



PERSPECTIVES



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

A shift in focus

The year may still be young but a new concern has already taken centre stage: out with the endless debates over Fed tapering, in with the focus on emerging markets. Triggers include Argentina's decision to stop supporting its currency and, more importantly, worries about a Chinese trust fund defaulting. One consequence was a major sell-off in emerging bond, currency and equity markets. Another was policy reaction with monetary policy tightening to stabilise the currency and to fight inflation.

This combination exposes domestic demand to a double whammy of higher import prices and higher interest rates, whereas the competitiveness of the export sector gets a boost from the cheaper currency, provided inflation is under control.

Investors have been quick to discriminate between countries by rewarding those taking 'appropriate' policy actions. So contagion should be less of a risk going forward. Yet worries linger. Will some Chinese trust funds default after all? What is the impact on economic growth of tighter conditions in the Chinese shadow banking system? Several countries (India, Indonesia, Turkey, Brazil, etc.) have elections this year. How will politics influence economic policy? Investor unease over these factors translates into attractive valuations of the asset class.

Close monitoring of the catalysts for change is recommended in deciding when to move back in. Inflation, the state of the current account and growth momentum are of key importance in this regard.

10 February 2014



William De Vijlder
 Vice-Chairman of BNPP IP



Joost van Leenders
Chief economist, Multi Asset Solutions team - BNPP IP, Amsterdam

Emerging markets and monetary policy cause volatility

January was not a good month for equities. Markets were down for the first time since August. Emerging markets were distinctly out of favour with valuations declining for the third consecutive month. However, economic growth in the US and the eurozone appears to be improving and the earnings season in the US has been good so far. What does all this mean for asset allocation?

Is the turmoil in emerging markets a correction, or the start of something worse?

I don't think this is the start of a crisis. The Fed has started tapering and the 'fragile five' (Brazil, India, Indonesia, South Africa and Turkey), as they are sometimes known, have come under pressure. In late January, when Argentina announced it would stop supporting the peso, the sell-off in emerging markets accelerated. The Argentine peso plunged 15% in two days. A number of central banks hiked rates, including Turkey, where the central bank imposed an eye-watering increase in official rates from 4.5% to 10%. Such rate hikes are intended to make the respective currencies more attractive, discourage capital outflows and put an end to the equity market rout. In our view these events do not signal the start of a general emerging market crisis. However, we do think it is too soon to buy back into emerging equities. Valuations are attractive, but we would still want to see more evidence of improving growth before buying.

Does this only relate to emerging markets or are there other issues involved?

I think central banks in developed countries are also causing some uncertainty. Despite unrest in emerging markets and disappointing data (for the labour market and durable goods orders) in December the Fed decided to continue tapering its assets purchases. Admittedly, the economic data may have been distorted by the extreme weather - overall US growth in the fourth quarter remained strong. Another source of uncertainty is the monetary policy tool, introduced in December 2012, known as 'numerical forward guidance'. The Fed intended this to link possible rate hikes to the unemployment rate level. The Bank of England followed suit last August.

However, unemployment rates in the US and the UK have come down much faster than the central banks expected. Both central banks now say that unemployment levels are merely thresholds, not automatic triggers, and that they are unwilling to hike rates just yet. In doing so, they have effectively made these thresholds meaningless. This of course has increased uncertainty, as it is unclear what will come next. Uncertainty

"We do think it is too soon to buy back into emerging equities"

regarding the ECB concerns questions of whether it will take additional stimulation measures or not. Inflation is low enough to justify more action, but the economy is improving. We believe the tool with the greatest impact on markets, outright quantitative easing, is also the most unlikely. In our view, another rate cut or more long-term loans to the eurozone banks will impress markets less.

Bond yields have fallen recently. Have yields overshot?

Yes, I think so. Government bond yields fell in the US and Germany and the yield curve flattened. In both countries it was the largest monthly decline in ten-year yields since May 2012. Of course, inflation is down and central banks are keen to keep yields low. In our opinion, the recent drop looks excessive. After all, growth is improving.

In our strategy, we aim to benefit from stronger economic growth and earnings through our global equity overweight. We closed our overweight in emerging equities early in the month, as we did not see growth improving. This asset class has sold off further since then, but we think it is still too early to buy back into emerging equities. More defensively, we have some positions which we like on account of the positive carry they provide. These include European high-yield corporate bonds and emerging market debt in US dollars. We have also imposed a short duration position in German bunds. We think the recent demand for safe-haven assets is overdone in a climate of improving growth.

