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The investment outlook for 2015

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As we count down towards the start of a New Year, our investment teams are confronted with the possibility that in 2015, the US Federal Reserve may embark on a new cycle of interest rate hikes. If so, this would bring to an end the period of unconventional monetary policy that began in the United States in late 2008.

Among the challenges we face as investors in 2015 will therefore be the question of how a change in the Federal Reserve's monetary policy will affect asset prices. But Central Banks are just one of the numerous factors to be considered when one assesses the factors influencing asset prices. Over time, trends in real asset prices are determined by real (non-monetary) factors.

We hope our views and expectations, brought together in this Outlook publication, help you by starting to set the scene for 2015.

We present these views in two articles and three interviews. The first article assesses the global macro-economic environment and the outlook for inflation 2015. The interviews dig deeper into our expectations for fixed income, emerging equities and global equities.

All of us at BNP Paribas Investment Partners look forward to providing you with guidance and advice as to how you can best meet the challenges – and understand the plot – in 2015.

I wish you the best for 2015.

Written 05/12/2014

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The **Forest Stewardship Council** (FSC – www.fsc.org) – a not-for-profit alliance between NGOs, governments, and paper and timber companies – originated in 1993 in California in response to growing concerns over the destruction of forests worldwide.
Over the last 20 years there has been a decline in global deforestation, thanks partly to the increased use of recycled paper and the purchasing of paper products that are certified as coming from responsibly managed forests. This has been driven by consumers. Deforestation still however continues at an uncomfortably high rate.
The FSC uses a system of inspecting and tracking timber and pulp right through the production, supply and manufacturing chain. So far, 182 million hectares of forests have met its strict criteria. Violence and the displacement of indigenous peoples are also prohibited in its chain. This is crucial: forests support 1.6 billion of the poorest people in the world.
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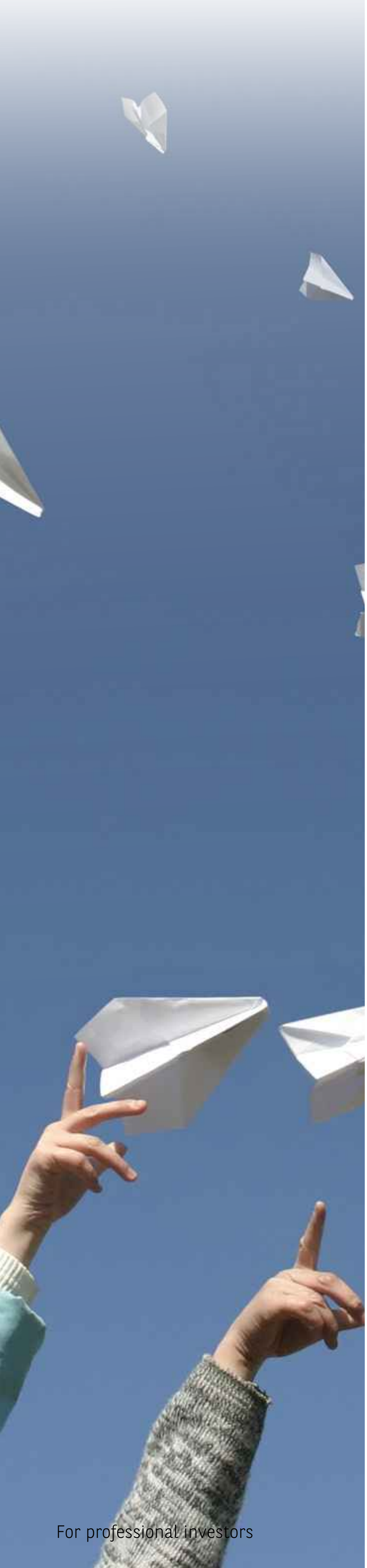

Our answers to the challenges

Our key macroeconomic convictions and the conclusions we draw from this analysis, with regard to the investment capabilities we favour in 2015.

- The positive news is that there are good reasons to expect an improved economic environment in 2015. Stronger growth should provide respite from disinflationary pressures. The main risk to our central scenario of stronger growth is a policy error or a downturn in the eurozone that weighs on the global economy. We do not exclude (in fact, we actively envisage) the possibility that growth surprises on the upside with distinctly positive implications for risky assets.

- In our opinion, valuations in emerging markets are approaching levels at which their numerous strengths (e.g. strong growth, low debt, structural reform, favourable demographics) will become apparent to investors seeking attractive returns over the appropriate investment horizon.

- The Bank of Japan may now have taken up the baton of quantitative easing from the Federal Reserve, but inflation will remain conspicuous through its absence. For this reason, we see no abrupt end to the bull market in bonds (now entering its 33rd year). Nonetheless, the historically low yields of G7 sovereign debt lead us to recommend prudence with regard to interest-rate risk as the day of reckoning approaches.

- The fact that valuations of developed stock market indices remain close to their post-crisis highs emphasises the pull that equities exert on investors with the appropriate investment horizon in a world where real interest rates are exceptionally low as far as the eye can see. We believe global equities have the potential to once again generate attractive absolute returns as better economic growth and attractive valuations provide the basis of a virtuous cycle.

Our analysis leads us to highlight in the following interviews three investment capabilities that we see as being particularly well-suited to the macroeconomic environment that we foresee for 2015:

- **Fixed income:** Guy Williams, chief investment officer at FFTW[1] and Alex Johnson, co-head of global fixed income at FFTW, set out the key features of FFTW's absolute-return strategy.

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- **Emerging market equities:** Don Smith, CFA, and Rick Wetmore, CFA, chief investment officer and deputy chief investment officer, respectively, with the global emerging market equities team in Boston, explain their positive outlook for this asset class in 2015.

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- **Global equities:** Sander Zondag, chief investment officer global equities in Amsterdam, outlines the mega-trends that, in his view, can help companies do well independent of slower GDP growth.

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1 Fischer Francis Trees & Watts (FFTW), the investment manager providing active, fixed income capabilities to institutional investors around the world, manages single and multi-currency mandates across global, US and emerging bond markets. For more, go to www.fftw.com

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For more on the investment opportunities, go to www.bnpparibas-ip.com

Economic growth in 2015: above or below trend? That is the question…

Divergence – the hallmark of 2014 when it comes to economic and financial market trends – looks likely to be an important feature of 2015 as well. We expect the US and UK economies to maintain their lead, followed by the emerging markets with the eurozone and Japan making up the rear-guard. We would rank them in this order, when we consider prospects for improvement. As for the direction of global economic growth, 2015 should see more synchronisation: all major economies look set to expand. In what respect are they likely to continue to diverge? In the effects that growth differentials will have on monetary policy. We expect this to lead central banks in the US and the UK to embark on cyclical tightening. Chief economist Joost van Leenders explains.

Trend growth

For any outlook one year ahead, trend growth should provide an anchor around which we build our forecasts. Trend growth is the speed at which economies can grow over the longer term, as determined by the growth of the labour force and the pace of improvement in productivity. Growth can be below trend due to shocks, such as higher oil prices or a credit or housing market bust, but growth can also exceed the longer-term average. This typically happens after recessions, when low utilisation rates for labour and capital leave ample room for growth without capacity buffers being hit. So where is trend growth heading in 2015?

“Trend growth would be…”

For the US, we estimate it to be at around 2.5%. In the 10 years to the second quarter of 2014, labour productivity growth averaged 1.5% year-on-year (YoY). Population growth slowed to 0.8% in 2013, but the size of the labour force has been almost unchanged in the past five years. Further improvements in the labour market should enable the labour force to grow more in line with the population.

“around 2.5% in the US…”

In the eurozone, the population and the labour force have been growing at roughly 0.25% a year. Labour productivity has grown at 0.6% YoY in the past 10 years, but during this period, the economy went through a double-dip recession. It is more difficult to increase productivity when output falls, since it requires employers to shed labour at an even faster pace than the decline in output. We estimate trend productivity growth in the eurozone to be at around 1% and accordingly, trend growth is 1.25%.

“and 1.25% in the eurozone”

In Japan, the population is shrinking, so a higher participation rate is needed to expand a labour force that has been static in recent years. To address this, the government has announced measures to encourage more women to join the labour force, but the implementation of reforms has been slow. Unsurprisingly, at an average of just below 1%, productivity growth in Japan has been weaker than in the US. We estimate trend growth to be at around this level too, which may even be on the generous side.

