



# PERSPECTIVES



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BNPP IP is the source for all data in this document as at end of March 2014, unless otherwise specified.

## On edge

Investors are increasingly on edge as various signals suggest that times are changing. With tapering on auto pilot, focus is now shifting to the Fed's first rate hike. Was Janet Yellen's suggestion that there would only be a six-month period between the end of the Fed's quantitative easing programme and the first rate increase a slip of the tongue or a deliberate gauging of the market's reaction? Investors weren't amused and appreciated her subsequent dovish clarification. Same story in Europe where the ECB's 'no change' was met with disappointment until Bundesbank chief Jens Weidmann spoke of the need to temper the euro's strength.

'On edge' manifests itself in ways other than jittery reactions to central banker's statements. There is increased sensitivity to valuations; witness the corrections in US small caps, tech and biotech valuations after their great run, and the rotation into safer value stocks. Talk of bubbles in social media stocks, in corporate bonds or even in equities exacerbates the state of edginess. However, just as markets exhibit momentum, so do the themes being pursued by newspapers. So 'expensive' should not be confused with 'bubble'.

'On edge' also means seeking and finding opportunities in markets previously considered unattractive. The renewed appetite for emerging equities is a case in point. Interestingly, there is no global macro catalyst at work but different country-specific developments suggest that emerging markets may be making a comeback. Admittedly, emerging equity markets should be considered as the final frontier for value. For the rally to last, earnings growth must pick up. In that sense, their challenge is no different from that faced by developed markets.

4 April 2014



**William De Vijlder**  
Vice-Chairman of BNPP IP



Joost van Leenders

Chief economist, Multi Asset Solutions team - BNPP IP, Amsterdam

## Geopolitical tensions and central banks set the stage

Equities generally lacked direction in March. Improving economic conditions in the US and the eurozone supported investor sentiment, but rising geopolitical tensions and a hawkish Fed acted as drags. US bond yields rose, but low inflation held yields down in the eurozone. We are positively exposed to market risk, although we closed our overweight in European equities and our short euro position. We rotated our overweight in US real estate into European real estate.

### Tensions between Russia and Ukraine influenced markets. How did you react?

When the tensions arose, we developed different scenarios and analysed which of our positions were most vulnerable. We concluded these were our overweight in European equities versus US equities and our short duration in German Bunds. As the crisis developed, we closed our overweight in European equities versus US equities. We still believe there are fundamentally positive factors supporting this trade such as an improving economic outlook in the eurozone, favourable monetary policy, attractive valuations and the prospect of strong company earnings growth.

### The Fed has a new chair and there have been some dovish comments from European monetary policy makers. Is central bank policy still positive for equities?

In March, the Fed's Federal Open Market Committee (FOMC) policy meeting, the first led by Janet Yellen, produced an unsurprising media statement. The Fed continued tapering its asset purchases by USD 10 billion per policy meeting as it felt the recent economic slowdown was mainly due to adverse weather. At this pace, the Fed should have wound down quantitative easing (QE) by October or December. It ditched its 6.5% unemployment rate threshold in favour of a broad range of indicators as monetary policy guidelines. In this regard, it is back to normal for the Fed. But at the subsequent news conference, Janet Yellen said the time between the end of QE and the start of rate hikes could be as short as six months. She stressed the labour market was weak, but improving. FOMC members expected rate hikes to come sooner and faster than previously thought. This drove up bond yields, but we think it is too soon to see monetary policy as a headwind for equities. Yellen sounded more dovish in a speech at the end of March.

After its early March policy meeting, it seemed the ECB was done with easing. Several indicators pointed to improving growth. For example, the Economic Sentiment Index rose in March to its highest since 2011. Portugal, Italy and Spain are leading in terms of annual improvements. In Q4 2013, employment rose

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“The ECB has opened the door to more policy action, although we do not think it will go as far as quantitative easing”

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for a second consecutive quarter for the first time since 2008. Overall, the gains were marginal, inflation was very low and the euro was on its way to 1.40 USD. So when Bundesbank president Weidmann and the head of the Finnish central bank Liikanen discussed additional monetary easing, such as a negative rate for banks depositing excess reserves at the ECB and even QE, their primary goal appeared to be to talk down the euro. It worked: the euro depreciated. The ECB has opened the door to more policy action, although we do not think it will go as far as QE. At its early April meeting, the ECB left its policy unchanged. All in all, we see monetary policy as positive for global equities.

