



PERSPECTIVES



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2012: cloudy with some sunshine

2011 will be seen as a year marked by natural and political tsunamis (Japan and the Arab Spring) and the realisation that the Great Recession of 2008 left us with formidable structural challenges. The market consequences have been profound, nowhere more so than in the eurozone where some of the media even questioned its very future. Ahead of a new year, we can only welcome the latest moves to strengthen eurozone governance so as to enhance credibility and rebuild investor confidence. If successful, these initiatives would help clear away the market clouds. But the sunshine may be brief. Other clouds could appear, not least the cyclical environment in Europe, where recent data and the prospect of unavoidable fiscal policy tightening combine to create expectations of a weak first half. Later on, investors may turn their focus to the US elections, which will be critical in view of the structural issues the new administration and Congress will need to address. Elsewhere, numerous emerging markets should provide calmer 'weather conditions'. Although they, too, face slower growth, they have the monetary and fiscal policy flexibility to react. Moreover, monetary transmission is working in these countries, so policy impulses are effective in influencing final demand.

From a markets perspective, one needs to go back a long way to find a year when the word 'uncertainty' was so omnipresent in the analyses. That explains our cautious stance while we focus on monitoring the catalysts for change. For now, this means 'all eyes on Europe'.

We wish all our readers a prosperous and happy new year.

Written 7 December 2011

William De Vijlder
CIO Strategy and Partners





Nathalie Benatia
Strategist - BNPP AM

2011: a trying year

The past year has been trying from every viewpoint: economic, financial, geopolitical and even natural if you recall the terrible earthquake that struck Japan in March. While the geopolitical aspects (the Arab Spring and the rise in oil prices) and the tsunami had only limited and temporary effect on industrial production, the same cannot be said of the concerns related to growth and sovereign indebtedness. The flow of bad news on these fronts has not yet dried up.

Sluggish growth fuels doubts over its sustainability

In the United States, average quarterly GDP growth from September 2010 to September 2011 came in at 1.5% (annualised). Any slowdown from this threshold which is well below potential growth could arouse fears of a relapse into recession. Although the figures published recently showed a sharp pickup in the US economy, the still weak job market – and the appearance of long-term unemployment – is undermining confidence and curbing spending and credit demand. European economic statistics traditionally have less influence on investors' behaviour. This is fortunate, because the indicators published since the summer show that eurozone GDP is likely to contract after growing moderately (0.2%) in the second and third quarters. A recession in the eurozone should remain limited though and have no major consequences for the rest of the world. According to the IMF¹, global growth should be around 4% but, due to its uneven nature in the developed countries, observers will not be reassured by this figure.

The unending nightmare of public debt

The major turmoil in financial markets, affecting the morale of economic agents and the access to credit, is due to a combination of factors since the summer. The most symbolic of these was S&P's decision to withdraw the United States' triple-A rating, pointing to a lack of political cohesion following the long debate on raising the debt ceiling. This announcement did not permanently affect the level of US bond yields, but it was a cruel reminder that the deterioration in public finances resulting from the great recession of 2008 has spared no developed country. Against this backdrop, and at a time when the consequences of the "Greek crisis", which broke out in the spring of 2010, had not yet been digested and the sovereign ratings of several eurozone countries were lowered, yield spreads against Germany, considered a safe haven, widened sharply. Despite very different economic situations, this contagion took place indiscriminately, striking solvent countries such as Spain

and Italy, and to a lesser extent France which was threatened with the loss of its triple-A. A sovereign crisis is, in itself, very worrying; it becomes even more so when it threatens to morph into a banking crisis. While a Greek debt default - organised or not - would be modest in absolute terms (EUR 350 billion), and would not necessarily be catastrophic for those holding the debt, the same would obviously not hold for Italian debt (EUR 1 900 billion). Although it is futile to anticipate an Italian default, the interbank market quickly came under stress. Faced with this situation, the ECB² has supplied the banks with unlimited liquidity and has, since August, resumed its purchases of public debt to prevent excessive pressure on bond yields, especially for those issued by Spain and Italy.

Official responses are not always appropriate

On 21 July, eurozone heads of state and government leaders met urgently to propose a new bailout plan for Greece and an extension of the EFSF³, whose capacity for action seemed inadequate. The need to have these new procedures approved by the 17 national parliaments delayed their final adoption until mid-October, by which time the measures announced in July were in part no longer valid. The European summit at the end of October provided some additional answers, in particular regarding a further change in the EFSF, but left many questions unresolved. The authorities are endeavouring to contain the crisis and reassure investors, but they still lack credibility. Political procrastination in Greece and Italy led to the setting up of governments of "technocrats" responsible for applying the deficit control plans, but this development, while theoretically able to satisfy observers, was received cautiously. Finally, although the fiscal policies adopted in recent months (deficit and debt reduction) will have a stabilising effect in the medium term, they are likely to be destructive in the short term: either the ambitious cutback programmes are applied fully, and they will threaten growth, or they are applied only imperfectly, and then they will threaten the credibility of those who presented them and will lead investors to demand new decision-makers. So 2011 was a decidedly trying year, and 2012 looks equally likely to prove complicated.

¹ World Economic Outlook, International Monetary Fund, September 2011

² European Central Bank

³ European Financial Stability Facility

Consensus forecasts: Growth & Inflation

| December 2011 | GDP YoY % | | | | | | | | | Inflation YoY % | | | | | | | | |
|-------------------------|-----------|------|-----|------|--------|-----|-----|------|-------|-----------------|------|------|------|--------|------|-----|------|--------|
| | 2010 | 2011 | | | 2012 | | | 2010 | 2011 | | | 2012 | | | | | | |
| 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 | 3.0 | 1.8 | 2.0 | 1.7 | [1.7] | 2.1 | 3.3 | 1.1 | [1.9] | 1.6 | 3.2 | 3.3 | 3.1 | [3.1] | 2.1 | 3.5 | 1.5 | [2.1] |
| Canada | 3.2 | 2.3 | 2.4 | 2.1 | [2.3] | 2.0 | 2.5 | 1.5 | [2.0] | 1.8 | 2.9 | 3.0 | 2.7 | [2.8] | 2.0 | 2.6 | 1.6 | [1.9] |
| Eurozone | 1.8 | 1.6 | 1.7 | 1.5 | [1.6] | 0.4 | 1.1 | -0.8 | [0.6] | 1.6 | 2.7 | 2.8 | 2.4 | [2.6] | 1.8 | 2.5 | 1.3 | [1.8] |
| UK | 1.8 | 1.0 | 1.5 | 0.7 | [1.0] | 1.1 | 2.3 | -0.4 | [1.5] | 3.3 | 4.5 | 4.6 | 1.2 | [4.4] | 2.8 | 3.6 | 2.2 | [2.7] |
| Switzerland | 2.7 | 1.8 | 2.3 | 0.7 | [2.0] | 0.7 | 1.5 | -0.4 | [1.1] | 0.7 | 0.4 | 0.5 | 0.2 | [0.4] | 0.1 | 0.7 | -0.5 | [0.4] |
| Japan | 4.1 | -0.4 | 0.2 | -1.1 | [-0.5] | 2.1 | 3.8 | 0.5 | [2.2] | -0.7 | -0.3 | 0.3 | -0.5 | [-0.2] | -0.2 | 0.7 | -0.8 | [-0.2] |
| Australia | 2.7 | 1.6 | 2.2 | 1.2 | [1.7] | 3.5 | 4.6 | 2.7 | [3.5] | 2.8 | 3.4 | 3.6 | 3.3 | [3.4] | 2.9 | 3.7 | 2.3 | [2.9] |



