BNP PARIBAS
INVESTMENT PARTNERS | The asset manager for a changing world

PERSPECTIVES

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Increasing policy divergence

Monetary policy between major regions is increasingly diverging. In the US, the Federal Reserve will slow down Quantitative Easing: QE (`tapering') and stop it altogether by the middle of next year. Investors, paid to anticipate, started focusing immediately on the timing of the first rate hike and though this is about 18 months away, it was sufficient to cause some asset classes, such as US Treasuries, to sell off. In Europe, both Mario Draghi of the ECB and Mark Carney of the Bank of England created a welcome surprise by giving forward guidance on monetary policy in an effort to push down the long end of the respective yield curves after these had steepened on the back of the rise in US yields.

In Japan, non-conventional policy continues unabated. Finally in China, nerves have been stretched as investors have been struggling to assess the rationale and consequences of the squeeze in the interbank market. The real economic consequences, if any, will only manifest themselves in a couple of months' time but in the meantime, investors are concerned about risks of a hard landing.

Markets tend to overshoot in periods of great change, such as we're experiencing currently in the US. Corporate and emerging market bond spreads in general have risen too strongly. For yield hungry investors this creates interesting entry points though, more than ever, there is a need for selectivity. On the equity side, the twin engines of earnings growth and monetary impulses will function at different speeds depending on the region. Expect the equity markets' performance dispersion to increase.

8 July 2013

William De Vijlder
Chief Investment Officer,
Strategy and Partners

Nathalie Benatia
Strategist – BNPP AM, Paris

What is going on in the minds of central bankers?

Recent policy announcements by central bankers have triggered major moves in financial markets. Nathalie Benatia looks at the factors behind the main policy decisions and explains why, in her view, markets may have overreacted in some instances.

In recent weeks, central bankers have once again been the focus of everyone's attention[1]. The Bank of Japan (BoJ) first stole the show from its counterparts by announcing in April that it aims to double its monetary base in two years. Not to be outdone, the European Central Bank (ECB) hinted that the 2 May cut in its key rate to 0.5% would not necessarily be the last. In several emerging countries (South Korea, India, Turkey, etc.), central banks have lowered their policy rates to counter the economic slowdown.

What caught the most attention, though, was the prospect of seeing the US Federal Reserve taper off its bond purchases towards the end of this year. Since Fed chairman Bernanke's 22 May statement that bond purchases could be reduced should economic activity continue to improve, long-term interest rates have risen significantly. At the same time, equities have traded more hesitantly and drastic adjustments in positions have been seen in several asset classes; in particular, there have been major outflows from emerging equities. This investor nervousness also resulted in the unwinding of yen carry positions. The rally in risk assets had previously been fuelled by liquidity, even though the economic environment is hesitant and corporate earnings prospects do not seem very robust.

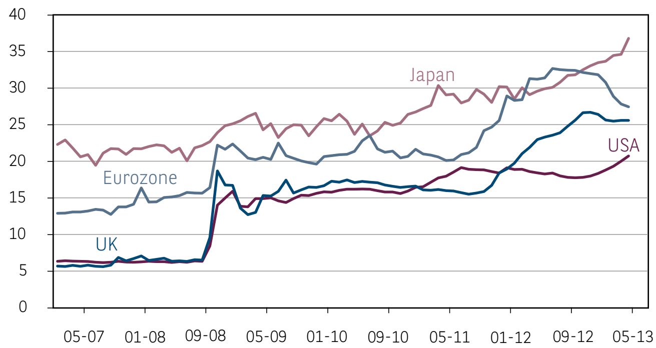
Communication slightly less under control?

Following the substantial increase in the central banks' balance sheets since October 2008 (see chart), debate concerning the future of these extension measures is regularly revived, while on the whole, economic activity remains disappointing[2]. Since the start of the year, investors have viewed the Federal Open Market Committee's (FOMC) discussions as indicative of a premature halt to bond purchases. In fact, possibly to avoid upsetting some sensitivities, Ben Bernanke has gradually shifted from saying that the benefits of continuing QE largely outweighed the drawbacks, to an announcement – at the end of the monetary policy meeting of 18/19 June – that bond purchases would be tapered off by the end of the year and halted in mid-2014. Investors were hoping for something more reassuring. Mr. Bernanke tried to qualify his statements by reminding us that monetary policy would depend on how the economy performs, that the Fed would continue to provide all the necessary support, that a fall in the unemployment rate below 6.5% would not automatically entail a hike in the key rates[3] and, finally, that during the QE3 exit phase, the Fed will not sell MBS but will hold them until maturity.

