



# PERSPECTIVES



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

## Managing uncertainty

Managing risk comes with challenges. Correlations and volatility fluctuate over time, drawdown limits need to be set and a risk budget must be determined. Long-term data series of financial asset prices facilitate this task. Dealing with uncertainty is another story. Time series are lacking and statistical probabilities cannot be estimated. Scenario analysis, focusing on how certain events can trigger future developments, becomes important. A key question is whether the fundamental drivers are influenced only temporarily or more permanently. Another question is the economic cost of uncertainty. Academic research has shown that uncertainty is equivalent to a fall in demand. Finally, confidence in economic and cash-flow forecasts will also decline, weighing on asset prices.

From the outset, important political developments were on our radar this year, with the US mid-term elections in November and the European parliamentary elections in May. The outcome could strongly influence how the market perceives economic policy making, particularly important in the eurozone as despite the cyclical upswing, structural challenges remain. In addition, there are numerous elections this year in emerging markets, several of which suffered from the market turmoil in January: Turkey, Indonesia, India, Brazil, etc. Ukraine, where events are unfolding fast, must now be added to the list of potential political flashpoints. The reaction of global markets has directionally been as expected, yet to a limited extent. This is comforting for now, but uncertainty prevails. It's an additional factor to take on board in what promises to be a challenging year.

3 March 2014



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





Joost van Leenders

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

# Severe winter weather causes US data weakness, geopolitical tensions increase

In February, developed equity markets recovered. Lower-than-expected inflation data kept bond yields low. While our equity overweight paid off, our short duration position in fixed income disappointed. On account of the rising geopolitical tensions we have closed our overweight position in emerging market hard currency debt.

## Recent weak US economic data is seen as being a consequence of the severe winter weather. Is this also your view?

Yes, we do believe that the exceptionally harsh winter in the US has had a strong negative impact on most US economic data recently, and recent market behaviour suggests that most investors agree with this analysis. We are mindful that we could be overestimating the impact of the cold winter as regional data shows weakness in areas not affected by the weather. Retail sales were already slowing before the weather turned extreme. Nonetheless, although the first quarter is shaping up to be quite weak, we expect growth to improve. For 2014 as a whole, we foresee stronger growth than in 2013, but still barely above the US's potential growth rate. We expect the Fed to maintain its policy of lowering asset purchases.

## We are increasingly seeing signs of a two-speed recovery: faster economic growth in developed economies than in emerging markets. Do you think this will continue?

Eurozone growth accelerated in the last quarter of 2013. At +0.3% relative to the final quarter of 2012, it was not particularly strong, but faster than in the third quarter. German growth was steady at 0.3%, while growth improved in France, Italy, the Netherlands, Belgium, Spain and Portugal<sup>1</sup>. The eurozone's composite PMI weakened, but the Economic Sentiment Index and Germany's Ifo index rose further. Structural improvements have brightened the outlook for some 'peripheral' countries. Spanish government bonds were upgraded by one of the main rating agencies and the return of Ireland and Portugal to capital markets was met by a healthy demand for their new issuance. Growth in the eurozone will be lower than in the US this year, but we think it has more potential for a surprise to the upside. Persistently low inflation could be worrying the ECB, but with improving growth, we foresee only small reflationary policy steps, if any.

In contrast, growth in emerging economies has generally slowed, but given the becalmed foreign exchange markets, we do not expect a severe slowdown. GDP data for the fourth quarter and PMIs for February (as far as available) were

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“Although the first quarter is shaping up to be quite weak, we expect growth to improve”

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mixed. Having said this, we see two main concerns. China's manufacturing PMIs fell further in February, stoking market worries about an uncontrollable slowdown. We do not expect this to happen, with no real economy or monetary indicators to suggest an imminent dramatic slowdown. Risks to the downside include the boom in credit in recent years. Political unrest could also cause upset, notably in Ukraine.