Vincent Treulet
Head of Strategy - BNPP AM

Choosing to hold course – despite the market volatility

Equity markets suffered a marked decline in November, which was followed by an equally fast rebound. Can you tell us how you deal with this volatility in your asset allocation?

Unless you are investing with a very short horizon and are able to take high risks, it is tricky to try and follow such moves. This is especially true when they are triggered by factors that I would qualify as intangible: for example, the equity market rebound was partly based on hopes of an end to the eurozone crisis before the summit of 8 and 9 December, even though no decision was yet known. That is why we prefer to maintain a slightly longer timeframe, over the coming months, even if it means at times suffering market moves in the opposite direction. We still expect risky asset markets to be under pressure. The verdict on the global economic environment is rather mixed, but not really bad: although a eurozone recession in the coming quarters has become a fairly consensual scenario, US and emerging economies, for their part, should hold up relatively well in the slowdown. However, it is hard for risky assets such as equities and credit to establish an enduringly positive trend when the global economy lacks an accelerating momentum or hope of a subsequent growth rebound. These two factors are lacking at present, and we believe this will continue to be the case in 2012. Moreover, the sovereign crisis in the eurozone is still a source of stress: at the time of writing, progress can be hoped for at the next summit, but it is not certain that the pressure will subside rapidly. As in the past months, we therefore maintain a cautious bias in the allocation, notably recommending the underweighting of developed market equities.

The eurozone crisis has for some time led you to underweight European equity markets in your

allocation. Does the recent underperformance not encourage you to change recommendation and take a bet on the apparent undervaluation of these markets?

It is true that European equities are inexpensive and that they have suffered severely from the situation in the eurozone. It is also true that the microeconomic situation is far better than the performance of 2011 suggests; in addition, listed companies in Europe are far from exclusively dependent on the economies of their home markets. However, from a tactical standpoint, for the time being we maintain the underweighting relative to other developed equity markets, because top-down factors - or macroeconomic and financial factors - are still at present the main drivers of stock market indices. So long as this phase continues - and we cannot see it ending yet - it will be hard for more purely microeconomic factors to prevail and trigger a readjustment of valuations.

Your cautious bias explains a positive recommendation on gold. Can gold and commodities really offset the fall in risky assets if risk aversion revives?

This question requires close analysis of each type of commodity, since each obeys different investment strategies. We consider the price of gold high, but we remain long as a hedge against systemic risks. Looking at its performance with hindsight, this works fairly well. Other commodities such as energy and base metals are more closely correlated to risk appetite and the stock market indices. For this and other reasons, we are waiting for more attractive entry points. That said, our bias on commodities nevertheless remains generally positive for 2012 because global growth (and hence demand) should remain satisfactory thanks to emerging markets and the liquidity injection by central banks worldwide is unlikely to dry up - in fact, quite the contrary.

Asset allocation

| MULTI-ASSET CLASS | | | EQUITIES DEVELOPED COUNTRIES | | | EQUITIES EMERGING COUNTRIES | | |
|-----------------------|---------|----------|----------------------------------|---------|----------|-----------------------------|---------|----------|
| | CURRENT | PREVIOUS | | CURRENT | PREVIOUS | | CURRENT | PREVIOUS |
| EQUITIES | | | US | = | = | Brazil | - | - |
| Developed Equities | - | - | Canada | - | - | China | + | + |
| Emerging Equities | = | = | Eurozone | - | - | India | = | = |
| FIXED INCOME | | | Japan | + | + | South-Korea | = | = |
| Government Bonds | = | = | UK | + | + | Taiwan | - | - |
| Corporate Bonds | = | = | Switzerland | + | + | Russia | + | + |
| High Yield | = | = | Australia | - | - | South Africa | = | = |
| Emerging Debt (ext.) | = | = | | | | Turkey | - | - |
| Emerging Debt (local) | = | = | BONDS COUNTRIES SOVEREIGN | | | | | |
| COMMODITIES | | | | CURRENT | PREVIOUS | | | |
| Brent Oil | = | = | US | - | - | | | |
| Base Metals | = | = | Eurozone | = | + | | | |
| Gold | + | + | Japan | = | = | | | |
| Agricultural | = | = | UK | + | + | | | |
| CASH | - | - | Switzerland | = | = | | | |

Notes: The indications in the tables reflect views not weights, whereby the "+", "-" and "=" signs respectively represent positive, negative and neutral views. Two different types of views are expressed in the tables. Those in the Multi-Asset Class Module are absolute returns views, or more precisely views on excess returns versus cash. Those in the equities and bond modules are relative return views. Here we assess relative excess returns amongst different countries. These views can of course be translated into portfolio weights. Their size will heavily depend on portfolio constraints and the specific risk budgets.



Benjamin Conquet
Investment Specialist Global Credit – BNPP AM

Quality corporate bonds: towards a new risk-free rate?

European corporate bonds have also suffered from the sovereign debt turmoil, but often offer corporates cheaper financing than that available to some sovereign borrowers. We think this is an indication of the way the market's perception of risk has shifted in favour of corporate bonds.

Unlike many heavily indebted developed countries, good quality companies have, for the past three years, carried out extensive restructuring of their balance sheets. This has been achieved partly by reducing the average debt ratio, and partly by securing longer-term funding, thus enabling corporates to avoid a concentration of major short-term financing constraints. So a feature of 2009 and 2010 was record volumes of corporate bond issuance, allowing companies to push back the "maturity wall".