To use a rather hackneyed image, the Fed is on a tightrope: it must gradually wean market operators off the abundant liquidity supply without jeopardising economic recovery or causing excessively violent movements in financial markets. The FOMC has tied the tapering of QE to quite a number of conditions, but commentators have paid little attention to these and focused instead on the risk that 'the punchbowl disappears at the end of the year'. The Fed is mindful of the "stock" (i.e. the size of its balance sheet), which will continue to increase, albeit more slowly, whereas investors are more focused on the monthly buying "flows". They interpret this decision as monetary tightening, which it is not, or at least not yet. Ben Bernanke still has a few months to clarify this point, because he apparently does not want a third term in office. His monetary policy speech before Congress in mid-July would seem an ideal occasion to do so.

Misgivings are starting to surface regarding further unconventional credit support measures by the ECB; the BoJ must yet prove that it is itself convinced of the validity of its monetary policy; and pressure on the Shibor rate[4] is raising questions about the Chinese Central Bank's (PBoC) strategy for dealing with the shadow banking system. Despite all this, the Fed will almost certainly play the leading role in the coming months, and the appointment of its next chairman by Barack Obama could even be the saga of the summer. We hope this will be a radiant summer for you in every respect.

Total assets of central banks as a % of nominal GDP



Source: Bloomberg, Factset, BNPP AM

1 Except perhaps for those more interested in the Cannes Film Festival, the Roland-Garros tennis or the imminent birth of the heir to the British Crown, and we cannot blame them.
2 According to the initial figures available, world growth was 1.7% year-on-year in Q1, its lowest rate since mid-2009. For OECD countries, it stood at 0.8%.
3 This will not take place before 2015.
4 Shanghai Interbank Offered Rate.

Grégoire Rifaut
Investment specialist emerging market fixed income - BNPP IP, London

Where now for emerging market corporate debt?

Grégoire Rifaut, Investment specialist emerging market fixed income, explains why, in his view, prospects for emerging market corporate debt remain bright.

In our last Perspectives article (April 2013), we saw the still-developing emerging market (EM) corporate universe as offering better risk premiums, particularly for bonds rated BBB and B, for a given amount of leverage[1] than other credit sectors. We think this subject is worth revisiting after the US Fed's recent announcement that it might start to taper quantitative easing (QE) later this year.

Risk assets have been hit hard by the Fed's announcement. Risk premiums have jumped sharply at the signalling of QE tapering, which effectively acts as a form of global margin call. Risk assets tend to pause at the start of rate-hiking cycles, then outperform early on in monetary tightening periods – particularly when hikes are linked more to stronger growth and higher yields than to higher inflation.

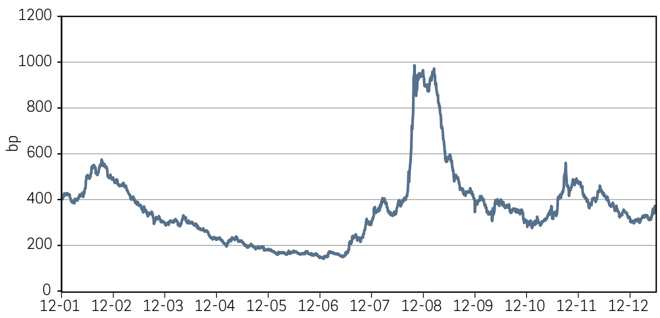
We thus see the recent correction in risk assets as an overreaction. What's likely to happen as markets settle is that yield increases will slow, volatility will ease and the rally in risk assets will resume. We expect spread sectors to outperform significantly from their current levels over the rest of this year, especially sectors such as EM external and local currency debt.

Valuations more attractive

Emerging market corporate debt yields, as measured by the JPM CEMBI Broad Diversified index, rose from a low of 4.43% in January 2013 to 5.60% as of 28 June. All EM asset classes posted negative returns in May-June with emerging corporates returning – 3.7% in June. This is a direct reaction to the prospect of rate normalisation in US Treasuries coupled with a worsening of sentiment on China and growth prospects for emerging markets.