### Have you changed your asset allocation?

We remain positively exposed to risk. We are overweight global equities, European high-yield bonds and European real estate and short duration in German Bunds. In a broad sense, economic conditions are improving in the US and Europe, inflation is low and monetary policy extremely stimulative. Valuations are stretched for US equities and European corporate bonds, but we do not expect this to drive markets in the short term. We de-risked our model portfolio by closing our overweight in emerging market debt in February and in European equities in March. We closed our short euro position since this was moving against us. We rotated our overweight in US real estate into European real estate where we expect fundamentals to start improving.

Written on 7 April 2014



**Vincent Lapointe**

Research officer for BNPP IP

Aix-Marseille Université (Aix-Marseille School of Economics), CNRS & EHESS

# SRI performance: Does size really matter?

A study<sup>1</sup> of BNP Paribas Investment Partners' Socially Responsible Investment (SRI) Best-In-Class universe of European stocks highlighted a size effect that determines financial performance. Study author Vincent Lapointe explains.

## Why has the interest in SRI risen recently?

In light of the recent economic and ecological crises, firms' Environmental, Social and Governance (ESG) practices have become more visible. So too has their sense of Corporate Social Responsibility (CSR) – their need to take social, ethical and environmental responsibility for their actions, even when not required to by law. This has heightened the interest in SRI, which is about investing on the basis of financial and extra-financial criteria and seeking added value from both of these elements.

“Our observations also highlighted the importance of the size of firms in the amount of performance generated”

## Is there any connection between financial and extra-financial performance?

The level of extra-financial performance – the quantity and quality of CSR actions – interacts with the value of firms via their cost of capital: those with no CSR policies are seen as being risky. But it also interacts with the value of firms via the profits their activities generate – depending on how their CSR actions are motivated by the search for profit. Cheaper capital and higher profits are reflected in a higher share price.

That said, many studies show the average performance of SRI funds to be similar to that of traditional funds. This has to do with how efficient markets are with information and/or there being fewer diversification opportunities with SRI funds. If markets rapidly digest all the data that can affect a firm's value, one cannot capture the related revalorisation. Conversely, if markets are inefficient, one can obtain abnormal returns by systematically buying into 'responsible' firms before this characteristic is priced in.

## How do you choose the companies that perform the best extra-financially and assess their financial performance in a portfolio?

The SRI Best-In-Class investment process of BNPP IP excludes from the investment universe companies that do not respect fundamental principles (e.g. the UN Global Compact), or being active in controversial sectors (e.g. the 'sin stocks'). With the remaining universe, we privilege companies that show best-in-class ESG practices. These are the 'IN' companies; those excluded are the 'OUT' companies.

To see whether a portfolio of 'IN' companies would financially outperform one of 'OUT' companies, we built a universe of 576 firms, which were all those in the MSCI Europe index that our SRI process recommended as being 'IN' or 'OUT' between early 2008 and mid-2013. We used this universe to back-test and calculate the absolute, relative and risk-adjusted performance of various cap-weighted (CW) and equally-weighted (EW) portfolios. The risk-adjusted data allowed us to take into account the differences between portfolios.

## What was your main conclusion?

As in other studies of SRI performance, we found that one can generate additional financial value by systematically selecting the shares of 'responsible' companies. However, our observations also highlighted the importance of the size of firms in the amount of performance generated. When small firms had larger weights, as in the EW portfolios, the portfolio of 'IN' firms generated 291bp of alpha a year, while the portfolio of 'OUT' firms lost 83bp of alpha a year. Small and medium size firms are more prone to be neglected and therefore to be less efficiently priced. We also noted that, across all sectors, the Best-In-Class selection favours large capitalisations and seemed to modify the exposures to risk factors such as the Market factor and the Fama-French SMB factor<sup>2</sup>.

In our view, these findings argue for more robust analysis of the extra-financial performance of medium and small-cap firms.

*If you would like a full copy of the original working paper<sup>1</sup>, please contact [investmentwriters@bnpparibas-ip.com](mailto:investmentwriters@bnpparibas-ip.com). (Currently available exclusively in French).*

<sup>1</sup> Lapointe, V. (2013), "Financial performance of socially responsible investment: does the size of firms in the portfolio matter?", working paper, Aix-Marseille Université and BNP Paribas Investment Partners.

