JFEBRUARY 2022

Investment Strategy Focus

Hold on amid market turbulence

1. **Expectations of sharply higher US short-term and long-term real bond yields trigger a stock market correction and a stronger US dollar.** Two-year US Treasury yields have risen 1%, while the US 10-year real yield has gained 0.5%. Higher real yields imply lower equity P/E ratios, with stocks now c. 10% cheaper than in December.
2. **A hawkish-sounding Fed:** Fed Chair Powell sounded hawkish during the post-FOMC press conference, triggering a nervous market reaction. We expect the Fed to talk tough until it is clear that inflation has peaked. But, US growth has already peaked, and manufacturing surveys suggest an imminent inflation peak. We see the recent revisions in market expectations as exaggerated and we stick to our view of 4 rate hikes in 2022 of 25bps each, starting in March.
3. **Beware the double-edged sword of leverage:** the high level of US retail investor margin debt, and forced selling post margin calls have been an important factor behind the decline in retail favourite growth stocks. We advise against using high leverage, especially in high-beta assets.
4. **We caution against an aggressive "buy the dip" mentality for now, given present Central Europe geopolitical uncertainties.** Should these concerns ease, we would gradually increase equity exposure, focusing on European stocks and quality factor/quality dividend strategies.
5. **Upgrade to positive on base metals:** The base metals short-term outlook is improving on: a) sustained demand linked to renewable energy, b) restocking needs, and c) a more accommodative Chinese policy stance. The medium-term outlook remains bright due to energy transition demand, and to limited new mine investment since 2015.

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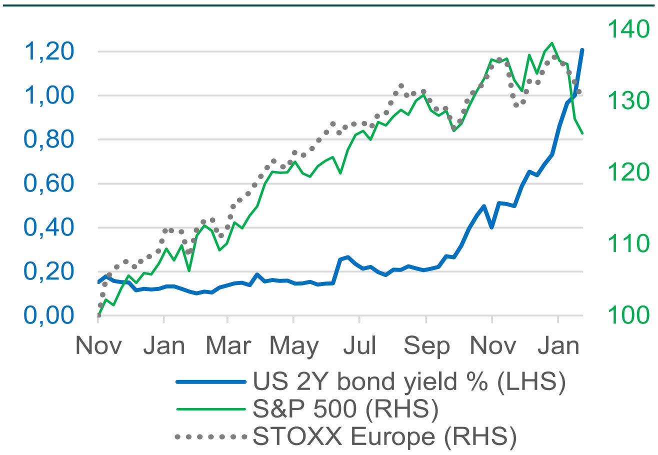
US, EUROPE STOCKS STILL +25/+30% SINCE NOVEMBER 2020



Source: Bloomberg

Edmund Shing, PhD

Global CIO

BNP Paribas Wealth Management

Taper Tantrum sequel, or something worse?

Hawkish Fed triggers a delayed market impact

Since September 2021, the US Federal Reserve has been sending increasingly hawkish signals regarding the start of a new rate hiking cycle, in response to the surge in US (and global) core and headline inflation that began in April 2021.

As the US Personal Consumption Expenditure core inflation rate (the Fed's preferred inflation measure) soared from 1.5% at the beginning of 2021 to 4.7% in November, interest rate expectations have reset from one expected Fed rate hike in 2022 to four rate hikes today.

This has driven both 2-year US bond yield and the 10-year US real yield sharply higher in the space of three months, triggering a corrective phase in stock markets.

Q4 2018 redux – Fed policy error, swiftly corrected: over the last quarter of 2018, the S&P 500 index fell by 18% and the Nasdaq Composite by 21% from peak to trough as stock market investors feared that the Fed were overtightening monetary policy via Quantitative Tightening (reducing their balance sheet by selling US Treasury bonds). Following the stock market selloff, the Fed then reversed course.