Though we expect short-term market volatility, we remain positive on the asset class as we see it as a good buying opportunity, for the reasons outlined above. EM corporates have a wider spread component that can evolve independently from the risk-free rate and help mitigate the ill-effects of US interest rates normalising. This spread cushion in the corporate market is currently at 3.50% (source: JP Morgan as of 28/06/13). We believe it could tighten as valuations become more attractive and fundamentals improve. Also, these companies have sound business models and are increasingly focusing on corporate governance. We believe solid credit fundamentals and a resilient business model are necessary for portfolio positioning and overall investment decisions. Where this is not applied, we may see dislocated pricing, which could offer a good buying opportunity.

Emerging market corporate spread



Source: JP Morgan as of 24/06/2013

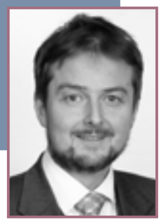
Good opportunity

At the same time, the indiscriminate sell-off we saw in May and June creates relative value trade opportunities, so we actively traded during the month. We did, for example, some relative value trades in the Middle East Financials. Spreads on some systemic subordinated bonds were above 650bp, which represents a good opportunity given the strong fundamentals.

We have reduced the risk in our portfolio by selling longer-dated bonds and non-investment grade credits. The rest of 2013 should be a period of relative value and credit selection rather than beta returns. In the past, security selection has been the source of most of our performance. We are looking carefully at markets, seeking bonds issued by companies that are undervalued relative to their fundamentals and their peers.

1 The level of risk premium paid by a corporate issuer can be compared to its debt load. For example, in January 2013 EM corporate spreads per turn of net leverage were around 103bp versus 161bp for the same BBB rating in US corporates (source: Bank of America, Merrill Lynch, January 2013). A one-to-one ratio between debt and EBITDA counts as one "turn of leverage" or debt equal to one year's earnings.

All data as of end of June 2013 unless specified.



Arne Eidshagen
Senior portfolio manager of Norwegian fixed income, Alfred Berg

Go north, high yield investor

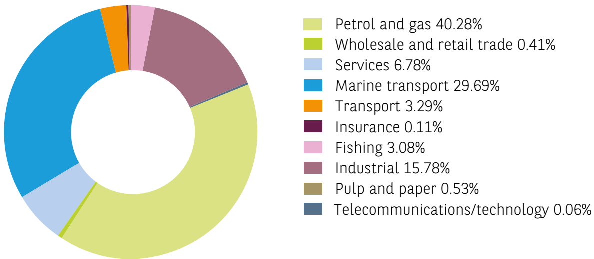
The Nordic high yield bond market has grown rapidly in recent years on the back of corporate demand for financing and investor appetite for yield. Previously, the market was dominated by domestic investors, but investors from outside the country are increasingly taking an interest says Arne Eidshagen, senior portfolio manager of Norwegian fixed income.

Although returns can be very attractive, we do not consider investing in Norwegian and Swedish fixed income to be very risky. Investors in Nordic bonds can earn relatively high credit spreads – on average 7%[1] – over the Norwegian krone three-month interbank rate. Spreads are this wide because issuers are competing for capital, often not available from banks or the equity market, so they have to pay a premium. There is also an illiquidity premium: many issuers are relatively small companies and issue size modest. These two premiums produce an attractively high yield. Also interest-rate risk in the Norwegian bond market is structurally low, which is attractive in the current environment with the first signs elsewhere of rising interest rates. Safe-haven buying of the Norwegian krone (related to the eurozone sovereign debt crisis) has benefited many issuers and market sentiment in general, helping returns.

Investors are attracted to this asset class because they are searching for a high yield investment in countries with strong economies and solid currencies. Asset flows into the Scandinavian bond market have been particularly strong: local bond funds have been among the top collectors of money. This reflects the social and political stability of these economies, government finances that are generally in better shape than in the eurozone and their positive prospects. This healthy macroeconomic backdrop mixed with the yields that can be earned on high yield corporate bonds, demonstrates the obvious attractions for investors independent of whether they are worried about the outlook for the euro, the shape of US government finances or the fortunes of the Chinese or Japanese economies – Nordic bonds provide a safe haven. Over more than 20 years global high yield bonds have outperformed investment grade and government bonds[2]. So for investors still hesitant about the stock market, but also deterred by government bonds or bank deposits offering such low rates, we believe the Nordic high yield credit market is a good place to be.