Written on 10 February 2014



Chi Lo

Senior strategist, Greater China – BNPP IP, Hong Kong

China's deflation scare revisited

Chi Lo reviews the fundamental macro-economic factors that suggest the outperformance of bonds in January may not be a one-off event in 2014.

In June last year I wrote an article¹ about the risk of deflation in China (see Chi Time: "China's structural reforms and renewed deflation risk", 19 June 2013), many dismissed it, predicting that quantitative easing (QE) would bring back global inflation. Evidence since then has shown a trend of disinflation world-wide. Now an increasing number of players are seeing a risk of inflation undershooting central bank targets over the year (perhaps years) ahead. Deflation remains a tail risk not solely in China.

The truth behind China's malaise is that the developed world is stuck with a balance sheet recession adjustment, which is characterised by the twin evils of the private sector deleveraging and becoming increasingly risk averse. The challenge arises from the fact that after the bursting of the asset bubble, the private sector cut spending in order to reduce its debt burden. Unless external demand and/or massive fiscal stimulus come to the rescue, income flows will fall during the deleveraging process. Falling income in turn aggravates the debt reduction effort, prompting more spending cuts and a spiral of debt-deflation.

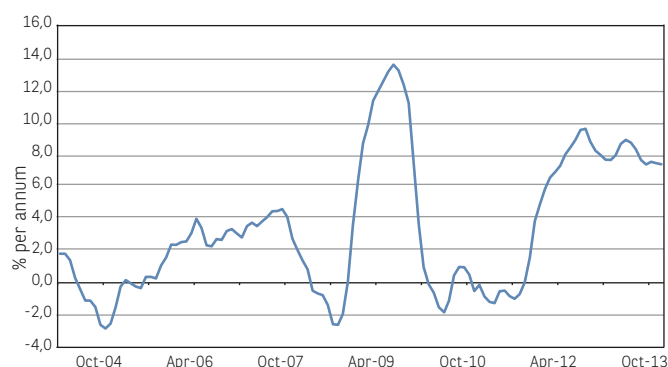
If this economic cleansing process is allowed to proceed unhindered, economic growth will be restored, albeit after a prolonged process of adjustment. However, short-term measures to reduce debt-servicing costs (zero interest rate policy and quantitative easing) and socialising losses (bailing out of non-viable institutions) impede the process.

It is impossible for both the developed and emerging worlds to export their way out of a balance sheet recession at the same time. So the onus for preventing a growth implosion rests with governments with fiscal deficits at levels that have become both socially and politically unacceptable. Pressure for deleveraging manifests itself in austerity measures. Inflation will not return easily in an environment of debt-deflation.

But we do see growth returning in the developed world, don't we? Well, yes and no. The recovery is weak and halting despite the most aggressive attempts to stimulate growth, in terms of fiscal and monetary policy, since World War II.

This is certainly not the sort of growth that will generate a lot of pricing power, still less inflation. Arguably, this kind of growth is barely enough to prevent certain economies from falling into outright deflation.

Exhibit 1: PPI deflation has pushed China's real borrowing cost* sky high



* 1-yr working capital lending rate minus PPI inflation
Sources : CEIC, BNPP IP (Asia), January 2014

Well, so much for the developed world, but what about China? Its closed capital account shielded its economy from the detrimental effects of the subprime crisis. But China has an inherent domestic deflationary bias (as seen in the wholesale price level), thanks to excess capacity and the misallocation of resources. Its core CPI inflation has not risen above 2.5% since the 1997-98 Asian crisis.

The new wave of structural reform, which is meant to right these wrongs, is going to generate more deflationary pressures in the medium term.

With disinflationary forces still prevalent, policy makers face a tough task in timing monetary tightening. Bonds may surprise us again and equities are likely to be pulled in different directions by the opposing forces of weak pricing power and benign liquidity.

1 "China's structural reforms and renewed deflation risk", 19 June 2013, please contact your dedicated client relationship manager to obtain a copy of this article.



Andrew Craig
Director of the Publication Centre – BNPP IP, Paris

A new era in bond and currency markets

In the wake of the financial crisis, a number of structural changes are under way. These are likely to create more opportunities for active managers able to implement opportunistic positions taking advantage of increased inefficiencies in global bond and currency markets.

