BNP PARIBAS
INVESTMENT PARTNERS

Sovereign risk in Europe

June 2010

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Key messages

- What characterizes the world at the moment is a growing dichotomy between mature and emerging economies
- It is obvious for growth and for public finance situation
- We do not believe that an European country is likely to default on its debt
- An exit from the Euro zone is difficult to imagine (political issue)
- Next step is a renewed fiscal discipline that will harm growth (in 2010 in Greece, Portugal and Spain, in 2011 for France and Germany)
- To watch: reaction of population to the tightening in fiscal policy (strikes, street demonstrations,…)
- The euro should remain under pressure on the medium term

Macroeconomic environment

The world continues to recover, with few economic surprises recently. However, mature economies are penalised by de-leveraging

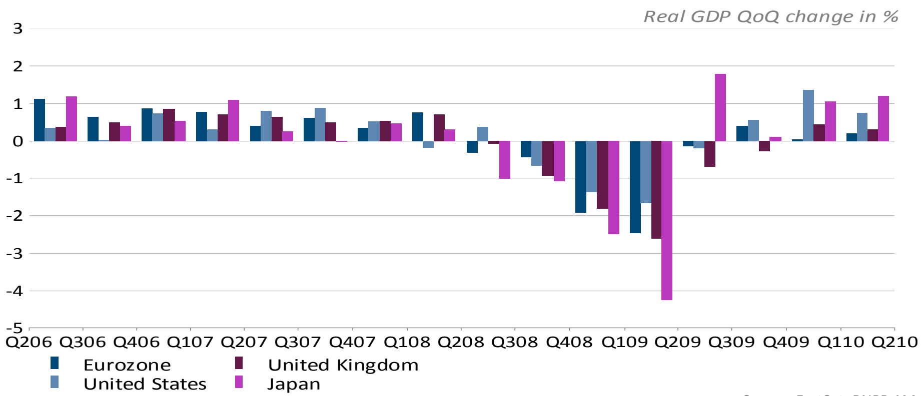
Consensus Forecasts: Growth & Inflation

03/05/2010 M= Mean; H= High; L=Low	GDP y.o.y % 2009	GDP 2010 M	GDP 2010 H	GDP 2010 L	GDP 2010 -1M	GDP 2011 M	GDP 2011 H	GDP 2011 L	GDP 2011 -1M	Inflation y.o.y % 2009	Inflation 2010 M	Inflation 2010 H	Inflation 2010 L	Inflation 2010 -1M	Inflation 2011 M	Inflation 2011 H	Inflation 2011 L	Inflation 2011 -1M
Developed Economies																		
USA	-2.4	**3.2**	3.9	2.5	[3.1]	**3.1**	4.4	1.5	[3.0]	-0.3	**2.1**	3.0	1.6	[2.2]	**1.9**	3.9	0.8	[1.9]
Canada	-2.6	**3.2**	3.4	2.5	[2.9]	**3.0**	3.6	2.3	[3.2]	0.3	**1.9**	2.2	1.5	[1.8]	**2.2**	2.6	1.7	[2.2]
Euro zone	-3.9	**1.2**	1.8	0.6	[1.1]	**1.5**	2.6	1.0	[1.5]	0.3	**1.2**	1.5	0.8	[1.1]	**1.4**	1.8	0.7	[1.4]
UK	-5.0	**1.3**	2.2	0.9	[1.4]	**2.3**	3.2	1.4	[2.3]	2.2	**2.7**	3.6	1.8	[2.6]	**1.7**	3.6	0.3	[1.7]
Switzerland	-1.5	**1.8**	2.5	0.9	[1.5]	**1.9**	2.8	1.1	[1.8]	-0.5	**1.0**	1.3	0.7	[0.8]	**1.1**	1.7	0.8	[1.1]
Japan	-5.2	**2.2**	2.8	1.5	[1.9]	**1.6**	2.9	0.9	[1.6]	-1.4	**-1.1**	-0.6	-1.6	-[1.1]	**-0.2**	0.6	-0.7	-[0.3]
Australia	1.3	**3.3**	3.8	2.6	[3.1]	**3.4**	4.3	2.7	[3.4]	1.8	**2.6**	3.0	2.2	[2.5]	**2.8**	3.3	2.6	[2.7]
Developing Economies																		
China	8.7	**9.9**	11.0	9.0	[9.9]	**9.0**	10.0	8.2	[9.1]	-0.7	**3.3**	4.0	2.5	[3.2]	**3.4**	4.9	2.4	[3.3]
India (FY10 & FY11)	7.1	**8.2**	9.0	7.2	[8.2]	**8.4**	9.1	7.2	na	11.7	**8.2**	11.0	5.5	[8.0]	**6.1**	8.0	4.5	na
South Korea	0.2	**5.1**	6.8	4.1	[4.9]	**4.2**	5.2	3.0	[4.3]	2.8	**2.8**	3.2	1.7	[3.0]	**3.0**	3.6	1.5	[3.0]
Taiwan	-1.9	**5.3**	8.2	4.3	[5.0]	**4.6**	5.5	3.6	[4.5]	-0.9	**1.3**	1.9	0.5	[1.2]	**1.6**	2.5	0.4	[1.7]
Argentina	-2.8	**4.6**	6.1	3.1	[3.8]	**3.0**	4.2	-0.4	[2.4]	7.7	**10.5**	12.2	8.0	[9.7]	**10.4**	13.9	7.5	[10.1]
Brazil	-0.2	**5.8**	7.0	5.2	[5.5]	**4.5**	5.1	3.0	[4.4]	4.3	**5.2**	5.8	4.5	[4.8]	**4.7**	5.5	4.4	[4.7]
Mexico	-6.5	**4.2**	6.0	3.2	[4.0]	**3.5**	4.1	3.0	[3.5]	3.6	**5.2**	5.6	4.1	[5.2]	**3.9**	4.6	3.4	[3.9]
Russia	-7.9	**4.7**	6.2	3.4	[4.5]	**4.6**	5.8	3.9	[4.6]	8.8	**7.1**	8.9	5.6	[7.0]	**6.7**	9.5	4.5	[6.9]
Turkey	-5.6	**4.9**	7.2	3.5	[4.5]	**4.4**	5.5	3.3	[4.3]	6.3	**9.2**	9.9	6.6	[9.0]	**6.3**	7.5	4.7	[6.2]

