

## Committee meeting of July 3, 2009

### Economic activity has yet to confirm survey data

Although the pace of the global economic contraction has indeed slowed, industrial production and firm manufacturing orders have yet to improve and unemployment continues to rise. **Even though a recovery is taking shape (as acknowledged by both economists and investors) growth will remain well below potential.** Investment, production and jobs data have not yet improved in the current manufacturing "mini cycle" driven by inventory adjustment, but should normally "catch up" with the leading indicators. Nevertheless, given the magnitude of the economic shock and its unusual nature (with frozen credit markets bringing global trade to a virtual standstill) the downturn may last longer than it normally would. Firms may be more hesitant than usual to resume production, investment and hiring, while consumers may prove more reluctant to spend or take out a mortgage to purchase a new home. Such a situation could discourage investors who fail to see the first promising buds of recovery blossom as expected, forgetting that most survey data so far merely suggest a stabilisation of economic activity. Although being able to rule out the possibility of a global depression was a great relief to investors they may soon become impatient.

### Another challenge for economic policy

The impatience of investors and of some government leaders may put even more pressure on central bankers, who certainly do not need another burden to bear after almost two years of continuous intervention and boundless creativity. Central banks, and above all the US Federal Reserve, will have to implement strategies for gradually returning to more conventional monetary policy, while making sure not to rush things and risk smothering the nascent recovery. A key concern is whether the unconventional policy measures adopted over the past few months will pose a serious inflationary threat to the global economy. **We are convinced that inflation is not a significant risk for two reasons: the weakness of growth and the impact of the new global economy, where keen competition limits pricing power and that few wages are still indexed to inflation.** However we are also aware that the fear of high inflation can have disastrous consequences, such as expectations of rapid monetary tightening and upward pressure on long-term interest rates. It is essential that central bank and government authorities clearly signify their commitment to eventually normalising their monetary and fiscal policies, as they continue to nurse their economies back to health.

### A bit more patience

**Although it will not be easy, central bankers and government authorities will have to find the proper policy balance before investors regain confidence in the riskier asset classes.** After the hiccups seen in equity markets over the past few weeks, technical factors no longer point to a marked correction in share prices over the near term, although volatility may once again come to the forefront as trading volume declines over the summer. **We are therefore maintaining our neutral position with a slightly positive bias.**

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July 13, 2009



# ASSET ALLOCATION

## Allocation decisions

- We are maintaining our slightly positive bias on equities through our positions in the emerging regions and Asia in particular.
- We are still neutral on government bonds, given the balance, on the one hand between the stabilisation of the economic downturn, long-term concerns and the high volume of issuance, and on the other the weakness of economic recovery.
- Our overweight in IG is maintained, along with our underweight in HY bonds.
- We returned to a more defensive allocation on commodities, being overweight in the least-cyclical ones if only for the portfolio diversification. Gold exposure has been reduced tactically for the near term.

## Developed equity markets

- Our overweight in Canada and Australia is maintained in view of the "premium" provided by their apparently stronger financial systems, and, in the case of Australia, high exposure to Asia that should ensure a particularly strong cyclical recovery. Exposure to commodities will have to be carefully monitored however over the near term.
- We are now overweight in Japan, whose highly cyclical market is likely to benefit from Asian recovery, the weaker yen, the pickup in domestic demand driven by the government's stimulus plan and the now positive relative price momentum.

- Still underweight in European and equity markets, despite their attractive valuations. We expect the euro zone to be handicapped by its weak economy, relatively timid economic policy and the euro's strength. The UK market will also receive diminishing support from sterling's depreciation and easy monetary policy.

## Emerging equity markets

- Still overweight in China. Fast action by government officials has already boosted the economy, as seen by the solid growth of industrial production and upward revisions in EPS forecasts.
- We have reduced our exposure to India and Brazil to a slight overweight and neutral respectively. The Brazilian market offers a rather dim outlook for earnings and the end of the monetary easing cycle is probably imminent. Although the structural reforms planned in India are likely to maintain investor interest valuations are less attractive.
- Given the favourable outlook for inflation, attractive relative valuations and positive relative price momentum, we have increased our exposure to Turkey.
- We are now underweight in Russia, given its poor outlook for growth and earnings.

transposed into any other portfolio whether benchmarked or not.

## Typical diversified model portfolio – Institutional clients

The model portfolio holdings below are measured against cash and may be

MULTI-ASSET CLASS1

	Sharpe Ratio	Jul-09 weights	Jun-09 weights
<b>EQUITIES</b>			
Developed Equities	0.1	0.2%	0.1%
Emerging Equities	0.2	0.6%	0.2%
<b>FIXED INCOME</b>			
Government Bonds	0.0	0.0%	0.0%
Investment Grade	0.1	2.0%	2.3%
High Yield	-0.1	-1.0%	-0.8%
Emerging Debt	0.0	0.0%	0.01%
<b>COMMODITIES</b>	0.0		
Brent Oil	0.0	0.0%	0.3%
Base Metals	-0.2	-0.8%	-0.5%
Gold	0.1	0.6%	1.0%
Agricultural	0.2	0.6%	0.4%
Cash Euro	0.0	-2.3%	-3.0%
Module Total		0.0%	

1- Hedged in Euro, 2- MSCI hedged in Euro  
3- MSCI local unhedged, 4- JPM GBI hedged in Euro,  
5- Forwards to Euro investor  
\* Risk Budget (in bp), \*\* VaR 99% 1 month,  
\*\*\*Ner: Multi-Asset Class

EQUITIES: DEVELOPED COUNTRIES1

	Alpha	Jul-09 weights	Jun-09 weights
US	0.0	-0.1%	0.1%
Canada	0.2	2.0%	2.3%
Euroland	-0.2	-1.9%	-1.5%
Japan	0.1	0.6%	0.2%
UK	0.0	-0.5%	-0.6%
Switzerland	-0.1	-0.6%	-1.1%
Australia	0.0	0.4%	0.6%
Module Total		0.0%	

BONDS: COUNTRIES SOVEREIGN4

	Alpha	Jul-09 weights	Jun-09 weights
US	-0.1	-4.5%	-2.4%
Euroland	0.2	10.6%	10.4%
Japan	0.0	-0.8%	-2.1%
UK	0.0	-1.4%	-1.8%
Switzerland	-0.1	-3.9%	-4.1%
Module Total		0.0%	

EQUITIES: EMERGING COUNTRIES3

	Alpha	Jul-09 weights	Jun-09 weights
Brazil	0.0	0.1%	0.3%
Mexico	-0.2	-0.7%	-0.6%
China	0.3	1.2%	0.8%
India	0.1	0.4%	0.7%
South-Korea	-0.1	-0.2%	-0.4%
Taiwan	0.0	0.1%	0.3%
Russia	-0.1	-0.4%	0.3%
Poland	0.0	-0.2%	-0.5%
South Africa	-0.2	-1.0%	-1.2%
Turkey	0.2	0.7%	0.2%
Module Total		0.0%	

PORTFOLIO STATISTICS

Ex-ante Volatility	1.00%
Ex-ante Var*	0.67%
Excess Return over Cash at 84.1% conf.	-0.17%
Conf. of beating Cash by 2%	12.10%
Risk of falling below Cash -0.5%	9.17%



# ECONOMIC OUTLOOK

## Viewpoint

### What about inflation?

The debate has just gotten underway and promises to be quite spirited and perhaps even a bit nerve-wracking over the next few months. Central bankers, and above all investors, are increasingly concerned about finding suitable "exit strategies" for ending non-conventional monetary policies. The big question is what impact will the expansion of central bank balance sheets have on inflation? This question is inspired by "monetarist" thinking, which in its bluntest form considers inflation to be a purely monetary phenomenon. It is not our objective here however to discuss the subtle differences between different schools of economic thought, particularly since we believe the debate about inflation is not motivated so much by theoretical concerns but rather by a Pavlovian reflex on the part of market observers and even some central bankers and government officials.

### Is there a genuine risk of inflation? We don't think so

We believe the key factor in the current environment is "demand-driven inflation", which we believe is not a threat since **the global economy is heading toward a long period of below-potential growth** and weak demand that will keep the output gap gaping for quite some time. We will end this "Keynes for Dummies" presentation of economic theory by pointing out that Friedmanian monetarism, in which inflation results from an increase in the money supply, assumes that there is no slack in production capacity, an assumption that many people tend to forget, as Patrick Artus points out in his provocatively entitled article<sup>1</sup>.

Lastly, as Philippe d'Arvisenet, Head of Economic Research at BNP Paribas observes <sup>2</sup>, it is rather strange that financial markets are fearing "inflation and deflation at the same time". **Deflation is currently the main concern of most central banks**, which either mention the risk explicitly (like the BoE), are facing deflation now (like the BoJ), see the threat diminishing (like the Federal Reserve, which failed to mention the threat of deflation in its last press release) or adopt a more discrete approach (like the ECB). Although the ECB's official statement at its press conference explains that risks are balanced and focuses only on headline inflation, the central bank's Monthly Bulletin for June provides a detailed look at "Recent developments in selected measures of underlying inflation for the euro area" and concludes that there is "little indication of emerging general price declines".