It is now apparent that the 'Great Financial Crisis' has led to a number of changes in how global bond and currency markets function. For investors, two of the most important changes are arguably:

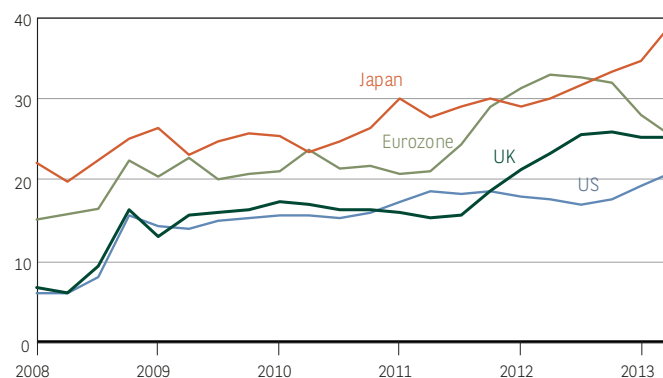
- A significant increase in intervention by central banks globally in bond and currency markets. Central banks now drive a significantly higher proportion of market activity than pure profit-seeking investors and intervene in markets to fulfil macroeconomic policy objectives. Their dominance may well impede the efficiency of markets, thereby creating opportunities for active managers.
- Stricter regulation (e.g. Basel III, Dodd-Frank, the 'Volcker Rule' prohibiting proprietary trading) in the wake of the crisis has led larger banks to curb their risk-taking and marketing-making activities in bond markets relative to the pre-crisis period. New regulations penalise bank trading desks for holding inventory. The upshot is a decline in secondary market activity. Although perhaps unaware of it, end investors may well have become buy-and-hold investors as the scope for trading corporate debt in secondary markets diminishes. The growth in corporate bond markets¹ in a low-yield world may also exacerbate this trend.

Regulations requiring banks to make higher capital allocations for the 'warehousing' of risk (holding significant positions, for example, in corporate debt on a trading book) are likely to reduce the appetite among banks for trading corporate debt in secondary markets. A reduction in secondary market activity is logically likely to increase the cost (the bid/offer spread) to investors of trading in and out of positions. If investors respond by holding corporate debt on a buy-and-hold basis, then the wait for a rotation from credit to equities may be a long one.

Intervention by central banks is even more significant. The US Federal Reserve's programme of quantitative easing via asset purchases of over USD 2 trillion in Treasuries and mortgage-backed-securities has been particularly aggressive, but the Bank of England, the Bank of Japan and the European Central Bank (ECB) have also engaged in large-scale intervention in bond markets (see exhibit 1 below). The implication of such intervention is

potentially two-fold. Firstly, central banks, insensitive to prices and fundamentals when purchasing, are now the most important player in each of the world's four largest bond markets. Secondly, the nature of central bank intervention is evolving from the initial 'one-way' purchasing of assets to a data-dependent exercise. This creates uncertainty and volatility, as we saw last year when the Fed – having indicated a desire to taper (reduce) its asset purchases – chose not to taper at its September 2013 meeting.

Exhibit 1: Central bank balance sheets highlight provision of liquidity (% GDP)



Source: Datastream, BNP Paribas Investment Partners, December 2013

The outlook: where might future opportunities lie?

There are reasons for believing that the change in the bond and currency markets environment is timely. Scope is limited for traditional sources of revenues (e.g. falling interest rates or tightening credit spreads to generate a return). A broader opportunity set and greater scope for relative value trades could constitute alternative sources of returns when directional risks are unattractive.

As to where such opportunities may come from in the future, two themes are increasingly apparent. The first is the potential divergence in central bank policy, which is likely to lead to greater volatility in global fixed income and currency markets. Secondly, it would appear that a broader range of

¹ By way of example, in December 2006, the iBoxx Corporates (IG) index had a market capitalisation of USD 700 billion with 864 issues. In January 2014 the market capitalisation had risen to USD 1.25 trillion with 1 384 issues. Source of all data: iBoxx indices and Bloomberg

pricing relationships will result from the recent growth in global bond markets. Simultaneously, the universe of global investors capable of monitoring these relationships and taking advantage of opportunities for arbitrage has shrunk.

“Central banks, insensitive to prices and fundamentals, are now the most important player in each of the world’s four largest bond markets”

In the period since the ‘Great Financial Crisis’ all major central banks have been in easing mode and have sought ways (e.g. forward guidance) to underline their commitment to keeping official rates ‘lower-for-longer’. As a result, investors now anticipate low short-term rates over the medium term. This trend is now reversing as the improving economic environment in the US and the UK leads investors to anticipate divergence in the future path of short-term interest rates. In Japan and the eurozone, ‘lower-for-longer’ is still very much on the menu for bond investors.