Unnecessary panic after the FOMC meeting

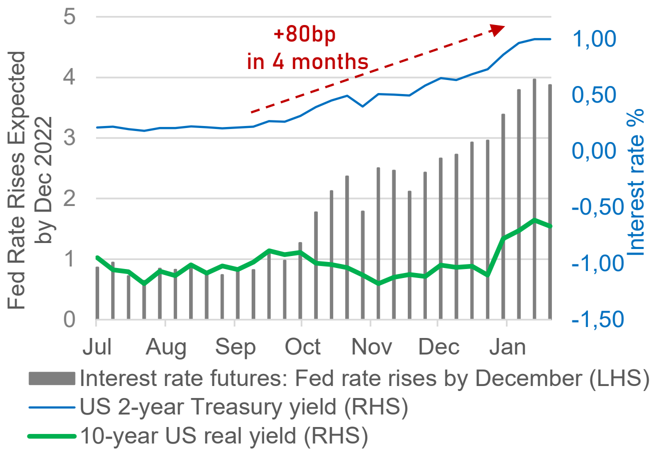
The Fed is set to normalise its monetary policy using, at the same time, a classic tool, i.e. interest rate hikes, and the balance sheet tool, with a gradual decrease in reinvestment of maturing assets, to allow its balance sheet to shrink gradually.

We think that Chair Powell is talking tough given that inflation is too high and has become a political issue. However, we believe that inflation will decline over the course of this year, allowing the Fed not to be forced to hike rates at every meeting. We stick to the view of 4 rate hikes in 2022, of 25bps each per quarter, starting in March.

The Fed seems to want to start the balance sheet reduction sooner rather than later. An announcement now looks more likely to come in June for a July start, one month earlier than we had previously thought.

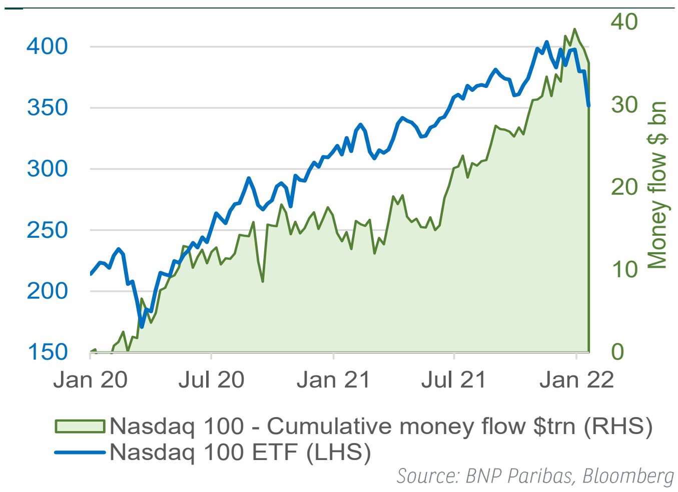
Assuming that both real and nominal (real growth + inflation) GDP growth rates remain above long-term trend in 2022, there is every reason to suppose that we can avoid a bear market as per the aftermath of the Year 2000 tech bubble. We remain optimistic that solid earnings trends and a higher equity risk premium can support positive stock market performance over 2022.

SHARP RISE IN 2-YEAR US BOND YIELDS, REAL YIELDS HAS PRESSURED EQUITIES



Source: BNP Paribas, Bloomberg

RETAIL INVESTORS HAVE POURED MONEY INTO THE TECH SECTOR IN 2021



Source: BNP Paribas, Bloomberg

The key trigger – sharply higher US short-term, real bond yields. Markets have moved quickly to price in 4 to 5 Fed funds rate hikes by the end of 2022. Two-year US Treasury yields have risen 80 basis points, while the US 10-year real yield has gained 50bp. Higher real yields, ceteris paribus, imply lower P/E valuations for stocks. Over January, the S&P 500 forward P/E has declined from 21.6x to 19.7x, with the STOXX Europe P/E falling from 15.8x to 14.7x.

Economic outlook

Growth higher than pre-COVID

For most developed countries, the impact of Omicron and the related impact on both supply and demand, suggests that activity – particularly in services – may be subdued over January-February. But thereafter, the underlying resilience, including in employment and business investments (including inventory rebuilding), suggests a strong recovery. Indeed, fundamentals support robust consumer spending over the coming quarters once we move beyond Omicron.

The synchronised government expenditure programmes and the related multiplier effects are expected to keep growth well above pre-COVID levels. Economic growth in the US and the eurozone should thus stabilise above 4% this year and at around 3% next year. Chinese economic growth slowed in late 2021, but the authorities are adopting a more expansionary policy mix. In the real estate sector, the authorities have made adjustments to stabilize markets, without changing the macroprudential limits imposed on developers. Growth should stabilise around 5.5% this and next year.