<sup>2</sup> One of three factors in the Fama and French stock pricing model. SMB accounts for the spread in returns between small- and large-sized firms, which is based on the company's market capitalisation. This factor is referred to as the "small firm effect", as smaller firms tend to outperform large ones.



**Damien Kohler**  
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## The case for European small-cap investing

While much of Europe is still trudging along recovery lane, many entrepreneurially-managed smaller firms are showing they can grow and adapt faster; indeed, small-cap stocks have shown excellent long-term risk-adjusted returns. And investors in small-cap stocks also stand to gain from larger, cash-rich companies' M&A ambitions.

### What are small-cap stocks and what advantages can they offer investors?

Small-capitalisation stocks (small caps) are typically listed companies whose market capitalisation falls in the low tier of the market cap range, the two other tiers being mid and large-cap stocks. The most important point, though, is that small caps are often those of companies in their pioneering or early growth phase. This is perhaps the best angle to approach this group as an investor, since such stocks are a way to 'play' superior growth investment vehicles. In Europe, a common rule of thumb says that small caps have market capitalisations of up to around EUR 3 billion and account for about 15% of the free-float adjusted equity market capitalisation of the region.

Financial theory asserts that small-cap stocks in developed markets should outperform large caps over the long term, although their volatility can be somewhat higher. This is regarded as one of the least contentious issues in finance. Eugene Fama, a Nobel economics laureate in 2013, and Ken French produced what is regarded as the definitive study<sup>1</sup> showing that over time, small-cap stocks unmistakably tended to outperform larger-capitalisation companies. Other research supports the same conclusion, even when approaching the subject from different angles. This seems to be a global pattern, since only very rare exceptions invalidate this view, as shown by a study by Elroy Dimson and Paul Marsh, two London Business School academics. And when it does, it seems to be due to the widespread dominance of local oligopolies that leave no room for small caps even to exist, such as in Mexico or Malaysia.

In effect, past performances commonly show that small-cap companies have generated significantly higher annualised returns than both their large-cap counterparts and the World Index, with only moderately higher volatility. In other words, not only has the absolute return been stronger for small-cap stocks, but the risk-adjusted performance (as measured by a Sharpe ratio for instance) has been superior as well (see Exhibit 1).

Exhibit 1: Better risk-adjusted returns for small caps

Asset class	15-year annualised returns (%)	15-year annualised standard deviation (%)	15-year Sharpe ratio
Small-cap	9.03	20.46	0.31
Large-cap	4.69	15.47	0.13
World	5.01	16.09	0.14

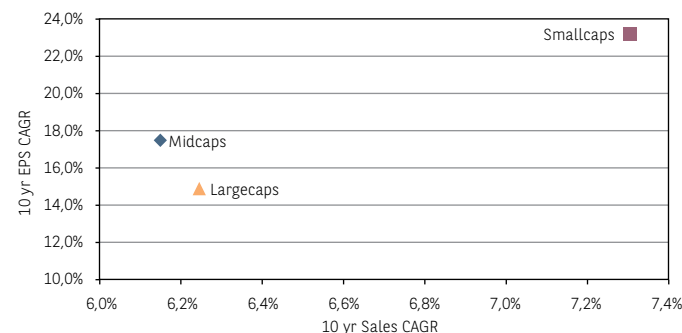
Source: BNP Paribas as of 28/02/14. Indices used: Small-cap - Russell 2000, Large-cap - S&P 500, World - MSCI World. Past performance is no guarantee of future returns.

1 See the following papers: Fama, E. F.; French, K. R. (1993). "Common risk factors in the returns on stocks and bonds". Journal of Financial Economics 33: 3; and Fama, E. F.; French, K. R. (1992). "The Cross-Section of Expected Stock Returns". The Journal of Finance 47 (2): 427.