The period of ‘lower-for-longer’ monetary policy resulted not only in investors anticipating that interest rates would stay low, but also that they would be less volatile. In the US this was particularly apparent – interest rate volatility implied by option contracts fell to a record low (evident in the Merrill Lynch MOVE index). As interest rate differentials are one of the principal factors influencing foreign exchange rates, the convergence of the anticipation of future interest rate movements and the decline in expected rate volatility had a calming effect (a decline in volatility) on currency markets. Today, as the ECB talks about

“the complexity of the situation” (see Mario Draghi’s comments after the meeting of the ECB’s governing council on 6 February 2013) and the Fed sends mixed signals about reducing asset purchases, volatility is significantly increasing in both global bond and currency markets.

The implications of these changes could be positive for active managers. It does not seem unreasonable to expect that bond and currency markets will be less efficient in this environment and that there will be broader opportunities for active managers focusing on relative value and idiosyncratic, security-specific risk.

A reduction in secondary market activity among banks could fundamentally change the pricing function in some global bond market sectors. Fewer trading participants in secondary markets may lead prices to ‘gap’ (rather than moving in a series of smaller steps) to the level at which buyers or sellers are drawn in. This could enlarge the opportunities for active managers in the following ways:

- Price distortions may result from a smaller volume of transactions than was necessary under the previous regime, where larger flows were required to create inefficiencies.
- Price distortions could well be larger today than they would have been previously although they may also be shorter lived.
- While the bond market is more global, the universe of opportunistic, global fixed income investors is arguably smaller on account of the reduced presence of bank trading desks, which no longer police relative value relationships across the market, across borders and between different market sectors.

These changes would appear to be favourable for active managers who can benefit from greater volatility in global bond and currency markets resulting from central bank policy. Further opportunities may well arise due to a diminished presence of broker/dealers policing market inefficiencies.



Konstantin Nemnov

Head of Fixed Income - TKB BNP Paribas Investment Partners, Moscow

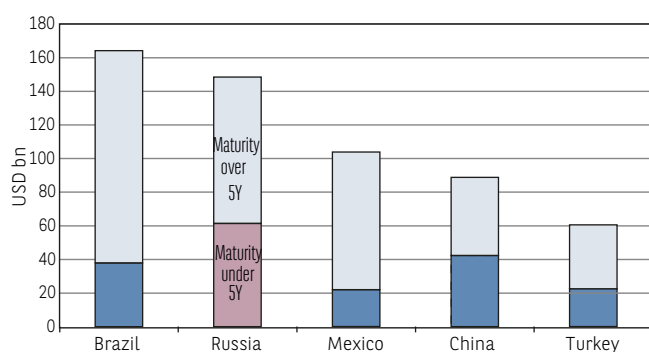
A journey through the Russian USD-denominated debt market

The Russian USD-denominated debt market can potentially offer investors attractive yield with limited exposure to global volatility. Konstantin Nemnov (KN) describes the market in terms of the range and quality of instruments and explains where opportunities may lie.

Perspectives (P): How would you describe the Russian USD-denominated fixed income market?

Konstantin Nemnov (KN): It is one of the largest and most diversified among its emerging market (EM) peers, second only to Brazil in size and valued at over USD 150 billion. Moreover, the short-duration segment with a maturity of under five years, is the largest in the EM group (see exhibit 1), offering a wide choice of short-term instruments to investors seeking to mitigate interest rate risk at a time of global volatility.

Exhibit 1: The five largest USD-denominated fixed income markets, split by maturity*



*Corporate and sovereign USD-denominated debt, excludes local currency debt
Source: Barclays Live, TKB BNP Paribas Investment Partners, December 2013

The market is expanding steadily with a regular supply of new bonds from existing issuers as well as new borrowers from various sectors and rating bands. This improves the liquidity and breadth of the universe, creating new diversification opportunities. Over the last couple of years, in addition to strong representation from the energy, financials and telecommunications sectors, we have seen issues from chemical companies, gold miners and infrastructure companies.

