



Weekly Strategy Update

12 January 2012



SUMMARY

- Three issues to dominate the markets: US growth; the eurozone crisis and recession; and an emerging market slowdown
- We start the year cautiously
- Asset allocation team overweights corporate bonds

We see three main issues shaping the trends in financial markets in the next few months. Firstly, will the improvement in the US economy morph into a sustainable period of growth at or even above trend? Secondly, will a solution be found for the fiscal crisis in the eurozone? And thirdly, to what extent will Japan and emerging markets be affected by the slow growth in the industrialised countries? Since we are sceptical on a positive outcome for the first two issues, we have not changed our cautious investment strategy. This includes a negative view on developed equities versus emerging equities and neutral views on most fixed income categories. In our asset allocation, we have upgraded high-yield corporate bonds from neutral to overweight at the expense of government bonds.

ISSUE 1: STRONGER US DATA

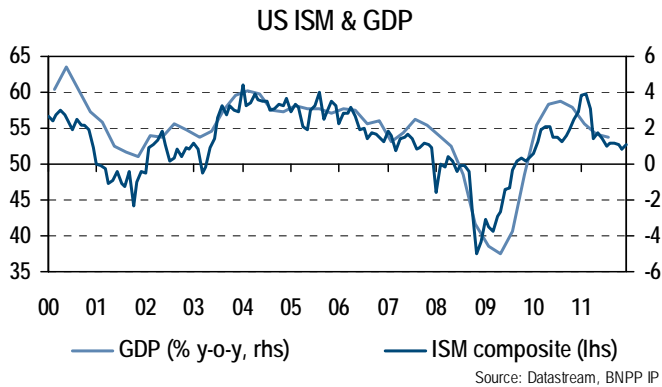
US data continued to be positive. Confidence has improved further at several levels: among consumers,

large manufacturers and small business owners. The latest labour market numbers were also encouraging as employment, hours worked and overtime hours continued to increase, while unemployment fell further in December. An index of pending home sales rose to the highest since the spring of 2010, when home sales surged on the back of temporary tax credits.

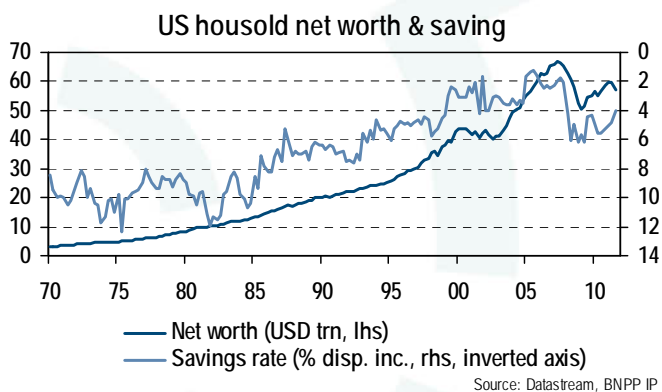
To be confident of a period of sustainable trend growth, we think the current positive momentum should be supported by continued investment and employment growth and we have not seen enough evidence of this. The new orders component of the ISM manufacturing index has improved, but does not point to strong order growth. Actual orders and shipments of capital goods – good proxies for business investment – have slowed in the past few months. As said, the employment report for December was mainly positive, but the number of 200 000 new jobs was flattered by a strong increase in transportation jobs. This was also the case in 2009 and 2010, but jobs in this sector fell back sharply in January. The trend in job growth looks more like 150 000 per month, just enough to accommodate a structurally rising labour force. That said, the drop in the unemployment rate from 8.7% to 8.5% was once again helped by a monthly decrease in the labour force. The labour force is currently almost 1 million people *below* its peak in October 2008, while the population has *grown* by almost 6 million people in this period. So there is still a long way to go to accommodate all redundant workers.



There are other reasons not to get overly excited. The combined ISM manufacturing and services indices do not point to strong growth.



And while households have gone some way to deleverage, the government has not even started. We do not expect major changes in fiscal policy in 2012. The payroll tax cut and the extended unemployment benefits, which were set to expire at the end of 2011, have been rolled over for two months. We expect them to be extended for the whole of 2012. If this does not happen, the fiscal drag would be significant and we do not expect political parties to take such a risk. Nevertheless, fiscal consolidation, probably starting in 2013, hangs as a dark cloud over the economy.



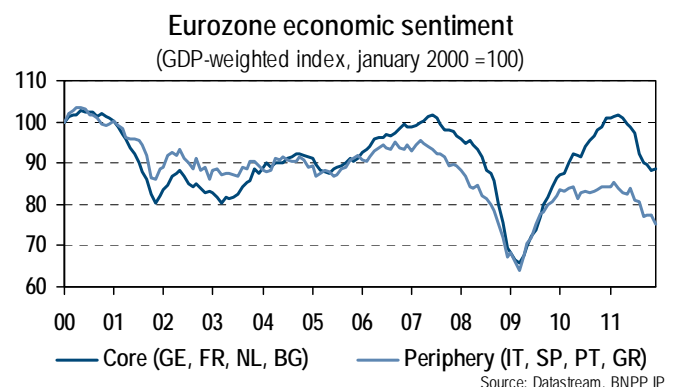
Finally, the improvement in the second half of last year was largely driven by stronger consumption. From June to November, real consumption increased by 2.7% annualised, while real disposable income fell by 1.0% annualised. The result was a sharp decrease in the savings rate. This is not uncommon in the early stages of a recovery, but starting from an already low savings rate and without any support from wealth gains (in fact, household net worth fell by USD 2.4 trillion in the third quarter of 2011 to the lowest since the third quarter of 2010 and net worth is still USD 9.4 trillion below its peak

in the second quarter of 2007) this does not look sustainable.