### What lies behind the outperformance of small-cap stocks in the long run?

Sales and earnings growth are key drivers of long-term performance for equities, and they happen to be often stronger for small-cap stocks than for larger listed companies. Investing in small-cap stocks usually coincides with capturing the returns from the early stages of new industries as they develop and benefit from the more entrepreneurial management and flexible business models inherent to their smaller size. Many such companies can indeed capture new market opportunities and adapt more quickly to changing trends, which is subsequently reflected in more robust sales and earnings growth (see Exhibit 2). Additionally, their business model is usually simpler (single product, for instance) and therefore easier to grow (providing working capital requirements are covered).

Exhibit 2: Sales and earnings per share (EPS) compound annual growth rate (CAGR) from 2003 to 2013



Source: UBS estimates, Bloomberg. Note: large caps = STOXX large-cap index, mid-caps = STOXX mid-cap index; and small caps = STOXX small-cap index. Financials have been excluded from the indices for the analysis. Historical sales and EPS numbers are for the current members of the respective indices. Past performance is no guarantee for future returns.

### Does the current environment favour European small caps?

Concerns about the eurozone crisis have almost vanished, and the latest progress towards a banking union on 20 March is adding further credit to this assumption. Besides, peripheral eurozone markets have even seen their bond yields falling dramatically, sometimes on record low levels, which is a good omen for their respective economies. So in an environment where PMIs are recovering, albeit slowly, and where the ECB downplays deflationary risk while maintaining a very accommodative monetary policy for longer than any other central bank, European small-cap companies should benefit the most from further growth 'normalisation'.

Moreover, European small-cap earnings and dividend growth rates are currently expected to be stronger than those forecast for most of the other developed equity markets. At the same time, their valuation (as illustrated by their price-to-book ratio in Exhibit 3) is generally aligned with the other developed equity markets, and indeed is cheaper than the US market. On these metrics, European small-cap stocks appear therefore more attractive than most developed equity markets.

Exhibit 3: Comparison of valuation characteristics of European small caps with other equity asset classes

	MSCI Europe small cap	MSCI Europe	MSCI USA	MSCI EM	MSCI World
Dividend yield (%) (Med NTM*)	2.6	3.6	2.1	3.1	2.7
Price/earnings (Med NTM*)	15.9	13.9	15.5	10.2	14.1
Enterprise value/EBIT (Med NTM*)	12.1	10.9	10.8	8.7	10.6
Price/book value (Med NTM*)	1.8	1.7	2.4	1.3	1.8
Earnings growth (FY0,1,2**)	17.5	11.2	12.5	16.4	13.0
Dividend growth (FY0,1,2**)	15.5	10.5	13.2	17.8	12.3

Source: FactSet

\*Med NTM: median next twelve months

\*\*FY0,1,2: fiscal year 0,1,2

Furthermore, given that growth is recovering in Europe, though timidly, while it is maturing in the US or becoming uncertain elsewhere in the world, large companies could find it attractive to reposition themselves within the European region. One of the fastest ways for them to do so would then be through acquisitions of European small caps. Besides, many large companies are currently cash rich or enjoying easy access to cheap financing in this very low interest environment; they thus have all the ammunition they need to pursue this course. Indeed, conditions are quite favourable for a significant M&A uplift in the current stage of the economic cycle.

### Why is stock selection so important?

Using analyst coverage data for small and large-cap stocks, i.e. the number of analysts providing at least one annual earnings

forecast for a company, we found that small-cap companies on average attract nearly three times less research coverage than large caps. This lack of coverage can lead to significant inefficiencies and mispricing of small-cap equities, which can be exploited through a combination of solid proprietary company research and active portfolio management.

Ultimately, our view is that in the small-cap universe, alpha is best generated through a bottom-up approach. However, with 879 constituents in the MSCI Europe Small Cap index, how does a bottom-up fund manager narrow such a broad universe?

To make such a broad investment universe 'workable', our five-strong European small and mid-cap team - where each member combines analyst and portfolio manager responsibilities and has an average experience of 15 years - has developed, with the help of our Financial Engineering team, a powerful proprietary quantitative screening tool that reduces this vast investment universe to a more accessible one. Filters, such as superior balance sheet quality, growth potential and cash flow returns, are involved in this process.

The tool helps portfolio managers spot companies that score highly, and these are then subjected to further in-depth, in-house research. The success of blending quantitative screening with subsequent qualitative research is reflected in the long-term performance of our European small-cap strategy.