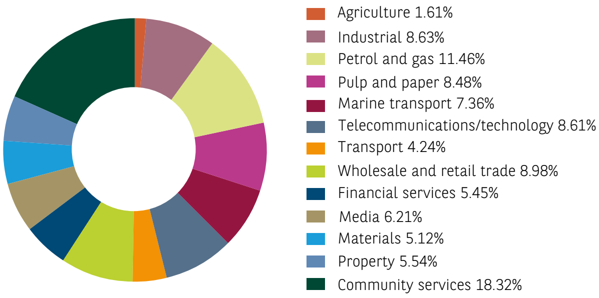
Undeniably, there is credit risk, which is closely related to the nature of the issuers. Many come from the maritime and oil & gas sectors where business can be quite volatile due to, for instance, swings in the price of crude oil or demand for ships. Also, many of these companies are relatively small, which means they are not covered by financial analysts or do not have credit ratings by the main agencies. To determine what shape they are in financially, we analyse the company fundamentals in-depth, including the strength of the management, and assess the probability of a default. Finally, we vet the bonds to ensure that management policies are bond-friendly and the financial strategy is conservative. After all, if there is a default, you want to know there is value left. We would recommend that investors focus on names with strong cash flow.

Norwegian high yield bond market by sector



Source: Alfred Berg, Barclay Capital, Norwegian Trustee, Nordea, Nordic Fixed Income, Bloomberg ; March 2013

Swedish high yield bond market by sector



Source: Alfred Berg, Barclays Capital, Swedish Trustee, Öhman, Nordea, Nordic Fixed Income, Bloomberg ; March 2013

To help investors reduce these risks, we believe strongly in spreading risk, especially in a market where many issuers are small and from volatile sectors. Admittedly, Norwegian high yield makes up the largest part of this market, as it is the most developed Nordic market and one where we believe relative valuations are still good. We feel it is important to look outside of this market, and its large oil & gas sector, since there will inevitably be a point when wells run dry and demand for financing ceases. We do not see this happening at any point in the foreseeable future, but investors could consider investing more in Sweden to diversify the sector exposure. Overall, we expect 2013 to be another year of solid performance in the Nordic high yield market where company demand for financing should remain high, international investor demand for high yield should stay strong and default rates should remain attractively low.

1 Source: Alfred Berg. Past performance is not indicative of future returns.
2 Source: Alfred Berg.

Andrew Craig
Head of financial market analysis and the Publication Centre - BNPP IP, Paris

Imploding populations in Japan and Germany

The notion of population implosion refers to rapid demographic decline in the absence of any of the traditional checks on population growth such as large-scale violence, pestilence, insufficient food supply or other negative external forces; or, to put it more cautiously, without any exogenous forces.

The term "population implosion" is used to describe the situation, prevalent in most developed countries, where birth rates have been below replacement rates for more than three decades. If this term sounds somewhat sensationalist in describing low fertility in the developed world, think again. That's the advice of the authors of a recently published book entitled "Imploding Populations in Japan and Germany"[1]. Depopulation, they advise, is a novel phenomenon, but more importantly, it's a dramatic phenomenon, without precedent anywhere at any time in human history.

Japan's projected population loss over the next 50 years is predicted at between 28.2 million (assuming relatively high fertility and low mortality), and 45.4 million (assuming low fertility and high mortality). However the population develops, it is a striking change and one without precedent anywhere at any time in human history.

Within Europe, Germany is at the forefront of population loss. Since 1972, the number of new-borns has not exceeded the number of deaths in a single year. Until 2003, population decline was masked by high rates of immigration. Since then, the overall population has shrunk by more than half a million. The Federal Statistics Office expects that Germany will have 12 million fewer inhabitants by 2060.

The broad underlying historical causes of fertility decline that lead to depopulation are still poorly understood. The phenomenon is complex, involving an interaction between, on one hand, economic, political and social change, and, on the other, population dynamics.

In Japan and countries such as South Korea, Taiwan and the German-speaking, Mediterranean and eastern European countries, the fertility rate falls far short of the death rate. Some researchers argue that fertility levels could rise from their current lows, but it is generally held to be 'evident' that these countries are set to undergo rapid depopulation in the decades to come.