ISSUE 2: EUROPE'S CRISIS AND RECESSION

It has been fairly quiet around the eurozone fiscal crisis in recent weeks. After the ECB lent EUR 489 billion to banks, 'peripheral' yield spreads came down, especially at the short end of the curve. As we said in December, we doubt there is a strong link since we do not expect banks to use the ECB funds in a meaningful way to buy 'peripheral' bonds. In Spain, spreads on 10-year yields declined after the elections. Due to the different political constellation in Italy, 10-year yields stayed high. We don't think the eurozone crisis has been solved. Politicians are currently working on the "fiscal compact" announced in December, but as said, we think this will not be enough to address the crisis.

Meanwhile, the eurozone economy is probably in recession. The composite PMI rose in November and December, but it is still below 50, pointing to contraction. The Economic Sentiment Index fell further in December. While it improved in Germany, the Netherlands and Belgium and stabilised in France, it deteriorated significantly in Spain and Italy. The French INSEE business climate indicator fell again in December.



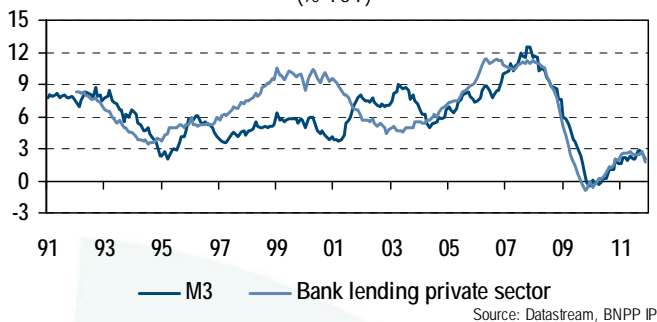
Retail sales were weak in November. Growth at -2.5% YoY was the weakest since September 2009, when the economy was recovering from recession. Consumer confidence continued to fall in December, albeit more slowly than in the July-September period.

Money growth weakened significantly in November. The headline figure for M3, a broad measure of the stock of money, fell to 2.0% YoY. The ECB's reference value for



M3 growth is 4.5% YoY and in normal times it has often exceeded this level. Bank lending to the private sector fell for the second straight month to a paltry 1.7% YoY. These data were from before the three-year loan supply from the ECB and underscored the risk of a credit crunch. The ECB loans have mitigated this risk somewhat.

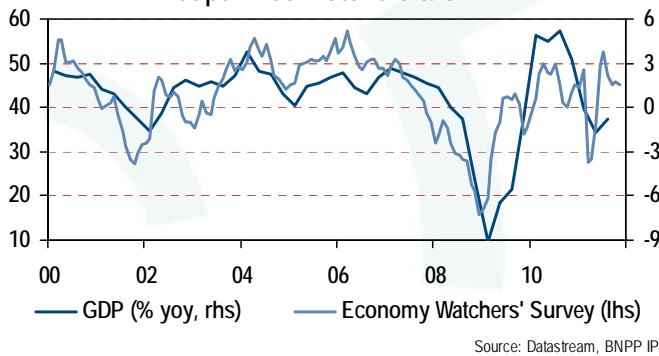
Eurozone money and bank lending
(% YoY)



ISSUE 3: JAPAN AND EMERGING MARKETS SLOWING

Most data from Japan show the economy is sputtering after the V-shaped recovery from the earthquake and tsunami-related dip. The Economy Watchers' Survey peaked in July and has trended lower since.

Japan Eco Watchers & GDP



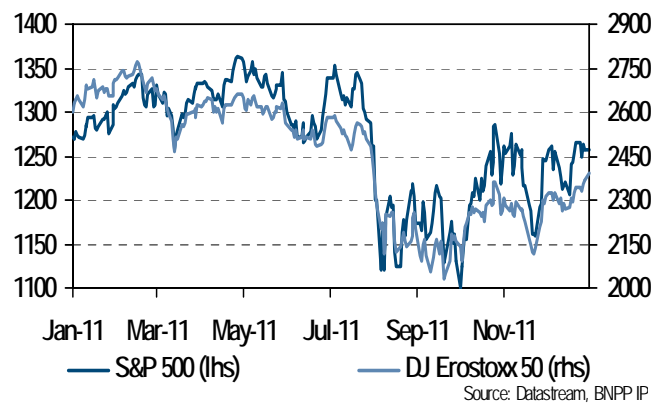
The Tankan survey of large manufacturers dipped below zero in the last quarter of 2011. For non-manufacturing companies, it rose somewhat, but only to a modest level. The manufacturing PMI improved in December, but is only marginally above 50. Consumer confidence, not particularly strong either, fell in November. Industrial production and consumer spending fell sharply in November. The Japanese economy, still mired in deflation, faces two headwinds: slowing global growth and a strong yen. Exports weakened significantly in October and November. Since we do not expect this to change soon, the economy is likely to continue to struggle.