<sup>1</sup> What can you do when investor expectations validate simplistic economic thinking? Natixis Economy Flash – 27 May 2009

<sup>2</sup> Inflation and deflation? Economic Market Monitor – May-June 2009

### Inflation could pose problems however

Changes in energy and food prices can cause rapid variations in price indices. Although food and energy generally account for only 20% to 25% of the headline price index, since their prices are volatile, they play a key role in whether inflation rises or falls. The base effects of falling crude oil prices since last July have pushed year-on-year inflation into negative territory. If however oil prices continue to rise, or even just stay at their current level, we will see a positive base effect appear in October or November. **The worst possible situation for central bankers would then be a combination of rising inflation with sluggish growth that would normally preclude the tightening of monetary policy.**

Furthermore, **countries with large public debts would certainly have no interest in allowing this imported inflation to get out of hand.** One school of thought, which can be traced directly back to the 1970s, believes that central banks will "let inflation run" to enable governments to reimburse their debts in "funny money". This thinking would be valid if the situation today were the same as after the oil shocks, i.e. if inflation were triggered by higher oil and commodity prices and sustained by rising wages. However, wages are less flexible today and there is less potential for wage inflation (or deflation for that matter). A country that adopted such a policy today would find itself with high inflation for a relative brief period, higher long-term interest rates (and therefore a heavier interest-rate burden on debt), weaker domestic demand – as higher energy prices reduce the purchasing power of consumers and the pricing power of firms – and finally declining nominal output that would further increase the debt burden. Preventing inflation is not just something that central bankers do; it is the best way of ensuring sustainable economic growth...

...and **anchoring inflation expectations.** Jean-Claude Trichet has made the latter a pillar of his monetary policy and we believe he was right to do so. His colleagues at the ECB have also become increasingly concerned about inflation expectations over the past few months. Although "growth cannot be decreed", inflation can be created and have a real impact on the economy, even when it is more imaginary than anything else. Although it is still quite early, one of the reasons that government and central bank officials are already talking about exit strategies is to dampen expectations of inflation once economies recover and thus limit upward pressure on long-term interest rates. **If they fail to do this investors will have to protect themselves against this "phantom" inflation.**



# ECONOMIC OUTLOOK

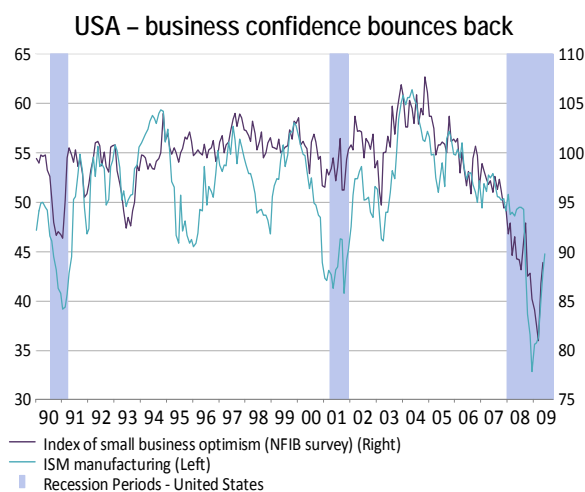
## Developed economies

### The outlook for growth in 2010 is a bit brighter

In its most recent Economic Outlook the OECD points out that it is the first in two years to present higher growth forecasts than the previous issue. The organisation now expects 0.7% GDP growth for the OECD countries in 2010, with improved growth prospects for the non-OECD countries (9.3% for China), 0.9% growth in the United States and 0.7% in Japan, while the euro zone continues to lag behind with zero growth. Private-sector economists seem to have adopted a similar scenario (see table), with the growth forecast for the Asia-Pacific region already raised the previous month. **Many observers are starting to believe that the worst has been avoided** and are showing relief. However, the OECD warns that "the recovery will no doubt be weak and fragile for some time and the crisis will have long-lasting economic and social consequences". This "prophecy" is likely to guide the actions of consumers, firms, investors and government officials over the coming quarters. Regarding the modest recovery expected in the euro zone in 2010, Jean-Claude Trichet pointed out that: "it is a mistake to believe that this is a sure thing: there are risks and uncertainties".

If the OECD's advanced economies were competing in a bicycle race, the United States would certainly be leading and wearing the yellow jersey in recognition of its relentless efforts under all circumstances. Its lead however would not enable it to take it easy and let up on its economic policy efforts. Japan's economy would no doubt wear the green jersey as the race's best sprinter, thanks to its highly cyclical economy that has quickly responded to economic recovery in Asia but may have to slow down in the future. Although it may be unfair to say that the euro zone is bringing up the rear, tension among the "ECB" team members has made co-operation difficult and it will have a hard time catching up after falling behind so far. But the race may end up being closer than we think, since some competitors may receive a boost from "fiscal and monetary" stimulants.

**US cyclical pickup continues.** Business surveys continue to show that the pace of contraction is slowing as firms gradually rebuild their inventories. The main indices are still quite low however, with the key ISM index at less than 50 and the small business confidence index below its long-term average of 100. This shows that economic activity is still weak, as reflected most clearly by payroll figures. Small and mid-size businesses in particular still say they are very cautious about hiring and investment. The fact that many of these firms are subcontractors partly explains why they are lagging behind the large corporations, particularly in terms of the inventory cycle. Judging from the ISM survey's index of manufacturing inventories destocking seems to be coming to an end. Demand, particularly for capital goods, is starting to show signs of recovering, which augurs well for business investment over the longer term. If we look at the **supply side of the US economy, the situation is returning to normal after the plunge in production early this year.** Yet firms still seem hesitant.



Source: Factset, BNPP AM

### Consensus Forecasts: Growth & Inflation

	GDP y.o.y %								Inflation y.o.y %											
	2008		2009				2010				2008		2009				2010			
	M	H	L	-1M	M	H	L	-1M	M	H	L	-1M	M	H	L	-1M				
<b>Developed Economies</b>																				
USA	1.1	-2.8	-2.4	-3.4	[-2.9]	1.9	3.8	-0.2	[1.8]	3.8	-0.6	0.7	-1.1	[-0.8]	1.7	3.2	0.7	[1.6]		
Canada	0.5	-2.3	-1.5	-2.6	[-2.5]	2.1	3.0	1.5	[2.0]	2.4	0.3	0.5	0.0	[0.3]	1.8	2.6	1.2	[1.7]		
Euro zone	0.6	-4.2	-3.0	-4.8	[-3.7]	0.3	1.6	-0.8	[0.3]	3.3	0.4	0.7	0.1	[0.4]	1.2	1.9	0.4	[1.2]		
UK	0.7	-3.7	-3.1	-4.5	[-3.8]	0.7	2.0	-1.3	[0.3]	3.6	1.7	2.5	0.9	[1.6]	1.8	3.2	0.5	[1.7]		
Switzerland	1.6	-2.5	-1.5	-4.0	[-2.4]	0.4	1.8	-0.8	[0.2]	2.4	-0.5	0.2	-1.1	[-0.5]	0.5	1.0	-0.6	[0.6]		
Japan	-0.7	-6.6	-5.5	-8.0	[-6.1]	1.3	3.6	-0.3	[1.3]	1.4	-1.2	-1.0	-1.8	[-1.2]	-0.6	0.0	-1.1	[-0.6]		
Australia	2.1	-0.2	0.4	-1.6	[-0.7]	1.5	2.7	0.3	[1.5]	4.4	1.6	2.0	1.2	[1.7]	2.2	2.7	1.7	[2.3]		

Source: Consensus Forecasts as of 08/06/2009



# ECONOMIC OUTLOOK

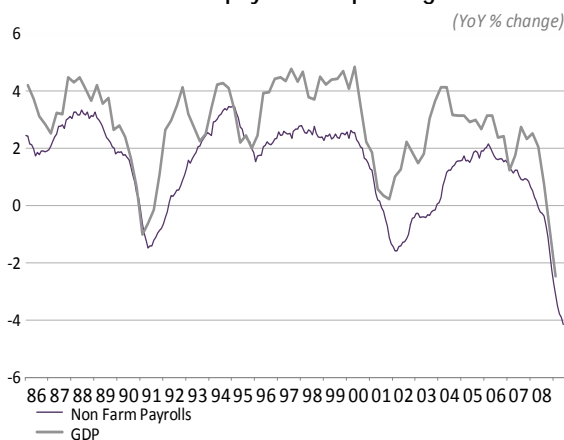
## Developed economies

### Recovery in the euro zone appears to be fragile

This hesitance explain why the dynamics of recovery seem to have slowed over the past few weeks and why the first "buds" appear to be having a hard time blossoming. We would not call this a "false start" however, but instead a rather slow start, and believe that hard production and employment data will take some time before they reflect a solid recovery. **Employment will be the last thing to improve** and the jobs report issued in early July is not very encouraging. In addition to a further increase in the jobless rate and 467,000 net job losses in June (albeit less than the average monthly job loss of 691,000 in Q1), given the relatively low level of temporary employment we should not expect an improvement soon.