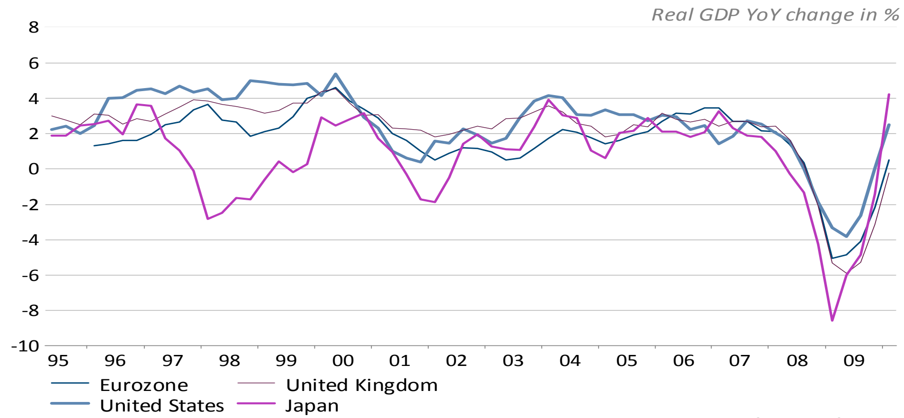
Source: Consensus Forecasts as of 12/04/2010; Asia Pacific as of 12/04/2010; Latin American as of 19/04/2010; Eastern European as of 19/04/2010