Look for inflation to peak soon

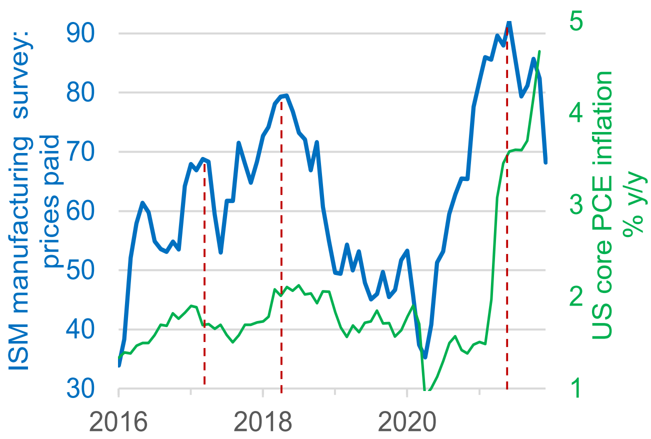
Inflation remains the key source of uncertainty. The year-on-year comparisons will become less extreme over the coming months especially for energy prices. This so-called "base effect" will thus be a source of lower inflation over 2022. However, we do see more resilience in price pressure from the supply chains.

Some indicators, like the global supply chain pressures index from the Federal Reserve Bank of New York reached new highs recently but seems to be peaking. We need more confirmation and a gradual normalisation is very probable.

On the job market front, the US and the eurozone face different situations. Wage pressures are more visible in the US. A wage-price loop over a longer period seems however unlikely as the unionisation rate has fallen continuously in recent decades. It is thus not so much about if inflation will fall but rather how long it would take to move closer to the central target of 2%.

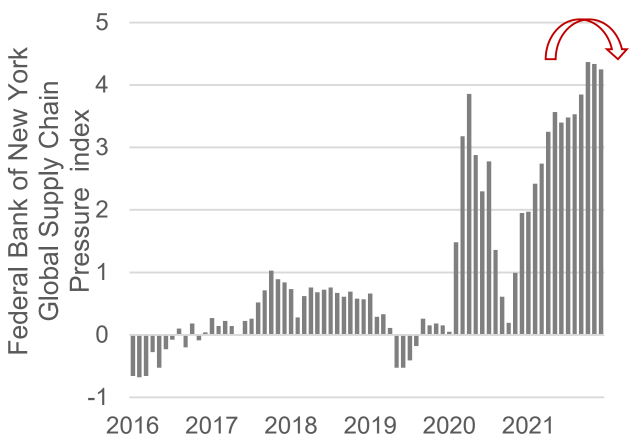
Guy Ertz

ISM MANUFACTURING SURVEY PRICES PAID COMPONENT FALLS, SHOULD LEAD A FALL IN US CORE INFLATION



Source: US Federal Reserve, German Bundesbank

NEW YORK FED GLOBAL SUPPLY CHAIN PRESSURES INDEX POINTS TO SOME EASING OF SUPPLY CHAIN DISRUPTIONS



Source: Bloomberg

We expect economic growth to stabilise above pre-COVID levels in major Western countries. We see strong support from consumer demand and government expenditure programmes. Inflation should peak soon, and it is not so much about if inflation will fall, but rather how long it would take to move closer to the central target of 2%.

Bond, Credit and FX Outlook

Higher inflation but lower breakeven rates in the US?

Higher inflation. All inflation metrics lead to the same conclusion: inflation has increased at an unprecedented rate since the 1980s.

Lower inflation expectations. Despite higher inflation data, inflation expectations have fallen significantly since their mid-November peak, indicating that investors believe that average inflation will fade over the long run.

Reason 1. Falling inflation expectations can be attributed to the expected end of supply chain disruptions at some point.

Reason 2. Equally important, the Fed has tolerated higher inflation to stimulate the recovery, in line with its new strategy called Flexible Average Inflation Targeting decided in August 2020. Under this new strategy, the Fed no longer targets 2% inflation, but seeks inflation that averages 2% over a time frame that is –conveniently- not formally defined. Falling inflation expectations is thus a sign that the market believes that the Fed is capable of fighting inflation.