Because of the importance of the stock selection process in delivering consistent alpha from this very dense investment universe, we believe that an assessment of the stock selection skills of the portfolio managers is a prerequisite to any investor's decision to allocate to this rich but broad European small-cap universe.



# A new generation target date strategy for investors to shape their projects

Charles Alberti, Investment Specialist at THEAM, and Anne Poirrier-Hamon, Head of Product Strategy at BNP Paribas Investment Partners, respond to Perspectives' questions regarding the cutting-edge target date strategy designed to provide investors with upside potential as well as formal protection by the BNP Paribas Group.

**Perspectives (P):** Why do you consider target date offerings are well-suited to allow investors to shape their projects?

**Anne Poirrier-Hamon (APH):** In life, there are a certain number of foreseeable events which have become increasingly important to prepare for ahead of time. These projects typically include funding our children's education, real-estate projects and retirement. Given the fall of the replacement rate provided by public pensions as well as the progressive switch from defined benefits to defined contributions, the question of maintaining one's lifestyle after retirement has become a major concern for most individuals. One common factor for these different projects is that their timeline can more or less be anticipated. This is precisely what makes target date offerings relevant to investors: based on their explicit reference to a given date, they allow a straightforward choice for the investor, taking into account their specific project horizon. The significant size of the Northern American target date funds market as well as their 'default option' status within the 401(k) is a good illustration of this fit.

**Charles Alberti (CA):** We believe several features need to be taken into account for a target date offering to truly meet investors' needs in preparing for their projects or retirement. Firstly, offering a range of target date funds is essential to cover investors' mid to long-term projects. Moreover, they need to remain open up until their maturity date, in order to allow investors to save at their own pace through regular investments, as well as to retrieve their capital ahead of the target date if needed. Last but not least, investors expect, of course, target date funds to offer upside potential for their capital to grow with risk-taking calibrated according to a specific time horizon, but also some type of protection to give them visibility on what they can expect – making them fully aware of the risk of market turbulence.

**P:** There are already a number of target date funds on the market. Why the need for a new offering?

**APH:** There are indeed a wide number of target date offerings already on the market. They typically break down into two types:

On the one hand, the widest number of target date funds follow a de-risking approach over time, often called a 'glidepath': an investor's portfolio will typically start out heavily invested in equities when they are far away from retirement, and will be re-balanced progressively over time towards a more significant

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*"We consider that investors should not have to choose between upside potential and protection when saving for their projects and retirement"*

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share of fixed-income instruments. Investors do not benefit from any type of formal protection in such offerings, which can be a blocking point for some of them, especially after drawdown experiences in 2008.

On the other hand, some target date funds offer a formal protection at maturity representing 100% of the highest Net Asset Value (NAV) reached by the fund over its lifetime. In this case, protection is clearly provided, but with the risk of sacrificing upside potential in low-interest rate environments such as the one we have been experiencing over the last few years: the protection is indeed excessively ambitious, and the risk is that no room will be left to take any risk due to monetisation. It is also worth noting that a 100% protection would on the contrary not be worth much for investments occurring in a hypothetical context with higher interest rates and inflation.

**CA:** This observation was precisely the starting point for us in designing the new target date strategy: at BNPP IP we consider that investors should not have to choose between upside potential and protection when saving for their projects and retirement. So we brought together our experts from THEAM and BNPP IP's Marketing, Innovation & Research teams in order to come up with a new generation of target date solutions, aiming to solve the previous dilemma.



**Anne Poirrier-Hamon**  
Head of Product Strategy at BNPP IP, Paris

**P:** How is BNPP IP's new strategy well-suited to combine upside potential and protection?

**CA:** BNPP IP's new target date strategy incorporates two main investment innovations, backed by proprietary research. On the one hand, a paradigm shift has been introduced as far as the protection mechanism is concerned, capitalising on THEAM's extensive and long-standing experience in protected investment solutions, managing around EUR 16.3 billion<sup>1</sup> in this field. We have moved away from the 'one size fits all whatever the interest rates' 100% capital protection towards a more adaptive protection taking into account the interest rate context as well as the time remaining to maturity at the time of the investment. This results in a formal protection of more than 100% of the capital invested when possible without sacrificing upside potential (typically for investments occurring on longer-dated solutions and/or in higher interest rate contexts) and below 100% when needed to leave room for upside potential.

