



Weekly Strategy Update

22 December 2011



SUMMARY

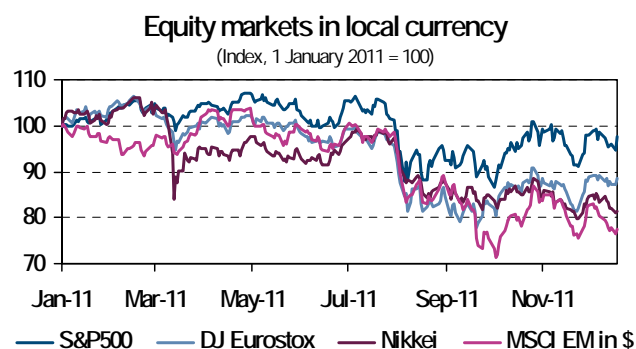
- Improved momentum in US economy, but no strong growth
- High interest in ECB's 3-year loans
- Strategy and allocation unchanged

Momentum continued to improve in the US economy, but we doubt it is strong enough to morph into a sustainable recovery. We think that developments in the eurozone sovereign debt crisis are moving in the right direction, but given the slow pace and the many structural issues still to be addressed, markets are still likely to be volatile. We have left our investment strategy recommendations and our asset allocation unchanged, remaining cautious on risky assets.

RANGE TRADING EQUITIES

With the end of the year approaching, US equities (measured by the S&P500 equity index) are on the way to a flat performance for the year, while European equities are down by 10%. Japanese and emerging equities are about 20% lower than they were at the end of 2010. The big moves in equity markets this year were the plunge in July/August, when eurozone leaders could not find a comprehensive plan to address the eurozone fiscal crisis, US politicians were bickering about the government debt ceiling, the US economy appeared to be

heading for another recession and emerging markets were faced with rising inflation. Markets recovered strongly in October when recession fears and inflation threats ebbed. Since the middle of October, equity markets have moved sideways in a fairly wide range. The question now is what could push markets out of this range.



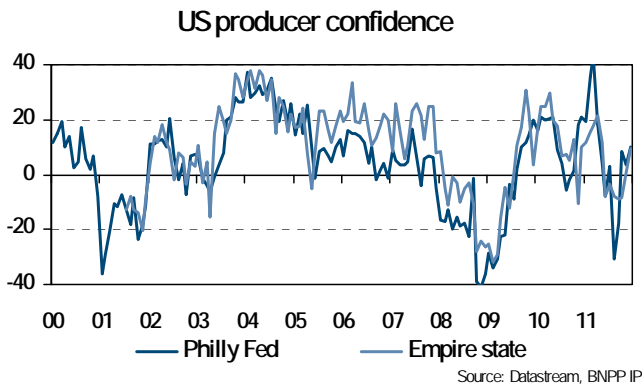
Source: Datastream, BNPP IP

IMPROVED MOMENTUM IN THE US

A move to the upside could come from further improvement in the US economy. Most data have surprised to the upside for quite a while now and this continued in the past week. The first two regional PMIs to be published for December – the Empire manufacturing PMI and the Philly Fed index – both improved from their November levels and were higher than expected. Looking



back, industrial production fell by 0.2% in November, keeping the annual growth rate in its downward trend.



Initial jobless claims fell sharply in the past week to a post-recession low. The four-week moving average, which mitigates weekly fluctuations, fell to a cycle low. Taken at face value, the current level of claims indicates monthly job growth of around 150 000, which is not strong and not enough to sustainably reduce the unemployment rate. There is one other reason to be cautious and that is that the decline was very steep and we now have only one week of such positive data. Although the US Department of Labor, which provides this data, did not report any special circumstances, weekly jobless claims can be volatile around this time of the year due to seasonal adjustment difficulties.

Housing starts and building permits surged in November and confidence among homebuilders improved further in December. The strongest gains were in the multi-family category, which reflects stronger demand for rental homes. Building activity is currently recovering from a dip earlier this year. Population growth argues for stronger activity, but the still large overhang for unsold homes should curb activity. Existing home sales increased 4.5% MoM in November. Sales data from 2007 onwards were revised much lower, but the uptrend in the past few months is a bit stronger according to the new data.

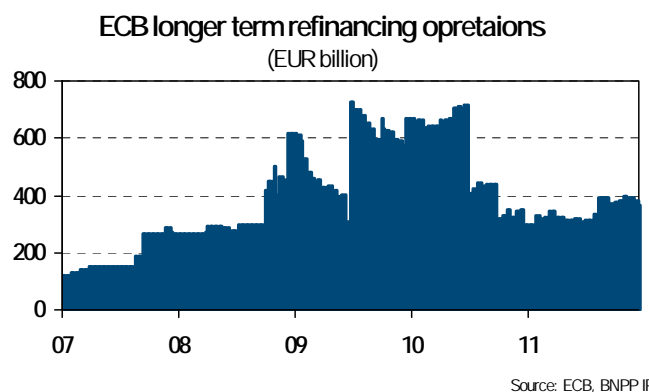
Looking at the latest economic data, we conclude that momentum has improved, but we doubt it is strong enough to lift the US to a higher growth path. We think the US outlook is more or less neutral for equities and will not push them out of their trading range.

QE ECB STYLE?

