INVESTMENT STRATEGY

August 2008

Investment Strategy of August 6, 2008

Equity Markets *(local currencies)*	**Last price 07/08/2008**	**1M chg**	**3M chg** *(% changes)*	**Ytd**
Stoxx 50	2 912	1.5	-11.4	-21.0
EuroStoxx 50	3 397	1.9	-12.3	-22.8
CAC 40	4 457	2.6	-12.2	-20.6
DAX	6 543	2.3	-7.5	-18.9
MIB	29 154	0.9	-15.6	-24.4
Ibex 35	11 718	-2.2	-16.5	-22.8
Footsie 100	5 478	-0.6	-12.5	-15.2
SMI	7 182	5.4	-6.0	-15.4
S&P 500	1 266	1.1	-9.1	-13.8
Dow Jones Indus 30	11 431	1.8	-10.8	-13.8
Nasdaq	2 356	5.0	-3.4	-11.2
Nikkei 225	13 125	-1.8	-6.9	-14.3
Topix	1 259	-4.1	-9.7	-14.7
MSCI Emerging (USD)	41 092	-3.5	-17.3	-20.3
Kospi composite	1 564	-1.0	-15.6	-17.6
Bovespa	57 018	-3.5	-17.4	-10.8
Russia RTS	1 843	-15.8	-16.3	-19.6
India BSE 30	15 117	11.8	-12.8	-25.5
HS China - Red Chip (HKD)	4 495	-5.9	-21.9	-26.5

Bond Markets	**Last yield 07/08/2008**	**1M chg**	**3M chg** *(changes in bp)*	**Ytd**
10-year US T-note	3.93	2	7	-16
2-year US T-note	2.43	-1	11	-69
10-year Bund	4.28	-15	9	-5
2-year Bund	4.11	-26	32	11
10-year Gilt	4.69	-22	-2	7
2-year Gilt	4.64	-28	20	23
10-year JGB	1.52	-18	-15	2
2-year JGB	0.73	-18	-6	2
	Last spread	**1M chg**	**3M chg** *(changes in bp)*	**Ytd**
Lehman Global High yield	728	28	156	231
Lehman US High Yield	785	38	150	221
Lehman EUR High Yield	836	54	238	383
Lehman US Invest.grade	288	18	52	91
Lehman EUR Corporate	189	12	31	69
JP Morgan EMBI+	290	-14	36	58

Currencies	**Last 07/08/2008**	**1M chg**	**3M chg** *(% changes)*	**Ytd**
EUR/USD	1.54	-1.8	-0.1	4.6
USD/JPY	109.6	1.9	4.0	-3.1
GBP/USD	1.94	-1.3	-0.4	-2.4
USD/CHF	1.06	2.7	0.3	-6.1
EUR/JPY	168.5	0.1	3.9	1.3
EUR/GBP	0.79	-0.6	0.2	7.2
EUR/CHF	1.63	0.8	0.2	-1.8

Commodities	**Last price 07/08/2008**	**1M chg**	**3M chg** *(% changes)*	**Ytd**
Oil (WTI), $/bl.	119.8	-15.2	-3.0	24.8
Reuters/CRB index	450.6	-3.5	-4.3	5.2
Gold, $/oz.	872.5	-5.7	0.6	4.0

Source: Factset, BNPP AM

August 8, 2008

The September issue of the Investment Strategy will resume its usual longer format.

Technical rebound in equities fizzles out

After a disastrous first two weeks of July for equity markets during which share prices fell below their previous lows of March in response to new concerns about the financial system (and about Fannie Mae and Freddie Mac in particular), a limited rebound began to take shape. However, the support that US officials have given to the two government-sponsored mortgage lenders does not seem to have completely reassured investors. Although quarterly results were higher than expected, news about the financial system, particularly in the US, continues to be mixed (with more regional mortgage lenders going bankrupt and announcements of new asset write-downs and capital-raising efforts) and economic activity across the world continues to weaken or disappoint. This economic environment explains why the outlook continues to fluctuate and why equity markets remain volatile.

Tactical positioning in equities

Near-term technical and sentiment indicators, lower oil prices and the neutral stances of central banks suggest that the increase in share prices observed since mid-July could continue. Not for very long however, since weaker economic conditions will dim earnings prospects over the coming quarters.

Equity indices have already largely priced in the expected slowdown in growth and earnings and their valuations are currently low. But investors have two more things to worry about, namely the soundness of the financial system and the price of crude oil. Regarding this first point, investors continue to be somewhat wary despite the most recent and very commendable efforts of US authorities to avoid a systemic crisis. Regarding oil and other commodity prices, speculation has made it difficult to interpret recent price trends. With real interest rates still very low and even negative it seems unlikely that oil prices will continue to fall as rapidly as they have, which has certainly been a key factor in the strengthening of equity markets.