*"We have moved away from the 'one size fits all whatever the interest rates' 100% capital protection towards a more adaptive protection"*

On the other hand, the risky part of the portfolio (completing the low-risk part ensuring protection at maturity) is invested in two performance engines, which we believe are unique and complementary. The directional engine, aimed at capturing risk premiums over the long term, offers a well-diversified exposure to financial markets with a risk-managed leverage. The non-directional engine incorporates THEAM's multiple alpha strategies, aiming to offer a positive return whatever the market context. Combining these two engines allows our target date strategy to be well-prepared to face different market conditions.

**APH:** These innovations should allow each investment to benefit from a relevant trade-off between upside potential and protection based on the market context at the time of the investment. As a result, this solution is particularly well-adapted to regular

investing, the most common pattern for individuals to prepare for an important life project.

**P:** What is the value proposal for the end investor with the new strategy offered by BNPP IP?

**CA:** The investor has the possibility to choose the best-suited solution amongst the range of eight solutions offered by BNPP IP, dated from 2018 to 2043, and to apply the savings pattern of their choice as the strategies remain open up until maturity. The investor can expect their capital to grow over time thanks to the two well-calibrated performance engines. In addition, the investor is given clear information on the minimum capital they will receive for their project, thanks to a value formally protected by the BNPP Group at the maturity date, which can only increase over time. For example, a 35 year-old individual preparing for his retirement in 25 years could, for an investment of EUR 10 000 in current market conditions, expect EUR 28 200 on average<sup>2</sup>, and count on a formally-protected minimum value of EUR 10 300 in 2038. For the same investment of EUR 10 000 in a higher interest-rate context (let us consider the conditions seen in 2009 as an example) he could expect an average of EUR 51 000 and benefit from a formal protection of EUR 17 800 twenty five years later.

**APH:** Because we are fully aware of the importance of accompanying investors, we have developed various interactive tools, including a web-based simulator allowing advisors to calibrate their savings effort in order to shape their projects.

*For any additional information, please feel free to contact Charles Alberti [charles.alberti@bnpparibas.com](mailto:charles.alberti@bnpparibas.com).*

<sup>1</sup> As of 31/12/2013

<sup>2</sup> Based on simulations. These simulations have no contractual value. These simulations have a strictly informative purpose, with neither express nor tacit guarantee relative to the achievement of the performance objective.



Chi Lo

Senior economist, Greater China – BNPP IP, Hong Kong

## Action on hot money flows does not dull renminbi's shine

China is tackling the challenges of a new paradigm head-on. These include slowing economic growth, leveraging issues for instance in the property market, on the corporate debt side and in local government financing, and the need for further reform to rebalance the economy. We expect Beijing to be able to manage the downside risks from these trials since the government has both the will and the means – economic policy tools including large currency reserves – to face them down.

While growth and policy concerns in the markets have undermined the renminbi recently, its long-term appreciation trend remains intact, argues Chi Lo, senior economist Greater China.

### Freer rein for market forces

The recent volatility of the renminbi shows that the People's Bank of China (PBoC) is exiting its policy monopoly as part of wider economic reforms. The renminbi is a heavily managed currency and its recent depreciation would appear to have been engineered by China's central bank as part of Beijing's grand strategy for internationalising its currency, which includes giving it the status of an official reserve currency. Opening up the market to foreign participants and giving market forces more leeway implies doing away with the perception that the renminbi can only rise, widening the trading band and permitting more volatility.

But rebalancing the economy – shifting away from investment as the main growth engine to consumption and services – is a delicate affair. To rein in debt excesses in the property and shadow banking markets, the PBoC has sharply curtailed the flow of cheap credit, retraining its sights on the pursuit of quality growth, including the promotion of deleveraging, addressing systemic risks and encouraging structural reforms. This tightening bias, reflected in the recent drop in aggregate liquidity and the rise in the seven-day repo rate, can be expected to last several years.

At the same time, though, we expect the central bank to ensure that aggregate liquidity will be sufficient to sustain Beijing's GDP growth target, set at a still brisk 7%-8% for 2014.