## Do you think the developments in Ukraine will have a lasting impact on markets?

While the Ukrainian economy itself is small, a large-scale conflict could threaten Russian gas supplies to Europe. Due to the turmoil in Ukraine, we closed our overweight in emerging market hard currency debt. Civil unrest could hurt market sentiment: investors might begin to scrutinise and overreact to issues in restive countries such as Venezuela and Thailand. Impressed by the market's resilience, we've maintained our overweight in developed market equities. Last month, what we considered to be an excessive fall in US and German bond yields led us to implement a short duration position in German sovereign debt. Yields however have fallen further, driven by safe-haven flows provoked by political unrest in emerging economies. We continue to think bond yields are too low given the improving economic environment and the fact that any stimulative ECB measures are fully discounted.

Written on 10 March 2014

<sup>1</sup> Source for all data: Bloomberg or Datastream, unless otherwise specified.



Denis Panel  
CEO of THEAM, Paris

## Disarming investments

More and more responsible investors are opting for investments that respect the environment, society and human rights, an approach that now extends to equity index funds. For Denis Panel, CEO of THEAM<sup>1</sup>, quality asset management is synonymous with responsible investment, which has led THEAM to become the first European asset management company to adopt benchmarks that exclude controversial weapons manufacturers.

The Responsible Investment policy is an integral part of the BNP Paribas Investment Partners (BNPP IP) approach. It applies ESG<sup>2</sup> criteria, based on the United Nations Global Compact, to its open-ended funds and applies specific sector policies to govern investments in controversial sectors.

As of 16 January, in line with BNPP IP's strategy and recommendations published in April 2013 by the French Asset Management Association (AFG)<sup>3</sup>, THEAM is breaking new ground. In fact, THEAM now excludes the securities of companies that are involved in the supply or manufacture of cluster munitions and anti-personnel mines from the equity indices used for its range of open-ended index funds.

This new strategy is yet another major step forward in BNPP IP's Responsible Investment policy, under which it has excluded manufacturers of controversial weapons from all its assets under management since 2010 - excluding index funds - as part of its policy in the defence sector.

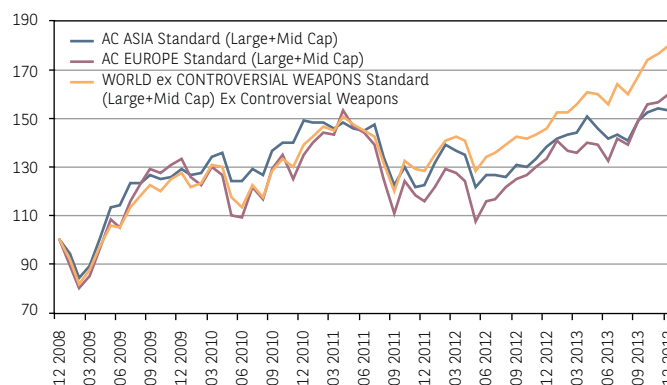
Prior to this, THEAM endeavoured to find ways to exclude controversial stocks from all physical-based index fund portfolios. But in mid-January we decided to make this commitment permanent by opting for benchmarks that exclude controversial weapons - namely, the MSCI Global ex Controversial Weapons Indices - for our range of index funds.

This decision is a first for an asset management company in Europe, making THEAM a front-runner in our field, and paving the way for more innovation in this area. Through the commitment to include ESG criteria in our index fund investment practices, THEAM is not only aligning itself with BNPP IP's principles, but also acting for the benefit of our clients.

We firmly believe that by including these criteria in our investments, not only is it possible to help manage exposure to long-term risks, such as social conflicts and environmental crises, but also to respect the risk/return profile of the investment.