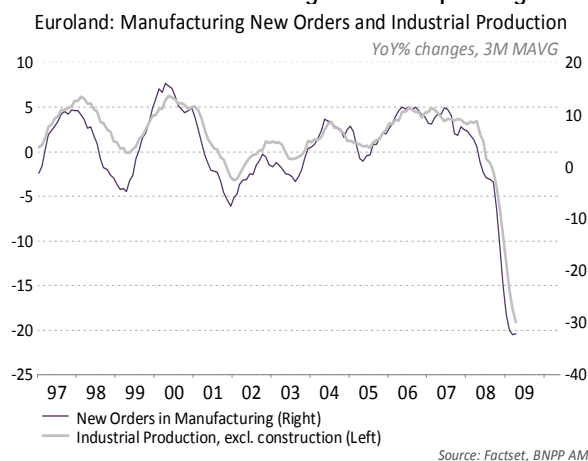
After its monetary policy meeting of June 23 and 24, the Federal Reserve reminded that **economic conditions will probably justify a maintenance of exceptionally low interest rates for a "protracted period"** and said it would continue with its programme to purchase agency MBS, agency debt securities and Treasuries, while making any adjustments necessary. Several funding facilities will be extended until February 1, 2010, while less used facilities will be reduced. President Obama will soon decide whether or not he wants Ben Bernanke to stay on as the Federal Reserve's chairman after January 2010. The US president will most likely ask him to finish the Herculean task he has undertaken. In this case, Mr Bernanke will no doubt take pains to do the best job possible (if only to avoid criticism such as that directed at Alan Greenspan for allowing interest rates to remain too low for too long) and start to mention exit strategies, but only to show that he is thinking about this for the time being. **It is still too early to tighten monetary policy.**

### USA – payrolls keep falling



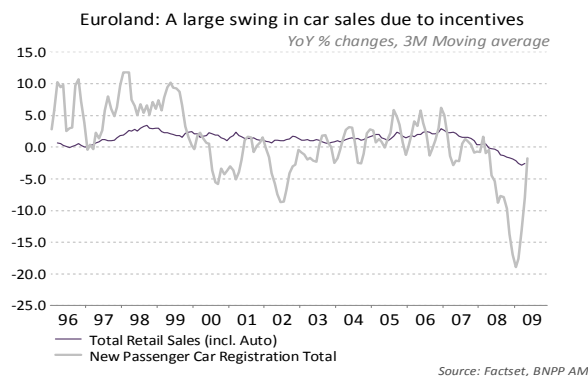
**Euro zone still lags behind.** Although the euro zone's indices of business confidence hit bottom a bit later than in the United States, they have improved rapidly since, particularly in terms of future prospects as seen by business leaders and securities analysts. In Germany, for example, the ZEW index's "expectations" component surged in June above its long-term average. Confidence is indeed returning. Although this is good news, it has yet to be confirmed by a pickup in industrial production, orders or even exports. The second quarter got off to a poor start with industrial production falling 1.9% and the jobless rate rising to 9.2%, its highest level in 10 years.

### Euro zone – manufacturing sector still quite fragile



**And yet consumers are more confident than early this year** and claim to have recently made more large purchases. This may seem surprising since rising unemployment generally causes households to save rather than spend. But on the other hand, the savings rate is already very high in the major euro zone countries (such as France, where INSEE estimates it was 15.3% in 2008) and may partly offset the decline of purchasing power.

### Euro zone – tax incentives boosts car sales



# ECONOMIC OUTLOOK

## Developed economies

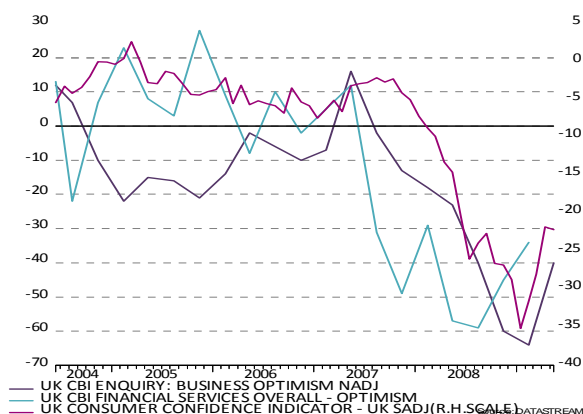
### UK and Switzerland are doing relatively well

We doubt however that European households will start dipping heavily into their savings when the financing of pensions could once again become a hot topic of debate and bring with it concerns about demographic imbalances, rising unemployment, weak growth and growing public deficits. As usual, unemployment benefits will provide a cushion for consumer spending, while tax reductions and other incentives to boost automobile sales in several euro zone countries will provide an illusory improvement in consumer spending. The prospects for a more sustained recovery appeared to be limited. Although external demand will play a large part in the recovery, the euro's strength may weigh on exports.

**The ECB's attitude** is not going to make things any easier. Even though Jean-Claude Trichet has repeated that "1% is not a hard floor for the refi rate", his main objective has been to stabilise key policy rates since lowering them in early May and we expect him to keep the refi rate where it is since he considers it to be "appropriate". Expectations that it could be raised relatively soon arose in early June, in light of the habitual dissension among the members of the central bank's monetary policy committee and the rather hawkish statements made by some. At the ECB's press conference in early July, Mr. Trichet adopted a rather conciliatory tone and did not exclude the possibility of a further rate cut. **For now, we expect the ECB to pause, to assess the effectiveness of what it has done so far** and in particular its first 12-month fixed-rate refinancing operation of late June. At 442 billion euros it was a success and the central bank is now urging banks to "live up to their responsibilities", which means reinject this money into the economy in the form of lending. The results of the covered bond purchases initiated in July will be another good test of the "pertinence" of monetary policy, to use Jean-Claude Trichet's term.

**The worst of the recession seems to be over in the United Kingdom** judging from the many positive signals we are seeing, such as the above-50 PMI index for the services sector, the 0.2% increase in industrial production, rising prices for existing homes (up 2.7% in June m/m according to the Halifax index) and the slower pace of job losses. The number of unemployed increased less than expected in May and the Confederation of British Industry (CBI) expects the outlook for growth to be less gloomy at the end of the year. The steadying housing market and the imminent stabilization of the job market will be essential to underpinning the confidence of consumers and therefore will play a decisive role in how much they may spend or save.

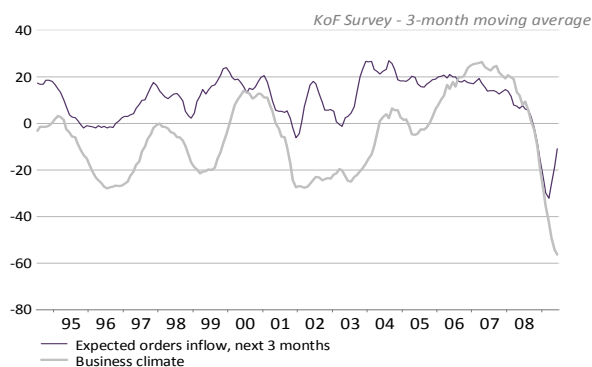
### United Kingdom – confidence improves



**The BoE has kept its key policy rate at 0.50%** since cutting it 50 bp in March and is expected to complete its 125 billion GBP asset purchase programme in two months (92 billion GBP have been spent as of June 18). As for the possibility of further securities purchases, more information about this will be provided in August when the central bank presents its assessment of the country's economic situation in its quarterly report on inflation. For now the BoE will pursue its energetic and expansionary monetary policy, which is beginning to bear fruit, although a large majority of households and firms believe that credit is still too tight. Forecasts for inflation (2.2% in May) will also be a key concern. The BoE currently believes inflation will fall below its 2% target this year and to 1.5% in 2010, which is considered to be too low. Even though the UK economy is showing signs of recovery, **rising public debt and the financial sector's difficulties may jeopardise its performance over the longer term.**

**The outlook for the Swiss economy also seems brighter**, now that the global downturn has slowed.

### Switzerland – more manufacturing orders expected



Source: Factset, BNPP AM



# ECONOMIC OUTLOOK

## Developed economies

### Cyclicality and fiscal stimulus give Japan's economy a boost

The KOF barometer, Switzerland's forward-looking economic indicator, rose to -1.65 in June after being stuck at -1.8 for two months, its lowest level since June 1991. The outlook for manufacturing is also improving with PMI indices rising for the third month in a row, to 41.8% in June, a level that still reflects economic contraction.

**Still convinced the franc is too high, the Swiss National Bank** sold the currency directly in the market in late June, as it did in March, to prevent it from appreciating against the euro. The SNB succeeded in bringing the EUR/CHF rate back up to the more acceptable level of 1.52-1.53. The central bank also maintained its objective of gradually lowering its Libor rate from near 0.40% in early July to 0.25%, as well as its forecast for GDP contraction of 2.5% to 3% in 2009. According to the central bank's vice-chairman, the main risk is the fragile position of the country's large banks, which have substantial exposure to the global economy. He advises them to take advantage of the more stable economic environment to rebuild their capital bases.

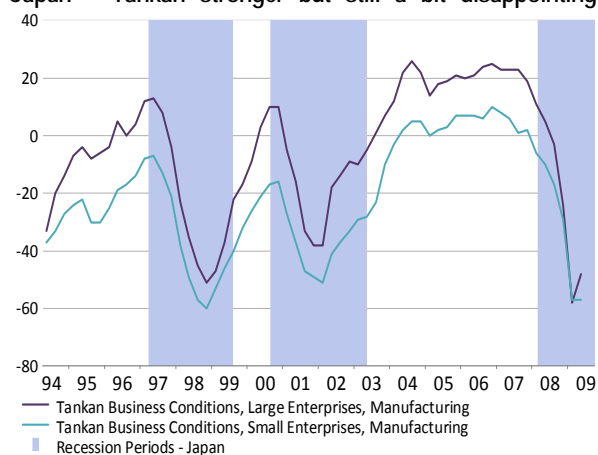
**Japan enjoys a sharp cyclical upturn.** The cyclical improvement in Japan's economy has been quite substantial over the past few weeks and has just been officially acknowledged. The Bank of Japan and government officials are now less pessimistic and feel that **the worst of the crisis is over**. According to METI statistics industrial production rose for the second straight month, rising 5.9% m/m in May, as in April. This growth, the sharpest since 1953, is attributable to the increased external demand resulting from the various economic stimulus plans many countries have implemented and which have considerably boosted Japan's exports of automobiles and technology products. However, industrial production is still down 29.5% y/y and monthly production gains could start petering out. Indeed, even though the PMI manufacturing index has improved since the beginning of the year it is still in recession territory, at 48.2 in June. Japanese exports are still falling for now, but at a slower pace. The 2.6% increase in real consumer spending in May can probably be attributed to the initial effects of the government's stimulus plan, which has been very well received by both consumers and firms, no doubt thanks to its exceptional magnitude.