Trend growth for emerging economies is quite heterogeneous. For China, the official growth target is more relevant. The target for 2014 is 7.5% YoY. For parts of 2014, the economy grew at this pace only with fiscal and monetary support. In our view, trend growth is below the current growth target, more likely at around 7%. For other emerging markets as well, the heady days of strong growth now seem a thing of the past. Since 2000, GDP-weighted growth in the 10 largest emerging markets excluding China, has averaged 4.3% YoY. In the years just before the financial crisis, growth peaked at 6%, but it has slowed to a rate just above 3% since 2010. Trend growth could be higher, especially in Asia.

2015: above or below trend?

There are reasons to expect above-trend growth in the US. Even if the Federal Reserve were to start hiking interest rates in 2015, official rates would remain well below levels seen as neutral for the economy. In other words, monetary policy would remain stimulative. The drop in oil prices since the summer of 2014 should support growth. Any drag on growth from a strengthening US dollar and a further decline in the government budget deficit is likely to be small. The fiscal deficit has already narrowed significantly and we expect the pace of deficit cuts to decline. Since the US economy is relatively closed, the impact of fluctuations in the US dollar dollar should be limited.

Can pent-up demand, especially in cyclical sectors such as consumer durable goods, housing or business investment, provide a boost? Car sales have already recovered. While relative to GDP, business investment has been higher historically, the recovery is now well-advanced. There is room for the contribution to growth from housing to rise. Sales and construction are still way below pre-crisis levels. So how does this stack up when looking at the shape of the US economy late in 2014? Leading indicators generally point to strong growth. Households have enjoyed rising wealth, both from housing and equities, but wage growth has been modest. This could improve over the course of 2015 if the labour market continues to do well and unemployment declines further. However, higher jobs growth could lead discouraged workers to return to the labour market, capping wage growth and thus limiting any burst in consumption. Business investment should continue to grow as corporate balance sheets are strong and profitability is high.

All in all, we expect the US economy to grow at 2.7% in 2015, slightly ahead of its trend rate. Since it may take longer before capacity constraints emerge, the growth phase may last longer this time.

“2015 growth could be a solid 2.7% in the US...”

For the eurozone, trend growth currently looks unlikely after the economy stumbled in the summer of 2014. We expect the main factor causing this slowdown – the geopolitical unrest over Ukraine and the uncertainties about the fallout of Russian sanctions – to fade. Monetary policy has become even more stimulative than in the US and low oil prices are also positive for the common currency area. Some countries have made their economies more flexible, more so in the ‘periphery’ than at the core. We believe there certainly is pent-up demand. For the region as a whole, business investment relative to GDP is still close to an all-time low and demand for consumer durables remains well below the historical average. However, the latest leading and real indicators do not point to an imminent improvement. Ending 2014 at a slow pace will inevitably handicap the average rate of growth for the full year 2015. So even if growth slightly exceeds potential in most 2015 quarters, the total for the year could still only be close to 1.25%.

“and only close to 1.25% in the eurozone”

Japan faces countervailing forces in 2015. Less slack in the labour market and less spare capacity in the manufacturing sector should lead to higher wages and more business investment. However, real household incomes have been severely hit by inflation, as a result of the weaker yen and the April 2014 increase in the consumption tax. The impact may fade, but it will take time for consumption to recover. The consumption tax may be hiked again in October 2015, which will again rattle retail sales. Overall, consumption should grow at a modest pace. Compared with the US or the eurozone, fiscal drag is likely to rise in Japan. All in all, the economy could struggle to reach its potential growth rate.

The Chinese economy grew at 7.3% YoY in the third quarter of 2014, marginally slower than in previous quarters and slightly below the government’s target rate despite a range of small stimulus measures. The main risks are clear to us: a sagging housing market, heavily-leveraged property developers and high corporate debt ratios in general. However, the government still has a tight grip on parts of the economy. It controls the banks and the amount of credit creation. It can also decide on defaults: companies at risk can be bailed out or merged with healthier competitors. The government has started on a tightly controlled reform and liberalisation programme. This should lead to a better allocation of resources. With a closed capital account and control over bank interest rates, it looks unlikely that any of the risks will cause a hard landing in 2015. Growth could slow though and the growth target could be trimmed to 7%. In other emerging economies, the prospects diverge. Brazil should climb out of recession, but Russia will likely struggle to do so. In Asia, Taiwan and India look stronger than South Korea.

Will inflation rise in 2015?

Inflation has been described as the dog that did not bark[2]. Even during the recent years of record monetary stimulus, it has remained subdued. That is, goods inflation. We have seen asset price inflation, but Colin Graham will cover this topic in the next section (from page 9). With growth in many economies still below levels forecast before the financial crisis and growth in some economies not even back at pre-crisis levels, spare capacity around the world has curbed inflation sharply. This is particularly visible in the eurozone where inflation has fallen to uncomfortably low levels. “Lowflation” is, however, a truly global phenomenon. Even in Germany, the strongest economy in the eurozone, inflation has fallen. In China, producer prices have been dropping for 18 months and the latest rate cut by the South Korean central bank was partly driven by low inflation.

2 For instance in chapter 3 of the World Economic Outlook, April 2013, www.imf.org or EU should stop worrying about deflation, Andrew Sentance, May 2014, www.ft.com

> *"Inflation, described as the dog that did not bark, should be muted in 2015"*

The disinflationary trend is less pronounced in the US, but wage growth is still largely absent there.

Will this change in 2015? Cyclically, it may. In the US in particular, inflationary forces strengthened somewhat in the course of 2014. An actual growth rate only slightly above potential growth is however likely to mean any return of inflation will be only gradual. The main issue in the eurozone will be whether disinflation becomes deflation. We think the latter will be avoided. The main price and wage adjustments have taken place in 'peripheral' economies. Prices and especially wages should become stickier. It is easier not to increase wages than to actually cut them. Such rigidities could prevent deflation. If, as we expect, growth resumes in 2015, the downward pressure on prices should slowly recede. Nonetheless we do expect consumer price inflation to remain well below the ECB's target of close to, but below 2%, YoY.

The outlook for weaker growth in China argues against sharply higher inflation. This should help contain inflation in other countries. With the services sector gaining ground, growth is gradually becoming less commodity-intensive, reducing demand and thus taking the pressure off commodity prices. Furthermore, overcapacity in some sectors should keep inflation down.

Overall, while the trend of disinflation should end in 2015, we expect the dog to remain silent for another year.

Monetary policy: ready for take-off?

> *"The Federal Reserve will be at the forefront of monetary policy regime change"*

Yes, 2015 will be the year when we will see rate hikes by some of the major central banks for the first time in years. The Fed ended its asset purchase programme in October 2014. While slack in the labour market, the strong dollar and weak global growth may delay a hike, jobs growth and emerging wage pressures should mean that the Fed will not leave rates unchanged. In our view, the first rate hike is most likely to come at the end of the second quarter. But the Fed has repeatedly stressed that policy decisions are data-dependent, so the timing may shift according to economic developments. The Bank of England (BoE) could move in early 2015, before the Fed does, since the UK economy is doing well. Recently, however, BoE officials have suggested that there is no hurry.

Rate hikes are not in sight for the ECB, the Bank of Japan or the People's Bank of China (PBoC). In the summer of 2014, the ECB announced a range of stimulus measures to be implemented in the second half of 2014 and in 2015. Although recent years have shown how difficult it can be for central banks to create inflation sustainably, and while we think that the ECB measures will be no exception, the ECB is unlikely to proceed to large-scale government bond purchases soon. As for the Bank of Japan, we expect more quantitative easing when the current drivers of inflation fade and are not supplanted by new ones. The PBoC might well continue with targeted stimulus measures and we would not rule out more general easing such as a cut in the central bank rate or in banks' reserve requirements.

Written 06/11/2014

Markets face an unusual year

An interview with Colin Graham, CFA - chief investment officer, head of tactical asset allocation and research with the Multi Asset Solutions team.