We see the situation in Europe as negative for equities. Eurozone leaders agreed to lend EUR 150 billion to the

IMF, which is less than the EUR 200 billion announced after the 8-9 December EU summit because the UK refused to join in. To please Germany, the money was not earmarked for Europe, but it is clear to us that the eurozone sovereign debt crisis was the main reason for this exercise. EUR 150 billion is a lot and can be added to the EFSF, the eurozone bailout fund, which (after what is needed for Greece, Ireland and Portugal) has just over EUR 300 billion left. However, given the pace at which the ECB has bought bonds since the middle of August (on average EUR 7.3 billion a week for a total EUR 139 billion), one can seriously question if this will be enough. Spain and Italy face large bond redemptions in January and February. Furthermore, EUR 150 billion is a far cry from the amounts of up to EUR 2 trillion which were discussed only a few months ago in relation to leveraging up the EFSF.

Risk spreads on eurozone sovereign bonds narrowed in the past week. For Spain, this could be due to the austerity measures announced by the new administration. These should put the country on the right path again since it looks set to miss its budget deficit target this year. However, the measures could hurt economic growth. Spain managed to sell three- and six-month bills at only half the interest rates paid at the end of November.



Another argument for the decline in spreads is the three-year loans from the ECB to eurozone banks. Estimates for the take-up ranged from EUR 150 billion to EUR 600 billion, with a median estimate of EUR 293 billion. Actual demand was for EUR 489 billion. To put this in perspective, banks are currently borrowing almost EUR 400 billion from the ECB through shorter maturity loans. The new 3-year loans will at least partly replace the current loans. In 2009/10 such loans peaked around EUR 700 billion. And according to the Bank of England's financial stability report banks need to refinance EUR 600 billion of maturing debt in 2012. The idea appears to be that banks use these loans to buy government bonds and



benefit from the difference in the rate paid to the ECB and the yield received on these bonds. This would be an indirect form of quantitative easing by the ECB.

We do not believe this will work. European banks have been deleveraging and have trimmed their positions in 'peripheral' government bonds. We do not expect them to return to these markets with meaningful amounts. When asked in an interview by the Financial Times, ECB president Draghi dodged this issue by saying that the purpose of the ECB loans was to provide liquidity to the banking system and the ECB did not intend to support 'peripheral bond markets'. Draghi once again underscored the reluctance on the part of the ECB to buy 'peripheral' bonds, saying that the ECB's bond purchase programme is *"neither eternal nor infinite"*.

Economic data from the eurozone continued to be weak, although the German Ifo business climate index surprised positively with a second straight monthly gain. The services and manufacturing PMIs for the eurozone improved a bit in December, but both stayed firmly below 50, pointing to a contracting economy. Industrial production was flat MoM in November, while the annual growth rate fell to a paltry 1.3%. Construction output fell for the third month in a row in October and employment fell slightly in the third quarter in the first quarterly decline since the last quarter of 2009.

HARD LANDING IN CHINA?

A hard landing in China would push equities lower. We see this as a risk, but it is not our main scenario. Sure, property prices may have risen too quickly in some cities and there has been speculative overbuilding, but given the generally low indebtedness of Chinese households and the limited investment choices, we do not think that the property bubble is big enough to cause a hard landing. The flash estimate of the HSBC manufacturing PMI came in at 49.0, up from 47.7 in November. Data on foreign direct investment in November drew attention last week showing the first fall since July 2009. However, one month of decline does not mean that foreign investors are massively pulling out of China. The Chinese renminbi fell a bit in November, but resumed its trend of appreciation in December. Growth in bank loans and the money supply has slowed in reaction to the monetary tightening from 2009 to November this year, but at 12.7% YoY, money supply growth still does not look overly contractionary to us for an economy growing at around

14% YoY in nominal terms. Moreover, the People's Bank of China has already started to ease.

INVESTMENT STRATEGY RECOMMENDATIONS

We have not changed our investment strategy recommendations. We expect markets to remain volatile and risk appetite limited due to economic concerns and the perception that sovereign risk is high in advanced economies. Volatility would also reflect the structural worries about the balance of debt in mature economies, which go beyond the muted short-term economic climate.

Our view on risky assets remains bearish. We are negative on developed equities. Apparently low valuations are not that attractive in our view, when taking the fundamentals into account. Lower future growth should constrain price-earnings multiples. We are neutral on emerging equities. Valuations are fair in our view, inflation is easing and monetary policy could become supportive. However, we do not see the weakening macroeconomic cycle as supporting higher valuations.

In fixed income, we remain neutral on government bonds, investment-grade and high-yield corporate bonds as well as local and foreign currency emerging market debt. Government bonds should offer some protection in a downturn, but prices are relatively high. Corporate bonds could be attractive in a low-growth environment, but for us, the risk of spread widening is too high to recommend this asset class.

In commodities, we are only positive on gold since we continue to foresee strong investor demand.

GBS ASSET ALLOCATION

We have not changed our asset allocation. We are modestly underweight equities due to our bearish economic outlook. We are negative on the market environment which reflects the unrest in the eurozone bond markets, the unfavourable climate for IPOs and M&A and the funding problems for banks. We see monetary policy as positive. This could even improve if the US Federal Reserve embarks on another round of quantitative easing (QE3). At this point though, we do not see this as compensating for the negative factors. Since analysts are still revising down their estimates for company earnings, we do not foresee a lasting rally. However, we stand ready to exploit tactical opportunities, which is why we are overweight cash. Regionally, we



continue to underweight Europe versus the US, we are underweight Japan and overweight emerging markets.

We are neutral on bonds generally with an underweight in government bonds. Our neutral duration position reflects the view that we do not foresee meaningful changes in yields soon. We are neutral on inflation-linked bonds, high-yield bonds and US dollar denominated emerging market bonds. We have a small overweight in local currency emerging market debt. We are neutral on real estate globally and regionally (US, Europe and Asia), on commodities and on convertible bonds.

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