Ratings are no guarantee

Although growth expectations for Europe are fairly lacklustre, this is overall positive for this asset class as it historically benefits from weak macroeconomic scenarios. Even so, the situation is contrasted: while industrial firms and utilities are generally doing reasonably well, financial companies, especially banks, are still in the eye of the storm. Due to the sovereign debt carried on their balance sheets and the new Basel III regulatory requirements, the potential upside on these issuers is limited. We therefore favour industrial firms, which have better earnings visibility.

At present, these companies, rated A-/BBB+ on average, obtain funding at levels of 3.22% on typical 5-year maturities, with some disparities as yields range from 2.60% for non-cyclicals (pharmaceuticals, retailing, alcohol & tobacco) to 3.70% for telecommunications. On the same maturities, Spain (A+) and Italy (A) have to pay yields of 5.72% and 6.42% respectively, whereas France (AAA) pays only 2.60%. A growing number of companies can therefore now obtain funding on better terms than Italy or Spain, and close to the terms for France. Ratings are therefore no longer the sole guarantee of security, as underscored by the widening spread between sovereigns and corporate issuers; in these troubled times, investors' perception of risk plays a much more important role.

This analysis is not as obvious for banks, which obtain funding at 5.44% on average (through a combination of conventional senior debt and more volatile subordinated debt). Given the uncertainties surrounding sovereign debt in Europe, bank bonds remain subject to sharp price fluctuations. Accordingly, despite their attractive yield, they are not safe haven investments for risk-averse investors, as may be the case with certain industrial issuers.

Overcoming volatility

In an environment influenced by numerous, and often divergent, European political announcements as well as national elections (e.g. Spain, Italy, France, Germany etc.), volatility still prevails in the credit market, raising the twofold question of (i) what should the entry point be, and (ii) how should one value these investments?

Since we do not expect a quick resolution of the sovereign crisis, we believe that the spreads between the private and the sovereign issuers will persist. So there will still be entry points in the coming months even if it means waiting a few weeks for credit premiums, which can occasionally be very volatile, to return to more favourable levels.

Secondly, regarding valuations, we believe the best way to elude market volatility remains the carry or target date fund approach: as investors hold their bonds to maturity, they no longer suffer from fluctuations in the price, because (barring default) they will be repaid 100% of the debt's value at maturity.

That is why we currently favour carry portfolios with a three to four-year time horizon focused more specifically on industrial firms (BBB and even BB) and including a careful selection of sound financials generating a worthwhile extra yield, with the goal of crystallising a rate of return while limiting the mark-to-market impact.

| Type of bonds | Average rating | Yield to maturity as % | Credit premium in bp above Germany for identical maturity |
|--|----------------|------------------------|---|
| Corporate bonds | A- | 3.22 | 129 |
| Private utilities | A | 3.59 | 167 |
| Private financials | A+ | 5.44 | 387 |
| Total euro-denominated corporate bonds | A | 4.00 | 211 |
| France 5-year sovereign | AAA | 2.59 | 159 |
| Italy 5-year sovereign | A | 6.49 | 549 |
| Spain 5-year sovereign | A+ | 5.72 | 472 |
| Germany 5-year sovereign | AAA | 1.00 | 0 |



Eduardo Yuki
Chief Economist, BNPP AM Brasil

Brazil: a new safe haven?

Brazil has substantially reduced its solvency risk thanks to the government's reduction of its debt, a high level of international reserves and tight financial market regulation. Although there are several challenges ahead, we argue that, for investors looking for an alternative safe haven country, this is a good time to consider Brazil.

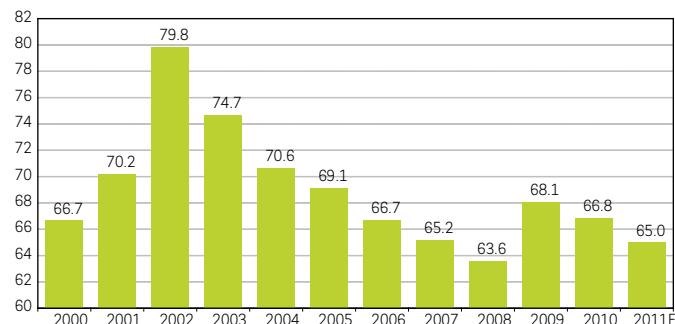
Government debt reduction

Despite market concerns at the start of this year, Brazil's primary fiscal surplus is above the official target of 3.1% of GDP. Net public debt was down to 37.2% of GDP in September 2011 from 60.4% of GDP in 2002. Gross government debt has also declined substantially since 2002 (see chart below).

According to IMF forecasts, Brazil's gross government debt will decline by 1.9 percentage points (ppt) this year to 65% of GDP, while developed economies' fiscal debt will rise by 5.6 ppt to 119% of GDP. Debt reduction in Brazil is a consequence of structural reforms started in 1999, such as the Fiscal Responsibility Law and primary fiscal surplus target. The fact that the primary fiscal surplus has remained consistent for several years has also helped to reduce fiscal vulnerability.

Moreover, the debt sustainability over the medium and long term depends on economic growth which is still relatively strong. The Brazilian government has several weapons to help avoid an economic recession and stagnation, as interest rates and reserve requirements are still high. So unlike many other countries around the world, the government has the flexibility to protect its economy should the global economic outlook worsen.

Brazil: Gross Government Debt (% GDP)



Source: IMF and BNPP AM Brasil.

External accounts improved

Brazil's international reserves reached USD 350 bn in November 2011, which equates to some 15% of GDP or 118.6% of external debt. Net external debt is -3.4% of GDP. The most important

development has been the substantial reduction of net external liabilities to 25.7% of GDP in October; in 2007, it stood at 40.3% of GDP. It should also be noted that the current account deficit, at 1.9% of GDP, is lower than that of several advanced economies, which minimises the risk to the Brazilian real. These indicators suggest that external solvency risk is also very low.

Tight financial regulation

In Brazil, the minimum capital adequacy ratio required of banks is 11%, which is above the current Basel minimum capital ratio. However, the banks' average capital ratio was 16.9% in December 2010. We believe that, due to a cyclical adjustment and a slowdown in economic growth, the loan delinquency ratio will increase in the coming months but that it is very unlikely to represent a risk to the financial system.