These are however extremely hard to predict. Hence the dynamics of depopulation not only cross national borders, they also concern a known unknown. Experience cannot be a guide.

Population implosion heralds an age of uncertainty:
- Can the high standard of living and the characteristic of imploding societies be sustained as the labour force shrinks in the wake of population ageing?
- Is a zero-growth economy sustainable in the long run?

> "Longevity and immigration are the two factors that can counteract population decline"

- Can increased immigration alleviate the problems?
- How will industry adjust to fewer and older consumers with different needs and demands?
- Will social security funding be sustainable?
- And can a new equilibrium between working and retired people be found?

These are just a few of the questions that arise in the face of population ageing and implosion. Developing policies to address these questions is a huge challenge for governments because there is no precedent. For asset managers, there are of course factors already driving secular trends in financial markets and creating opportunities for investors.

1 Imploding Populations in Japan and German, A Comparison, Edited by Florian Coulmas and Ralph Lützeler, 2011.

Interview
SPOTLIGHT

William De Vijlder
Chief Investment Officer, Strategy and Partners

Mid-year outlook: status quo rockin' all over the world

Equity markets got off to a good start in 2013 as risks to the global economy decreased and support from central bank stimulus remained strong, while bond yields stayed low and credit risk spreads narrowed. Investors were still faced with relatively low returns, but now there are signs that the status quo will not last. Joost van Leenders (JvL), investment specialist - allocation & strategy, and William De Vijlder (WDV), CIO Strategy & Partners, discuss the latest developments and their implications for investing in the second half.

***JvL:** What has changed in the first half?*

WDV: I see six major changes. Firstly, eurozone policymakers are easing up on austerity, acknowledging its negative impact on weak economies. Secondly, markets are clearly focusing on when the pro-growth quantitative easing in the US will be wound down. Thirdly, massive quantitative easing in Japan has raised questions about how much monetary policy can achieve to support growth. As a fourth change, valuations across asset classes are gaining in importance for investors. Fifth, correlations between asset classes are shifting and finally, recent bailout policies in the eurozone are pointing to a greater role for shareholders and large depositors.

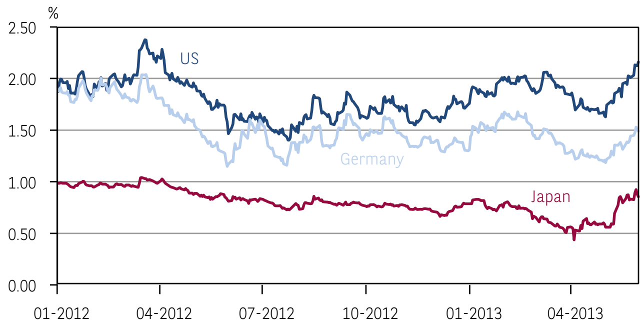
***JvL:** Let's look at these in detail. What was the IMF's role in the change in attitude towards austerity?*

WDV: It has adjusted its views: IMF research has shown that growth was mostly overestimated in countries with the largest fiscal adjustments, while the impact of austerity was underestimated. The recent discussion about thresholds for government debt beyond which growth slows has also had an impact. While textbooks suggest that rapid fiscal consolidation should lower bond yields, in practice the opposite happened: yields rose as austerity curbed growth and questions arose about the sustainability of government debt levels. The ECB's launch of Outright Monetary Transactions (OMTs) changed investor perceptions of risk in 'peripheral' eurozone countries, breaking this negative spiral and lowering yields. But I think the room for less austerity is limited.
So while the possibility of the ECB buying bonds should help keep yields low, I do not see room for strong boosts to growth in the eurozone 'periphery' either.

***JvL:** The end of quantitative easing (QE) in the US has rattled markets recently. What do you think the Federal Reserve will do next?*

WDV: A few strong labour market reports could see the Fed slow, or 'taper', its asset purchases in support of growth and employment as early as September. But if growth slows under the weight of the recent tax hikes and government spending cuts – and signs of this are emerging – the Fed may wait. The impact of QE on markets should not be underestimated: it boosted equities and depressed yields on many asset classes, driving investors to search for yields in areas that they might feel less at ease with. I think that for equities to rise after QE ends, earnings expectations will have to be revised upwards, risk perceptions should fall or risk premiums should narrow further. The extent to which any of this will happen in the second half is limited in my view.