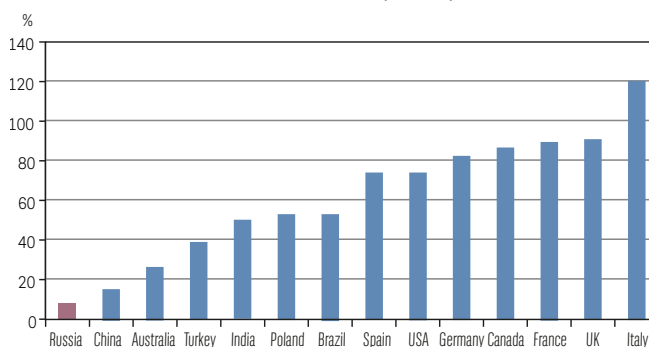
Most of these issues are benchmark-size securities that fall within the global investment grade and high-yield indices. As a result, most issues are held by international investors, estimated to own over 70% of the outstanding amount in the market. There

is also very strong demand for new issuance, with books generally three to five times over-subscribed due to the attractive risk-return profiles of Russian hard currency denominated bonds.

P: What distinguishes Russian USD-denominated bonds from other EM hard currency debt?

KN: First of all, across the government, corporate and private segments, Russia has one of the lowest debt levels in the world; Russian government debt is currently around 10% of GDP. This is a clear positive compared to the high levels of leverage in some developed countries with a similar or higher credit rating.

Exhibit 2: Government debt, % GDP (2013F)



Sources: Russian Ministry of Finance, Economist Intelligence Unit, December 2013

Second, the underlying credit quality of Russian corporate issuers is strong relative to similarly-rated international peers. For example, Russian BBB and BB issuers on average have lower net debt/EBITDA and debt/capital ratios compared to their counterparts in the US and Europe, and higher EBITDA and net margins. During the rapid development of the Russian economy over the last 20 years, the financial and commercial sectors have grown to recognise the importance of sound financial health and strong liquidity. As a result, major Russian companies have adopted a risk-conscious approach towards financial management and leverage. At the same time, Russian fixed-income securities, especially in the corporate and quasi-sovereign segments, provide an attractive spread compared to their EM peers.

Finally, the Russian fixed income universe is very broad and diversified in the short part of the curve of under five years. This allows investors to build a short-term portfolio with an attractive level of yield while having a low sensitivity to potential curve steepening.

P: What are the potential threats to Russian USD-denominated securities?

KN: First of all, the health of the Russian economy drives expectations on the future financial performance of Russian state and corporate borrowers and affects the required risk premium, which is reflected in the spread of Russian bonds to US Treasuries. The rate of economic growth has recently slowed due to cooling commodity prices, as in other emerging markets. While the Russian economy is still greatly influenced by oil price movements, there are also internal growth resources e.g. strong potential of the service and agriculture segments. In addition, the government generally runs a balanced budget, which keeps overall debt very low. So overall, the macroeconomic risks to Russian debt securities are maintained at modest levels.

Second, there are some risks inherent in the changing nature of global risk appetite that shape investors' attitudes towards EM fixed income securities and influence Russian bond valuations. Emerging markets have seen impressive investment inflows over the last five years, although their intensity varied substantially. The key recipients of capital were economies with a negative current account balance that depend heavily on international economies. Other economies, including Russia, have not experienced any significant capital inflows; they have a current account surplus and run a low level of leverage. Our view is that investors will start to differentiate between EM economies on this basis, which would be a supportive factor for the Russian fixed income market, for us one of the strongest in the EM universe from a fundamental point of view.

Third, there is some dependency on the dynamics of US Treasuries, as these are used as benchmark securities for USD-denominated bonds and affect valuations globally. We believe that in the near future, forward guidance on interest rates from the US Federal Reserve will outweigh the importance of its QE tapering activities. The market will closely monitor US unemployment and inflation

data to deduce the most likely point of exit from a near-zero interest rate policy. At the same time, Russian bonds look more balanced compared to 2013, with no signs of overheating. For example, Gazprom bonds maturing in 2034-2037 are currently trading with a yield of 6.5-7% which is 150bp above the recent low and comparable with levels previously seen in 2005, 2007 and 2009-2011. So in our view, the volatility of US Treasuries will have only a limited impact on Russian hard currency denominated fixed income securities in 2014.

P: What opportunities do you see in the Russian USD-denominated fixed income market?

KN: The market consensus, recently formed around the steepening of the US Treasury yield curve, drives investors towards shorter-term positions in the fixed income universe. This is generally in line with our consensus and we believe a well developed and diversified universe of Russian bonds with a maturity of under five years should provide interesting opportunities in terms of risk and return. The breadth of the Russian USD-denominated debt market means there is a large choice of issues and issuers amongst the low duration bonds.