### Renminbi rout to stabilise growth

The PBoC's recent curbs on the flow of cheap credit caused domestic growth to slow more severely than expected. To counter the threat of an economic hard landing, weakening the renminbi can be seen as a useful policy fine-tuning tool. A weaker currency can fire exports and preserve the pace of GDP growth, while lifting import prices and encouraging consumption as (imported) inflation picks up.

Support for the economy also came in the shape of a modest government stimulus package focused on investment in railways and social housing. Illustrating the effectiveness of the measures to put a floor under growth, the latest official PMI data indicated that the crucial manufacturing sector was stabilising.

Arguably, the threat of higher inflation from a weaker currency should be limited. Core inflation has not exceeded 2% in the past decade, while producer price inflation has been non-existent for more than a year. At the same time, urban household income has stabilised, rural and migrant workers' income growth is picking up mildly and demand for labour exceeds supply. Accordingly, a negative policy shock in the form of central bank action to curb inflation looks unlikely at this point.

Of course, a devaluation policy might provoke tensions with China's trading partners. But if devaluation is only temporary and helps balance growth with structural reforms, Beijing should be given the benefit of the doubt.

### RMB depreciation: Now you see it...

RMB/USD rate - daily movements (March 2013-March 2014)



Source: CEIC, BNP Paribas Investment Partners (Asia); April 2014



“We believe the currency’s long-term appreciation trend is unbroken. It remains undervalued relative to the country’s strong economic fundamentals”

**One step backwards for three steps forwards**

Looked at in perspective, the renminbi’s drop occurred over a matter of weeks only and was hardly unprecedented. The latest weakness was merely a dent in an eight-year trend of gradual appreciation against the US dollar and other major currencies. It surprised investors who were used to the slow and steady rise that made the renminbi one of the world’s strongest-performing currencies in 2013, rising by 3% against the US dollar, in line with similar size gains since 2005.

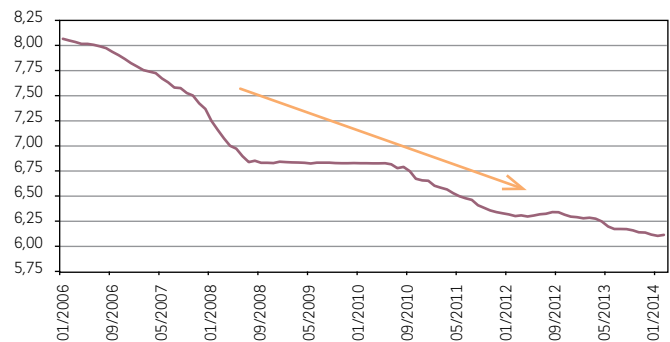
We believe the currency’s long-term appreciation trend is unbroken. It remains undervalued relative to the country’s strong economic fundamentals, which include a healthy balance of payments, while the advancing internationalisation of the renminbi should continue to fan investor interest. We are still looking for further gains on the US dollar, though the pace of the advance might well be milder than that of recent years and further bouts of volatility might still cause the currency to swerve from this track on occasion.

**Stay cool and keep eyeing the opportunity**

From an investor viewpoint, the renminbi’s appreciation potential reinforces the 100bp-200bp yield pick-up that offshore RMB government and non-government bonds already provide relative to bonds in large international markets with a similar credit rating. The short duration of the offshore RMB market is a further favourable feature that should support international investor (and local depositor) demand.

**...now you don’t**

RMB/USD rate - monthly movements (Jan 2006-Feb 2014)



Source: CEIC, BNP Paribas Investment Partners (Asia); April 2014

Undeniably, there are risks. The squeeze on shadow banking and local government debt issuance could sap local government and non-state spending. Rising interest rates could also undermine overall growth, as could overly harsh measures to slow property investment, especially in non-prime cities. Further bond defaults could cloud the perception investors have of the Chinese fixed income market, though they should remember that such hiccups are part of the market’s progress towards maturity and the current economic reforms are long-term positives that should be uppermost in investors’ minds.

Overall, we believe there are convincing reasons to have faith in the feasibility of the reforms, the government’s rebalancing efforts and its growth targets. Thus, rather than being a concern, any short-term weakening of the renminbi can be seen as an opportunity for investors with steady nerves.