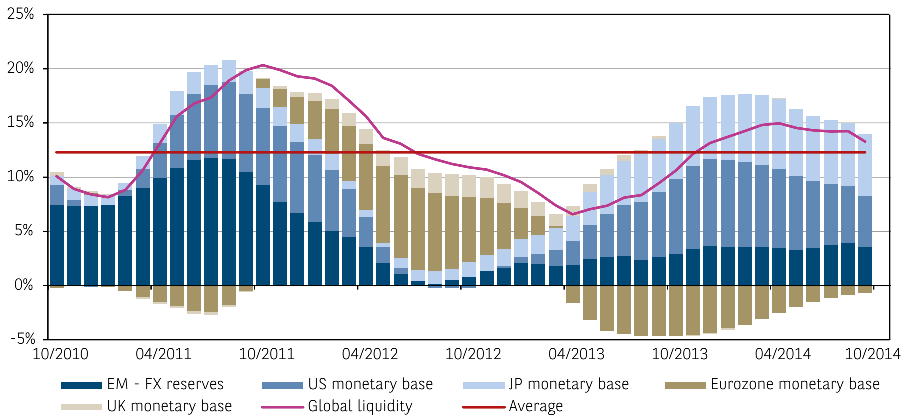
The context

What are the main points you'd emphasise regarding the macroeconomic outlook going into 2015?

There are two main points I think that will be important. Firstly, the economic environment should look more constructive. The lower oil price and stronger dollar should perk up US consumers. Stronger US demand and more favourable exchange rates should, in turn, boost exporters in the rest of the world. As a result, business activity in cyclical areas of the global economy should improve, boosting overall global economic growth. Inflationary pressures will, however, remain low in our opinion. Catharsis will continue in the eurozone and China, and any consequences will tend to be disinflationary.

Secondly, 2015 should see the end of the zero bound – as Joost van Leenders has outlined (see his section on the macroeconomic outlook from page 6). We expect the US Federal Reserve to exit its zero interest-rate policy (ZIRP) and raise the price of money. The other major G7 economy that is likely to embark on a new cycle of interest-rate hikes is the UK. The economies of the eurozone and Japan are, however, not yet robust enough to cope with higher interest rates. We could even see some of the emerging markets take the path of lower interest rates. So 2015 could be an unusual year as monetary policy diverges between the US (and the UK) and the rest of world.

Exhibit 1: Global liquidity remains above the historical average
(major monetary supply and currency reserves; YoY change)



Source: BNPP IP as at 15/09/2014

What are the likely consequences of a Fed rate hike in 2015?

In our view, there is scope for some unintended consequences in the wake of official interest rates lifting off in the US. We envisage that volatility will rise across most asset classes. Additionally, post the financial crisis, we have seen considerable deleveraging as lenders have restricted access to credit, so the scope for individuals and companies to borrow short term and smoothen out any kinks in their cash flow has been reduced. We believe this is a change that may lead to more uncertainty around the direction of the economy.

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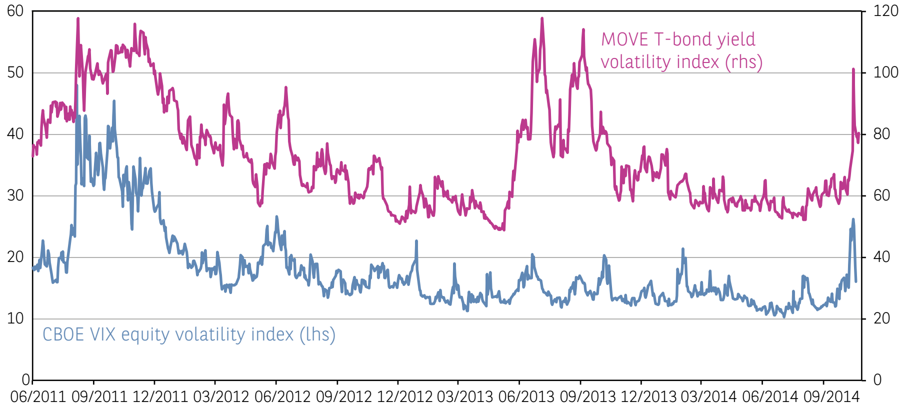
For more on the investment opportunities, go to www.bnpparibas-ip.com

Exhibit 2: Volatility could spike as US monetary policy is normalised



Source: Bloomberg, BNPP IP as at 27/10/2014

In the environment I've outlined above, the role of the US economy as the locomotive leading the world economy would not, initially, change. However, as over the next 18 months the global recovery takes hold, cheaper assets in other regions where the outlook for growth is improving will start to attract investors. The average US economic cycle lasts for about a decade. We are now six years into an unusually slow recovery. We believe that this cycle is already different for many reasons, so we could experience an extended cycle in US this time.

What about Europe? What is your analysis of the outlook for European financial markets?

With the Asset Quality Review behind us and the ECB embarking on its version of quantitative easing (QE), there should be a freeing-up on bank balance sheets and more of a focus on "doing business" since uncertainty about the new regulatory environment has been removed. In our view, since European equities are distinctly cheap compared with US equities, we expect investors to rotate into eurozone equities. Valuations of eurozone bonds (both government and corporate) will be supported by the ECB's quantitative easing.

“We expect investors to rotate into eurozone equities”

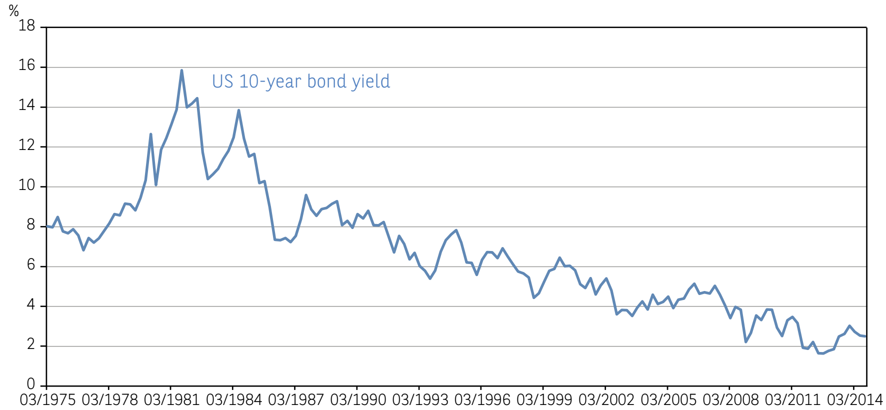
How would emerging market equities perform in this environment?

The likelihood of rising rates in the US has weighed heavily on the valuations of emerging market assets. More recently, the US dollar rally and the rise in volatility have pushed valuations even lower. Emerging market bears may warn that such valuations have all the hallmarks of a classic value trap, but in the Multi Asset Solutions team, we expect valuations, at some point in 2015, to reach a level where these assets are cheap enough to buy. The positive side of such developments in US and Europe is that it should allow emerging market central banks to pursue an accommodative monetary policy.

And what about bonds? Is 2015 going to see an end to the bull market in bonds?

For the last 30 years, government bond investors have had it all: capital preservation, inflation-busting growth and income. However, with interest rates at emergency lows, yields close to all-time lows and the Federal Reserve poised to raise rates, my intuitive expectation is to predict the end of the bond bull market. I recognise that investors have been predicting a change in bond markets for several years now, so why should 2015 be the year? I'd turn the question on its head and say, what do we need to see for this bull market to continue? The answer is a Japanese-style outcome – deflation and lost decades. As already explained, this scenario is not on our macroeconomic road map in 2015, the US not being Japan in so many structural ways. We expect government bond yields to rise, but in an orderly fashion.