The Bank of Japan's quarterly Tankan survey of business confidence has confirmed that **the economy probably hit bottom in March**. The survey's indices rose in June, albeit less than expected, and the outlook for September has also improved.

The index for large manufacturing enterprises – long considered the most representative Tankan index – posted the strongest gain. The overall index, which includes companies of all sizes and in all sectors, did not do as well. However, the

upturn in September does not make up for the first quarter, which saw indices plunge to historical lows. **The Tankan shows that Japanese firms are still a bit cautious about investing and hiring.** Monthly surveys of confidence are more positive.

### Japan – Tankan stronger but still a bit disappointing



**An election for nothing?** The recent accumulation of satisfactory economic data could encourage the country's prime minister Taro Aso to call for an election in August, rather than wait for September. Mr Aso's unpopularity is expected to cost the Liberal Democrat Party the election and he is even disavowed by members of his own party and administration. The opposition party is hardly in any better shape and is having trouble finding a new leader after Ozawa Ichiro's implication in a campaign financing scandal. Strangely however, these legislative elections, which could mark the end of 55 years of practically uninterrupted LDP rule, do not seem to promise any specific changes and particularly with respect to economic policy. A change of government could cause consumers and firms to wonder about the future direction of fiscal policy.

Against this background, the BoJ, whose assessment of the economy is somewhat more cautious than the government's, will continue to play a key role in Japan's recovery. **We expect policy interest rates to be maintained for the foreseeable future and asset purchase programmes to be extended.**



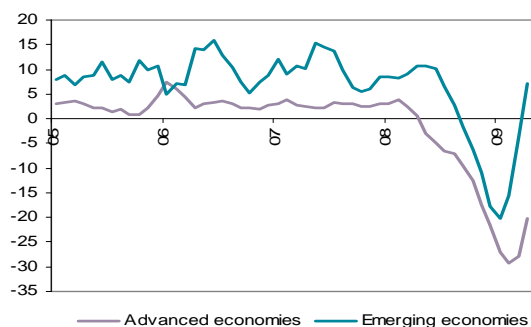
# ECONOMIC OUTLOOK

## Emerging economies

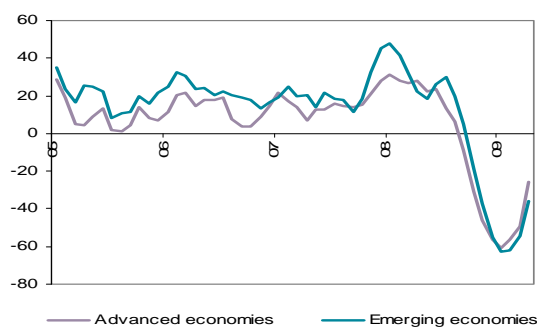
### Asia – cyclical recovery is well underway

The cyclical rebound in the emerging economies will continue to accelerate over the next few months, but with substantial differences between regions. Asia is leading the recovery with above 5% growth forecast for 2009 and 7% in 2010, thanks to a very favourable outlook for China and India. Both of these countries benefit from massive stimulus plans and favourable monetary conditions that have revived domestic demand, although the risk that weak external demand may fall back is still high. The situation is different for Latin America and Eastern Europe, where growth forecasts have been lowered in light of their substantial exposure to global trade and the financial crisis. Price indices have dropped sharply in the emerging countries, as core inflation approaches 1.5%, below that of the advanced economies.

#### Industrial production is expanding (y/y in %)



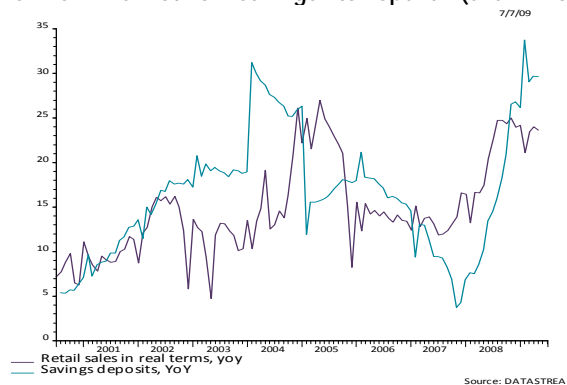
#### Global trade still depressed (y/y in %)



Chinese survey data still show that firms are very confident and that economic activity is expanding. This optimism is confirmed by economic data that point to an acceleration of the recovery. After hitting a low of 6.1% in the first quarter, we expect GDP to rise to at least 7% in the second and accelerate to over 9% in the fourth. This would mean an annual GDP growth rate of 8% and 9% in 2009 and 2010 respectively. Domestic demand is replacing exports as the main driver of industrial production, which rose 8.9% in May.

This growth is corroborated by the increase in power consumption. Infrastructure investment surged over 38.7% in May, automobile sales set a new record and the property market has come roaring back in response to an abundance of cheap liquidity. Higher prices for both real and financial assets are bolstering consumer confidence and retail sales.

### China – a lot of savings to spend (even more)



The financial crisis and the violent shock of plunging global demand on the country's economy may encourage Chinese authorities to shift their focus to strengthening domestic demand. China must become less dependent on exports, rely more on private consumption and develop a social security system that will free up consumer savings and encourage spending. These new structural orientations should create a more balanced economy over the next few years.

Lower interest rates, massive economic stimulus plans and strengthening external demand are beginning to have a positive impact on Korea's economy. We are therefore raising our GDP forecasts and now expect contraction of only 1.6% this year and positive growth of 3.4% in 2010. The business cycle hit bottom in the fourth quarter of 2008 and we expect growth to rapidly accelerate over the rest of this year. The outlook is therefore much more optimistic than in Q4 2008, when concerns about refinancing foreign debt caused the won to plunge and raised fears of a second Asian financial crisis.

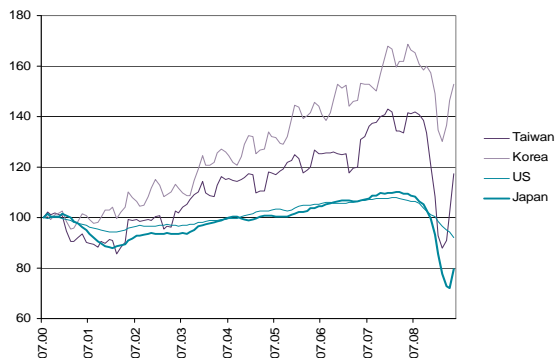


# ECONOMIC OUTLOOK

## Emerging economies

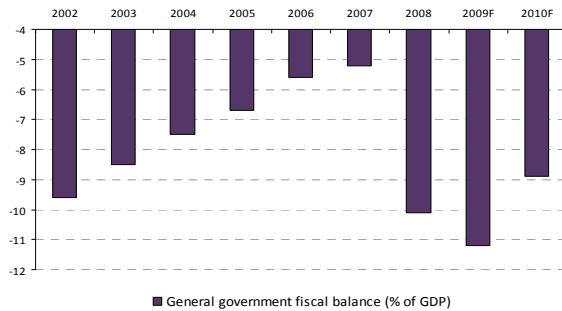
**Taiwan's** industrial production has bounced back strongly, regaining half of the ground lost since the crisis began, despite the appreciation of the Taiwanese dollar and the fact that the country's exports are less diversified than those of Korea. The export shock and the financial crisis caused GDP to shrink 10.2% in the first quarter, pushing the economy into deflation territory. All in all, the outlook for Taiwan is not very bright since it is highly dependent on global demand, which will remain quite sluggish over the next few years.

Asia – Industrial production bounces back (rebased: 2000 = 100)



The budget presented by **India's** new government in early July was a bit disappointing due to its implications for public debt and the lack of a clear roadmap for reforms. The new budget should have been more than just a statement of national accounts and should have set forth clear guidelines for the country's economic policy. Indeed, it will now be much easier to achieve major structural reforms with the new majority government, whose priority will be to consolidate economic recovery by increasing infrastructure spending and subsidies for low-income households and encouraging direct foreign investment. The manufacturing cycle is still heading upwards and industrial activity is likely to accelerate thanks to a combination of aggressive monetary policy and economic stimulus plans, which are essential in stimulating domestic demand. The GDP growth forecast has been exceptionally revised upward, to 5.8% and 7% for 2009 and 2010, respectively.

India's budget deficit should decline in 2010



### Latin America

The global crisis has had a substantial impact on **Brazil's** economy, causing both domestic and external demand to drop sharply in Q4 2008 and Q1 2009. However, recent indicators suggest that the domestic economy is improving. The jobless rate edged downward for the second month in a row, from 8.9% in April to 8.8% in May. Retail sales were up 6.9% in April y/y. Brazil will also profit from the recovery of commodity prices and should be one of the first countries to emerge from the global crisis.