We can take the MSCI World ex Controversial Weapons index from the range of MSCI Global ex Controversial Weapons indices as an example. Its annualised performance over the past five years totals 15.7%, perfectly on par with that of the MSCI World index.<sup>4</sup>

Exhibit 1: Performance of the MSCI World ex Controversial Weapons, MSCI AC Asia and MSCI AC Europe indices (Dec. 2008-Dec. 2013, in USD, Dec. 2008=100)



Source: [http://www.msci.com/products/indices/esg/ex\\_controversial\\_weapons/performance](http://www.msci.com/products/indices/esg/ex_controversial_weapons/performance), January 2014.

We believe that when it comes to index funds, quality management can be synonymous with responsible investment. The idea is to offer our clients index funds that meet their needs and have a limited tracking error compared to traditional indices.

It is for these reasons that we have opted for the MSCI Global ex Controversial Weapons indices, after extensive analysis of the construction methodology of these MSCI indices and comparison with their standard versions. These indices exclude mid and large-cap companies that are involved in the controversial weapons sector (chemical and biological weapons, cluster bombs, anti-personnel mines and depleted uranium), and are weighted according to their float-adjusted market capitalisations. Their composition is reviewed every quarter.

Clients who were interviewed beforehand all responded positively to this development. We hope that this new commitment will encourage the creation and development of indices favouring responsible investment on a larger scale. It is our belief that these indices are the benchmarks of the future, and that they will only gain in importance as more investment solutions with a high social value are developed.

1 As part of BNP Paribas Investment Partners and benefiting from a close partnership with BNP Paribas Corporate Investment Banking, THEAM is an asset manager specialising in Protected, Indexed and Model-Driven Management offering investment solutions across a broad spectrum of underlying assets, adapted to the needs of distribution networks and institutional investors. At the end of December 2013, THEAM employed 122 professionals and boasted assets under management of close to EUR 40 billion.

2 Environmental, Social and Governance.

3 Recommendations published in April 2013 by the French Asset Management Association (AFG) regarding the application of a policy that excludes companies involved in the supply or manufacture of cluster munitions and anti-personnel mines from index fund portfolios.

4 More precisely, the annualised performance of the MSCI World ex Controversial Weapons index is 15.69% against 15.68% for the MSCI World index.



Chi Lo

Senior Economist, Greater China – BNPP IP, Hong Kong

# China's interest-rate liberalisation: the next steps

Interest-rate liberalisation will be crucial to the success of China's broader financial reform ambitions. Yet, faced with conflicting interests, Beijing needs to proceed with caution.

International experience shows a deposit insurance system to be a prerequisite for deregulating deposit interest rates. Japan and the US set up deposit insurance before deregulating their deposit rates; South Korea and Taiwan did so in parallel with the deregulation process. Beijing has now reached a policy consensus for setting up deposit insurance as a next step forward.

The primary task is for Beijing to gradually allow market forces to determine the deposit rate. To this end, the Chinese government took an initial, albeit small, step by introducing an interbank market for negotiable certificates of deposit (NCDs) in December 2013. However, trading is restricted to inter-bank players for the time being. A natural next step would be to introduce NCDs that are tradable in a public secondary market open to large Chinese firms and ultra-high net worth depositors. Japan is an example of a country which began interest-rate liberalisation by introducing tradable NCDs for its large depositors.

Subsequently, Beijing may consider eliminating the deposit rate caps on large-denomination long-term deposits such as those of five years and longer. This was what the US did before scrapping Regulation Q in 1986. Since long-term deposits account for less than 1% of total bank deposits, their potential systemic effects should be easily manageable.

“Beijing has to balance the interests of the winners and losers in the liberalisation process.”

## The benefits are clear

A roadmap for liberalising China's interest rates is one thing, but the timing and sequencing of implementation is quite another, because Beijing has to balance the interests of the winners and losers in the liberalisation process. The benefits are clear: interest-rate liberalisation, together with other financial reforms, should help improve capital allocation efficiency. It is also a prerequisite for China to be able to deepen its capital markets, enable correct risk-premium pricing and lay a solid foundation for completing

capital account and RMB convertibility.