The key to capturing these opportunities is to take a cautious approach to selecting bonds. Confidence in a particular instrument can only come from an in-depth, fundamental assessment of its credit quality, which is in turn based on a thorough knowledge of company-specific characteristics together with the influence of sector and economy-wide developments. This is not an easy task; it requires an experienced team of analysts and portfolio managers. It is however absolutely crucial as those companies that demonstrate strong or improving credit quality are the most likely to be able to withstand global economic volatility, which is crucial for investing successfully.



Naruki Nakamura
Head of Japanese fixed income – BNPP IP, Tokyo

Nothing lost in translation – an updated view from Tokyo on Abenomics

Recent Japanese economic data is encouraging with regard to Prime Minister Shinzo Abe's objective of hitting a 2% inflation target within 2 years. However, structural reform to improve prospects for stronger economic growth in Japan in the longer term looks like being harder to achieve.

An update on our view of Abenomics

On 22 January, Japanese Prime Minister Shinzo Abe made a keynote speech at the annual World Economic Forum in Davos. He was very upbeat about Japan's recent economic recovery "Japan's economy is just about to break free from chronic deflation," said Mr Abe, predicting higher wages and consumption. "People are now more vibrant and more upbeat. It is not twilight, but a new dawn breaking over Japan". He went on to announce planned reforms in corporate governance and taxation that could see the corporation tax rate, one of the highest among OECD countries¹, decline by 2.4%. This might have attracted more attention back in mid-2013, when such a cut was considered as one of the key elements necessary to raise trend growth in Japan. Or in other words, the centrepiece of 'the third arrow' of Abenomics (the first arrow is drastic monetary easing to eliminate deflation. The second arrow is flexible fiscal policy to support Japan's economy in the short run. The third is structural reform, to raise investment and trend growth). In Davos little attention was paid to Mr Abe's comments on corporation tax. The audience was more interested in the geo-politics between Japan and China. In our view the reason behind the reaction (or lack of reaction) is that people's expectations of Abenomics are becoming more realistic, and the initial euphoria has dissipated.

A more realistic assessment of what Abenomics can achieve is doubtless appropriate. On 24 January, the first day of the annual 150-day session of Japan's Diet, Abe made his policy speech with almost no reference to corporate tax rates. The sole reference was to rescind the supplementary 2.4% corporate tax rate a year earlier than originally planned (a tax introduced to fund recovery activities following the Eastern Japan earthquake). This is old news and nothing substantial. Although Abe himself seems to be keen on corporate tax reform, the Ministry of Finance, one of the most powerful players in Japan's political process, insist on a new source of tax revenue as a pre-condition to withdrawing the supplementary corporation tax, which considerably complicates matters for Abe.

Apart from the issue of corporate tax, we see delay over several key components of 'the third arrow'. For example, reform of labour legislation² in order to trigger a shift in labour towards higher growth sectors and deregulation of health care (unveiling his 'third arrow' last June, Abe promised to 'dramatically' expand mixed care in health by increasing the range of treatments and reducing approval times in order to boost growth, by increasing demand for innovative drugs and medical devices). This has however made little progress. In our view, conflicting interests mean that drastic reform of Japan's healthcare system is unlikely.

Overall, our evaluation is that the 'third arrow' of Abenomics is set to disappoint, which is in line with our initial assessment of Abenomics back in December 2012³.

We recognise the Japanese economy is in recovery phase, which is partly thanks to Abenomics, mainly via the stimulus provided by monetary and fiscal policy. The recovery seems set to continue over the next few years barring a major negative shock from an extraneous event. However, it is difficult to believe Japan can achieve drastic structural reform and substantially raise its potential growth rate in the near future. In his initial declaration of Abenomics, Abe declared his plan will enable real 2% and nominal 3% average GDP growth for the next 10 years. We then evaluated the plan as 'unrealistic' and we continue to believe this one year on⁴. In order to achieve that ambitious target, we think Abe needs to aggressively accelerate deregulation and, most importantly, persuade the Japanese people to accept a much more liberal immigrant policy. We continue to believe the realistic growth target is closer to real 1% and nominal 1.5% growth in the current environment.