Exhibit 3: An orderly end to the 30-year bull market
(US 10-yr bond yield - March 1975 through September 2014)

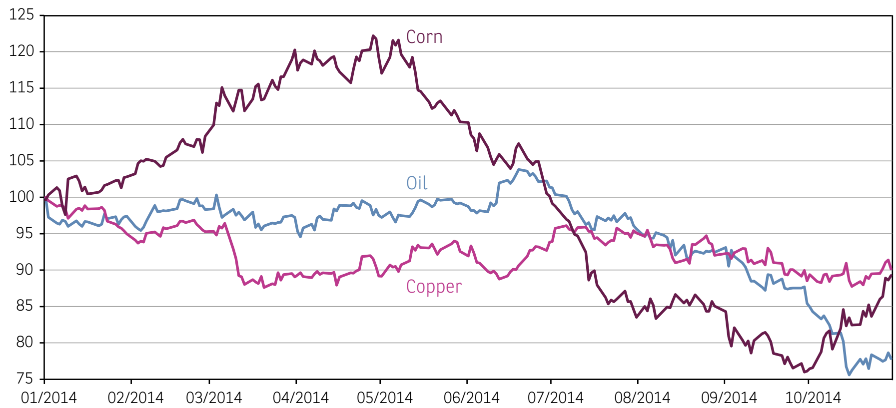


Source: Bloomberg, BNPP IP as at 30/09/2014

What other factors should investors take into account?

The commodities, geopolitical and economic growth puzzle continues to confound many investors. Even if, at the start of 2014, investors had known how any one of these elements would evolve, their forecasts of the other two elements would still probably have been completely wrong. For example, it was by no means obvious that a rise in political risk in the Middle East and Russia would lead to a 22% fall in oil prices (year-to-date as of end-October 2014 based on prices of Brent). A significant fall in the oil price does not correlate to trend growth in the US economy and a soft landing in China. The way to square the circle: increased US energy self-sufficiency and its effect on US foreign policy and the supply outlook for oil. Higher geopolitical risks are here to stay, in my view.

Exhibit 4: Squaring the circle: commodity price volatility



Source: BNPP IP as at 31/10/2014

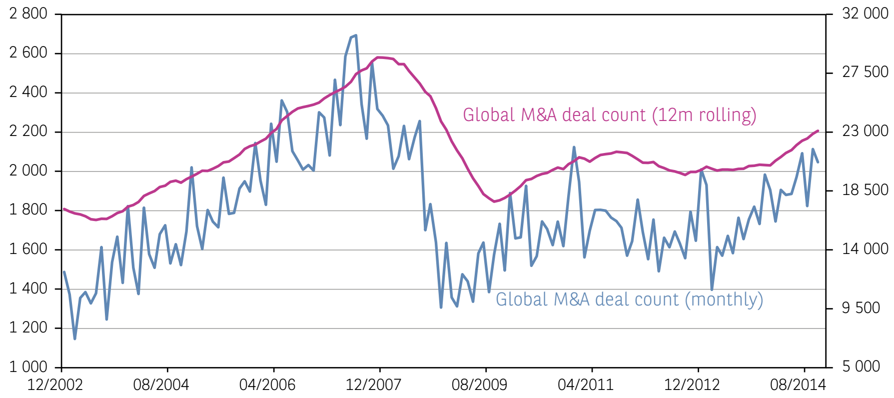
The rise in volatility from low levels will cause alarm in short bursts as investors adjust to larger price shocks. There will be times when diversification does not work and times when the successful buy-and-hold strategies are questioned. Dynamically changing portfolios should be able to benefit from the bigger price swings.

> **“Cheap assets with higher yields stand to receive flows”**

Global financial repression has compressed investment yields and income, as highlighted in the government bond market, but investors still have an appetite for income-generating assets. This should push yield-hunters further up the risk curve in search of returns to satisfy their liability structures. In our opinion, cheap assets with higher yields stand to receive flows and this cycle will become self-fulfilling as sentiment improves and volatility becomes a secondary concern.

Business leaders are increasingly confident about the future. See, for example, the latest Ernst and Young – Global Capital Confidence Barometer[3]. Accordingly, we saw a significant jump in merger and acquisition activity in 2014. We expect this to continue and reach levels last seen in 2006 and 2007. The consequences for investors depend on where you are invested in the capital structure, i.e. in corporate or high-yield bonds or in equity. The growth dividend for equities as managers put their cash balances to work should push equities higher, on average. However, the abundance of cash and access to 'cheap' financing could create conditions for an unfavourable turn in the default cycle in a couple of years and negatively impact the outlook for high-yield returns.

Exhibit 5: Merger and acquisition activity has further to run



Source: BNPP IP as at 31/10/2014

Can you sum up your outlook for the main asset classes in 2015?

For the global economy, the catharsis continues as a period of trend growth and low inflationary pressures soothes investor nerves. Although interest rates are likely to rise in the US, they should remain very low from an historical perspective. That should trouble bond investors more than equity investors. However, we should bear in mind that the quantity of money in the system will remain plentiful as cash balances on corporate balance sheets remain high and the eurozone, Japan and China all continue to prime the pumps to support their economies.

"Persistently low interest rates should trouble bond investors more than equity investors"

Equities

Valuations have recovered from recent lows, leaving US equities slightly expensive relative to the rest of the world. Valuations in cyclical areas of the global economy look cheaper and can provide buying opportunities, particularly if we get the recovery in earnings whose absence so far is reminiscent of a stage play called *Waiting for Godot*. We expect opportunities to present themselves, particularly in Japan and the eurozone in 2015. As I mentioned above, the US market is still likely to lead for now, apart from a few periods of sharp US dollar appreciation.

For emerging equities, I am probably safe in assuming that, as volatility rises, we will have major divergences between winners and losers in 2015. Falling commodity prices should provide investors with an investible theme since those countries that have large energy deficits (i.e. import energy or implement energy tariffs) can benefit from improved terms of trade and their currencies should be less vulnerable (India, South Korea, Taiwan and China). Those countries that rely on energy exports will see their revenues fall and current populist policies may become unsustainable (Brazil, Russia and the Middle East).

3 For more information, please visit www.ey.com

Bonds

As US rates edge higher next year (more on the risks below), along with official rates in the UK and Canada, Federal Open Market Committee (FOMC) policymakers can be expected to attempt to inject uncertainty into the market's expectations to create a more balanced positioning and views. This should increase volatility in rate expectations, such as we experienced in September and October 2014, with a cascading effect onto other assets.

The eurozone's deflation scare should pass, but inflation should remain benign, giving the ECB plenty of room to manoeuvre. China should tend towards an easy monetary policy as do many emerging markets.

Property

Many housing markets slowed in 2014, but a re-acceleration is likely until interest rates are normalised, which should be some time off. The fall in unemployment and the reintegration of disaffected workers in economically productive jobs should boost demand for all types of property. Attractive yields in some sectors should support demand for the asset class, and if headline inflation remains benign, a return of the feel-good factor should lift investor returns.

Commodities

The significant fall in oil prices should support the global economy. Lower oil prices are here for longer given the increase in domestic production in the US and the reduced influence of OPEC. Industrial metals and coal should remain in oversupply due to – now excess – capacity built when demand from China, India and Brazil was at its peak. Gold faces further pressure as paper money starts to pay interest (again) and the recent financial crises are consigned to the history books.

"The risks include poor eurozone data, political turmoil, a slowing global economy and a hard landing in China"

What do you see as the main risks to your outlook?

The main risk is a reloading of a crisis, with the eurozone being the wild card. Poor economic data has recently caused investors to again question the premise that a recovery is underway and to revisit the structural issues encumbering the region. There are, in addition, a few identifiable events that could dent sentiment. At this stage, we are more sanguine on, but well aware, that the European political cycle begins again with elections in Greece and Spain where both incumbent governments face internal division. We should bear in mind that Chancellor Merkel was one of a select few leaders to be re-elected after the eurozone crisis. What is more, there is a German request for the EU Court of Justice to rule on the legality of the ECB launching the Outright Monetary Transactions (OMT) support programme. Finally, the next round of EU budget negotiations is underway. The issue of how Germany compromises on the Maastricht treaty guidelines will be a key signal on the next phase of the eurozone project.

There is also the risk that, on the other side of the Atlantic, the US economy fails to shake off the shackles of a slowing global economy and succumbs to the drag of weak growth and low inflation elsewhere. If this were to be coupled with a hard landing of the Chinese economy, the next global recession would erupt. However, this is not our core scenario.

On the other hand, economic growth could stage a 'prison break': our macroeconomic outlook is balanced around trend growth. The foundations are, in my view, in place for a positive surprise as growth picks up faster, plentiful liquidity boosts economic activity and the Federal Reserve is considered to be behind the curve. However, strong economic growth could have a number of undesirable consequences with increased economic activity sucking money out of the system, to the detriment of financial markets. Government bond yields would rise disorderly, roiled by a series of sharp rate rises. However, on balance, we expect the positive implications to outweigh such a risk.

