.6%	-8.8%	-17.6%	-10.0%	-11.2%	-1.5%
May-04	Dec-08	61.4	32.5	-1.2%	1.8%	-1.9%	-0.5%	4.7%	7.0%
average performance				-1.9%	-0.9%	-4.6%	-2.2%	-1.4%	0.4%
median performance				-1.9%	-1.2%	-4.6%	-4.4%	0.3%	0.8%
% of periods with negative performance				61.5%	53.8%	84.6%	69.2%	46.2%	38.5%

Source: Datastream, BNPP AM

Valuations are reasonable



[1]The Committee of European Banking Supervisors

EQUITY MARKETS
Developed markets

The publication of these results next July 23 will clear up uncertainties as to the soundness of bank balance sheets and reveal their capital requirements. The amount of recapitalization that will be necessary and the means by which it will be provided will however be crucial factors in determining how financial markets respond.

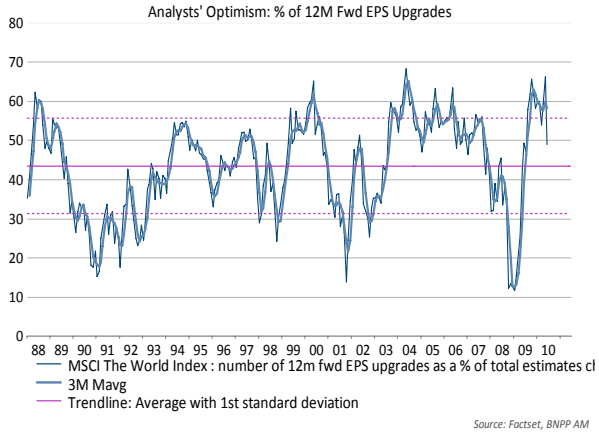
... and positive EPS surprises for Q2 could provide near-term support for equity markets

- Second-quarter earnings are once again likely to be stronger than expected. However, given their less optimistic outlook firms could give more cautious guidance for the second half of the year. Although positive earnings surprises are likely to raise a few EPS forecasts this year, these upward revisions will not be enough to reverse the declining trend of earnings growth over the next few quarters. As the economy slows, so will the revenues of firms while potential to further expand operating margins is limited. The earnings cycle will therefore gradually subside and cause analysts to lower their earnings forecasts. Moreover, their optimism, as measured by the percentage of upward forecast revisions, has already begun to reverse. Under these conditions, the consensus forecast of 19% EPS growth in 2011 for the MSCI World index, after 34% growth this year, seems overly optimistic and this could come to weigh on markets.

Geographic allocation: US overweight reduced and euro zone exposure increased to neutral

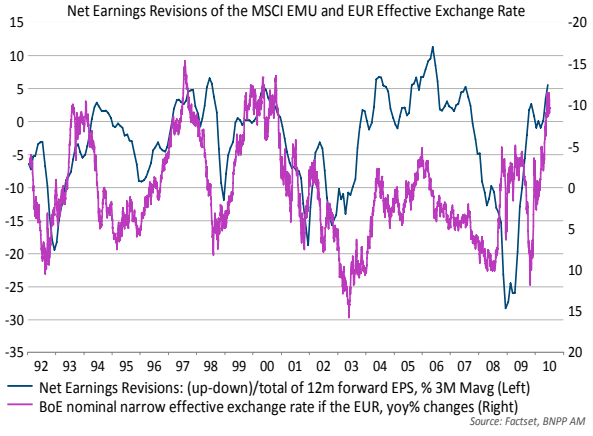
We have increased our exposure to euro zone equities this month to neutral, in consideration of three factors: 1) the resilience of leading economic indicators during the "Greek crisis"; 2) the upcoming publication of the stress tests and the uncertainty in the banking system this should clear up; and 3) the weaker euro's favourable impact on profits. However, considering the structural challenges ahead for the EU's economy, which remains fragile and highly disparate, we prefer to be cautious and have increased our position only to neutral. In doing so we have reduced our overweight in the United States, since the positive factors of still high risk aversion and the Fed's decision to keep interest rates low for an extended period are now offset by the slowing of earnings revision momentum. Despite the resilience of their domestic economies during the current slowdown, we are maintaining our underweight in the Australian and Canadian markets. The main reasons for this are the still relatively unattractive valuations, the monetary tightening currently underway (even though central bankers are taking their time and have even suspended rate hikes in light of concerns about the European financial crisis) and high exposure to commodities.

Fewer upward revisions



Source: Factset, BNPP AM

Weaker euro boosts European earnings



Source: Factset, BNPP AM

EQUITY MARKETS

Emerging markets

Superior performance with lower beta

Emerging markets have consolidated a bit in response to the heightened risk of recession in the developed countries, the slowdown in China and the sovereign debt crisis in Europe. As a result, emerging equities are now attractively valued, whereas recession risk in the emerging countries is relatively low given the strength of their economies, in terms of both domestic demand and exports.