The main news from emerging markets is the rapid fall in inflation recently. This is mostly due to falling food prices, but non-food inflation also appears to have peaked. This has enabled an increasing number of central banks to stop hiking interest rates or even start easing monetary policy. This should mitigate to some extent the fallout of the global growth slowdown, which is clearly visible in emerging market exports. On a more positive note, the global emerging market PMI has been stable at around 50 for the past six months. Not strong, but not pointing to a sharp slowdown either (in the 2008/09 recession, this index dipped below 40).

OUR MARKET VIEWS

In our investment strategy and asset allocation, we have kept our cautious stance. We are negative/underweight developed equities. We think the improvement in the US is not strong enough to lift all developed equities. By the way, this is widely discounted by the markets already: the S&P500 has risen by 17.5% from its low on 4 October 2011. The Eurostoxx 50 is up by a similar amount in local currency terms: 17.6% since 22 September (although European equities had fallen much more from July to September).

S&P500 & DJ Eurostoxx 50



This has made valuations a bit less attractive, although we don't see this as the main driver for equities this year. We think that the eurozone recession and sovereign debt crisis still pose downward risks for developed equities. Downward earnings revisions have become somewhat less intense, but we still see this as negative for developed equities. In fact, we think earnings could disappoint in this quarter or next. We are more positive on the US than Europe given the better growth prospects. We reduced Japan from positive to neutral in our

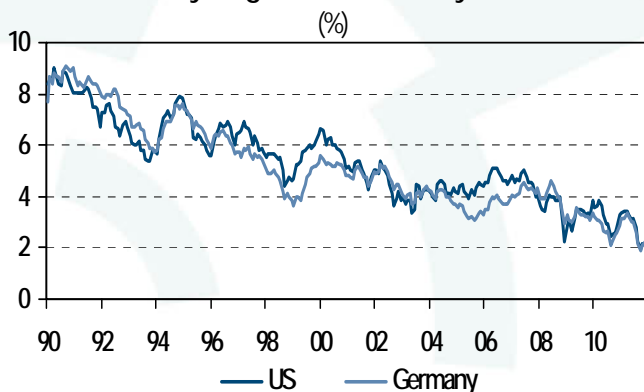


investment strategy and maintained the underweight in our asset allocation, given the recent growth slowdown and the continuing strength of the yen and despite the low valuations.

We are more positive on emerging markets. We have a neutral recommendation in our investment strategy and an overweight in our asset allocation. We still believe in the structural growth story for emerging markets. The cyclical headwinds should be partly compensated for by falling inflation and monetary policy easing.

We do not think that US or German government bond yields will move by much. We expect growth and inflation to stay low. Surprises could come from further rate cuts by the ECB and the Federal Reserve could embark on another round of quantitative easing (although stronger US economic data have diminished the likelihood of this happening in the first quarter). But with two-year yields already at 0.24% in the US and 0.15% in Germany (which even managed to sell six-month bills at a negative yield this week) and 10-year yields below 2%, we do not see much room for declines.

10-year government bond yield



Source: Datastream, BNPP IP

We are neutral on credit in our investment strategy recommendations, but our asset allocation team decided to go overweight. Corporate bonds should do well in a slow growth environment. For the asset class as a whole, our asset allocation team sees corporate balance sheet strength as a positive. The implied default rate is also markedly higher than the actual default rate. The large exposure of investment-grade credit to the banking sector was a risk, but this was reduced after the three-year loan offering from the ECB eased funding stress. Increased inflows into credit funds and improved investor sentiment towards credits have encouraged the team to go

overweight. We sold government bonds to fund this overweight.

Our investment strategy team and our asset allocation team are fundamentally positive on emerging market bonds, but only our asset allocation team has an overweight in local currency bonds. These bonds can benefit from relatively high growth, lower inflation and monetary policy easing and potentially from currency gains, although risk aversion and monetary easing could also lead to currency depreciation.

Regarding commodities, both teams are positive on gold. Jewellery demand has fallen lately, but we see this as temporary. The stronger dollar has been a more important driver behind the recent declines in our view, but we do not expect the dollar to continue to rise this quickly. Furthermore, investor demand has stayed strong.

Our asset allocation team is underweight inflation-linked bonds. This asset class could suffer as a debt downgrade, of Italy in particular, could lead to index changes. Furthermore, output gaps are large, which should keep inflation low. And January tends to be a weak month for inflation-linked bonds.

Our asset allocation team is neutral on real estate and convertible bonds and overweight cash.

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Investment specialist - allocation & strategy



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