"We gonna need a bigger boat"

This expression, which can be traced back to Steven Spielberg's film *Jaws* (1975), is commonly used in the United States to describe a situation that may seem hopeless. Given the series of crises that investors have had to face over the past year they do seem to need a bigger boat. There are currently no fundamental factors that could transform the current technical rally into a more sustained bull market. Although low valuations certainly augur well for future long-term performance, they only attract attention when investors are confident about growth prospects. In the current environment volatility is therefore likely to remain high in all financial markets over the coming months.

We expect equity prices to continue to move trendlessly until investors are convinced that the economy is recovering. The Federal Reserve could contribute to this scenario. If the prospect of a hike in key interest rates becomes likely – for example because Ben Bernanke says he is less concerned about growth (perhaps sometimes early next year) – investors will be more willing to embrace the riskier assets. After all, the great white shark was defeated in the end.

ASSET ALLOCATION

Typical diversified model portfolio – Institutional clients

The model portfolio holdings below are measured against cash and may be transposed into any other portfolio whether benchmarked or not.

MULTI-ASSET CLASS[1]

	Sharpe Ratio	Aug-08 *weights*	Jul-08 *weights*
EQUITIES			
Developed Equities	0.0	0.0%	0.1%
Emerging Equities	0.4	1.0%	1.1%
FIXED INCOME			
Government Bonds	0.1	2.0%	0.0%
Corporate Bonds	0.2	3.3%	3.4%
High Yield	0.1	0.9%	1.1%
Emerging Debt	-0.1	-0.7%	-1.0%
COMMODITIES	0.0		
Brent Oil	0.0	0.0%	0.0%
Base Metals	-1.1	-3.1%	-2.6%
Gold	0.1	0.4%	0.7%
Agricultural	0.2	0.5%	1.1%
Cash Euro	0.0	-4.4%	-4.0%
Module Total		0.0%	

1- Hedged in Euro, 2- MSCI hedged in Euro
3- MSCI in Euro, 4- JP Morgan GBI hedged in Euro,
5- Forwards to Euro investor
* Risk Budget (in bp),** VaR 99% 1 month,
***Net: Multi-Asset Class

EQUITIES: DEVELOPED COUNTRIES[1]

	Alpha	Aug-08 *weights*	Jul-08 *weights*
US	0.1	1.4%	2.5%
Canada	0.1	0.8%	1.5%
Euroland	-0.2	-2.1%	-2.6%
Japan	0.1	0.9%	1.4%
UK	-0.1	-0.8%	-0.6%
Switzerland	0.0	-0.1%	-1.5%
Australia	0.0	-0.1%	-0.6%
Module Total		0.0%	

EQUITIES: EMERGING COUNTRIES[3]

	Alpha	Aug-08 *weights*	Jul-08 *weights*
Brazil	0.1	0.7%	1.3%
Mexico	-0.2	-0.8%	-0.2%
China	0.0	0.1%	-0.3%
India	-0.2	-0.8%	-1.6%
South-Korea	0.2	0.9%	1.3%
Taiwan	-0.3	-1.2%	-1.2%
Russia	0.4	1.6%	1.7%
Poland	0.0	0.3%	0.0%
South Africa	-0.3	-1.7%	-0.9%
Turkey	0.3	0.9%	0.0%
Module Total		0.0%	

BONDS: COUNTRIES SOVEREIGN[4]

	Alpha	Aug-08 *weights*	Jul-08 *weights*
US	-0.1	-3.4%	-4.5%
Euroland	0.2	9.7%	10.0%
Japan	-0.1	-3.0%	-5.4%
UK	0.1	1.2%	6.4%
Switzerland	-0.1	-4.5%	-6.5%
Module Total		0.0%	

PORTFOLIO STATISTICS

Ex-ante Volatility	1.00%
Ex-ante Var*	0.67%
Excess Return over Cash at 84.1% c	0.20%
Conf. of beating Cash by 2%	21.08%
Risk of falling below Cash -0.5%	4.49%

Strategy overview

- Slight overweight in equities is maintained through exposure to emerging markets.
- Overweight in government bonds, as the acceleration of the slowdown (particularly in Europe and Japan) has overshadowed inflation fears, which moreover have eased a bit.
- We continue to prefer corporate debt (since valuations are attractive and bank deleveraging will be good for the market) and also high yield because of the carry.
- In commodity markets we are maintaining our overweight in gold and agricultural products and increasing our underweight in base metals, which are suffering from the global slowdown.