**Mexico's** economy probably hit bottom in May after the government eased its measures to prevent the spread of swine flu. We expect a gradual improvement in economic activity that will limit GDP contraction to 5.9% this year. The unemployment rate stabilised at 5.3% in May, in line with the improvement in the US economy. Concerning the mid-term elections to be held on July 5, the consensus view is that no clear majority will emerge. With fears growing that the country's sovereign credit rating may be downgraded, the candidates have been debating the measures proposed to reduce the budget deficit as well as the government's dependency on oil revenues.

**Russia's** GDP continues to plunge. The outlook remains mixed for consumer spending, which is hindered by rising unemployment, to 9.9% vs. 5.3% just a year ago. Inflation is stable at a worrying 12% and is primarily fuelled by rising food and energy prices, which reduces purchasing power. In addition, real wages and disposable income are shrinking and the drop in the price of crude oil in 2008 has deteriorated public finances even further.

# BOND MARKETS

## Government bonds

### All eyes are focused on central banks and exit strategies

The stabilisation of the pace of economic contraction, the strengthening of some leading indicators and the ruling out of a scenario of economic catastrophe have all contributed to the recent pressure on government bond yields. The better-than-expected job figures in early June had a particularly significant impact at the short end of the yield curve.

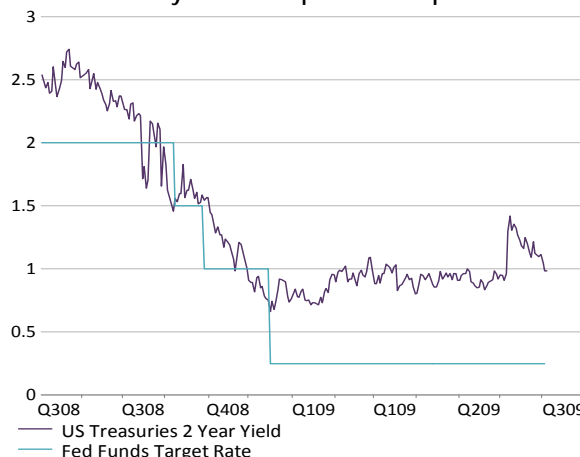
The increasing upward pressure on money market yields can clearly still be attributed to three things: signs that economic activity and leading indicators are stabilising/improving; the increase in the risk appetite of investors, who are turning away from "safe haven" assets; and to more technical factors in play in some countries. Yet although we can now rule out a scenario of depression and deflation, the road toward sustained economic recovery will be a long one. The dim outlook for growth and the maintenance of easy monetary policies for a relatively long period will continue to counterbalance the various factors mentioned above.

All in all, we expect near-term interest rates to continue to move closely with policy interest rates, yet however with more volatility given the concerns as to how and when monetary stimulus will be removed. This raises the question as to whether central bankers decide to stop their unconventional policy measures first or will begin by simply raising interest rates. We doubt that rates will be raised any time soon, particularly since monetary authorities are stressing the need to maintain monetary stimulus for a protracted period, even though they are beginning to talk about exit strategies.

Longer-dated bonds will continue to be volatile. Long-term worries about budget deficits and the return of high inflation will continue to be key investment concerns. These will be counterbalanced however by expectations of below-potential growth for a few more quarters.

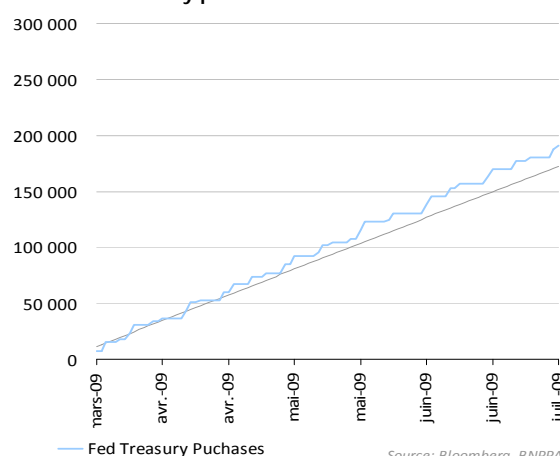
In this environment we have decided to maintain a **neutral** directional position.

Short-term yields reveal premature expectations



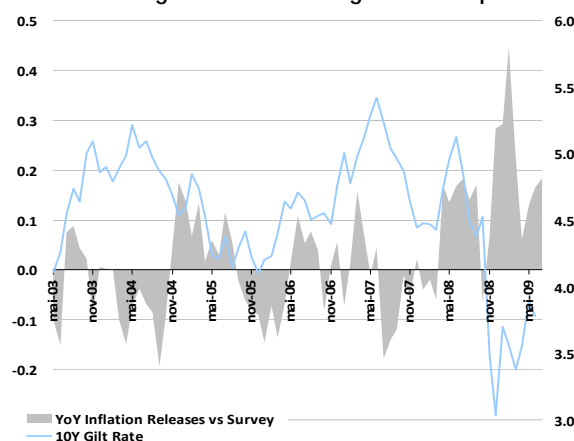
Source: Factset, BNPPAM

Fed has already purchased \$200 billion in Treasuries



Source: Bloomberg, BNPPAM

United Kingdom – inflation higher than expected



Source: Bloomberg, BNPPAM

# BOND MARKETS

## IG and HY credit

### The market catches its breath... a little!

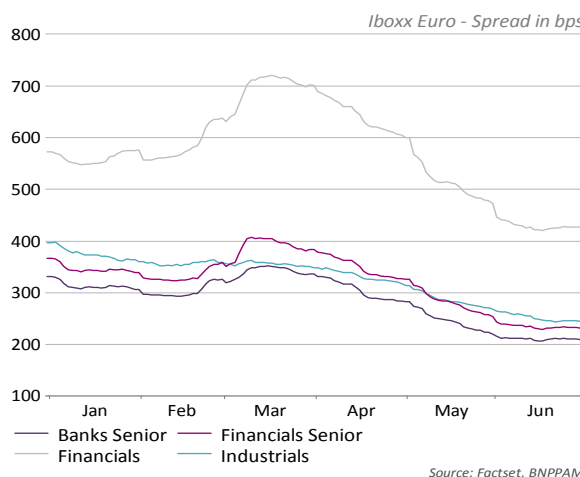
**Investment Grade** – One of things that credit investors have been trying to figure out recently is when spreads will stop narrowing. Although this may now seem to be the case, what we are seeing is more of a slowdown in spread compression rather than a reversal. After the bankruptcy of Lehman Bros., fears of a catastrophe scenario in Q4 2008 and pressures resulting from concerns about subordinated bank debt, investors were reassured by the massive monetary and fiscal policy response and returned to the more riskier asset classes, such as credit, which strengthened substantially. The large volume of issuance, particularly of non-financial debt, was well received as demand continued to be strong.

But the credit market, as we have often said, is not a bed of roses. The global economy is still weak and the outlook is not very encouraging, the banking system is still fragile and investors already have very long credit positions. Although the secondary market is stronger than it was a few months ago it is still in convalescence. Furthermore, IG credit is less attractively valued, although it certainly is not expensive. It should also be noted that declining underlying interest rates offset widening spreads. We are therefore reducing our exposure a bit, **but are still overweight**.

**High Yield** – Like the IG market, HY credit has also stabilised after making some impressive gains. Issuance remains high in the United States, with low-rated (single B) issuers tending to dominate the market recently, in contrast with the first four months of 2009 when most new issues were BB.

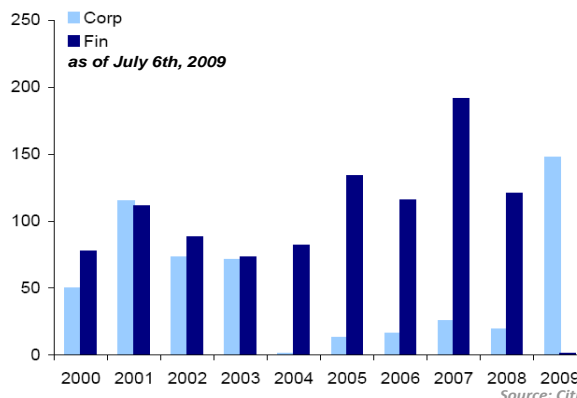
We have recently adopted a more cautious stance toward this asset class since the global recession has left many firms in a precarious position and recovery will be very slow. This is a crucial factor since it threatens the survival of many companies that will not be able to generate sufficient cash flow and may keep default rates high for longer than anticipated. We believe the current narrowing of spreads, particularly in the US, reflects excessive optimism. A slump in fund flows into HY bonds could be an early sign of weakness and we have decided to **maintain our light underweight position**.