Not perfect though

Certainly Brazil still has some challenges to overcome. There are clear arguments to say that it must improve its fiscal policy and increase both its productivity gains and national savings levels. Additionally, there are several challenges ahead if the country is to increase its GDP growth above 4% per year. In fact, Brazil's domestic economic activity has decelerated since the second quarter of this year, corroborating our real GDP growth forecasts of 2.9% for both 2011 and 2012, which are below the consensus estimates of 3.1% and 3.5% respectively. On the other hand, we see lower economic growth improving the inflation dynamic, reducing it from 7% YoY in October this year to 5% YoY in December 2012.

We believe that the easing monetary cycle could take longer than the consensus expects. This is because the government has tightened fiscal policy and several officials are now signalling that the primary fiscal target will be achieved again next year. This would represent a substantial economic policy improvement. Nevertheless, we believe that Brazil now deserves to be regarded as a safe country in which to invest, particularly when compared with most other economies around the world. Of course, it faces a number of challenges, but we would stress that it has substantially improved its solvency risk indicators. Moreover, strong domestic demand and the easing monetary cycle should improve its resilience in the face of an adverse global outlook.



Chi Lo
CEO, HFT Investment Management (HK) Ltd

China: what hard landing?

Economy slowing, not crashing

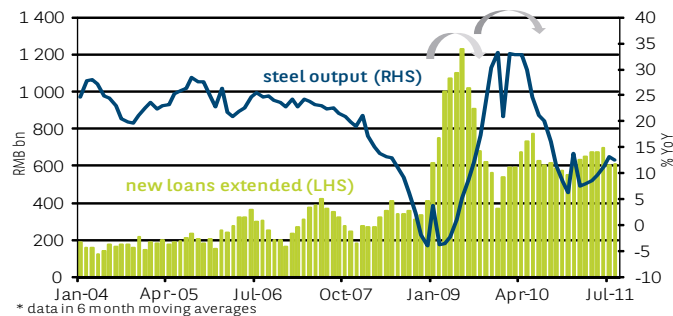
It is clear that China's growth is slowing, however, major Chinese economic indicators point to a moderation in growth not a hard landing for the economy: shadow bank lending is being reined in, the labour market is still tight and domestic demand remains strong, suggesting no imminent need for full policy easing. We expect Chinese inflation will trend down from here.

A dismal backdrop...but reasons for optimism

Europe looks to be slipping into a recession and US growth is feeble with a good chance of a second-dip recession. As these two regions are China's biggest export markets (accounting for over 42% of total Chinese exports, fears of a Chinese economic hard landing have been mounting on faltering external demand. The European banks are deleveraging under the weight of the sovereign debt crisis, which could cause a liquidity squeeze for China, putting further pressure on growth.

However, despite this dismal background, we believe there are still plenty of reasons to be optimistic on China. The recent key macro data for Chinese growth in imports, industrial output, money supply, retail sales, and fixed-asset investment all point to slower economic growth but not a contraction. Industry indicators, such as freight volume, power output and steel output, have all slowed down significantly albeit from very high growth rates of more than 20% last year. Nevertheless they are still growing at between 9% and 15% - hardly evidence of an economic hard landing. This is due to previous policy tightening, which has satisfied the government's objective of lower new loans growth (see Chart 1). Meanwhile, domestic consumption growth, in terms of retail sales and imports, has remained robust, averaging over 17% and 27% YoY respectively. Investment growth will continue to be supported by the large social housing programme expected to build 36 million units over five years and the more than 100 000 infrastructure projects currently underway.

Chart 1: New loans lead steel output growth in slowing down

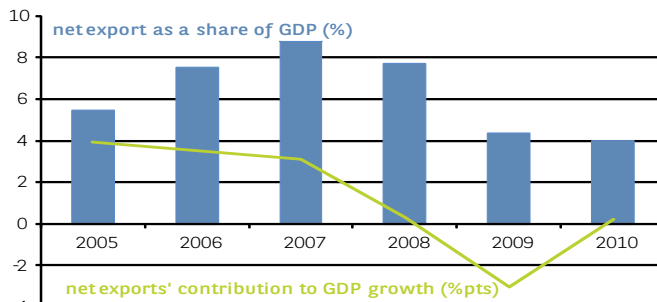


Source: CEIC, HFT (HK)

Less dependent on exports

Further, we believe the trade shock from a developed world recession would have less impact on China's growth today, as China has now become less export-reliant (Chart 2): net exports as a share of GDP have fallen from 9% in 2007 to less than 4% today. Crucially, since 2008, net exports have stopped contributing to China's GDP growth - their contribution to growth averaged -0.83 between 2008 and 2010. In fact, net exports were a big subtraction from growth in 2009 (see Chart 2). The negative trade impact will still be felt if China's largest export markets slip into a recession, but it may not hurt as much as before.

Chart 2: China's economy has become less dependent on exports

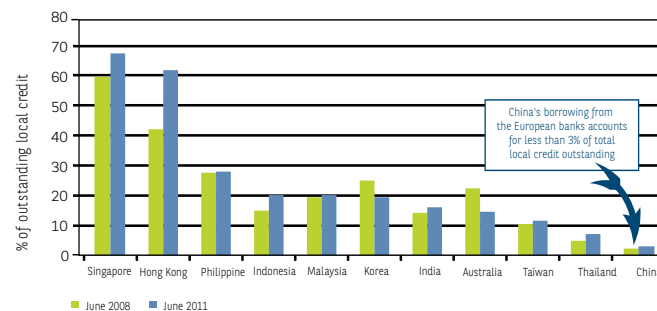


Source: CEIC, HFT (HK)

Chinese banks still strong

European banks are under severe pressure to shrink their balance sheets so as to improve their capital bases, and the European authorities are raising bank capital ratio requirements by summer 2012. This is imposing massive deleveraging pressure on European banks, forcing them to liquidate overseas assets, including calling in loans from Asia and China. However, the negative impact on Chinese growth is likely to be limited, since Chinese banks' exposure to European lending is very small (see Chart 3).

Chart 3: European bank claims on Asian banks



Source: BIS, HFT (HK)

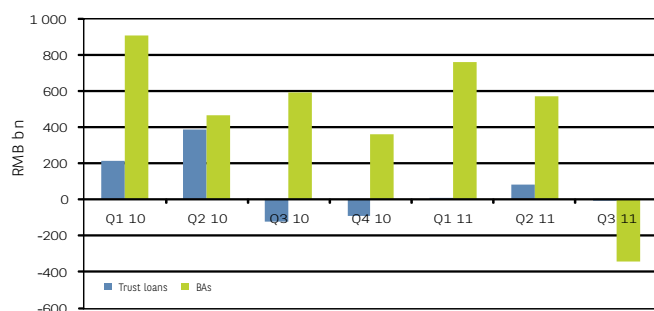
Inflation is poised to fall...