Geographic equity allocation

- We continue to prefer the US market. Although growth is weak government authorities are doing everything possible to correct the situation (e.g. the fiscal stimulus plan, measures to aid homeowners and steps to rescue Fannie Mae and Freddie Mac) and monetary policy continues to be highly accommodative.
- Overweight in Canada, one of the rare markets where earnings are being steadily revised upwards.
- Exposure to Japan has been trimmed. Although valuations are attractive the risk of a recession has weakened confidence.
- Underweight in euro zone lowered slightly. Although the ECB has given no signs that it will soon loosen its monetary policy further increases in key rates seem highly unlikely. The sharper slowing of growth, pressures on profit margins and diminished earnings prospects are weighing on this market.
- Underweight in the UK. Although valuations are relatively attractive and monetary policy will probably be loosened, the decline of the housing market and slower growth will be strong headwinds.
- Among the emerging markets, we continue to prefer Russia, Korea and Brazil. We have reduced our exposure to the latter country however despite the robust growth of GDP and earnings, since rising inflation is likely to prompt higher interest rates.
- We now have an overweight in Turkey, where monetary tightening is expected to end, valuations are still attractive and political risk has subsided.

Government bonds

- We are overweight in the euro zone and the UK, where looser monetary policies are expected, momentum is positive and relative valuations are more attractive.
- We are underweight in the US because of expectations of tighter monetary policy and the country's advanced position in the economic cycle.
- Underweight in Japan, where yields have already priced in much of the weak growth.

GENERAL OUTLOOK

INVESTORS HESITATE

Global economy less buoyant

Economic news from the United States has been rather mixed over the past few weeks. Despite the steadily rising jobless rate, there has been only a modest decline in manufacturing activity. Most economic indicators in Europe, Japan and certain emerging regions have however fallen substantially. The global economy seems to have returned to a time when the US business cycle "led the way", both upward and downward, in advance of each region to varying degrees. For example, the European business cycle generally lags the US economy by two to three quarters. The very small contraction of the revised US GDP figure for the fourth quarter (an annualised -0.2%) has been an "obvious" signal for investors, who were surprised by this even though growth was practically zero before the revision. Now, six months later, the effects of the US slowdown are being seen throughout the world.

Globalisation does not solve everything. Some economists have been pointing out that the world's economies are "decoupling", as the emerging countries play a growing role in the global economy. Although the major emerging countries are no doubt developing in an increasingly independent manner (although investment does play a major role) since private consumption still accounts for a relatively small portion of their GDP they are not completely sheltered from the ups and downs of the global economy. Although stronger "emerging" demand may smooth out business cycles they will not disappear entirely, despite the appearance of "regional growth dynamics" as seen in Asia, where China's growth has boosted the entire region, including Japan. But the limits of regional growth engines were recently made apparent as Chinese measures to reduce inflation in spring have begun to weigh on economic activity and further depress Japanese exports which were already suffering from the US slowdown. The statement by Japanese officials in early August that "the economy is weakening" suggests that the country may have entered a recession. The situation in Europe is hardly more enviable as purchasing managers' surveys and business climate now point to clearly weaker activity and prospects as a result of numerous headwinds, which include the US economic slowdown, the euro's strength, high oil prices, relatively tight monetary policy despite the financial crisis, and the downturn in housing markets.

We expect the global economy to slow sharply, but not collapse.

Lower oil prices bolster growth and sentiment. The rapid decline of oil prices since mid-July has been the biggest news over the past few weeks and was warmly greeted by equity markets. The WTI barrel price fell from an all-time high of $147 on July 11 to less than $123 on the 25th, representing a 16% drop in two weeks. This decline, which was amplified by the unwinding of speculative positions, may be attributed to various fundamental factors, such as softer demand (particularly in China) and reduced geopolitical tensions. But such factors can be rather volatile, as seen by the recent attacks on oil facilities in Nigeria late last month, which caused prices to spike up on July 28. Although the market has been volatile since, the WTI price fell back again in early August to below $120. Despite the recent sharp drops, crude oil is still 25% more expensive than at the beginning of the year. Although the near-term bearish momentum appears strong, fundamentals do not justify further declines over the medium term, barring a severe global recession and a collapse in the demand for oil. Both geopolitical and purely financial factors may keep oil prices quite volatile over the coming months. Since real interest rates are negative, commodities in general are likely to continue to be the preferred real asset of investors, in the absence of a better alternative. Nevertheless, at the end of the day the drop in the barrel price from $150 to $120 is good news not only for growth (since it reduces the "oil tax" on consumer spending) but also for inflation, since it almost immediately reduces the headline inflation rate. Lower oil prices are furthermore likely to improve consumer confidence and also enable central banks to delay or suspend monetary tightening. Lastly, by calming inflation fears, the decrease in the price of oil may help stabilise equity and other financial markets. If inflation starts to slip central bankers may have a hard time keeping it under control (according to Karl Otto Pöhl it's like putting toothpaste back in the tube) and this, in addition to lower profit margins, could weigh on share prices.

Although most investors would certainly consider an "orderly" slowdown to be the lesser evil, a sharper recession could ultimately have a more positive impact by "wiping the slate clean". Central bankers however do not seem ready to apply such drastic medicine. Let's trust them: they are certainly better doctors than those of Molière.

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