### Spreads stabilise



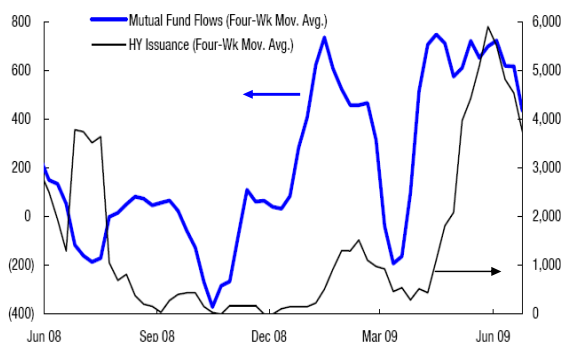
### A large volume of non-financial issuance

Annual Total Year To Date Net Issuance, Fixed and Floating Volume, € Billion



### Will HY fund flows reverse?

High-Yield Market Supply and Demand Balance Jun 08– 25 Jun 09 (Dollars in Millions)



# CURRENCY MARKET

## Expected easing of risk appetite affects currency markets

Currency markets were a bit more volatile in June. Movements in key exchange rates were somewhat more erratic, even though month-end to month-end variations were relatively modest. A decline in risk appetite over the past few weeks caused the dollar and the yen to appreciate against the other currencies of our investment universe.

**EUR/USD consolidates.** Over the past few weeks the EUR/USD rate has ranged from 1.4338 (this year's high on June 3) to 1.3740 and stabilised at around 1.40 in early July. The dollar's slip in early June may be explained by a renewed interest in riskier assets (particularly equities and high-yield currencies) on the back of relatively stronger economic indicators and in particular fewer job losses according to June 5 Jobs Report. The dollar's future depends mainly on conditions in financial markets (i.e. the strength of risk appetite) and the expected outlook for the US economy. We believe that both of these factors will tend to strengthen the dollar. In contrast, the main factors now weighing on the dollar are US fiscal policy and doubts concerning the greenback's future as a reserve currency. Regarding the latter, at their recent summit meeting the leaders of the BRIC economies (Brazil, Russia, India and China) discussed the need for another reserve currency in addition to the US dollar and to diversify their investments, while making it clear that they in no way wished to "demolish the dollar" or "destabilise financial markets", but simply to make their own markets less dependent on the dollar. This mix of positive and negative factors confirms our scenario for EUR/USD consolidation over the coming months.

**Support for yen will not exceed near term.** The yen was strengthened when the Bank of Japan presented a more positive economic outlook after its latest monetary policy meeting. According to BoJ officials: "Japan's economic situation has stopped deteriorating". Less appetite for risk has also resulted in some consolidation between the yen and procyclical currencies like the AUD or CAD. The yen may continue to benefit from declining risk appetite over the next few months. Over the longer term however, Japan's economic fundamentals are likely to weigh on the yen.

**Other noteworthy events.** The Swiss National Bank intervened directly in currency markets again in June to keep the franc from appreciating. We are certain that SNB officials are ready to intervene again if the franc strengthens against the euro. We therefore expect the franc to fall further before the end of year.

The **Australian dollar** and the **Canadian dollar** have certainly been boosted by rallies in equity markets, increasing risk appetite and the rapid rise of commodity prices up to mid-June. Nevertheless, the stabilisation of risk appetite could weigh on the commodity currencies over the near term.

According to our "fair value" model, **sterling** is still undervalued. However, the possibility that the BoE may step up its quantitative easing through Gilt purchases continues to weigh on GBP. Since these factors will continue to play out over the coming months we expect to see EUR/GBP consolidate.

## FX Rate Forecast Summary (Major Currencies)

End of Period		2008	01-Jul-09	3Q 2009		4Q 2009		1Q 2010		2Q 2010	
				Min	Max	Min	Max	Min	Max	Min	Max
USD Block	EUR / USD	1,39	1,40	1,38	1,43	1,42	1,47	1,40	1,45	1,40	1,45
	USD / JPY	91	96	97	102	100	105	105	110	110	115
	USD / CAD	1,23	1,16	1,10	1,15	1,10	1,15	1,10	1,15	1,10	1,15
	AUD / USD	0,70	0,81	0,80	0,85	0,82	0,87	0,80	0,85	0,80	0,85
	GBP / USD	1,44	1,65	1,61	1,71	1,70	1,81	1,68	1,78	1,68	1,78
	USD / CHF	1,06	1,09	1,07	1,10	1,06	1,09	1,09	1,12	1,09	1,12
EUR Block	EUR / JPY	126	135	136	143	145	152	150	157	157	164
	EUR / GBP	0,97	0,85	0,82	0,87	0,80	0,85	0,80	0,85	0,80	0,85
	EUR / CHF	1,48	1,53	1,50	1,55	1,53	1,58	1,55	1,60	1,55	1,60

Source: BNPP AM as of 1/7/2009



# EQUITY MARKETS

## Developed markets

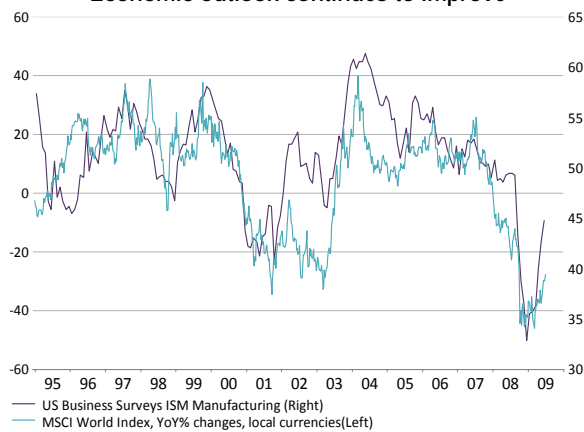
Fundamentals have improved but technical indicators are negative over the near term

Although the economic environment is definitely more solid, concerns about the recovery's strength and sustainability are weighing on investor confidence. Driven by extremely easy monetary and fiscal policies, the economic outlook continues to improve in the major advanced countries and in Asia (particularly China) thus confirming that the economic recovery is indeed underway. Furthermore, the combined efforts of central banks and government officials have ruled out the possibility of a systemic banking crisis and several US banks have begun to repay their TARP funds or are planning to do so soon. Another recent and major development was assurance from central bankers that they will not retighten their monetary policies too soon, thus keeping their policy interest rates low and avoiding, at least for the time being, the tricky question of how they will end their accommodative policies and in particular their quantitative easing measures.

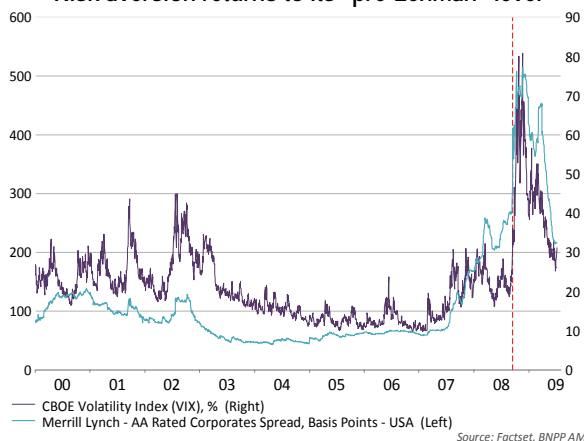
Despite some encouraging signs a few dark clouds remain. Signs of improvement in the US housing market are still very tenuous, the consumer deleveraging process will be long and unemployment and savings are rising rapidly. These factors weigh on consumer spending and raise questions as to how strong the recovery will be. After the sharp drop in implied volatility in equity markets and the narrowing of investment-grade credit spreads both have returned to their levels prior to Lehman's bankruptcy. Yet despite less risk aversion, cash investment levels are still extremely high, which may mean that long-term investors are still not convinced the economic recovery will last.

The earnings cycle should start to pick up over the coming months. The plunge in earnings during the current recession has been spectacular and similar to declines observed in previous recessions. The MSCI World's EPS figures are now over 30% below their long-term trend. We therefore expect to see a gradual recovery from this low point over the coming months. In line with the strengthening of leading indicators, the outlook for earnings has indeed improved, as reflected in the improvement in net revisions of EPS forecasts 12 months forward. Although earnings are likely to begin to recover in the second half of the year, the considerable pressures on profit margins, tight credit conditions and deleveraging in the consumer and business sectors will continue to weigh on bottom lines.

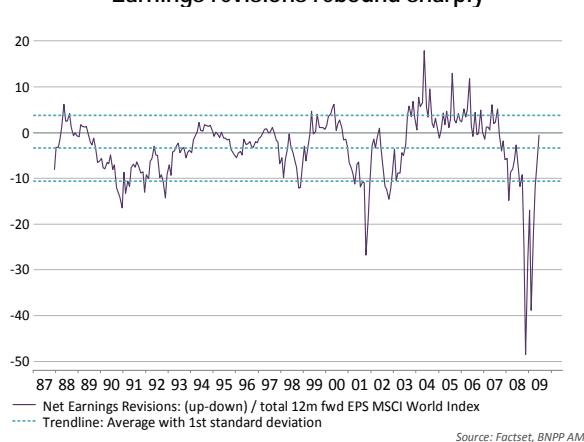
Economic outlook continues to improve



Risk aversion returns to its "pre-Lehman" level



Earnings revisions rebound sharply



# EQUITY MARKETS

## Developed markets

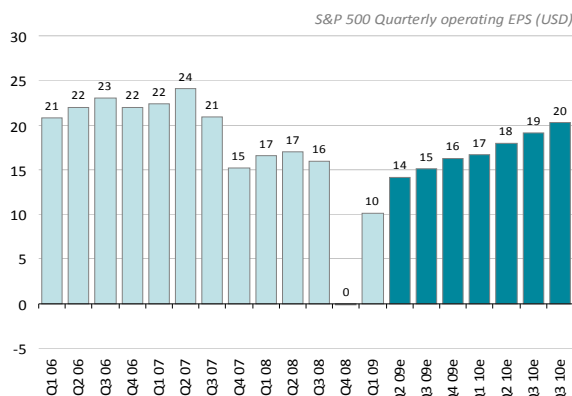
**From macro to micro – short-term investors will be keeping a close eye on the Q2 earnings season.** The reporting of second-quarter earnings, which has just gotten underway in United States, will be a crucial yardstick for investors seeking to assess the health of US firms, particularly in the non-financial sector. Since top-line growth will be weak during the recession, the only way firms will be able to present positive earnings surprises is if they continue to slash costs, as in the first quarter. Judging from the increase in unemployment and the moderation of wages over the past few weeks there is some potential for positive surprises, although it is hard to say how much. Volatility is likely to vary with the release of earnings figures over the next few weeks.