We expect China's inflation to fall due to a moderating economy, a high base effect last year, falling agricultural prices and lower energy and commodity prices. Input costs and the PPI have been falling steadily, suggesting a fall in upstream inflationary pressure. CPI inflation is expected to come down towards the 3.5%-4.0% range in the coming year. However, the wildcard is the effect food prices could have: if they surge again due to natural disasters, CPI would go back up and this could potentially lead to stagflation. We believe this potential shock has a low probability.

Monetary indicators also point to falling inflationary momentum. Not only has money supply growth fallen below the government's annual target and nominal GDP growth rate, but informal lending through shadow banking - a significant funding source for excessive investment that has been boosting price pressure - has also dropped. Growth of total social financing (TSF), which includes all types of financing and is supposed to be a better monetary indicator for the economy, fell by 30% YoY in Q3 2011, after contracting by 1.6% and 7.1% in Q2 and Q1, respectively.

Recent data have also revealed that this TSF contraction was mainly due to regulatory action taken to close credit supply loopholes. One popular scheme involves margin deposits that firms made at banks in exchange for bank acceptance bills (BAs) which could then be discounted for cash. Before Q3 2011, there was no reserve requirement for margin deposits, so banks rushed to issue BAs to skirt the government's lending restrictions. However, since Q3, the regulators have expanded the reserve requirement to include margin deposits, leading to a significant reduction in BAs issuance. Moreover, trust loans - another form of off-bank balance sheet lending - have also dropped sharply as the regulators ordered banks to put trust loans back onto their balance sheets, thus putting them under the credit rationing directives. All these measures have helped close the corresponding credit supply loopholes (see Chart 4).

Chart 4: Informal bank lending falling



Source: Nomura, HFT (HK)

... But not sufficiently to prompt a policy shift

Declining inflation per se is not sufficient in our view to prompt an all-out easing policy by the Beijing government anytime soon as growth momentum in the real economy is more crucial to them. Steady domestic demand and a tight labour market do not make a good argument for an imminent policy easing. China's labour demand/supply ratio has stayed above 1 since Q3 2010, suggesting the persistence of a tight labour market. This is in sharp contrast to 2008 when the sub-prime crisis pushed the labour demand/supply ratio far below 1.

Last but not least, during the upcoming political transition (between H2 2012 and H1 2013), the leaders will do all they can to prevent any sharp drop in growth or high inflation. Barring any unforeseen shocks, Beijing will remain policy neutral, using only selective loosening tools to fine tune liquidity conditions to help specific sectors, such as the SMEs and public housing, and fiscal policy to direct spending and income distribution.

In a nutshell, an economic hard landing is not the biggest risk; inflation is on the way down to 4.0% and the overall macro risks are within manageable limits.



Eric Borremans
Head of Development
Sustainable & Responsible Investments – BNPP IP

European asset owners turn to ESG criteria

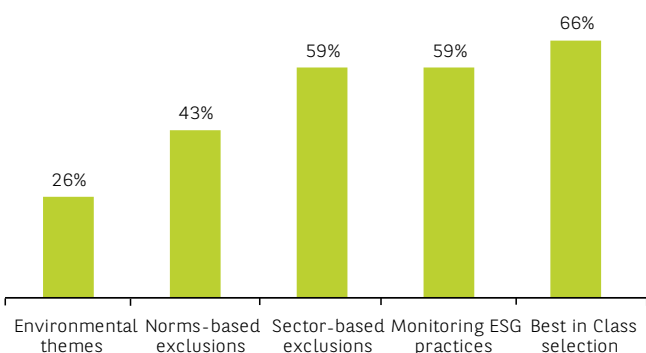
For the second year running, BNP Paribas Investment Partners has sponsored the Novethic¹ survey on "Environment, Social and Governance (ESG) attitudes and incorporation practices of European institutional investors". The responses show a gradual adoption of ESG criteria, but the definitions and implementation of Socially Responsible Investment still vary greatly from one country to another.

For this 2011 survey, more than 250 institutional investors in 11 countries were questioned on the incorporation of ESG criteria in asset management. The results cover four main areas: (i) why and how to incorporate ESG criteria in investment decisions; (ii) the impact on risk management; (iii) the methods used, and (iv) the asset classes most concerned.

A well-understood concept, but diverging practices

European investors incorporate socially responsible investing into a combination of approaches that can be grouped into three main categories: first, positive selection of issuers based on ESG criteria (66%), then normative and sector exclusions (43% and 59% respectively), and finally the implementation of thematic strategies (26%), e.g. in the social or environmental area. The survey also reveals that these three approaches hold widely differing importance from one country to another. For example, thematic management is emphasised by nearly 50% of investors in Sweden, 40% in Germany and Denmark, but less than 5% in Italy and Spain. The exclusion of companies and sectors is widely used in some countries such as Denmark (73%) and Finland (75%), but far less so in others, for example in France, where it is mentioned by only 28% of respondents.

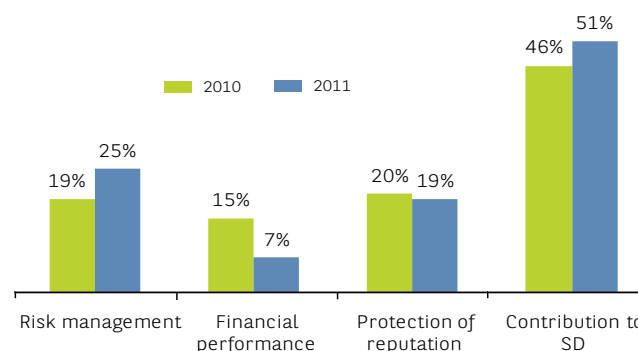
Perception of the integration of ESG Criteria



Source: Novethic - 2011 survey: European asset owners' ESG perceptions and integration practices.

The two main incentives for the incorporation of ESG criteria remain the contribution to sustainable development (51%) and long-term risk management (25%). The great majority of investors surveyed do not consider allowance for ESG criteria to be incompatible with fiduciary responsibility. In Benelux, Finland and Germany, more than 90% even consider that allowance for such criteria is in the long-term interest of the beneficiaries.

Main incentives



Source: Novethic - 2011 survey: European asset owners' ESG perceptions and integration practices.