Written 02/11/2014

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For more on the investment opportunities in this asset class, go to www.bnpparibas-ip.com

Fixed income: fishing in all pools

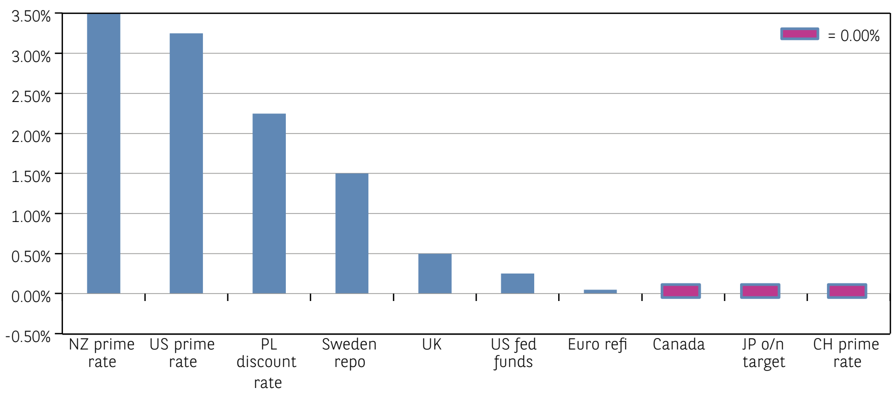
There can be little doubt that 2015 will be the year in which the long-running bull market in fixed income will come under the most serious threat in decades as interest rates bounce off the bottom amid a strengthening, or at least solidifying, global recovery and as monetary policy normalisation sets in. Investors would, in our view, be well advised to maintain an interest in the consistent returns and the diversification and capital preservation characteristics of fixed income, ideally through an approach targeting absolute rather than relative returns. Guy Williams and Alex Johnson set out the key features of FFTW's absolute-return strategy[4].

Guy, fixed-income investors need to be nimble and have a flexible mind-set in the quarters ahead given the challenging market environment. What are the main opportunities and what risks could trigger them?

As you have already read in the section on the macroeconomic outlook (from page 6), divergence will be a major theme in 2015 and this applies to global fixed-income markets as well. Divergence is apparent in a number of areas. Growth and inflation outlooks differ widely across the developed and developing worlds, both cyclically and structurally. Central banks' approaches to monetary policy (see exhibit 6), including unconventional monetary policy, diverge. There are growing gaps between market expectations and policymakers' views, differences in approaches to structural and political reform and an increasing emphasis on idiosyncratic risk rather than systemic risk.

In terms of fixed-income investing, this is an ideal environment for skill-based rather than benchmark-driven solutions in which the primary driver of portfolio returns is the manager's ability to source diversifying ideas for alpha returns from a wide, and increasingly rich, opportunity set. At the macro levels, we believe the largest opportunities revolve around reading the Federal Reserve's moves towards policy normalisation correctly and gauging the extent of the deflation threat in the eurozone and the availability of policy responses. Elsewhere, there are opportunities around the chances of success of Abenomics in Japan or China's efforts to rein in excess credit growth. Those investors able to anticipate shifting geopolitical risks and understand which asset classes are most vulnerable and which least vulnerable to adverse shocks will be well placed to generate alpha. At the micro level, opportunities abound for finding relatively undervalued securities, particularly among the lower-rated and high-yield corporate bonds, supported by a strong, primary research process.

Exhibit 6: Official interest rates



Source: Thomson Reuters/FT.com as at 10/11/2014

4 FFTW (Fischer Francis Trees & Watts) provides active, fixed-income capabilities to institutional investors, managing single and multi-currency mandates across global, US and emerging markets. It is a wholly-owned subsidiary of BNP Paribas. www.fftw.com

Guy, given the current market environment, it appears that unconstrained fixed-income solutions make a lot of sense. Does moving from a benchmark to an unconstrained approach mitigate or introduce risk?

It can do both. Overall, we believe that moving towards an unconstrained approach mitigates risks by allowing managers to focus only on those risks that they actually want to take on behalf of clients, taking into account the opportunities available and the comparative advantages of their investment processes, while applying the fundamental first principles of fixed-income investing. This approach directly targets outcomes for clients, seeks to avoid unwanted portfolio characteristics and exposures and aims to minimise the risk that actual delivered outcomes fall short in terms of client expectations and needs. The approach effects this by eliminating as much as possible beta, or passive market risks, which individual managers cannot control but can only mitigate, in favour of alpha, or manager skill risk, which they can control. Delivered outcomes for benchmarked fixed-income portfolios are typically highly correlated with overall market returns and largely reflect passive market performance rather than manager skill in active investment decisions. Returns from unconstrained fixed-income portfolios are largely, if not entirely, driven by managers' skill in identifying and generating alpha from a particular opportunity set. This dramatically shifts the composition of risks from markets to managers, while mitigating the overall level of risk.

> ***"Even away from a benchmark, bonds can act as a portfolio diversifier and a source of consistent returns and capital stability"***

Guy, the flexibility of an unconstrained approach allows for allocations to be based on the relative attractiveness of an assets class rather than following the benchmark's allocations. Do unconstrained bond funds still serve the traditional role of fixed-income in a portfolio?

Yes. If anything, this role is enhanced. Traditionally, fixed-income provides relatively consistent returns (income or yield), diversification from investments in other asset classes, typically equities, and capital stability (which can take the form of risk moderation in normal times and acceptable drawdowns in bad times). An unconstrained fixed-income approach also provides all three, but more directly and coherently since it avoids large implicit exposures to market-cap weighted fixed-income benchmarks.

Alex, flexibility also means wider diversification of risks. How do you implement that in benchmark agnostic absolute-return portfolios and how would you compare that approach to managing more benchmark-aware unconstrained portfolios?

> ***"There are opportunities in asset classes ranging from global interest rates, foreign exchange and global credit to structured securities and emerging market debt"***

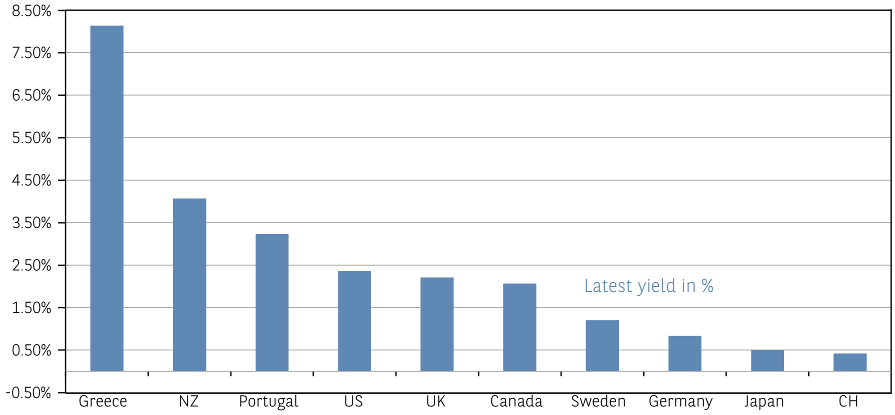
Following on from Guy's response, an absolute-return approach firstly frees investors from the arbitrary constraint of an opportunity set defined by how much debt has been issued, while allowing them the flexibility to build portfolios from all the available fixed-income instruments. We would recommend building portfolios maximising diversification. The problem, as we have seen time and again since 2008, is that benchmarks may expose investors to highly concentrated risks through the accident of their construction. The growing presence of very low-yielding, but increasingly indebted Japan in traditional benchmarks is one example, but there are many others. Taking positions against these benchmarks may add value, but unless such positions are very large, they cannot offset these structural issues – and by definition, such large trades would tend to increase concentration.

