For professional investors

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

Weekly Strategy Update

15 November 2012

SUMMARY

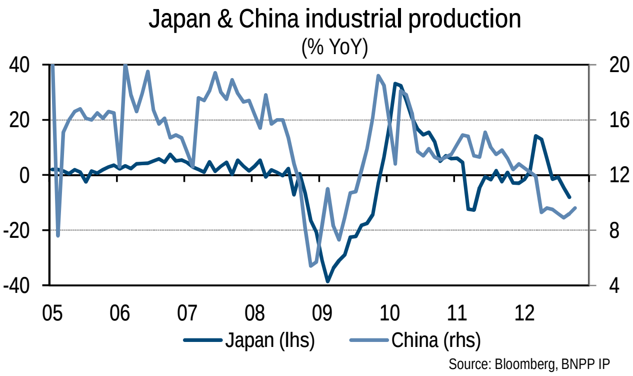
- Japan probably in recession, but China stabilising
- Equities struggle due to fiscal challenges
- Asset allocation unchanged

Equity markets have been weak since the US presidential elections amid growing concern about the looming 'fiscal cliff' and the limited time for Congress to start addressing the US's debt and deficit issues. Both the Democrats and the Republicans have opened up to a compromise, but this has not alleviated investor worries. Luckily, the US economy is not in too bad a shape. In the eurozone, politicians were busy with Greece's finances and the 2013 EU budget. In Asia, we see a strong divergence between China and Japan. Given all uncertainties, we have left our asset allocation unchanged.

JAPAN AND CHINA DIVERGE

The Japanese economy shrank by 3.5% QoQ annualised in the third quarter, the largest drop since last year's tsunami. Consumption and imports fell more modestly than GDP, but investments and exports dropped more rapidly. The plunge in GDP was not unexpected - leading indicators had pointed to weakness. Unfortunately, these indicators have not turned yet. The Economy Watchers Survey and consumer confidence fell further in October and the composite leading index tumbled in September. Orders for machines and machine tools fell more rapidly in September and October. Some of the weakness could be temporary. Exports have suffered amid political tension with China over Islands in the South China Sea, though this may fade. Signs of stabilisation in China's economy should also help. But the strong yen and weak domestic demand, plus weak demand from Europe, will likely continue. Thus, growth could stay negative in the fourth quarter which would push the country into a recession technically.

Developments in China have been more positive. Exports rose by 11.6% YoY in October, a dramatic change from the muted 1% YoY growth as recently as July. Imports continued to grow at a modest 2.4% YoY. Thus, the trade surplus surged to its highest since January 2009. While positive for growth in China, it would be negative from a global perspective if this trend continued, since it would bring back global imbalances. However, the trade surplus tends to peak in October, so it could fall in coming months. More positive from a Chinese as well as a global perspective were the gains in retail sales and industrial production.

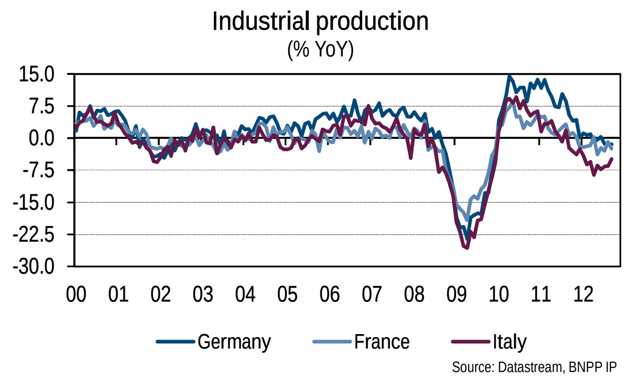


With leading indicators also improving, the risk of a hard landing by the economy has clearly diminished. We see lingering risks in the Chinese shadow banking system where credit has grown and risk management does not seem optimal.

ECB LEAVES POLICY UNCHANGED

As expected, the ECB left its monetary policy stance completely unchanged at last week's policy meeting. During the media conference ECB president Draghi admitted that eurozone growth was weak and that the ECB could lower its growth forecasts next month. The central bank sees the current level of inflation as transitory and expects it to fall to below 2% next year. It sees the risks around this outlook as broadly balanced. When asked about deflation Draghi answered that he never mentioned the word. We do not agree with the ECB on this point. The upside risk to inflation from higher indirect taxes, as mentioned by the ECB, is by definition temporary and higher taxes should be disinflationary in a weak economy since they undermine consumer spending power. We do see a risk of deflation with unemployment at levels not seen before and banks hardly lending. Much of the question & answer session of the ECB media conference focused on Greece and Spain. Its basic message was that the ECB does not have many options left to support Greece and that it is ready to start buying bonds under its OMT programme as soon as Spain applies for a bailout. This should be accompanied by strict conditions.

Meanwhile, data on the eurozone economy remained weak. The German ZEW index, an early but quite volatile leading indicator, fell in November. Factory orders, industrial production and exports all fell by more than expected in September. Searching for positives, one could point to the stabilisation of the annual growth rates of orders and production. Industrial production was weak in many eurozone countries in September, including France, Italy and Spain.