Widening of US High Yield spreads in sync with the equity market sell-off

Boom and bust? US High Yield bonds performed strongly in 2021, +5.3%, but started 2022 on the wrong footing (-1.8%).

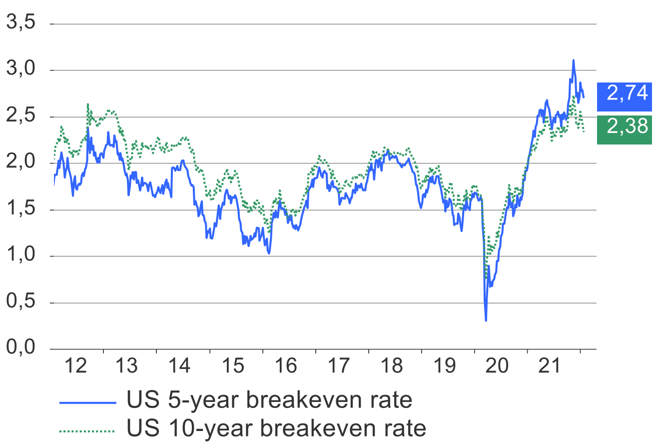
What went wrong? 2021 was a year of recovery, with strong growth, extremely easy financial conditions, abundant liquidity and record low default rates. This led to tight valuations and heavy investor positioning in High Yield credit.

The fundamental picture has not changed much this year, but the dynamics changed when the US Federal Reserve pivoted away from the concept of transitory inflation at the end of last year. Monetary policy shifted from being very accommodative with zero policy rates and generous QE, to the prospect of higher refinancing costs and reduced amounts of liquidity. This was detrimental to risk assets such as High Yield bonds and equities.

It hasn't been all bad for High Yield bonds. Today they offer a decent carry and the expected default rate remains very low in 2022.

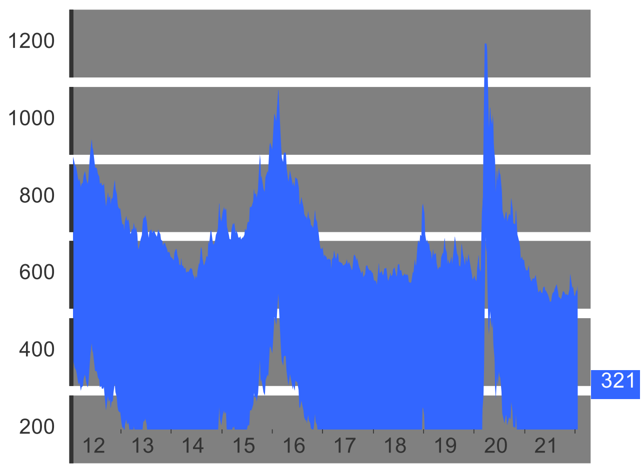
Edouard Desbonnets

THE BOND MARKET IS CURRENTLY PRICING IN INFLATION OF AVERAGE 2.7% OVER THE NEXT 5 YEARS AND 2.3% OVER THE NEXT 10.



Source: Refinitiv Datastream, 25-01-22

US HIGH YIELD BONDS SPREAD OVER TREASURIES (IN BPS)



Source: Refinitiv Datastream, 25-01-22

The US Federal Reserve pivoted away from the concept of transitory inflation at the end of last year. As a result, risk assets such as High Yield bonds and equities have fallen in anticipation of a less accommodative monetary policy, with inflation expectations also declining in parallel.

Equities Outlook

Equity markets hit the skids in 2022

January proved a tricky month for financial markets worldwide, as air was seemingly let out of the retail investor-driven asset bubbles in stocks, recent IPOs, SPACs, high yield credit, and cryptocurrencies.

Most retail investors' favourite assets suffered from the pullback in market liquidity as retail investors sought to preserve whatever gains they had left in these assets, in this Federal Reserve-inspired risk-off market move.

UK equities have a long way to catch up post Brexit: UK large-cap equities have been one of the best-performing regions since November 2021, helped by cyclical exposure to commodities and financials.