Minimising the risks

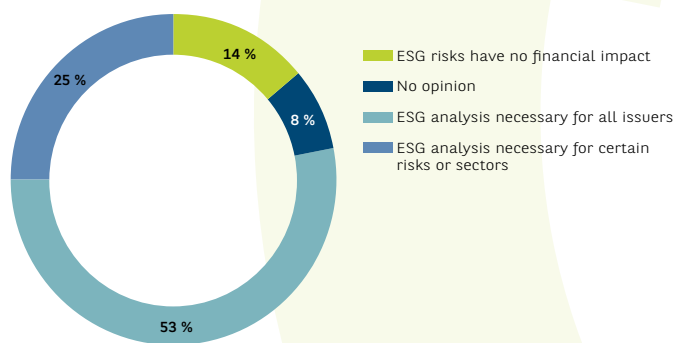
The exclusion of certain sectors is still closely related to the impression the respondents may have of the reputational risk to which their clients or beneficiaries could be exposed: the aim is to avoid being attacked by the media or targeted by NGO campaigns on the nature of their investments. This fear is very widespread in Northern Europe, but much less so in the South. It is interesting, nevertheless, to note the astounding progress on certain subjects: controversial weapons (antipersonnel mines and submunition bombs) are blacklisted by 80% of the investors surveyed, whereas this theme was non-existent some ten years ago; tax havens and commodities seem less problematic but are nevertheless mentioned by 42% and 34% of the panel respectively.

It is worth highlighting that to avoid holding securities that risk, not only an investor's reputation, but also their financial results, a new practice is being increasingly adopted: normative exclusion.

¹ Novethic, part of Caisse des Dépôts, is a research centre in France on Socially and Responsible Investment (SRI) and Corporate Social Responsibility (CSR)

Of the 40% of the panel who incorporate ESG analysis for all their equity investments, 62% practice normative exclusion. This approach involves eliminating companies that have been guilty of proven violations of the major international conventions in the areas of human rights, labour legislation and anti-corruption.

Contribution to risk analysis



Source: Novethic - 2011 survey: European asset owners' ESG perceptions and integration practices.

The role of the rating agencies

To apply socially responsible investment policies, almost half of the investors surveyed state that they obtain information from the specialist rating agencies, while 40% use an outside management firm. Conversely, only 25% have in-house ESG analysts.

Toward new asset classes

Whereas 40% of the investors surveyed declare that they incorporate ESG criteria for all their equities management, only one-third apply it to corporate bonds, and one-quarter to government bonds. This is followed by asset classes such as money-market funds, private equity and commodities.

From theory to practice

The survey shows that – and this is a positive development – European investors have become aware of ESG issues, but this does not necessarily translate into actions: less than one-quarter of them say they have revised their investment policy

following events such as the explosion of the BP platform. In the case of the Fukushima power plant explosion, only 16% of investors surveyed say they have reviewed their exposure to the nuclear sector.

Apart from the limited impact that major disasters can have on investors' approaches, this new survey shows that a socially responsible investment policy absolutely must reflect the specific features of the organisation in question and allow for the sensitivities of its beneficiaries. There are also numerous complementary investment solutions. For example, the application of normative and sector exclusions to all assets can be perfectly well combined with more targeted strategies aimed at investing in issuers applying best ESG practices, or in goods and services with high social and environmental added value. We shall go back over the organisation and benefits of these various investment strategies in a later issue.

SURVEY PANEL

259 institutional investors (private and public pension funds, private and mutual insurers, non-profit organisations - foundations and NGOs, banks, public financial institutions, religious congregations) with EUR 4,540 billion in assets were surveyed by phone and email between June and September in 11 countries: Germany, Belgium, Denmark, Spain, Finland, France, Italy, Luxembourg, the Netherlands, the United Kingdom and Sweden.



William De Vijlder
CIO of Strategy & Partners



Joost van Leenders
Investment Specialist
Allocation and Strategy

2012: a frugal and crucial year

As 2011 draws to a close, the outcome of several issues that dominated the headlines and markets remains unclear. Will the eurozone find a solution to its sovereign bond crisis? Will the acceleration in US growth be sustainable? What about the eurozone: will the region relapse into recession? And how will emerging market economies cope with lower global growth? Given the uncertainty about the outlook and the lack of clear bargains among the main asset classes, 2012 will be a challenging year for investors. Following the publication of our 'Market Outlook for 2012'¹, *Perspectives* asked William De Vijlder (WDV), CIO of Strategy & Partners and Joost van Leenders (JvL), Investment Specialist – Allocation and strategy, for their views.

Perspectives (P): *Let's start with what is probably the most daunting and sensitive question, how do you see the eurozone government bond crisis evolving in 2012?*

WDV: This is indeed a tough question as so many things are interrelated in sometimes complex ways. We think that a comprehensive deal should include several elements. Firstly, a buyer of last resort for the government debt of eurozone member states which are facing liquidity problems. This could be an enlarged EFSF, but the recent widening of risk spreads on EFSF bonds shows that this may not be easy to accomplish. It could also be the ECB, although some member states clearly oppose this.

JvL: It is also very important to increase the structural growth rate in 'peripheral' countries facing years of austerity, for example, by speeding up investment through the EU's cohesion funds. This should be accompanied by strong political pressure to address fiscal deficits and structural impediments to growth to prevent moral hazard.

WDV: More debt restructuring and some form of debt collectivisation may be inevitable. I think that ultimately a solution will be found as the eurozone leaders have shown both flexibility and determination in 2011. However, it may take time which means that further market volatility is likely.

P: *If the eurozone leaders did find a comprehensive solution, would that give risky assets a strong green light?*

WDV: Of course this would lead to a relief rally. But the crisis is not the only reason to be cautious on risky assets, at least in the first part of 2012. The fiscal challenges in the US are no less daunting than in the eurozone. Austerity may be delayed to allow the economy to recover, but the uncertainty over a long-term solution will probably remain well past the presidential elections in November 2012. We must also keep in mind that we are still in a period of deleveraging, with both governments and households in many developed economies cutting debt and spending. I think that deleveraging and uncertainty together do not provide a favourable backdrop for risky assets.

P: *Overall, the corporate sector is in good shape with strong cash positions and high profitability. Couldn't this lead to a positive cycle of investment, employment and consumption growth?*

JvL: Indeed, this could positively impact our somewhat bearish scenario. The latest developments in the US look encouraging. Business investment grew quite strongly in the third quarter of 2011 and this has in the past been a good leading indicator for employment growth, which, at the moment, is sorely lacking. Consumption grew at its strongest pace since the last quarter of 2010, but there was an unsustainable streak to it since households did not consume more as a result of growing income, but because they dipped into their savings. Although this is not our main scenario, it is possible that this spending increase could be the spark setting off a more robust recovery.