10-year government bond yields have risen in anticipation of QE end



Source: Datastream, BNP Paribas Investment Partners ; June 2013

***JvL:** In Japan, 'Abenomics' initially boosted equities and depressed the Japanese yen, but recently, markets have corrected. Does this show the limits of what monetary policy can do?*

WDV: Yes, to some extent. Rates are either at zero per cent or close to it in all major economies, shifting the onus onto other measures such as quantitative easing. But this policy stops working once risk premiums are low, as they are in Japan, and where bond yields are extremely low too.
The ECB has a different issue to grapple with: it is not allowed to finance government deficits through monetary policy. It has had to come up with the OMTs to support interbank and government bond markets. But this has not led to the revival of bank lending needed to lift growth.

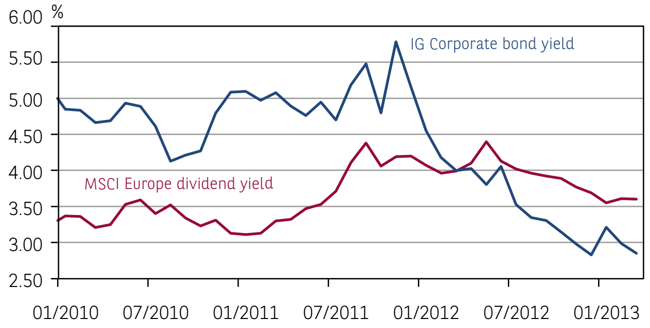
Joost van Leenders
Investment specialist allocation & strategy - BNPP IP, Amsterdam

JvL: Do you think central banks have blown asset bubbles?

WDV: Generally, no. The low US, German and Japanese government bond yields can be explained by market expectations of low official rates, low growth and low inflation. If growth picks up, yields will likely rise and bonds would suffer. But I do not see this as a near-term risk.

On equities, we don't see valuations in general as extreme. The Shiller price-earnings ratio which evens out cyclical fluctuations indicates that US equities are becoming expensive, while European and emerging equities are valued attractively. But earnings growth in emerging markets is even weaker than in developed markets, leaving us tactically neutral on EM equities. Probably the closest to a bubble are corporate bonds. Investment-grade spreads have fallen to, or are near, record lows, motivating us to go overweight in European equities versus European IG credit. In terms of yields, European equities offer a dividend yield of nearly 3.5%, while the yield on IG credit is just below 3%. Corporate credit also looks like a crowded trade to us.

European equities now offer yield pick-up over credit



Source: Bloomberg, BNP Paribas Investment Partners ; June 2013

JvL: What do the changes in correlations between asset classes and in policymaker attitude towards eurozone bailouts mean for investors?

WDV: Corporate bond spreads have fallen so far that they no longer support equities. This correlation could return to normal as monetary policy tightens. The Fed is contemplating tapering QE; the ECB is looking for acceptable unconventional monetary policy measures and the Bank of Japan has just started a massive QE programme. These diverging paths may result in different growth and inflation rates, affecting momentum in local equity and bond markets and creating opportunities for active investors.

Within equities, we see that company-specific factors are having a bigger impact on stock prices, boosting the attractions for stockpickers. Equity and bond investors should also consider themselves forewarned now that eurozone policymakers are embracing bail-ins.

JvL: So the drivers of financial markets are shifting. What about your view on the economy?

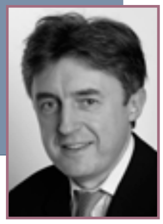
WDV: Growth in the US has remained below par. Credit growth is not strong and while rising house prices lift consumer confidence, the effect of this increased wealth on spending could be smaller than before the financial crisis. We see fiscal policy as capping disposable income. The automatic cuts in government spending could damp producer confidence and in the labour market, a relatively small number of the working age population is actually at work.
The eurozone is still in recession, although there are signs of improvement and some countries are getting more time to adjust their fiscal deficits. Growth could turn positive later this year, but this may not suffice to stabilise government debt relative to GDP. Growth is not strong in emerging economies, but modest inflation is enabling central banks to cut rates. In China, the government may be trying to wean the economy off investment as the prime growth driver, which would be positive, but rapid credit growth remains a concern.