Euro Zone is the laggard of the G7

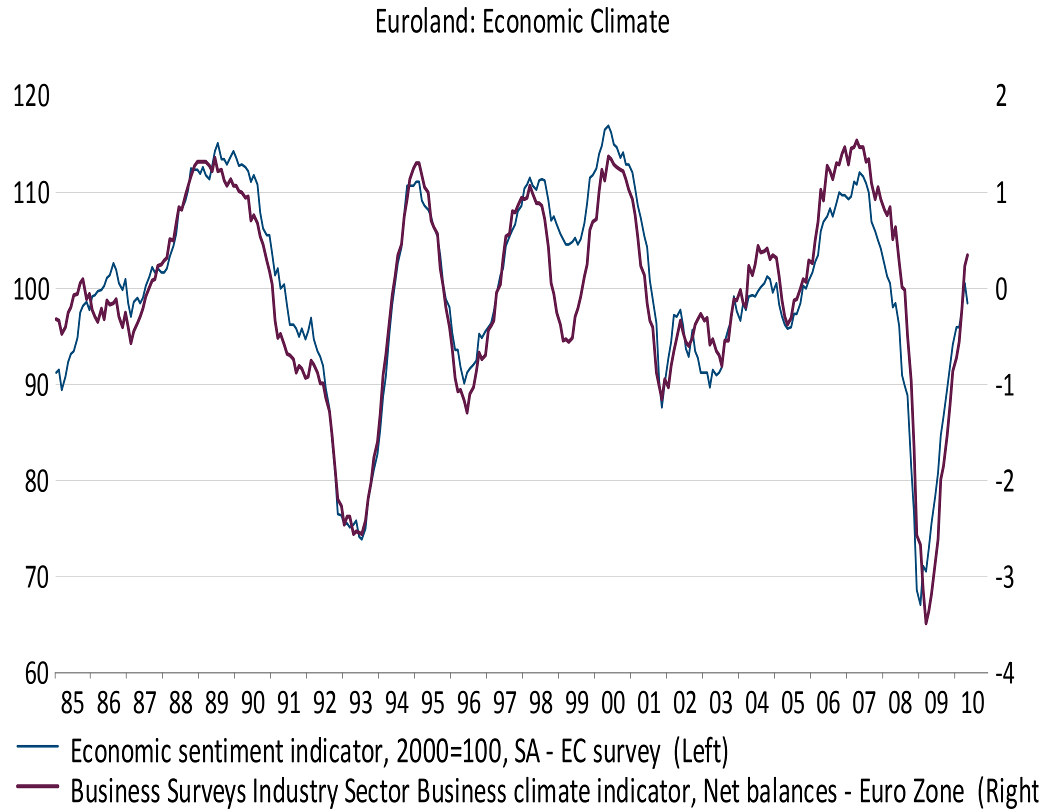
Disappointing GDP growth in Q1 (+0.2%); activity accelerated towards the end of the quarter and in the early part of Q2 before reaching a ceiling in May. A slowdown could occur in the second half of the year. Worries about the sovereign debt crisis have probably dented confidence