P: *As you said, our global growth scenario for 2012 is relatively bearish. Is there anything that governments or central banks could do to support the global economy?*

WDV: In the developed countries, the options on the fiscal front are quite limited, either for economic or for political reasons. It is clear that many countries in the eurozone can only go as far as implementing strict austerity. According to the IMF, Germany and the US have room to stimulate their economies in the near term, but we don't see the political will to do much.

JvL: There is room for further monetary stimulus, but I have doubts about the effectiveness, even though interest rates are not the only central bank tool. The ECB should continue to give unlimited liquidity to banks for most of 2012. The US Federal Reserve has already said that it will keep rates low through to mid-2013 and embarked on Operation Twist, selling short-term Treasuries from its portfolio and buying longer-dated paper to 'twist' longer yields lower. But, in October, the Fed strongly cut its growth outlook for 2012 and 2013 and an increasing number of Fed officials have spoken about additional stimulus: I would therefore not rule out another round of quantitative easing, a QE3 most likely targeted at mortgage rates and the housing market.

¹ Titled *2012: a frugal and crucial year*, this document presents our views and market outlook for 2012 at the five main investment opportunities we recommend. It is available in English and five other languages from your CRM as well as our internet site

WDV: In emerging economies, the fact that the central banks have much more room to cut rates, and have in some countries already started to do so, is one of the reasons why we see better growth prospects there and why we are more positive on emerging equities than on developed equities.

P: Equities are relatively cheap at the moment; do you think that the time has come to increase exposure to equities?

JVL: Valuations may not be the key market driver in 2012 because macroeconomic and political developments will be more important and I'm not too optimistic on those points. I do not foresee a lasting rally for now. If appropriate policy measures are taken and investor confidence improves, we could see a more lasting upturn later in 2012, but this is shrouded in uncertainty.

P: Regarding equities, which are your favourite regions?

WDV: The US may do better than Europe for reasons such as structurally higher growth, a more aggressive central bank and less acute fiscal challenges. US equities also tend to be more defensive in a downturn, but valuations are lower in Europe and earnings expectations are more modest. Valuations are certainly low for Japan, which may be a compelling argument, but investors should bear in mind that many Japanese companies are geared towards the global economy and may continue to struggle with a strong yen.

JVL: There are many arguments in favour of emerging equities. Emerging market growth has continued to be faster than in many developed economies and I do not expect this to change much. Emerging countries have favourable demographics and do not have to deleverage. I also think emerging equities are attractively valued relative to developed equities. Of course, emerging equities cannot escape the gravity of falling developed markets and are therefore vulnerable to shocks, nevertheless we have a positive outlook on this asset class, especially relative to developed equities.

P: What are your recommendations for fixed income?

WDV: Credit tends to outperform equities and government bonds in a low-growth environment in which companies are forced to focus on their core activities. They are less likely to embark on adventurous investment projects or mergers and acquisitions and companies do not have to deleverage. Defaults could rise from the current low levels, but I think only to a limited extent. Due to the larger exposure to banks, we are therefore more reluctant to increase exposure in investment-grade bonds than in high-yield bonds, even though investment-grade bonds may be more attractively valued on a relative basis. We don't see the need to step up our purchases in this asset class quickly as recession fears may cause further spread widening in the near term and liquidity has worsened lately.

JVL: I'm not too optimistic on government bonds. Of course they can offer some downside protection in the case of a recession. But current yields can hardly compensate investors for inflation. I don't expect yields to rise by much in this low-growth, low-inflation environment, but with yields as low as they are, even small increases can lead to negative returns. Rather, I see opportunities in emerging fixed income. Fiscal positions are much stronger in emerging markets in general and falling inflation and lower official rates may boost this asset class in 2012. The resilience of emerging market growth may also lead to currency appreciation.



Jean-Marie Piriou
Head of quantitative analysis
FundQuest

How to select flexible funds

The recent crises have generated renewed interest for flexible allocation funds, with active management strategies designed to dampen shocks when the market falls. However, faced with an offer that is now very large and diverse, selecting the right investment medium can be more complicated than it might seem. How to achieve this was the theme of a study¹ by FundQuest and in this article we present the main findings.

Difficulty in identifying flexible funds

The asset allocation fund universe covers two management styles: profiled funds and flexible funds. The former are managed against a composite index resulting from a fixed allocation between equities and bonds. Conversely, flexible funds actively manage their exposure to risky assets during the market cycle.

Distinguishing flexible funds from profiled funds is not straightforward, as it involves identifying both a difference in the degree of risk and a difference of nature (profiled or flexible) in a diverse universe. One must therefore determine how much risk will arise from the leeway that the manager allows himself as part of his active management of exposure to risky assets. Fixing the exposure variation threshold, based on which a fund is defined as profiled or flexible, is thus the key issue governing classification; however, since these thresholds relate to the whole universe, they can only be determined satisfactorily after establishing the overall spectrum of behaviours forming the universe.

The difficulty in classifying profiled funds and flexible funds is thus due less to the definition than the methodology. Analysis of the categories defined by data providers highlights sufficiently large divergences to justify the choice of performing segmentation of the universe ourselves: on an equivalent basis¹, 44% of the asset allocation funds regarded as flexible by Lipper are profiled

funds for MorningStar. Therefore, adoption of these categories introduces a major bias in any analysis.

Characterising flexible funds

Since performance is an outcome of the risk accepted, the criteria for defining flexible funds are basically indicators of risk taking - one can observe both the absolute level and changes during the market cycle. One sees significant changes in exposure between bull and bear markets in the case of flexible funds when profiled funds maintain a constant exposure. Thus, there is a significant increase in the betas, volatility and tracking errors of flexible funds in bull markets by comparison with profiled funds, even though these indicators seemed similar in bear markets.

The flexible sub-groups reveal value added in selection

The statistics for the group averages mask major disparities. Based on the risk/reward ratios over the whole universe (see table), flexible funds seem less attractive than their profiled peers: for a volatility of 14.5%, the Flexible Moderate (Risk) funds post an average cumulative return of -6.3% over three years, whereas the balanced profiled funds achieve -5.4% for a volatility of 12.5%. This observation is valid for all the flexible groups.

Moreover, on average all the groups significantly underperform their respective indices²

¹ See the full article "Flexible Funds", 2011, FundQuest, available in English from your Client Relationship Manager.