However, interest-rate liberalisation changes the rules of the game by reshuffling the positions of the winners and losers. Small and mid-sized enterprises (SMEs) and households with net savings stand to gain the most as they obtain access to credit and higher returns. But banks and state-owned enterprises (SOEs), the main beneficiaries from financial repression, are likely to be the losers. This could well be a barrier to implementation as the losers would be those with extensive vested and political interests.

## A cautious approach would be best

Financial repression has created a minimum 300 basis point spread between the lending and deposit rates of Chinese banks, ensuring them a monopolistic profit to the detriment of households. Scrapping the deposit rate cap will drive up the deposit interest rate as the competition for funds spreads out across different market segments, removing the banks' monopoly and hitting their profits. The SOEs stand to suffer significantly from much higher financing costs.

Liberalising interest rates too fast could aggravate the risk posed by local government debt, which has markedly deepened China's public debt burden since 2010. One measure of the long-term viability of public debt is the gap between the nominal interest rate and nominal GDP growth rate. At 53% of GDP, China's current total public debt load is manageable. But interest-rate liberalisation could threaten this by pushing up the public sector's debt-to-GDP ratio through a sharply higher interest cost.

Given such challenges, China's leaders are likely to take a cautious approach to interest-rate liberalisation. Gradual implementation would give the losers time to adapt, while Beijing sustains the momentum on pivotal reforms.



**Christophe Auvity**  
Head of Global Credit - BNP Paribas Asset Management, Paris

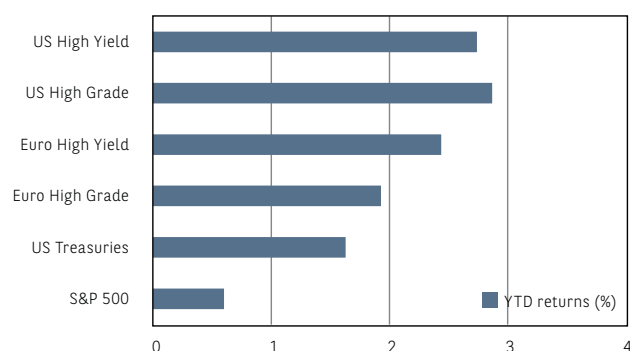
## Spreads grind lower in credit markets

The corporate credit market started strongly in 2014. Christophe Auvity, Head of Global Credit, discusses the environment for corporate credit and runs through the factors he sees as explaining the excellent performance so far this year.

**Perspectives (P):** Christophe, do you think fixed income credit markets can remain this strong throughout 2014?

**Christophe Auvity (CA):** Yes, after a very strong start (exhibits 1 and 2 show some elements of performance for credit in the first two months of 2014), yields are now close to record lows, so inevitably questions are being asked as to what will happen next. We believe the market remains supported by strong fundamentals and excellent technicals, so spreads can grind tighter. The search for yield remains a powerful force in credit markets and should not be underestimated. Recent weakness in US economic data is a result of the severe winter and does not, in our minds, foreshadow further slow growth. We expect the Fed to continue to wind down its unconventional policy measures, but interest-rate hikes are, if anything, further off than we thought at the start of the year. In Europe, the very low inflation environment means the ECB is biased towards easy monetary policy. In our opinion, this will, in combination with the slow pace of economic growth, support demand for corporate bonds as investors continue to scour the markets for yield.

Exhibit 1: Strong absolute performance from credit in the first two months of 2014



Source: Barclays Capital as of 7 March 2014

The high-beta credit sectors have done best (e.g. subordinated financial debt has outperformed senior financial debt and high yield has outperformed high grade, etc.). This trend is well illustrated by the compression in the spread between European

high grade (represented by the CDS Main index, composed of the 125 most liquid CDS referencing European investment-grade credit) and high-yield credit (represented by the X-Over index which is composed of 40 sub-investment grade credits). At the end of February the ratio between these two indices was at its lowest level since the financial crisis in 2007.