Our approach goes back to first principles. We divide opportunities into seven groups, covering the breadth of the market. These are: global interest rates, foreign exchange, global credit, structured securities, emerging market debt, quantitative strategies, top-down sector rotation and longer-term trade ideas reflecting opportunities across the other six groups. In an absolute-return portfolio, we want to see virtually all of these themes at all times – in a balanced way where no one theme dominates. This is because, firstly, different asset classes perform differently in different situations: some have predictable returns for long periods of time followed by significant sell-offs, others may have more volatile returns, but less downside risk. Secondly, rather than trying to pick winners, we believe that in some market circumstances, there may be structurally fewer opportunities. Taken together, this result is a balanced set of opportunities from across the fixed-income groups.

Alex, some investors look at absolute return fixed income as a panacea for interest rate risk. Does that work in practice?

Interest-rate risk is the key risk that any fixed-income investor faces. We cannot, nor would we want to, insulate ourselves from it completely. Interest rates are, after all, how the income is set. Changes to the expected value of those coupon payments – whether through the operations of a central bank, changes in the (perceived) creditworthiness of the bond issuer or inflation expectations – affect all fixed-income securities. A bondholder typically looks at passive return as being a function of "carry" – broadly, the interest paid on the securities, less any funding costs – and "roll down" – the capital gain an investor can expect in normal markets coming from the fall in time- and risk-premiums as the bond's maturity approaches. These risks are not just unavoidable; they are an essential driver of returns in a fixed-income portfolio.

Exhibit 7: 10-year government bond yield



Source: Thomson Reuters/FT.com as at 10/11/2014

But what is completely avoidable is having your returns buffeted by changes in interest rates because the portfolio matches a given benchmark. As interest rates rise, price falls, all things being equal. If interest rates rise sufficiently, this loss will not be compensated by coupon income, and the bond, or even the whole portfolio, will face a capital loss in absolute terms. This is problematic when interest rates are very low and the ability of yields to fall is low, meaning there is a heavily asymmetric pay-out profile. That this predictable loss should happen through the matching of a benchmark and for no other reason is what absolute-return is about: absolute return fixed income offers the chance of fixed-income returns and diversification without a correlation to market direction. Put simply, pursuing diversified opportunities where a manager can be long or short based on his or her conviction to mitigate what in 2015 more than in the preceding years will be the single largest risk in a portfolio: interest-rate risk.

Written 24/10/2014

A positive outlook for emerging market equities

An interview with Don Smith, CFA – chief investment officer global emerging market equities, and Rick Wetmore, CFA – deputy chief investment officer global emerging market equities[5].

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Slowing global economic growth, falling commodity prices, sagging or more volatile stock markets, currency volatility and declining bond yields make investors nervous. What can you say to reassure them when it comes to emerging markets?

We believe global emerging market equities can offer solid appreciation potential over a multi-year holding period and maintain a positive view. The long-term investment case for emerging market equities remains attractive. Supportive factors are favourable demographics, a growing share of emerging markets in global consumption, lower debt-to-GDP ratios and potential for structural reforms. Economic growth in emerging economies, while modest, is still meaningfully higher than in developed markets.

Inflation should moderate due to lower commodity prices, allowing for generally accommodative central bank monetary policy. The de-synchronised monetary cycles being pursued in the US, EU and Japan should ensure that adequate liquidity is available. Lower commodity prices are also a positive factor for margin and earnings growth in countries that are importers of commodities including China and India.

What in your view will be the main triggers for performance in 2015 and what will be the main risks?

There are quite a few positives for emerging markets that should drive performance in 2015, in our view. A renewed focus on appealing economic and company fundamentals, the elimination of political uncertainty, reforms in selected markets, declining correlations across emerging markets, attractive valuations and lower inflation are some of the main triggers. Now that the uncertainty over elections in major emerging markets such as Brazil, India, Indonesia and Turkey is over, investors can again focus on the fundamentals, particularly earnings growth. Earnings revisions for MSCI EM index companies are starting to trough and improve in markets including China, Indonesia and Taiwan.

At 12%, estimated 2015 earnings growth[6] for MSCI EM companies is expected to be slightly ahead of that of the US (11.7%) and higher than that of Japan (10.8%). South Korea, China and Brazil account for around 60% of the estimated growth. Median estimated earnings growth[6] is much higher for emerging markets than for developed markets: 14.7% for emerging markets vs. 11.8% for US, 11.2% for Europe and 9.3% for Japan.

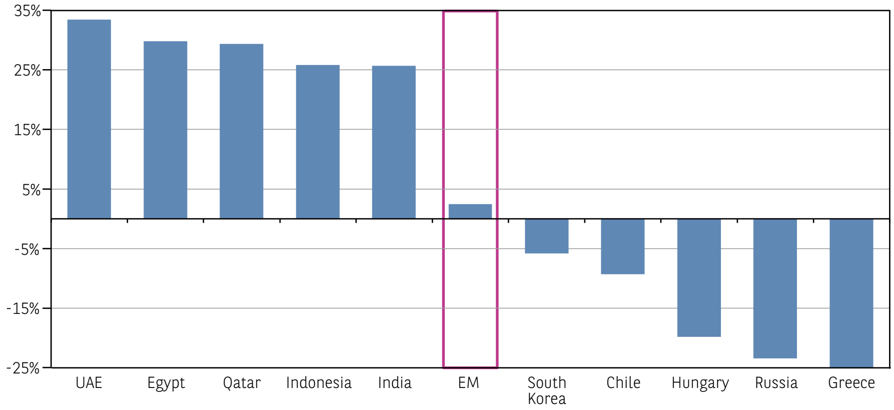
The political environment in India, Indonesia, Thailand and Mexico now appears conducive to reform and improved growth. In India, the new government should be able to drive growth more efficiently through faster project approvals and more consistent policies. It has already begun reforms by removing diesel subsidies and raising the state-controlled price of natural gas. Telecommunication and energy reforms in Mexico are starting to move ahead after much anticipation. Pro-growth policies put forward by the military administration in Thailand, including not raising the VAT rate, reducing personal income tax and free visas for Chinese tourists, have provided stability and boosted confidence.

"The triggers include appealing economic and company fundamentals, faster earnings growth, less political risk and attractive valuations"

5 The BNPP IP global emerging market equities team is based in Boston
6 Source of data: IBES, Datastream, JPMorgan calculation, BNPP IP

Another driver should be declining equity correlations among emerging markets as investors differentiate between markets based upon their fundamentals (see exhibit 8). Additionally, companies are being recognised for the growth and quality of earnings, resulting in more differentiation among securities and lower stock-specific correlations. This favours fundamental approaches such as ours which focus on stock-picking based on companies' earnings and cash flow growth and seek to benefit from the dispersion of returns across emerging market equities.

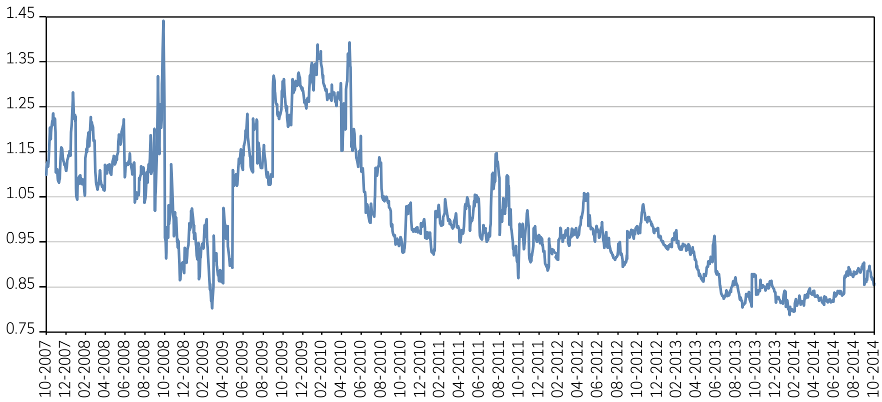
Exhibit 8: 2014 saw a dramatic dispersion of returns by country in emerging market equities



Performance so far in 2014; source: MSCI, BNPP IP as at 31/10/2014

Attractive valuations are another potential driver for emerging markets. The price/earnings ratio for the MSCI EM index is currently below the multi-year average.