² Composite balanced European index comprising 50% equities and 50% bonds; conservative: 1/3 equities; dynamic: 2/3 equities; the equities index is the MSCI Europe NR and the bond index is Barcap Euro Aggregate

Divergences between universes, 1st decile and 1st quartile

| Period: 31/12/2007 - 31/12/2010 | UNIVERSE | | | 1 ST DECILE | | 1 ST QUARTILE | |
|---------------------------------|----------|-------|------|------------------------|------|--------------------------|------|
| | Fund No | Ret. | Vol. | Ret. | Vol. | Ret. | Vol. |
| Indexes & Peer Groups | | | | | | | |
| Conservative EUR Composite | | 5.2 | 9.0 | | | | |
| Balanced EUR Composite | | -0.5 | 13.4 | | | | |
| Dynamic EUR Composite | | -6.2 | 18.2 | | | | |
| Conservative | 318 | 1.4 | 5.5 | 11.4 | 5.4 | 9.6 | 5.3 |
| Balanced | 134 | -5.4 | 12.5 | 3.4 | 11.8 | 2.1 | 12.0 |
| Dynamic | 113 | -13.3 | 19.7 | -3.7 | 19.1 | -2.9 | 19.8 |
| Flexible low risk | 135 | -2.0 | 8.1 | 16.3 | 7.8 | 13.3 | 8.4 |
| Flexible medium risk | 88 | -6.3 | 14.5 | 14.3 | 13.8 | 16.9 | 14.4 |
| Flexible high risk | 71 | -14.3 | 18.5 | 12.6 | 18.1 | 6.1 | 18.5 |
| Flexible | 294 | -6.3 | 12.5 | 14.8 | 12.0 | 12.7 | 12.6 |

Source: FundQuest

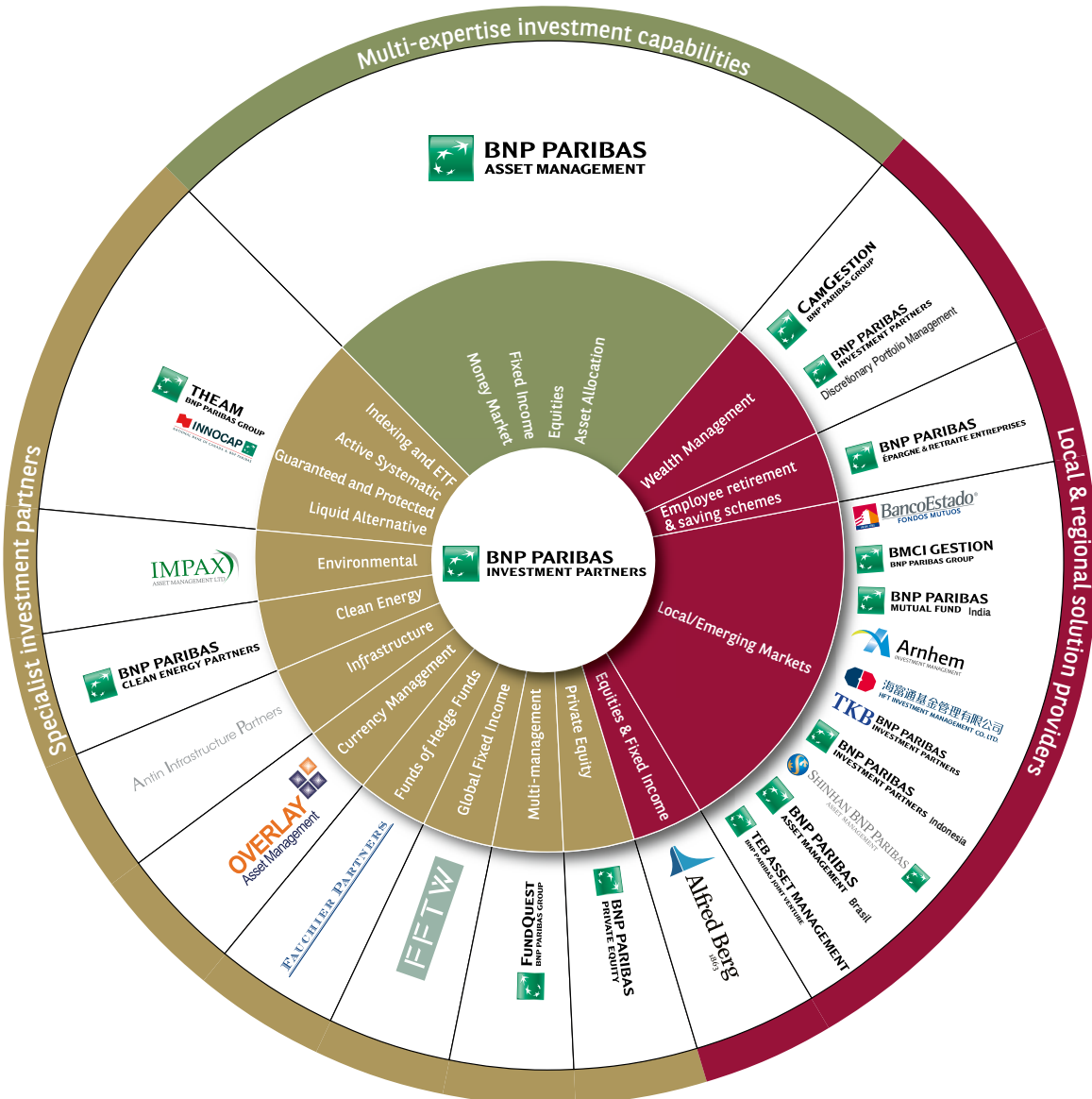
On the contrary, the perception of the respective interest of each group changes radically when examining the first decile: in this case, in addition to largely outperforming their respective indices, the best 10% of flexible funds offer a risk/reward ratio far superior to the best 10% of profiled funds, whatever the risk category targeted by the investor (14.3% for Flexible Moderate Risk versus 3.4% for Profiled Balanced, etc.). The same remarks are valid for the first quartile.

This can be explained by the great diversity of profiles covered by flexible funds, resulting in greater disparity of returns and risks. Piling these heterogeneous funds into a single group does not allow efficient selection; conversely, the establishment of sub-groups of funds with more homogeneous behaviour favours comparison and the extraction of alpha, and makes it possible to hope we can reproduce this behaviour over time.

In conclusion, our flexible funds study makes clear the strong added value that is in the sub-group, as long as there is rigorous selection within an asset class wherein the vast majority of funds significantly underperform the universe.



Expertise



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