Exhibit 2: Sector performance for European credit, YTD at 28/02/14

Sector	Spread (bp) as of 31/12/2013	Spread (bp) as of 28/02/2014	Change	2014 YTD change
Corporates	122	121	-1	-0.90%
Industrial	113	114	1	1.30%
Utilities	124	120	-4	-3.00%
Corporate Hybrids	273	276	3	0.90%
Lower-tier 2	227	209	-18	-7.90%
Tier 1	323	321	-2	-0.60%
Insurance Senior	102	109	7	6.80%
Sub Insurance	290	269	-21	-7.20%

Source: SOC GEN, Barclays Capital as of 7 March 2014

Credit from 'peripheral' eurozone countries is another example of higher-beta credit that has done well since the start of the year. The upgrade of Spanish sovereign debt by rating agency Moody's from Baa3 to Baa2 with a positive outlook on 21 February 2014 reinforced the positive investor sentiment on a general improvement in the 'peripheral' countries.

**P:** Credit markets have been impervious to events in emerging markets (EM) and the upheaval in Ukraine. How do you explain this?

**CA:** This highlights that, to a certain extent, credit is seen as a defensive asset supported by strong fundamentals – companies have strong cash positions and ample access to financing. Earnings levels are not too bad and default rates remain low. Technical factors also provide support. For example, there are significant redemptions of corporate debt this year that gross

issuance is going to be unable to match and we continue to see new investor cash coming into the asset class. As I have already mentioned, the macro-economic picture is also looking favourable for credit.

*P: Credit markets have seen a period of strong growth. Do you expect this to continue this year?*

**CA:** Yes, the European high-yield market grew strongly in 2013 with a record annual supply of EUR 141.2 billion according to Dealogic. Last year also saw explosive growth in the corporate hybrid market with EUR 21 billion of supply. So we are seeing a significant expansion in volumes across the market.

Debt capital markets are offering issuers attractive funding at a time when banks are retrenching and loan books are contracting. Both trends look set to continue, so it is likely that we will see more companies turning to bond financing. A study by Moody's showed that the average European high-yield company has a funding mix of 40% loans and 60% bonds, versus 30% loans and 70% bonds in the US. Deleveraging by banks and financial disintermediation would suggest that the transition to an expanded use of bond financing in Europe is likely to continue.

Overall, the corporate bond market in Europe has grown significantly in recent years. From a EUR 700 billion market at the end of 2006 with 864 issues, the market represented by the iBoxx Corporates (IG) index has grown to a EUR 1.25 trillion size with 1 384 issues.

*P: How you do view European corporate credit in comparison with the US market?*

**CA:** In my view, the US market is further advanced in terms of the credit cycle. We are seeing more signs of US companies taking on leverage. Merger and acquisition activity is picking up and there have been a number of leveraged buyouts. Some companies have been issuing debt to fund share buybacks. For a bondholder, such operations, which may add pressure to companies' balance sheets, are typically not positive signals. European companies are lagging their US counterparts in terms

of the credit cycle, so we would favour European corporate debt versus the US markets. Having said that, we do evaluate the overall environment as positive for US credit markets with the factors I have cited underpinning European markets supporting valuations in the US too.

The US market saw USD 49 billion (data from Dealogic) of new issuance in the last week of February, making it the biggest week for issuance since last September when Verizon issued a record USD 49 billion bond. Issuers are keen to take advantage of the compression of spreads and the strong demand from investors with cash to put to work. Risk premiums in US credit markets are now at around their narrowest since the financial crisis of 2007. On 6 March the average spread for US investment-grade corporate bonds was 111 basis points and 397 basis points for high-yield debt. This reflects the strong demand and the search for yield.