Source: FactSet, BNPP AM



Source: FactSet, BNPP AM



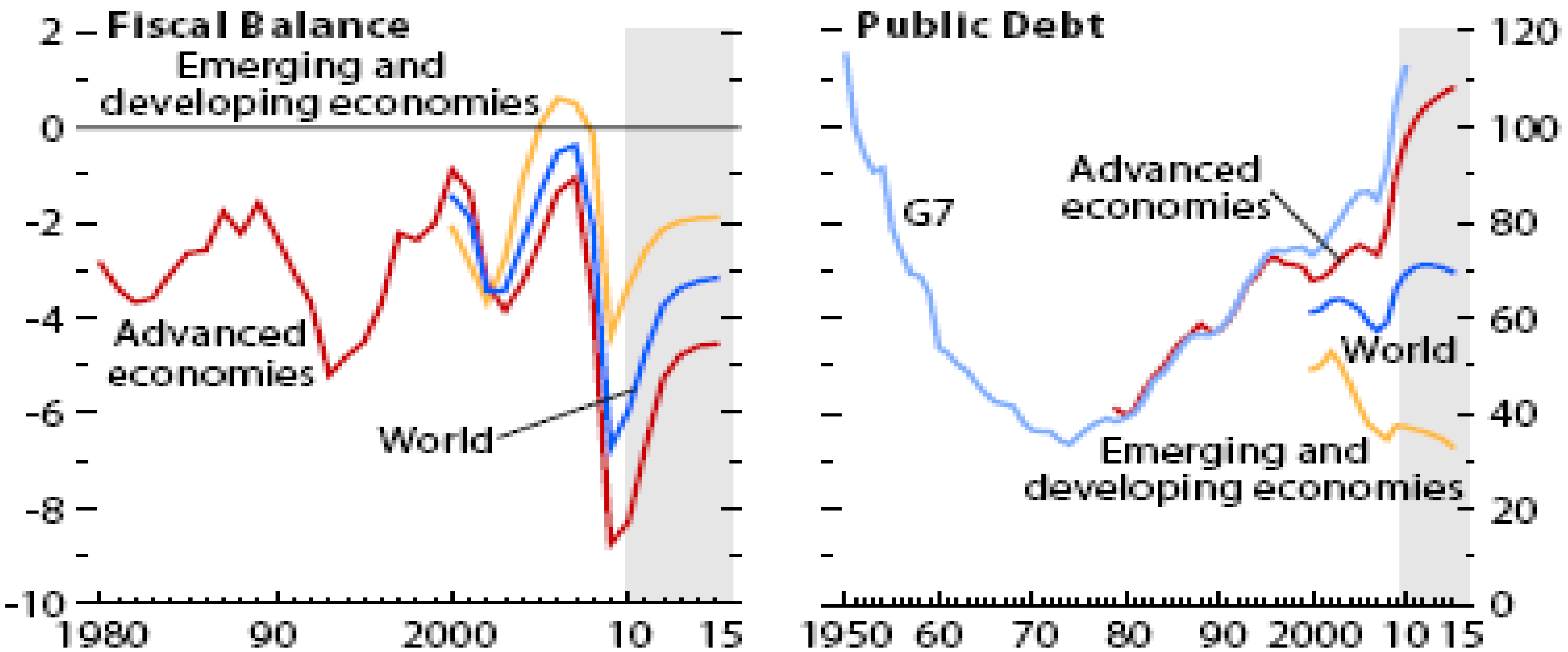
Source: Factset, BNPP AM

Sovereign risk: what to think?

The rise in sovereign risk is an additional development in the debt crisis that started in 2007

All major mature economies are concerned; not only the Eurozone

Fiscal balance and public debt as a % of GDP



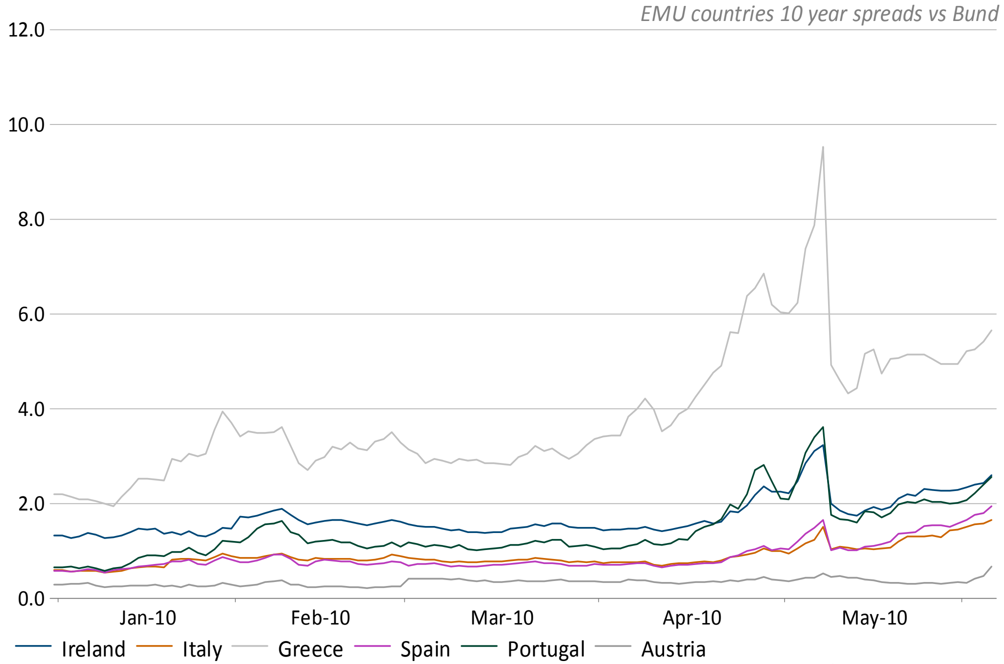
Source: IMF, World Economic Outlook, April 2010

Sovereign risk: what to think?