Exhibit 9: The price/earnings (P/E) ratio of the MSCI EM index is below the historical average



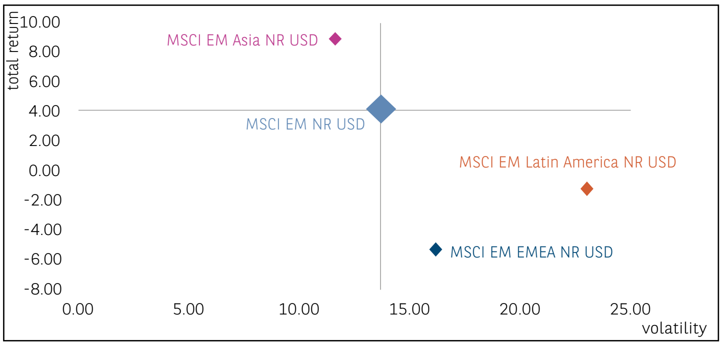
Source: FactSet, MSCI BNPP IP as at 31/10/2014

In our view, the main risks to emerging market outperformance are geopolitical instability, the vulnerability to reduced liquidity and, in some cases, a heavy reliance on commodity exports. Russia will likely continue to be affected by the fallout from the conflict with Ukraine, sanctions imposed by the West and declining oil prices. Commodity exporters such as Brazil, Peru and South Africa face headwinds during periods of weaker commodity prices. Slowing growth in China also remains a risk; however, its growth problems should be mitigated by lower energy and commodity prices.

Asia has been holding up better than other EM regions, even in the face of slower growth in China. Will this last?

Over the past 12 months, Asia has outperformed the other emerging market regions with lower volatility. In spite of slower growth in China, Asia has on average grown faster than emerging countries in Latin America and EMEA. Asia should continue to benefit from the combination of resilient economic growth and declining commodity prices. The outlook for lower inflation and relatively strong growth is also positive for Asian equities. Earnings-per-share growth is improving in Taiwan, China and Indonesia. The region features some of the best opportunities for countries that are expected to have an improved policy environment as a result of the recent political changes. India, Indonesia and Thailand all have the potential to enact reforms that are growth-oriented and create greater stability.

Exhibit 10: In 2014 Asia outperformed other emerging markets with lower volatility (risk-reward; 01/10/2013 - 30/09/2014; calculation benchmark none)



Index	total return (1 yr) month-end USD	standard deviation (1 yr) month-end USD
MSCI EM Asia NR USD	9,03	11,62
MSCI EM NR USD	4,30	13,67
MSCI EM Latin America NR USD	-1,04	23,01
MSCI EM EMEA NR USD	-5,39	16,17

Source: Morningstar Direct as at 30/09/2014

Where do you see the best opportunities in 2015?

We believe the prospects for health care, consumer discretionary and financials will be bright. While health care is generally a small part of the investible universe, the sector should continue to benefit from secular growth. In consumer discretionary, lower inflation should boost available income across emerging markets. Moreover, lower input prices should help drive margin expansion opportunities for companies. Both factors should underpin equities in this sector. In financials, lower inflation should lead to more accommodative monetary policies, contributing to higher returns in the sector.

“We believe the prospects for health care, consumer discretionary and financials will be bright”

Additionally, we believe small and mid-capitalisation stocks can offer outstanding growth potential in what is typically a less efficient segment of the investment universe. With the average number of analysts covering emerging market small caps only about a quarter of that for emerging market large caps, active investors should be able to find small companies that the rest of the market has not yet discovered.

Written 31/10/2014

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For more on the investment opportunities in this asset class, go to www.bnpparibas-ip.com

Global equities: look for opportunities within the mega-trends

While growth around the world looks likely to settle into a slower pace in 2015, and accordingly global corporate earnings expectations will have to be adjusted downward, there can be little doubt that for investors in search of returns, equities will remain the place to be. Across-the-board buying of equity markets can earn investors a return ahead of alternatives (such as fixed income or money markets). For a more promising pickup, they would be well advised to be selective and look for dominant quality companies in attractive industries enjoying the benefits of the current mega-trends, says Sander Zondag, chief investment officer global equities.

Taking a bird's eye view, what is your assessment of the market environment in 2015?

Economic growth will be slower than that we have seen in the past decade. In my view, this will be the case not only in 2015, but for many years to come. Europe and Japan will lag the US and emerging markets. In the US, growth should be supported by favourable demographics and a more flexible labour market. In emerging markets, growth should still be ahead of the rest of the world, even as the Chinese economy gears down to annual GDP growth of 5% to 6% from the 8% pace of recent years. That is the mostly likely scenario, but it does not mean that stock markets cannot do well (it is generally accepted that there's little correlation between economic growth and equity returns[7]). There will still be sectors and industries that will outgrow the national or global economy and investors can still capture the performance of attractive companies in faster-growing industries.

"I believe there is no way around equities"

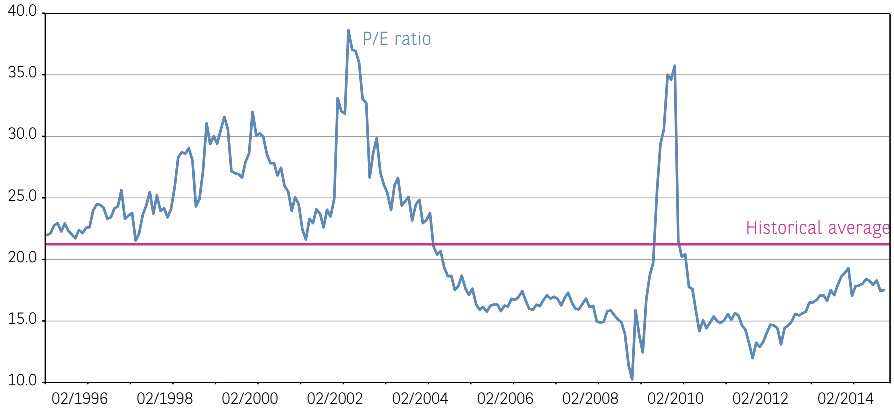
Historically, equities have returned 8%. We may not see such a return from equities in 2015 and beyond. While global bonds earned a still respectable 6% in recent years, it is clear to me that it will be very difficult to keep making such significant returns in fixed income in an environment with extremely low interest rates. Furthermore, central bank policy is likely to veer away from a now very accommodative stance and higher interest rates are on the cards. The outlook for equities is more promising. They are supported by factors such as the scope for growing dividend yields – you can already find many companies worldwide with a dividend yield of at least 3% – and relatively low levels of leverage compared with many Western national debt-to-GDP ratios. In such a context, from the point of view of an asset allocator looking for a return, I believe there is no way around equities.

Broadly speaking, slower economic growth entails slower earnings growth and this together with the improvement in valuations in 2014 could leave less upside for equities in 2015. Would you agree?

It would be an oversimplification to equate slower GDP growth overall with slower earnings growth overall. On a regional and country basis, growth is likely to be very uneven, as said. Also, GDP growth is not the best indicator of equity market prospects, in my view. For one, many companies no longer depend solely on their domestic market for revenue and earnings. If you were to look at the fastest-growing economies only and would consider buying those stock markets, you should know that, for instance in the case of China, you are investing in an index with many state-owned companies lacking a shareholder-oriented culture, focused on creating jobs for the local population and paying relatively low dividends. Those are not the best investment opportunities, in my view. A global investor should look beyond the local market and the local economy and drill down to investments in companies with attractive product/market combinations, solid fundamentals and high cash flow generation.

7 See, for example, Economic growth and equity returns by Jay R. Ritter; University of Florida, Gainesville; Pacific-Basin Finance Journal 13 (2005)

Exhibit 11: The price/earnings (P/E) ratio of the MSCI World index is below the historical average



Source: Bloomberg, BNPP IP as at 31/10/2014

Taking a closer look at the potential for upside, in the context of the valuation of global equities over the past 30 years, the current P/E ratio is still below the historical average (see exhibit 11)[8], so if we simply apply mean reversion, there is still upside left. However, as is the case with GDP growth, equities do not need (the prospect of) multiple expansion to be attractive to investors. Earnings growth can suffice and I would say that companies offering 6% to 7% earnings per share growth can still be found. This may look generous, but if you assume 4% to 5% organic earnings growth – ahead of global GDP growth expectations for the longer term – and a 2% boost to EPS from share buybacks, you have total EPS growth that is well ahead of global GDP growth and that can produce a return that is clearly more attractive than that of many of the alternatives.