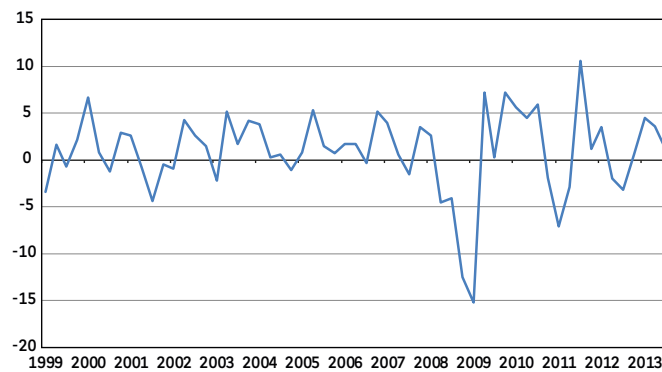
¹ According to KPMG, Japanese corporate tax rates were the highest among OECD countries in 2013 (38% compared to an OECD 25.32% average). www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx

² For a comprehensive overview of Japan's labour market: <http://www.imf.org/external/pubs/ft/wp/2013/wp13202.pdf> The Path to Higher Growth: Does Revamping Japan's Dual Labor Market Matter?

³ There are two examples of measures under 'the third arrow' which seem to be making progress: 'Casino project' – where the government designates special zones where resort complexes would be built to attract tourists and to revitalise regional economies.

⁴ Note that according to Abenomics, an annual increase in the GDP based deflator (the broadest possible measure of inflation) of +1% is equivalent to +2% annual CPI growth.

Exhibit 1: Japanese Prime Minister Abe is targeting average annual real GDP growth of 2% for the next ten years



Source: Bloomberg, 26 January 2014

Inflation

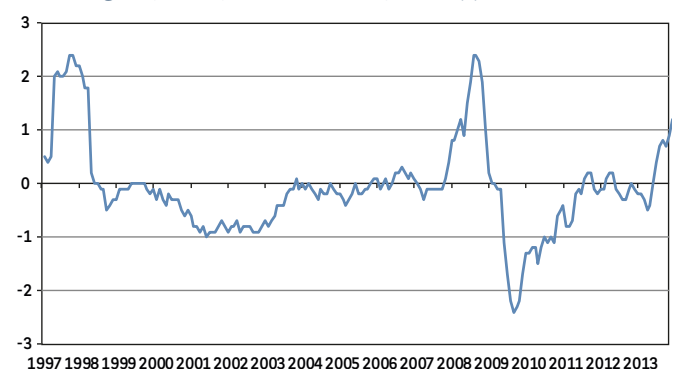
During 2013, the CPI inflation rate generally exceeded the market's pre-release consensus expectations.

In the 'Outlook for Economic Activity and Prices' released in April 2013, BoJ Governor Kuroda and majority Monetary Policy Meeting (MPM) members proudly showed their inflation outlook for the fiscal year 2015 (April 2015 – March 2016) at +1.9%, excluding direct effect from a consumption tax rate hike. This is very close to their target announced earlier in the month, when they began massive quantitative monetary easing. The slogan then was '2% inflation in 2 years'. At the time, Japan's main CPI index (Japanese style core, CPI ex fresh food) growth was at -0.5% YoY (March 2013 figure). On the other hand, at the same time, the consensus among the economists foresaw an inflation rate of +1.0% inflation for fiscal 2015 under the same conditions. Today, 9 months later, the latest survey shows the same results for both. The BoJ did not change their forecast in the January updates and the market consensus was similarly little changed.

However, when we look at the shorter-term horizon forecast, it is striking that the market consensus has been more erratic. The consensus expected that Japanese style core CPI YoY growth would peak, temporarily, at a level below 1.0% early in 2014. However, the latest figure (November 2013) shows YoY growth

of +1.2%, already surpassing the expected peak and judging from leading indicators, it seems it will accelerate even further. In addition, US style core (CPI ex food and energy) is showing an even more impressive gain. The November 2013 data showed a rise YoY of +0.6%, which is the highest growth since August 1998.