JvL: So what are your conclusions in terms of investment opportunities?

WDV: Most importantly, there is no asset class currently that clearly represents great value in our view. Probably the closest to a value investment is European equities. We think the search for higher yields is still very important, which is why we would focus on emerging market debt in US dollars and US real estate. We also see greater scope for actively managed portfolios.

Written 25 June 2013

Expert's view
SPOTLIGHT



Hubert Goyé
Head of international equities - BNPP IP, Paris

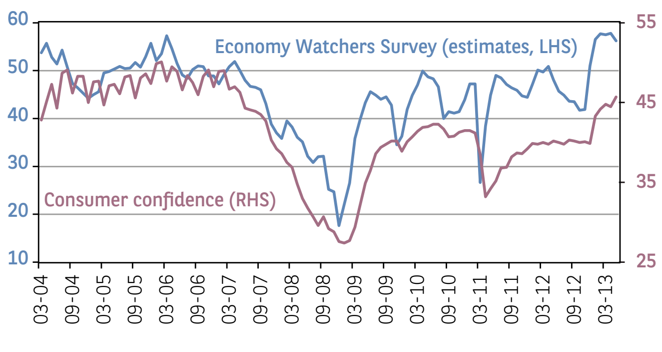
Bullish trend for Japanese equities: is it for good this time?

On 22 May 2013, the Topix index comprising all 1 700 companies listed on the First Section of the Tokyo Stock Exchange closed approximately 85% above its lows of 2012. A correction however followed, which soon revived fears that the bull market would be short-lived, but we don't agree with this view. As a matter of fact, confidence indices, both for corporations and consumers, have experienced an impressive rebound in the last few months, and one can even see the first signs of a concrete economic recovery.

There is nothing extremely original in the measures that Prime Minister Shinzo Abe has begun to implement since the Liberal Democratic Party regained power at the end of 2012. Taken individually, each of them has already been tried on several occasions, to no avail.

What is new is that they have all been regrouped to form a global strategy with three complementary objectives: address the long-lasting problems which have been plaguing the Japanese economy since the 90's, trigger a broad-based recovery in the country, and simultaneously carry out structural reforms to help make the ensuing results sustainable. It is this global coherence which allows us to believe that the strategy will likely be much more successful than previous policies.

"Abenomics" boost confidence



Source: Economic and Social Research Institute of Japan ; July 2013

Some of the planned measures, aimed at ending deflation and developing infrastructure for the country, should have a mechanical, rather quick effect on economic growth.

Fighting deflation, which has been looming in Japan for almost 20 years, was set as a top priority. Mr Kuroda's appointment as the Bank of Japan's Governor and the definition of a 2% inflation target had already been interpreted as positive signs. The later announcement of a doubling of the monetary base in only two years surprised by its magnitude, all the more as it came with a commitment to doing "everything it would take" to bring price declines to an end.

Meanwhile, an increase in public spending should come on top of the effort already planned as part of the reconstruction following the 2011 earthquake. This effort should have effects throughout the country. It is expected to focus on projects that can be useful for the economic future of Japan, which makes it different from the past public spending policies. It may involve, among others, the modernisation of ageing infrastructure, the development of equipment for future energy supply, as well as initiatives in favour of airports' capacity and traffic.

If implemented efficiently, these measures will trigger an up-tick in domestic demand. Through its direct impact on corporations and employment, public spending will continue to support the return of confidence and the willingness to invest or consume, while the come-back of inflation will be a catalyst to accelerate these trends.

Exports could become a key contributor to the recovery again. The main reason is the weaker yen, but the stabilisation of overseas economies and the smoother relationship with China should help too.

Even though the official, politically-correct reason for the monetary easing is to boost the domestic economy, its obvious impact on exchange rates is not going to upset the Japanese authorities. The strength of the yen has been a serious problem for companies in the last few years, and the depreciation of approximately 25% observed in a few months helps rebuild exporters' competitiveness. The impact goes beyond this aspect, in that it also alleviates competition from imported goods in the domestic market for basic materials or intermediate products.

It should be noted however that many other factors, most of which are beyond the Japanese government's control, will also have an impact on exports. Economic growth remains sluggish in Europe, but China will probably be the main question mark. Everything will depend on its new leaders' ability to gradually reduce the various imbalances which have accumulated in the country.