In terms of earnings, the European reporting season is almost over and results are mostly in line with what we have seen in previous quarters with only a slight deterioration. These results did not have a major impact on the overall level of spreads, but they tend to show that corporates are adapting to the environment. The US earnings season has more or less finished and results show that most companies exceeded expectations. These results provide further support for corporate debt markets.

*P: So, in conclusion, you expect a positive year?*

**CA:** Yes, the environment remains positive for credit. Low growth in combination with low inflation means investors do not expect central banks to quickly change the interest-rate cycle. Clearly, there will be setbacks and corrections along the way, but the search for yield makes credit an attractive asset class in the current ultra-low yield environment. We are seeing strong demand with new issuance well oversubscribed, the volumes of deals increasing and bonds being priced inside their indicative ranges. This has been apparent for some time and reflects an environment in which there is much cash to be put to work and there are not enough bonds to satisfy demand. As said, the macroeconomic environment is favourable for credit and we maintain our positive outlook.



Sonia Liman,  
Head of CSR communication, BNP Paribas Investment Partners, Paris

## BNP Paribas Investment Partners launches CLIMAT[e]

After “Dialogue” and “AQUA”, BNP Paribas Investment Partners (BNPP IP) has published a new book aimed at increasing awareness of Corporate and Social Responsibility (CSR) issues, entitled CLIMAT[e], in collaboration with the GoodPlanet Foundation and Erik Orsenna, which examines the economic, social and environmental impacts of climate change.

**B**NPP IP is committed to contributing to a responsible and sustainable economy as well as actively participating in the development of investment solutions that help build a better future. In 2013, BNPP IP chose the subject of climate change as the framework to illustrate its responsible investment initiatives since we believe investments in preventing and adapting to climate change will be absolutely essential in the future. BNPP IP contributes to this by managing third-party assets in line with its responsible investing convictions.

We also seek to educate and raise awareness. Throughout 2013, we sponsored a series of conferences for institutional investors to examine the economic, social and environmental impact of climate change and the all-important issue of energy transition. To mark these events, our CSR team has published a book that is both attractive and takes a thoroughly documented, educational approach to present the facts, symptoms and mechanisms behind global warming.

The book’s goal is to nourish and advance the discussion with investors and other stakeholders about climate change. It underscores our active embrace of our role as a forward-looking player in responsible investment, making us more than ever the “asset manager for a changing world”. Through the book, we aim to shed light on the challenges and opportunities of sustainable development for investors.

This book aims to influence other people’s behaviour by suggesting solutions on how to slow down global warming now before it is too late. The images and commentary of French photographer, journalist and ecologist Yann Arthus-Bertrand and French author Erik Orsenna bring home the realities of climate change. CLIMAT[e] shows us that nothing is written in stone: various scenarios are possible and solutions do exist. It is now up to each of us to implement them and take action.

As Yann Arthus-Bertrand says in CLIMAT[e]: “The planet is changing right before our eyes. Travelling the world, nearly every day I meet men and women already feeling the impact of these changes in every country and every environment ... we

must brace ourselves for global warming, a world different from that one we have known until now, and anticipate the problems it will bring with it: changes in agricultural output, increasing frequency of natural disasters, more migration movements, etc.” In addition, the IPCC (Intergovernmental Panel on Climate Change)<sup>1</sup> predicts that by 2100, there will be: a sharp rise in the average temperature of our planet of 1.5 to 3 degrees centigrade, an increase in extreme climate events (in particular heat waves) and a rise of the oceans ranging from 0.25 centimetres to one metre, depending on the region.

As a major global player in long-term asset management, we are concerned about this worldwide issue. Although its causes and scope may be disputed, we hope to continue the debate and open up the discussion to more clients because, as Yann states: “For investors and bankers, climate change means thinking differently about the long term and taking a new parameter into account”. Investments in prevention and adjustments will be needed both upstream to back projects that aim to save energy and downstream to finance the research and infrastructure that can help determine the correct choices by public and private decision-makers to combat global warming’s innumerable consequences.