Amidst the tech wreck, European dividends hold up: conservative investors looking for yield can find an outperforming solution in European quality dividend strategies, yielding > 4% annually.

Commodity prices stay high, favouring Basic Resources: base metals price remain close to recent multi-year highs, with structural demand underpinned by electrification of the global economy.

Q4 2021 earnings season underlines growth

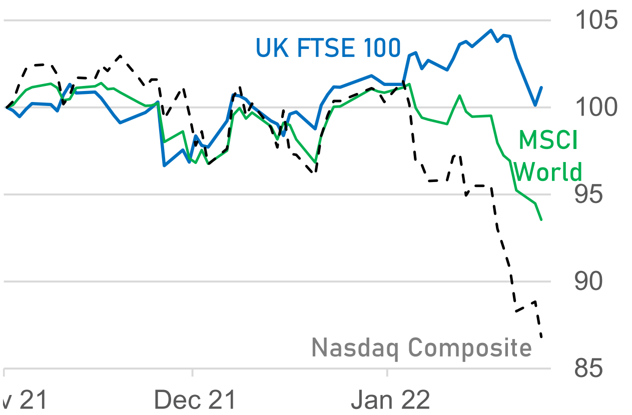
There were concerns that Q4 2021 earnings might not be as superb as in previous quarters. A *déjà vu*? Many companies are facing rising costs (wages and technology, energy, logistics and raw material costs), but in spite of this, profits in most sectors continue to grow and positively surprise. Higher costs are being passed through to end clients with often a positive impact on profits! And guess what? There are even signs that supply chain issues are improving, even in the trucks/ automobile industry.

All in all, in view of the outstanding results from certain major tech companies, virtually all sectors are now announcing reassuring earnings. In the US thus far, 80% have announced positive surprises, beating expectations on average by +4% (source: Bloomberg). In Europe, several bellwethers have also announced very strong results and forecasts.

We think that 2022e IBES consensus earnings growth forecasts (c. +7% for the US and Europe) are too conservative. We forecast around +12% earnings growth, considering the strong economic outlook and reopening. This favours cyclicals and small cap equity segments.

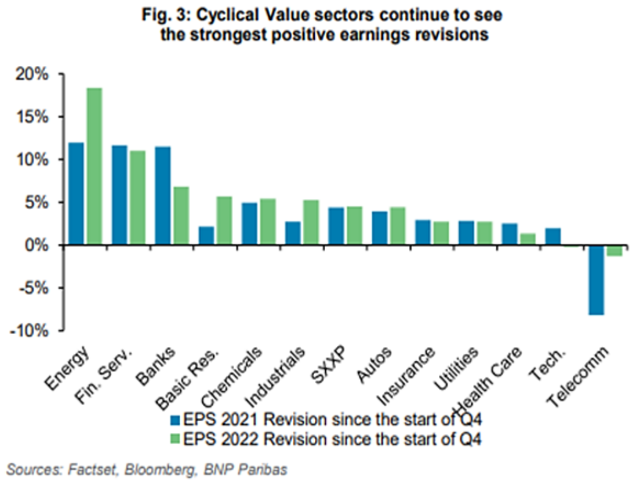
Alain Gérard, Edmund Shing

UK FTSE 100 OUTPERFORMS



Source: BNP Paribas, Bloomberg

EUROPEAN CYCLICALS DELIVER POSITIVE EARNINGS REVISIONS



US Federal Reserve overtightening of monetary policy is a key risk for equities, while the flare-up of tensions between Russia and Ukraine is the second geopolitical risk to monitor. UK, Sweden and France are pushing European stocks higher: favour the commodity exposure in UK large-caps which are driving bullish EPS growth forecasts, while the industrial exposure is the primary momentum driver for both the CAC 40 and OMX indices.

Commodities: Upgrade Base Metals to positive from neutral

Short-term outlook is improving

The Bloomberg Base Metal Spot Index has jumped 90% from its 2020 March low to May 2021. Since then, it moved sideways till end of December, mainly due to the uncertainties in China, the biggest global consumer of base metals.