**Valuations are reasonable.** Although the rerating of risk since the market trough in early March has increased valuation multiples they are still at very reasonable levels. This has brought the P/B and forward P/E ratios very close to their historical averages. When adjusted for the earnings cycle (Graham & Dodd and Shiller P/E) valuation multiples have not fallen to their historical lows during the current recession, but are still well below their levels of March 2003. Valuations are therefore reasonable. However, we believe there is little potential for multiples expansion given the current uncertainties surrounding the economic outlook and inflation.

**Some near-term technical indicators signal caution in equity markets.** As was the case last month, market "breadth" indicators (which measure the percentage of equity indices or securities above their moving average) suggest the market is overbought, which is not good. Furthermore, many equity indices have fallen through their 200-day moving averages since the market correction that began in mid-June, and are nearing major resistance levels.

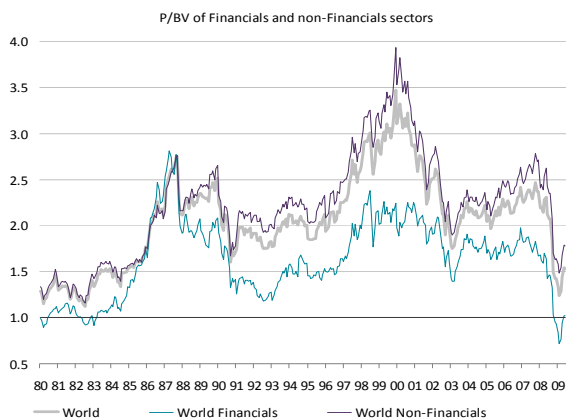
Despite the cyclical pick up and the ruling out of a systemic banking crisis scenario, given the concerns about the strength and sustainability of economic recovery and the negative near-term outlook judging from technical indicators, we are maintaining neutral exposure to developed equity markets.

### Quarterly earnings of US firms are expected to rise



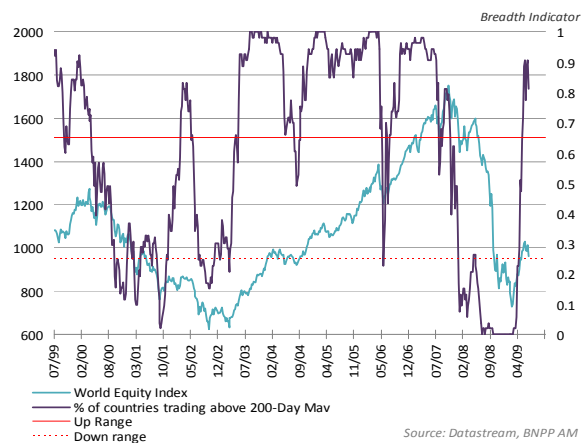
Source: Standard and Poors for reported and forecasts data, BNPP AM

### Valuations still reasonable



Source: Datastream, BNPP AM

### Overbought indicators recommend caution over near term



Source: Datastream, BNPP AM

# EQUITY MARKETS

## Developed markets

### No significant changes in our portfolio, except for increased exposure to Japan

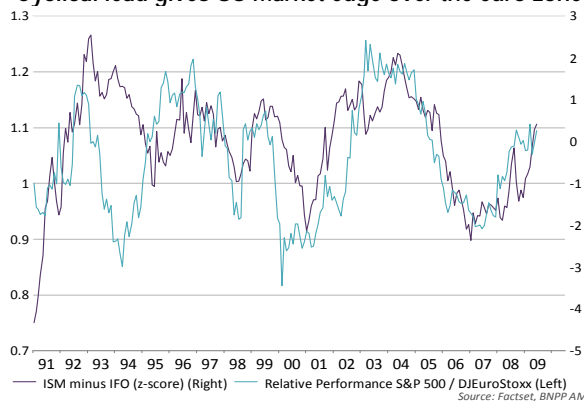
Except for a substantial increase in our exposure to the Japanese market, we made only minor changes to our portfolio this month. We have maintained our overweights in **Canada** and to a lesser extent **Australia**. However, given the uncertainty as to the recovery's strength and the correction in commodity prices, we are a bit more cautious toward these two markets, in light of their high exposure to oil and basic materials.

We are still neutral in the **United States** where we feel relative valuations are unattractive. Nevertheless, this market is supported by very aggressive monetary and fiscal policies, its lead in the economic cycle and recovery (particularly compared to the euro zone) and the dollar's weakness, which benefits exporters and increases repatriated earnings.

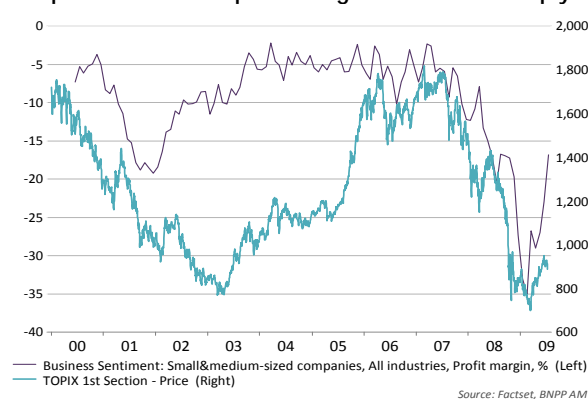
We expect **European markets** to underperform and our maintaining our underweight position. Even though relative valuations are still attractive, the weakness of the economy, relatively less vigorous economic policies and the euro's strength are likely to be a drag on the euro zone. As for the Swiss market, which is highly dependent on exports, it is handicapped by a strong CHF. Furthermore, given the uncertainty that surrounds the outlook for the country's financial sector we recommend special caution in this industry, which is such a major component of the Swiss economy and equity market. Although the UK market enjoys relatively attractive valuations and there are signs that economic recovery will be more rapid and more vigorous than in continental Europe, the relative advantage provided by the weakening of the pound and the BoE's extremely easy monetary policy is diminishing. Furthermore, relative price momentum is still in negative territory.

We are increasing our position in **Japan**, whose highly cyclical economy and exposure to exports mean that it should continue to profit from Asian recovery and the yen's depreciation. Furthermore, although Japan is going through a severe recession, the government's fiscal stimulus plan is strengthening domestic demand and the outlook for profit margins has improved sharply (in conjunction with the cyclical pick up), albeit from a very low base. In addition, this market is strongly supported by its low valuation and in particular its P/BV of almost 1. Finally, relative price momentum is once again positive.

Cyclical lead gives US market edge over the euro zone



Japan – outlook for profit margins rebounds sharply



Japan – relative price momentum strengthens



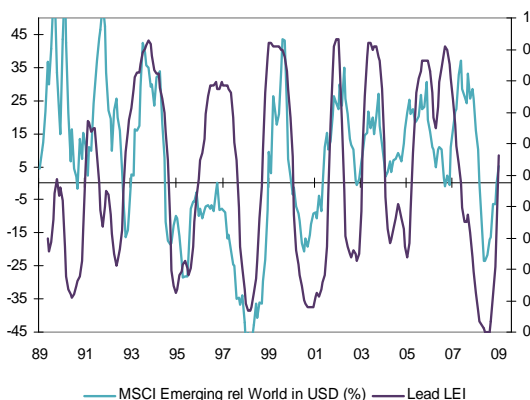
# EQUITY MARKETS

## Emerging markets

### Markets more volatile but general trend is firm

We expect emerging equity markets to continue their consolidation after closely approaching the resistance levels established just before Lehman's bankruptcy triggered the financial crisis. Newly issued securities are beginning to flood the market, resulting in a surplus that is saturating demand, particularly as mutual fund flows to emerging markets start to dwindle. Some indicators of sentiment, such as market breadth and investor surveys, are still too optimistic. This is another reason to adopt a "contrarian" approach and be cautious in emerging markets over the next few weeks.

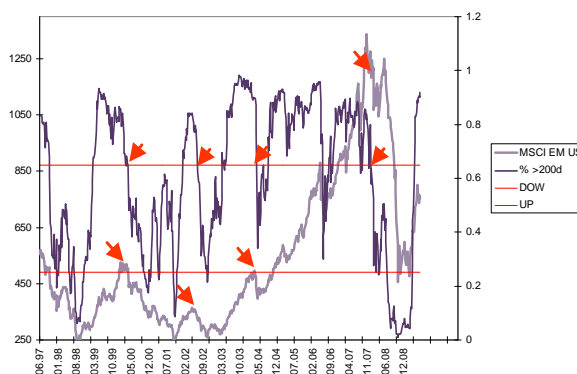
### Cyclical pickup means more outperformance



However, we see little chance of a reversal in the trend for emerging equities and of a protracted period of underperformance relative to developed markets, given their stronger economic dynamics, particularly in China and India. Furthermore, indicators show that the recovery cycle is far from over as easy monetary policy and stimulus plans continue to support economic activity. It should be noted that the IMF has just raised its growth forecasts for emerging Asia to over 5.5% and 7% in 2009 and 2010 respectively, while the manufacturing sector has recouped much of its losses. The strength of retail sales and bank loans also suggests that domestic demand is improving.