Where do you see the best opportunities for 2015 – at the regional, country, sector or even industry level?

I believe a bottom-up approach is best suited to the current environment. Investors should look for industries and trends that can do well independent of slower GDP growth and that have intrinsic drivers and for companies that can take full advantage of these trends. We have identified three mega-trends: globalisation, urbanisation and the rise of the middle-class consumer, especially in emerging markets.

As we've established, many companies have revenues and earnings from markets beyond national borders, they compete globally for the attention of consumers who with the help of the internet can source products and services from anywhere and can compare prices across borders. An example is information technology – think e-commerce or big data. This is a global trend that will last many years.

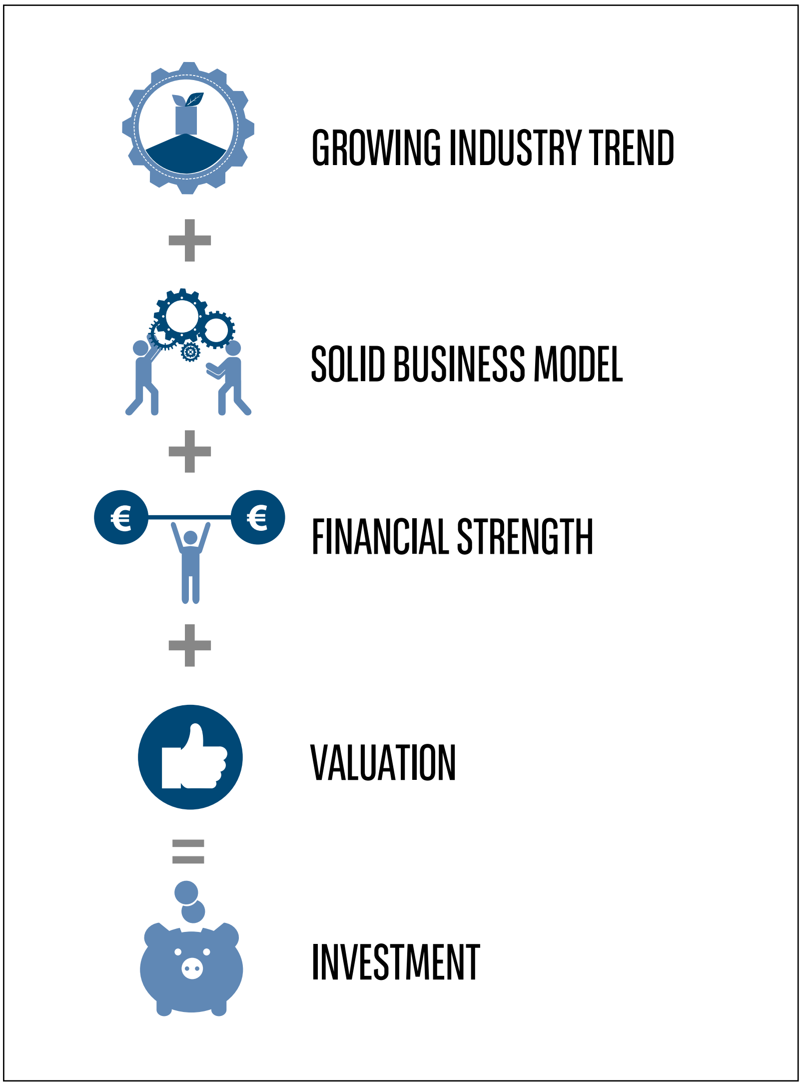
Equally, urbanisation is a long-term process. Admittedly, this is a well-established trend by now, but even in a country such as China where the urban population is now 53% of the total, you can still expect the number of people living in cities to grow by 1% a year. On a population of 1.36 billion, that remains a significant move towards the cities and hence an important driver for demand for infrastructure, housing, financial services etc.

The rise of the consuming middle class will also continue independent of global growth, especially in emerging markets. While markets for financial services or basic consumer goods are mature in many developed countries, in many emerging markets these sectors are still growth areas, which in my view, makes them worthwhile when assessing investment opportunities. I believe any investor with a longer-term perspective needs to have exposure on a global basis to these three mega-trends and to the industries and companies that stand to benefit the most.

"Any longer-term investor needs to have exposure on a global basis to three mega-trends: globalisation, urbanisation and the rise of the middle-class consumer"

8 Data as of end-August 2014; source: Bloomberg

Exhibit 12: An assessment of industry and company metrics as the solid basis for an investment



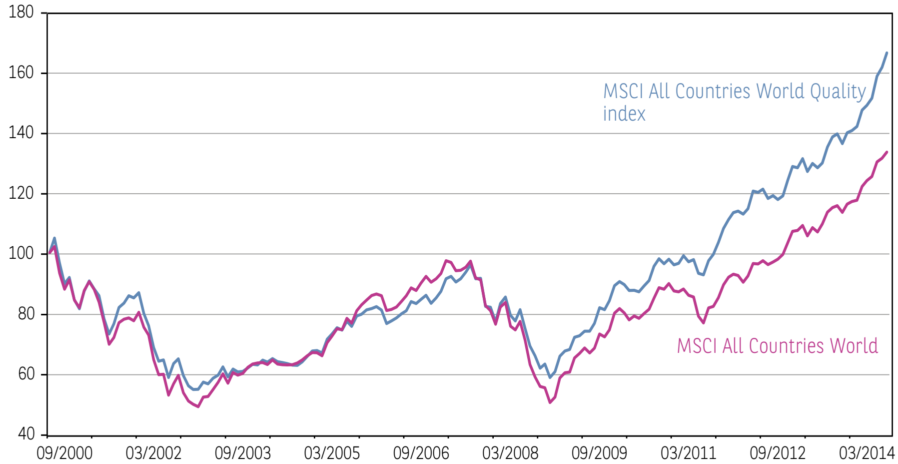
Source: BNP Paribas OBAM as at October 2014

What should an investor focus on when considering the winners in 2015? Value rather than growth?

I believe the winners will be those companies that stand out when it comes to the quality of their business. These are typically companies in growing but concentrated industries, with scalable business models, dominant positions in their industry and accordingly pricing power, and a shareholder-oriented way of running the business. Such companies often show sustainable higher growth and higher cash flow returns. A key metric is return on invested capital (ROIC) and a key question is whether the company can show consistent performance over time.

Such quality companies can be shown to have greater potential upside over the long term. Of course, valuation matters: a great company at a rich valuation is not a good investment. On the other hand, should investors be willing to pay a premium? Yes, in the longer run, these companies have shown better results. Over the last roughly 15 years[9], the MSCI AC World Quality index outperformed the broader MSCI AC World by more than 20% cumulatively (see exhibit 13). I believe quality companies can be found in many industries, so that putting together a diversified portfolio is definitely possible.

Exhibit 13: Global quality companies have outperformed
(cumulative performance MSCI indices since 2000)



Source: MSCI as at 31/10/2014

The MSCI Quality Index reflects the performance of a quality growth strategy. Quality growth companies tend to have high ROE, stable earnings that are uncorrelated with the broad business cycle and strong balance sheets with low financial leverage.

How would you tackle spikes in volatility?

No doubt even global companies in global markets will feel the pinch from a surge in volatility or a market sell-off. It is worth remembering that stock prices have historically been more volatile than company fundamentals and that a focus on the underlying company strengths will see you through as an investor. There are many unresolved issues for the markets and they can be expected to again feature in 2015: the course of monetary policy, the eurozone outlook, China's shift towards a consumer-oriented economy, Russia's role in Ukraine and the tensions in the Middle East, to name but a few.

A focus on quality companies can help contain the fallout from market fluctuations, also in 2015. Over time, stocks in such companies have suffered less from volatility given their inherently more stable business models. Investors typically prefer such companies because of their high cash generation which allows them to pay a regular and growing dividend, buy back shares and/or reinvest profits in the business. To conclude: valuations are not extreme at this point, so a market correction could be an opportunity to buy selected quality companies. After all, I can see few alternative to these when it comes to investments offering global investors the potential for attractive returns over time.

Written 22/10/2014

"A focus on the underlying company strengths will see you through as an investor"

9 Data as of August 2014; source: MSCI

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