No over-reaction in the short term:

- we think liquidity issues have been or can be adressed by the EU, IMF and BCE package

- markets are selective and are not attacking sovereign risk, but weaker countries



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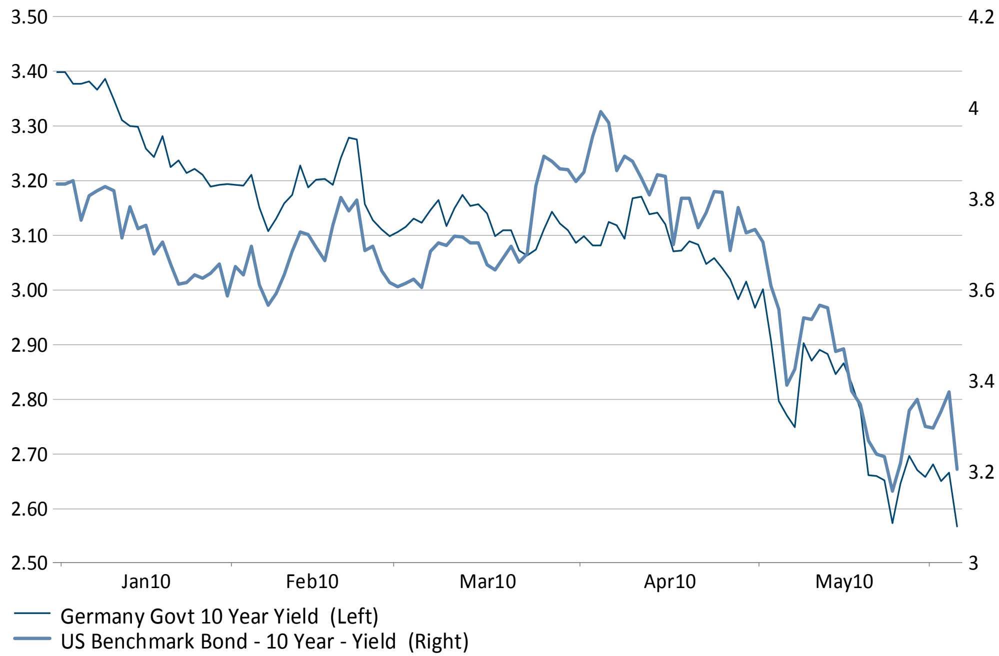
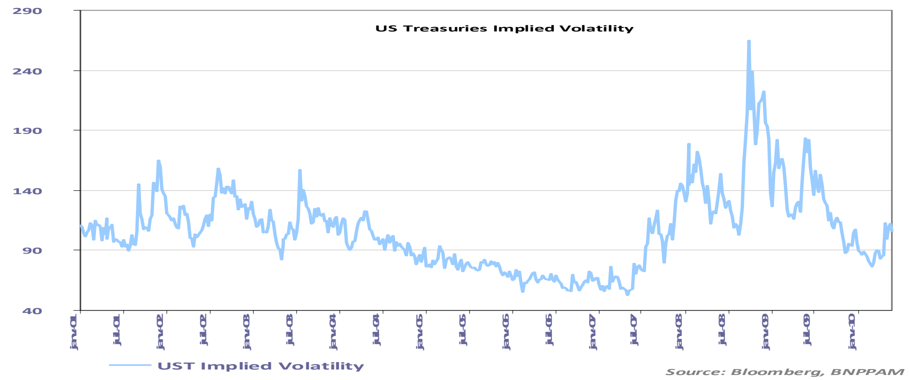


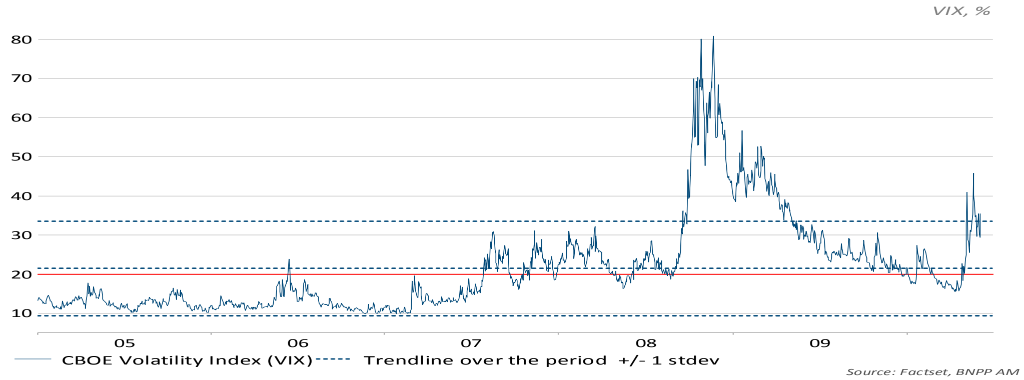
Source: Factset, BNPPAM

Sovereign risk: what to think?