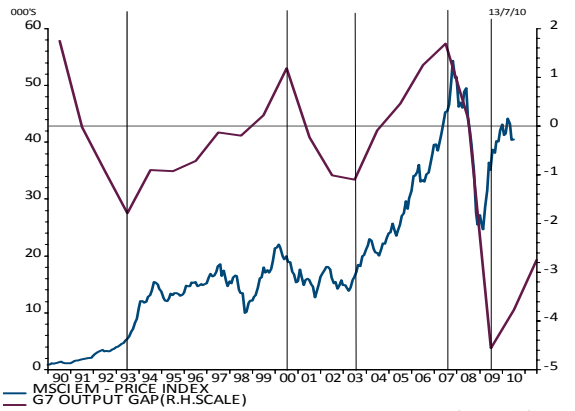
Leading indicators suggest no reversal for a few months

Leading economic indicators in emerging economies continue to decline, which means that their equity markets are likely to consolidate further for a while. Indeed, monetary tightening has just begun in Korea and Taiwan (albeit timidly), is hardly underway in those economies most exposed to domestic demand, such as Brazil and India, and is well advanced in China where the property market is finally beginning to cool. In this environment, emerging equity markets will tend to be more volatile over the coming months, since slower growth along with higher interest rates will result in downward earnings revisions.

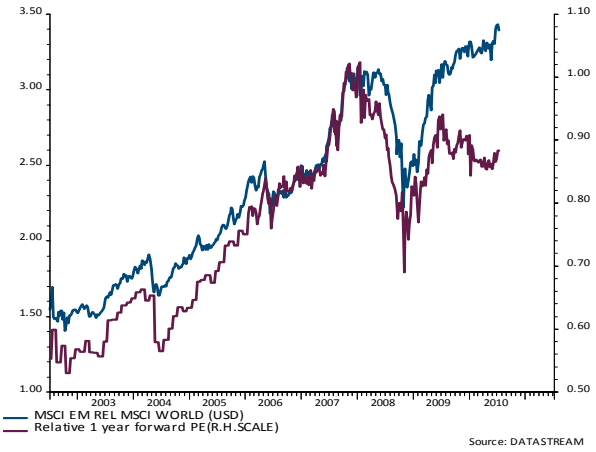
Emerging markets' firm earnings are mainly exposed to domestic markets

Yet we still see no major downside risk to emerging markets, just consolidation at most. Growth dynamics are highly domestic and intra-regional, equity valuations are once again attractive and the high level of ROE is a very positive factor along with the solidity of balance sheets. Furthermore, since Asian and G7 economies have large negative output gaps a moderate normalization of interest rates may be expected. This situation has historically been correlated with positive emerging equity returns. Lastly, emerging listed companies are highly exposed to their domestic markets. For example, the fact that listed Chinese companies generate 93% of their revenues domestically (87% for Brazilian firms) is not only excellent protection against economic uncertainty in the United States and Europe but also a good proxy for growth in the emerging economies. It is therefore not surprising that emerging equity indices have outperformed their developed counterparts, nor that small-cap and mid-cap stocks have done better over the past two months despite the general gloom in equity markets. Under these conditions, any dip in prices caused by an increase in risk aversion constitutes a buying opportunity. We will increase our allocation at the first sign that leading indicators are turning, toward the end of the year.

Negative output gap and positive performance



Emerging – outperformance at a cheaper price



EQUITY MARKETS
Emerging markets

Slight overweight in China while waiting for leading indicators to turn

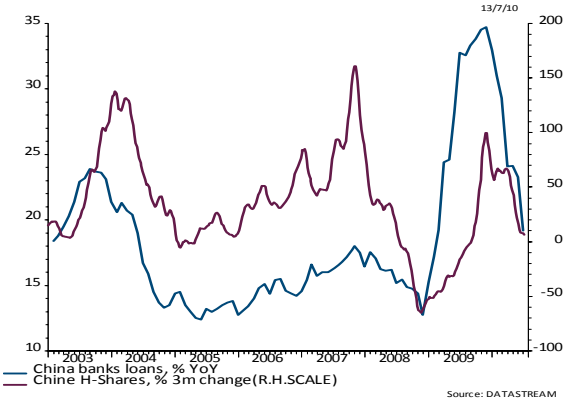
We are maintaining a slight overweight in China since the Chinese market is currently oversold, its valuations are relatively attractive and investors are still cautious. But the Chinese equity market is also very sensitive to changes in liquidity and bank lending. The country's economy is at last beginning to respond to monetary tightening, as seen by the moderation of business confidence indicators, the stabilization of inflation and above all the downturn in the property market. We expect Chinese authorities to start loosening monetary policy reins by the end of the year, when property prices have fallen considerably. This along with the stabilization of leading indicators will be an early signal that it's time to return to the Chinese market.