Exhibit 2: Japan's consumer price index is rising; Prime Minister Abe's target of 2% inflation within 2 years appears achievable



Source: Bloomberg, 26 January 2014

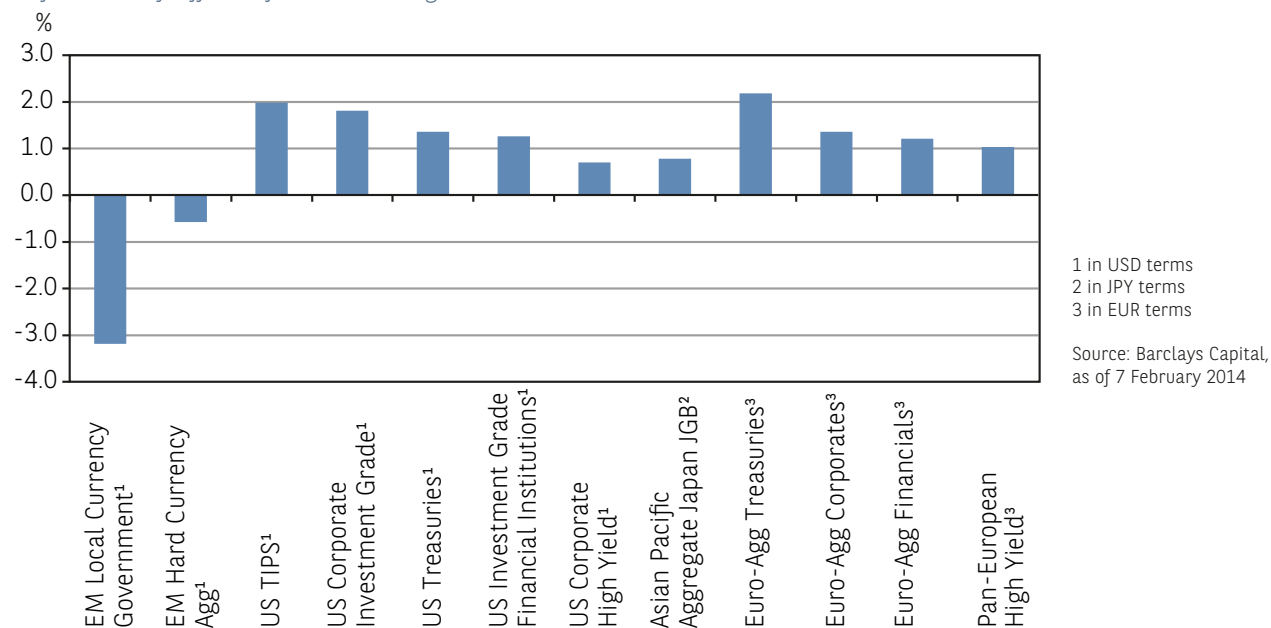
Economists now explain that their initial estimation of the impact currency depreciation would have on inflation was too modest, especially with regard to finished goods. They still think that the BoJ's outlook for fiscal year 2015 is too high unless there is a further substantial depreciation of the yen.

We agree with the consensus among market economists that the BoJ's prediction is too high. However, we also think that we need to watch the CPI figures carefully as they have been exceeding market consensus expectation (including ours). We (and maybe most of our peers) thought the impact of a weaker yen would be limited to oil and other commodity prices and would not feed through to finished goods. However, the higher US style core CPI growth suggests that Japanese producers and retailers have finally begun to transfer the cost to final consumers. The ability of consumers to absorb these price hikes will depend on the growth of their income. For this reason, we will keep a close eye on wage negotiations at the turn of the fiscal year (fiscal 2013 ends in March 2014).

Performancefocus
SPOTLIGHT

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

Performance of different fixed income segments YTD



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.

Performance of selected equity markets YTD

	Absolute return, in euro currency terms year-to-date through January 2014	Absolute return, in US dollar terms or, where indicated, in local currency terms, year-to-date through January 2014
S&P 500	-3.56%	-1.53%
Nasdaq	-1.74%	0.33%
EURO STOXX 50	-3.06%	-5.05%
Shanghai SE Comp	-2.40%	-3.92% (in Chinese yuan renminbi terms)
Brazil IBOVESPA	-7.62%	-7.51% (in Brazilian real terms)
TOPIX	-1.55%	-6.27% (in Japanese yen terms)
South Korean KOSPI	-4.29%	-3.49% (in South Korean won terms)
Indonesia - Jakarta Comp	5.38%	3.38% (in Indonesian rupiah terms)
Russia MICEX	-7.24%	-3.30% (in Russian ruble terms)
Turkey BIST 100 Index	-11.43%	-8.77% (in Turkish lira terms)
India S&P BSE 500 IDX	-3.33%	-4.21% (in Indian rupee terms)

Source: Bloomberg, as at 31/01/2014. All indices price change only (excluding dividends)

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