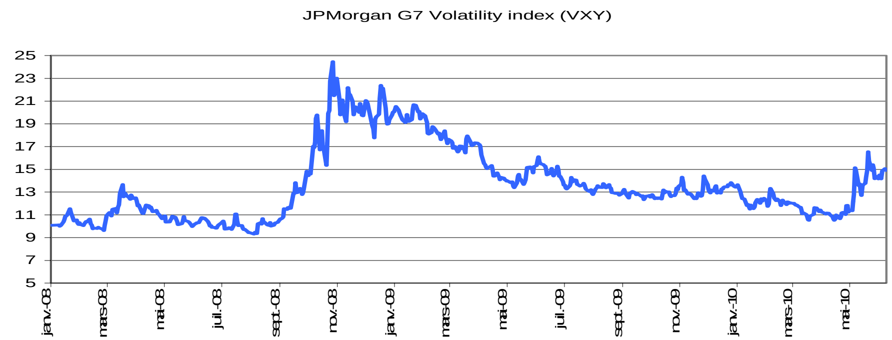
A long-term economic problem turning into a short-term market issue

Tension indicators (interbank market, equities, bonds, Forex) are back to high levels but not to crisis levels





Volatility on Forex



Source: Bloomberg, BNPP AM

Possible outcome: 3 main options

- A "bearish" case: growing tensions on banks lead to credit restriction and/or governments are forced to cut deficits faster under market pressure. A double dip takes place.

  Probability: low/average. Central banks can act to ease liquidity tensions between banks. Balance sheets have been partially cleaned up. A general crisis on sovereign debt looks unlikely as long as growth is sluggish (rise in savings rates, limited demand for credit from the private sector), and is not what we recently saw.

- A "bullish" case: after a period of volatility, it appears that the economic recovery is self-sustainable and surprises positively. Markets are reassured and the financial sector returns to business as usual, giving governments time to progressively cut deficits and stabilise debt.

  Probability: average. We doubt the recovery in mature economies can be as strong as in past cycles, because of the de-leveraging.

- Our base case: a systemic crisis does not materialize, but a slowdown in GDP growth in the next quarters, and continuing worries about the long-term impact of sovereign debt, maintain a quite high aversion to risk.

  Probability: high. We think markets should continue to hesitate between encouraging elements (positive growth, rebound in corporate profits, accommodative monetary policies, emerging countries…) and longer-term threats.

Key messages on asset allocation

- **Our portfolio in June is rather similar to** May and subject to relatively minor adjustments. We continue to think that markets reached a turning point in the past couple of months, and that **we have entered a structurally tougher environment for risk assets** (upcoming slowdown in economic growth, sovereign risk…). Despite this relatively bearish bias, we are not playing a further drop in the very near term.
- **Macroeconomic base case broadly unchanged:** slowdown in growth in mature economies (but no double dip), end of the acceleration in emerging countries, dichotomy in terms of inflation and public debt between emerging and developed regions. However, the risk of a double dip probably increased in the recent past.
- **Still no key rates hikes by the Federal Reserve, ECB, BoE and BoJ expected soon,** and recent developments could postpone a tightening even further (restrictive fiscal measures, market turbulences, "de facto" tightening with higher interbank rates in Europe…).
- EUR/USD still expected to weaken in the medium term, but we do not expect the parity to continue to drop in the near future.
- **Neutrality maintained on developed equities. We have a fundamental preference for emerging equities**, but they are not expected to outperform much in the short term (correlation, monetary tightening).
- **We also are neutral on sovereign bonds, and have a preference for high yield** given the absence of a double dip or market dislocation in our scenario.
- **In order to perform better in the longer term (more than three months), we believe investors from mature regions should directly or indirectly seek exposure to emerging economies, which can be achieved through emerging equities or commodities.**

Thank You !