The Korean market remains strongly underpinned by economic fundamentals and the prospect of upward earnings revisions. Korean equities are attractively valued at 8.9 times P/E. The return of the country's stock index near its pre-crisis levels of 2008 has triggered substantial profit taking by private investors who became highly risk-averse when equity markets turned down in May 2010 and are very happy to recoup their losses and find a safe haven in bonds. Although India is a good long-term structural play on domestic demand and reforms, from a near-term perspective we believe this market is still too expensive. Furthermore its monetary tightening cycle has just gotten underway.

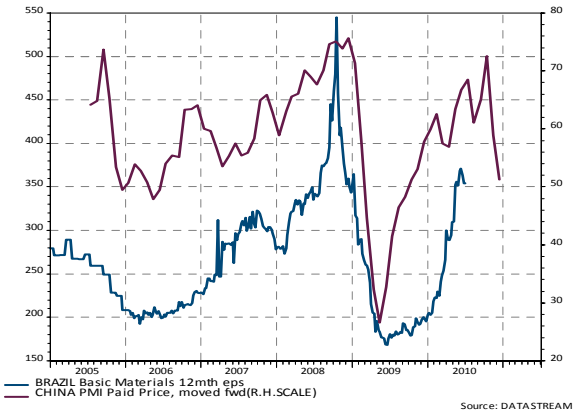
Brazil is exposed to monetary tightening and falling commodity prices

The Brazilian market must face two risks, the internal risk of an overheating domestic economy and the monetary tightening this will mean, and the external risk of slowing Chinese investment and falling commodity prices. The China PMI Paid Price index has been falling for two months and probably signals an upcoming bearish trend in the Brazilian commodities sector. Russia is also very dependent on commodity prices, and particularly on crude oil, since taxes on energy account for half of the country's budget revenues. Although we expect only a modest increase in the price of oil we are maintaining our slightly bullish bias on the Russian equity market, which offers a discount of almost 40% relative to the emerging universe.

China – a strong link between lending and performance



Brazil – commodity earnings depend on China



ALTERNATIVE STRATEGIES

Commodities

We are cautious about commodities and maintain a slight preference to gold

After the "cyclical" rebound, investors are expecting a transition to a sustained increase in global demand

While the demand for petroleum products in the United States continues to grow, concerns about the macroeconomic environment still weigh on the price of crude oil. The next few weeks will therefore be critical since we should learn whether the strengthening of physical demand we have seen so far will continue despite the economic slowdown. Although we are still optimistic about the price of oil in 6 to 12 months, there are still many near-term risk factors and **we have therefore decided to remain neutral** for now.

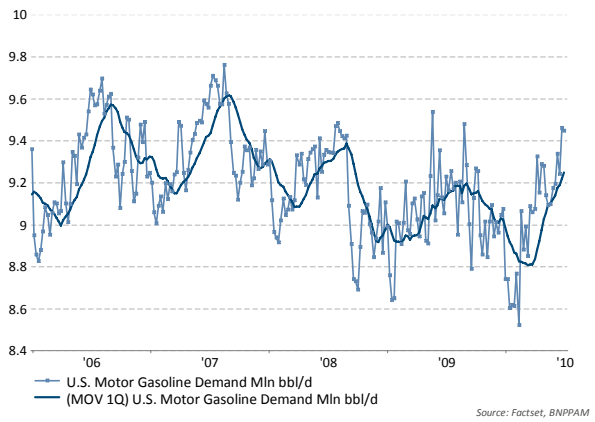
We have cut to neutral our exposure to base metals as we enter a period that is traditionally less auspicious for demand. Although the fundamentals of some metals should continue to be solid over the medium term, the combination of a seasonal slowdown in Chinese demand and the gradual fading away of the effect of the "manufacturing rebound" in the developed economies could weigh on investor sentiment and cause prices to consolidate a bit over the near term.

Investment demand should continue to support gold

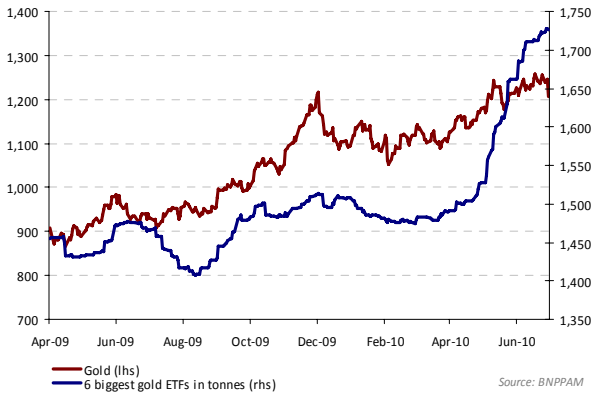
The recent return of risk appetite has reduced investment demand for gold over the past few weeks. However, the still highly favourable monetary environment and persistent concerns about the health of the major developed economies should continue to make the yellow metal an attractive investment over the near term. **We are maintaining a small overweight position in gold**.

We are still neutral on grains. The recent slump in grain market fundamentals has caused investors to flee. Although the current low prices limit downside risk, the forecasts of record harvests also limit upside potential. Corn still continues to offer the strongest fundamentals.

US demand for gasoline rises



Gold investment flows start to slow



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