Valuation multiples for emerging markets have become high and are above historical averages in many cases. Yet core inflation has also dropped sharply, which reduces the risk premium and increases the appeal of riskier assets. Net earnings revisions are now positive, thanks mainly to the Chinese, Indian, Korea and Taiwanese markets. The revisions trend is less favourable in Latin America and Eastern Europe. These two regions profited from the rebound in commodity prices, which was driven by very specific factors, such as opportunistic inventory rebuilding by Chinese authorities during the first quarter of the year.

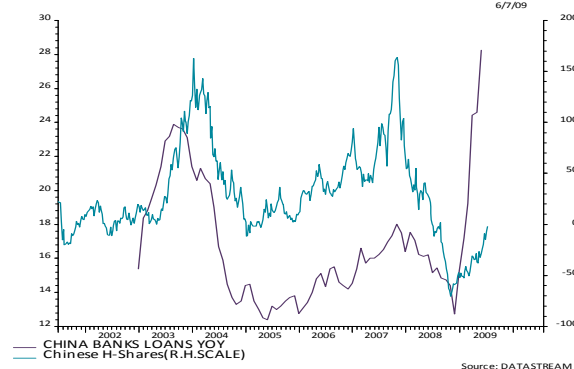
### No imminent downturn in emerging markets



Source: BNP PAM

Chinese equities are clearly overbought and have become highly speculative. Although H share prices are more than 30% above their 200-day average, this level is not exceptional. According to rumours, 20% of the 7 trillion yuan in new loans granted since the beginning of the year has been invested in the stock market, resulting in high volatility. The very low interest rates and the tremendous amount of liquidity, particularly in the form of bank deposits and savings, also justify a natural shift toward the riskier asset classes. Since this balance will not change anytime soon the market's outperformance is likely to continue but with much greater risk.

### Strong economy and liquidity support Chinese equities



# EQUITY MARKETS

## Emerging markets

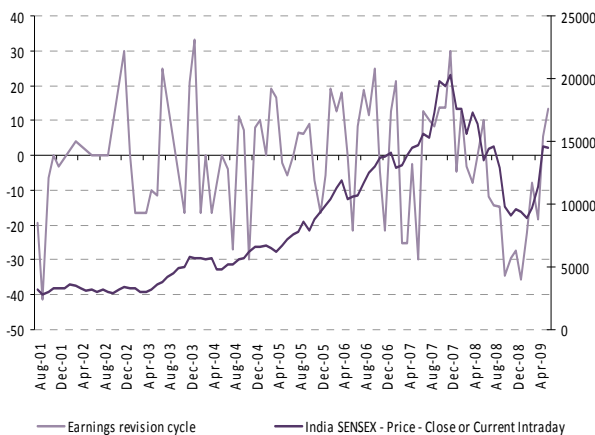
**India's** new budget, which investors found very disappointing, accelerated the 13% correction in Indian equities from their peak of last June, thus reducing the market's overall gain to only 12% since the legislative elections. The Indian equity market is firmly underpinned by the domestic economy and the country's potential for reform. Moreover, the earnings revisions cycle has turned upward. Foreign fund flows also continue to support the market and we expect this trend to continue since most fund managers are still underweight in Indian equities. However, this influx of liquidity has considerably increased valuation multiples and we are reducing our overweight in this country.

After gaining 64% during the first five months of the year, the **Russian** market corrected sharply in June, when it became clear that this performance was not justified by fundamentals. Indeed, first-quarter GDP shrank 9.5% y/y. Domestic demand continues to decline as both business investment and private consumption falter. Economic surveys also show no signs of improvement. Earnings growth is also less favourable than in the other emerging countries. In light of these factors we believe the market correction will continue this month and therefore recommend an underweight position in Russian equities.

**South-Africa's** economy continues to reflect the global downturn and domestic demand has suffered from a sharp drop in consumer and business confidence. In addition, many investors are concerned about the country's inflation, which at 7.9% in May is still well above the central bank's target. The poor outlook for materials, which account for 28% of the MSCI South Africa index, also augurs poorly for the market. We therefore recommend an underweight position.

Last month we reduced our underweight in **Mexico** in light of swine flu's reduced impact on the country's economy. This month we are making no change to our exposure since we see little improvement in either the fundamentals or valuations of Mexican equities.

India – the earnings revisions cycle turns upward



Compared to other emerging countries, **Brazil's** economy should recover more rapidly due to its very large domestic consumption, a solid banking system and the relative lack of wealth destruction during the crisis. The Brazilian stock market thus gained 40% over the first five months of the year, before slipping 9% in June. This reflects the less optimistic forecasts for earnings growth and the market's expectation that the country's central bank will maintain a high policy rate. We have therefore decreased our exposure to Brazil from slightly overweight to neutral.

# ALTERNATIVE STRATEGIES

## Commodities

### Exposure to commodities reduced

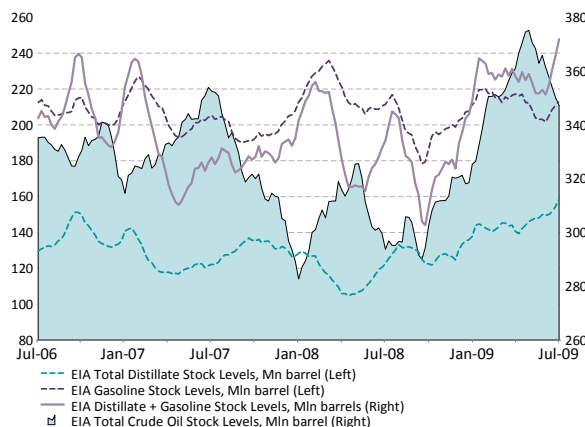
Like many investors we were wary of the sharp rebound in **oil prices**, and it is now clear that they got well ahead of fundamentals. Although crude oil inventories continue their steady decline, petroleum product stock levels are showing few signs that demand is recovering. With the demand for jet fuel and middle distillates hit hard by the manufacturing slump, refiners are counting on increased demand for gasoline as the summer driving season gets underway in North America. Considering the current high oil price, we decided to **trim our position to neutral** until we see clear signs that demand is strengthening. We will also be monitoring attempts by the CFTC to impose stricter regulations on speculation in commodity markets.

The price of **gold** continued to move trendlessly and implied volatility continues to decline steadily. Since the physical demand from investors and jewellers is stagnant, the US dollar is the main factor influencing the gold price. **We are reducing our overweight** until we see signs that physical demand is picking up.

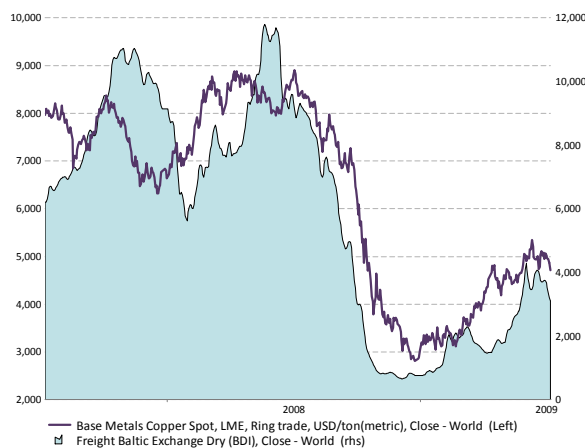
We continue to shun **base metals**. Investors are still uncertain about Chinese demand and there are reports that the SRB, which manages the country's copper reserves, may have put 100,000 tonnes on the market. Furthermore, the Baltic Dry and other freight indices show that trade in commodities is slowing. Prices could continue to correct, considering how sharply they have rebounded over the past few months and the fact that seasonality is now normally less favourable.

We maintain our **overweight position** in **agricultural commodities**. Grain and soybean prices fell sharply as speculators slashed their positions in response to improved weather conditions and weaker than expected US crop area data. Some investors may also have been reducing their exposure on fears that speculative positions would be more closely regulated. Nevertheless, at their current prices the balance of risks (and in particular of poor weather) is significantly tipped in favour of agricultural commodities.

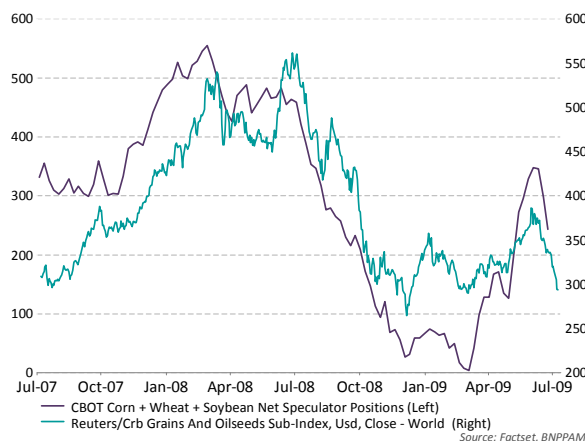
Oil – stocks of petroleum product are still bloated



Metals – freight indices slow



Grain & oilseeds – speculators cut their positions





# AVERTISSEMENT

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