Eurozone finance ministers discussed the 2013 EU budget and support for Greece, but did not reach any final conclusions. Some countries want to increase the budget, while others want it to be frozen. Eurozone leaders must now solve the standoff at their summit in December. Regarding Greece, the finance ministers decided to give the country more time to reduce its budget deficit. However, the EU and the IMF disagreed about the sustainability of Greek government debt, so the IMF may not increase its support to Greece. How Greece's slower adjustment process will be financed has not been decided though. With Germany, the Netherlands and Finland unwilling to provide more funds, a mix of lengthening the maturity of official loans to Greece or lowering interest rates could be applied. We doubt this will be enough. A debt restructuring including the official loans should not be ruled out.

US TRADE DEFICIT NARROWS

US exports rose more strongly than imports, both in real and nominal terms, in September, causing the trade deficit to narrow unexpectedly. Exports of food products, industrial supplies, aircraft engines and oil products were particularly strong. Exports of high-tech goods and cars fell. The main implication is that third-quarter GDP growth, initially reported at 2.0% QoQ annualised, will likely be revised higher. Together with other adjustments, it could go to 2.5% or even close to 3%.

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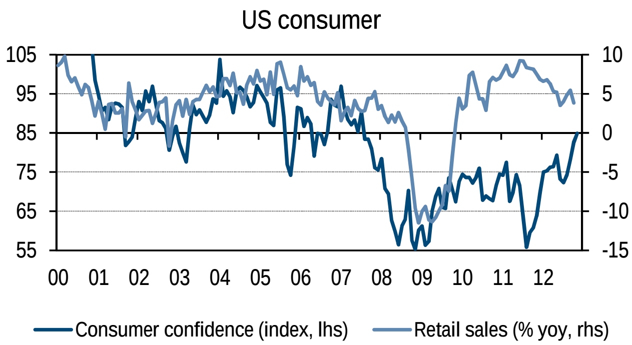
According to a University of Michigan survey, consumer confidence rose further in early November to the highest level since July 2007. Although this is positive, we question the relevance to some extent since the improvement in confidence has lagged the rise in retail sales.



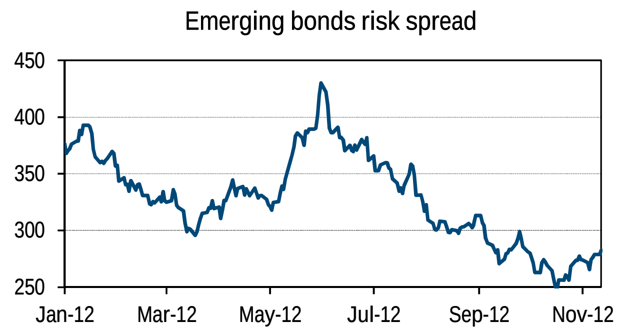
Source: Datastream, BNPP IP

Actually, retail sales lost momentum from the middle of last year through June this year. July, August and September were months with strong spending. In October retail sales fell for the first time since June. This weakness was most likely some payback for the earlier strength. Hurricane Sandy which hit the East Coast at the end of the month also impacted October retail sales, although the Commerce Department, who provides these data, was not able to asses Sandy's impact. With income growth still modest, we do not see much room for higher consumer spending at this point. Of course, consumers could borrow to support spending. In fact, in September consumer credit grew by USD 11.4 billion for a growth rate of 5.5% YoY. This looks healthy to us.

EQUITIES STRUGGLE

Equity markets have struggled since the US elections. This is somewhat surprising since the results did not differ that much from the polls. Perhaps investors who had bet on a Romney victory were disappointed. Or perhaps investors worry about a still divided Congress. Anyway, the 'fiscal cliff' is casting a shadow over the markets and this could last a while. President Obama and the Republican opposition appear willing to compromise, but whether this will be enough for a credible deal before the end of the year (or before the debt ceiling is reached in February) remains to be seen. The discussions in Europe about the EU budget and Greece have not been supportive either.

US and German government bond yields have actually fallen somewhat since the elections. Yields in Spain have drifted higher. The recent risk-averse climate did not have much impact on corporate bond spreads. Spreads on emerging market bonds have risen since the middle of October after narrowing sharply since early June. Looking at fundamentals such as the fiscal balances, growth prospects and external balances of emerging economies, we see room for spreads to narrow again.



Source: Datastream, BNPP IP

ASSET ALLOCATION UNCHANGED

We have not changed our asset allocation. Our neutral position on equities reflects our bearish view on the global economic cycle and the outlook for earnings and the supportive stance of monetary policy. Our underweight in emerging equities versus developed equities is driven by the relatively narrow growth differential and more favourable monetary policy in developed economies. We are underweight Europe and Japan versus the US since these economies appear chronically weak currently.

We are underweight government bonds. Since we are convinced that government bond yields in highly rated countries will stay low, we are looking to reinstate a tactical long duration position. We are underweight 'peripheral' eurozone bonds versus core bonds and underweight eurozone inflation-linked bonds. We do not see any inflationary pressures in the region now.

We have a relatively large overweight position in emerging market USD-denominated debt. In stark contrast to Europe, we expect upgrades of sovereign credit ratings to continue given the improving economic governance and the persistent bid for relatively high-quality spread products in the search for yield. Since we

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like the debt quality more than the currencies, we prefer hard currency debt. We are neutral on corporate bonds.

We see downside risks for commodities, although we are neutral, except for gold where we are overweight.

Two positions reflect our negative bias towards Europe. We are underweight European small-cap equities. The recession has seriously weakened their earnings prospects and we see little chance of that turning around in the near future. We are underweight the euro against a basket of currencies that broadly matches the European trade-weighted exchange rate. We expect a weaker currency to be part of the adjustment mechanism that should eventually restore the economy to health.

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