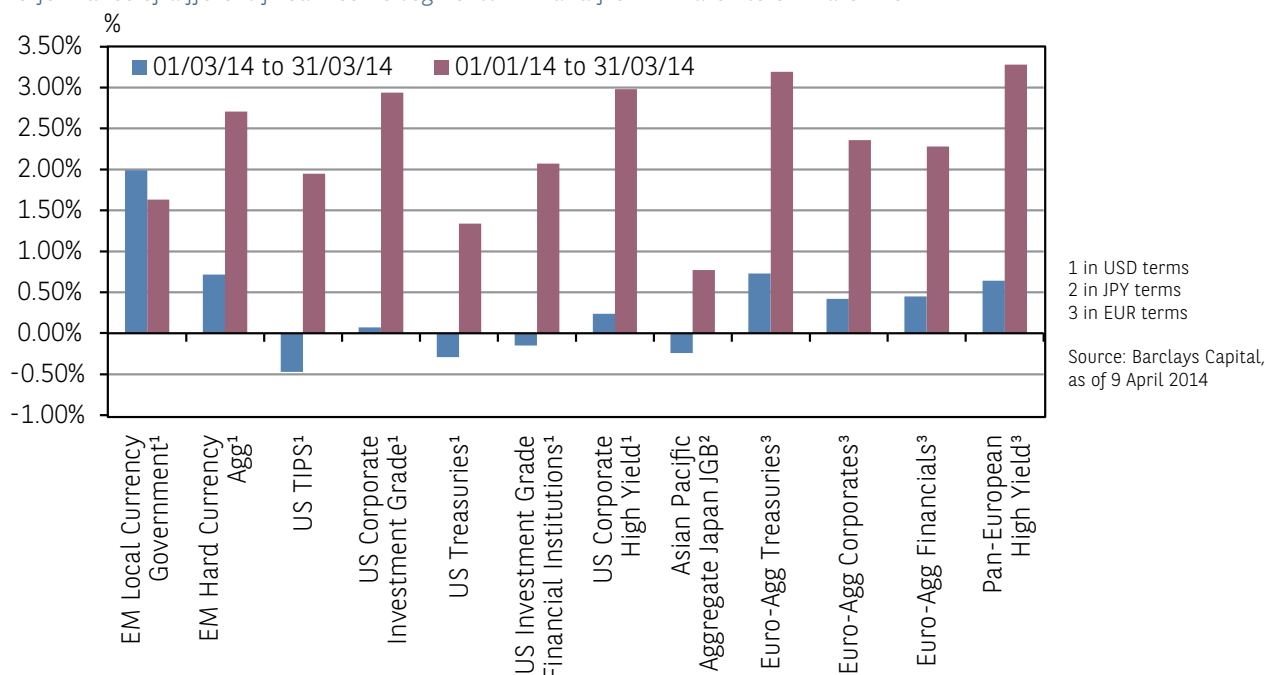
Written on 7 April 2014

# Performancefocus

## SPOTLIGHT

### Performance of selected equity and bond markets for the period from 1 March to 31 March 2014

Performance of different fixed income segments YTD and from 1 March to 31 March 2014



Performance of selected equity markets YTD

	Absolute return, in euro currency terms year to date through March 2014	Absolute return, in US dollar terms or, where indicated, in local currency terms, year to date through March 2014
S&P 500	1.42%	1.30%
Nasdaq	0.66%	0.54%
EURO STOXX 50	1.69%	1.57%
Shanghai SE Comp	-6.36%	-3.91% (in Chinese yuan renminbi terms)
Brazil IBOVESPA	2.53%	-2.12% (in Brazilian real terms)
Japan TOPIX	-5.64%	-7.63% (in Japanese yen terms)
South Korean KOSPI	-1.72%	-1.28% (in South Korean won terms)
Indonesia - Jakarta Comp	20.04%	11.56% (in Indonesian rupiah terms)
Russia MICEX	-14.43%	-8.96% (in Russian ruble terms)
Turkey BIST 100 Index	3.65%	2.85% (in Turkish lira terms)
India S&P BSE 500 IDX	9.57%	5.96% (in Indian rupee terms)

Source: Bloomberg, as at 31/03/2014. All indices price change only (excluding dividends)

Performance of selected equity/bond markets is shown in local currency terms in order to provide an indication of whether these currencies have appreciated or depreciated versus the euro and/or the US dollar during the period concerned.

Past performance is not indicative of current or future performance.

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