Kaori Hayama
Portfolio manager Japanese equities – BNPP IP, Paris

Japan's new government is preparing structural reforms of both the tax system and regulations. Their effect will of course be less automatic and more remote, but it is expected to make the recovery sustainable beyond the stimulus period.

The tax reform will be designed with a focus on avoiding the main side-effects of consumption tax hikes, which are expected to raise VAT from the current 5% rate to 8% in 2014 and 10% in 2015. The government is working on measures to encourage companies to invest, as well as raise salaries. Moreover, tax-free zones should be created to boost economic development and attract foreign investment.

Separately, deregulations should be introduced to enhance Japan's competitiveness. The country's involvement in the Trans-Pacific Partnership negotiation may have tricky implications, but Shinzo Abe's team is also working on new labour laws which will allow more flexibility, a full review of agricultural policies to encourage larger scale farming, and measures to start addressing the demographic issues of Japan, by boosting birth rates or facilitating immigration for specific profiles.

It is naturally very early to judge such measures' efficiency, as few details have been released, but just trying to deal with these structural problems is new, and probably represents a key step towards their eventual resolution.

Japanese corporations have made significant rationalisation efforts in the last few years to survive the adverse exchange rate, and this will help them leverage a more favourable environment.

The last decades' crisis, combined with the strength of the yen in recent years, have led Japanese corporations to adjust for their survival. Their managers have become more responsive in front of difficulties.

Many companies have, for example, taken more stringent cost reduction measures than usual. The strong yen has also allowed a series of inexpensive acquisitions overseas, and such benefits are going to be felt in the next few years, as and when synergies are achieved.

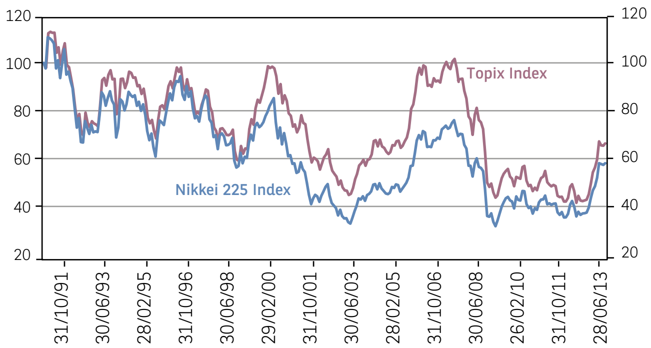
Companies are therefore in generally good health, with an improved cost base and solid balance sheets allowing sufficient financial flexibility for the next few years. A more benign environment will leverage this sounder situation, and the rebound in earnings should be all the more striking as current estimates are still based on a conservative FX assumption: since companies issued their earnings guidance for the current fiscal year, the yen exchange rate has constantly remained more favourable than they had assumed.

Fundamentals are therefore favourable to Japanese equities, which should benefit more as, even after a strong rally, their valuations are not excessive.

Putting things in perspective over a long period, following the logical correction that they have just gone through, the Japanese market's indices have not even retraced half the highs reached in 1996, early 2000 or 2007, ... notwithstanding the levels seen at the end of the 80's, before Japan entered the crisis.

Valuations remain reasonable. According to our calculations, using 12 month forward earnings forecasts from IBES, the average PE ratio of the TSE's First Section is only 14.3x and, for once, the likelihood of upward earnings revisions looks high.

Japanese equity Indices are still far from their previous highs (1991=100)



Source: Nikkei, TSE; July 2013

Finally, many investors still have a moderate exposure to equities, and even more so to Japanese equities. Their interest has started to build, but there must be more potential left, which will materialise as and when our scenario unfolds.

Written 1 July 2013

Performance focus

SPOTLIGHT

A policy that worked

On 3 November 2010, the U.S. Federal Reserve announced a new policy that became known as the second round of quantitative easing or QE2.

The term `quantitative easing', first widely used in Japan in the 1990s, does not have an agreed definition. It describes a policy in which the central bank buys assets from the financial sector, and does not necessarily - as in conventional monetary policy - confine such activities to the management of the government's own debt.

Since QE2 began, stock prices have risen. Interest rates are not far from where they were in November 2010 and gold prices, after soaring initially, have fallen back significantly.

Source: Bloomberg, BNPP IP

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