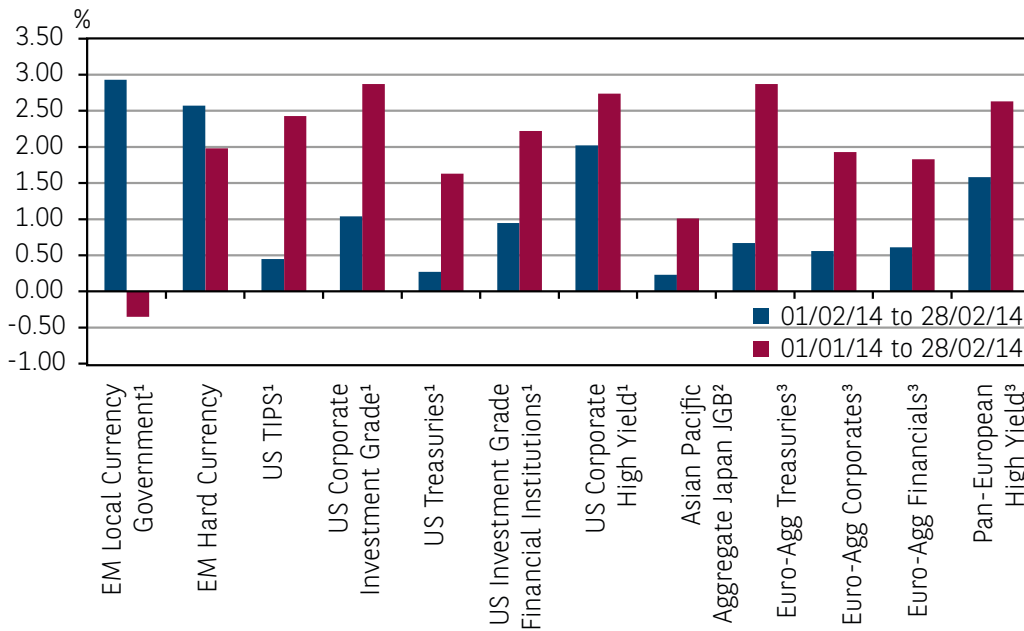
**CLIMAT[e] is available as an e-book.**  
For more information about CLIMAT[e] and our CSR engagement, please contact [sonia.liman@bnpparibas.com](mailto:sonia.liman@bnpparibas.com)

1 The IPCC is a group of more than 200 experts from around 40 countries. It has just released its fifth report (30 September 2013). [www.ipcc.ch](http://www.ipcc.ch)



Performance focus  
SPOTLIGHT

# Performance of different fixed income segments YTD and from 1 February to 28 February 2014



1 in USD terms  
2 in JPY terms  
3 in EUR terms

Source: Barclays Capital, as of 7 March 2014

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 for the period from 1 January to 28 February 2014

	Absolute return, in euro currency terms year-to-date through February 2014	Absolute return, in US dollar terms or, where indicated, in local currency terms, year-to-date through February 2014
S&P 500	0.46%	0.60%
Nasdaq	3.01%	3.15%
EURO STOXX 50	1.29%	1.43%
Shanghai SE Comp	-4.43%	-2.82% (in Chinese yuan renminbi terms)
Brazil IBOVESPA	-7.58%	-8.57% (in Brazilian real terms)
Japan TOPIX	-4.27%	-6.96% (in Japanese yen terms)
South Korean KOSPI	-3.00%	-1.56% (in South Korean won terms)
Indonesia - Jakarta Comp	13.70%	8.09% (in Indonesian rupiah terms)
Russia MICEX	-11.63%	-3.95% (in Russian ruble terms)
Turkey BIST 100 Index	-10.01%	-7.74% (in Turkish lira terms)
India S&P BSE 500 IDX	-1.97%	-1.65% (in Indian rupee terms)

Source: Bloomberg, as at 28/02/2014. 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.

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