But momentum is improving in China and base metal prices appear to be resuming their uptrends:

- Energy shortages in China have been solved,
- The seasonal factor will turn positive at the end of the winter
- We expect a major restocking cycle in Europe and US as manufactured goods inventories are very low.
- And the more important: a recovery in China is expected in the coming months on the back of policy easing, a major change from the restrictive stance of 2021.

Limited supply growth: Developing mines is a process that takes a very long time – often a decade or more - while the potential to increase the production of existing mines is limited.

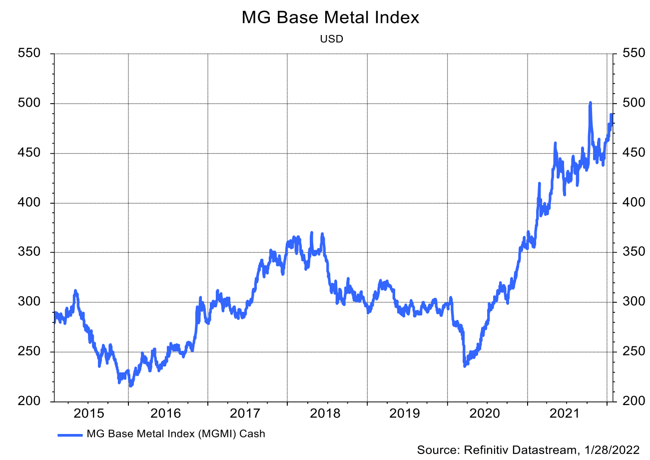
Medium-term outlook is bullish

To achieve a low carbon economy, huge quantities of metals will be needed to build out renewable energy capacity, electric vehicles and carbon capture and storage. According to the IMF, the clean energy transition may require as much as 3 billion tons of various base metals.

- **Copper**: Electric vehicle infrastructure and engines will require a lot of copper. Stockpiles are low. Weakness in copper prices could however be seen in the next few weeks due to Chinese COVID-19 lockdowns and seasonal weakness, but that would offer a clear buying opportunity.
- **Aluminum**: Decarbonization will drive demand for aluminum-intensive solar power infrastructure. This year, the primary aluminum market outside China will see a bigger deficit than last year.
- **Nickel** is facing its biggest squeeze in more than a decade, with buyers paying huge premiums for near-term supplies as stockpiles plunge. Rising demand for the metal used in electric vehicle batteries and concerns about exports from Indonesia are helping maintain prices close to the highest level since 2011.

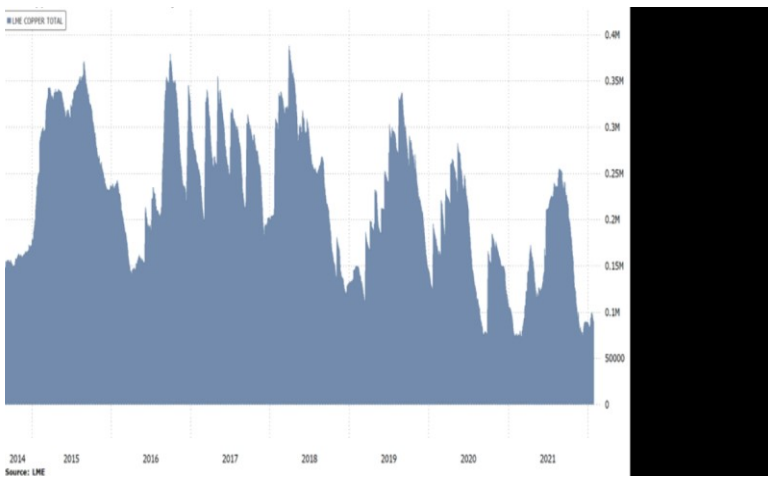
Xavier Timmermans

MG BASE METAL INDEX AT MULTI-YEAR HIGHS



Source: Refinitiv

LME COPPER STOCKPILES ARE VERY LOW BY HISTORICAL STANDARDS



Source: LME & Bloomberg

The short-term outlook for base metals is improving with the end of the winter, restocking needs and a more accommodative policy stance in China. The medium-term outlook remains bright due to energy transition needs, while base metals supply should remain tight for the foreseeable future.

Commodities: Oil Outlook

Risks remain on the upside

In spite of the Omicron impact on tourism and air traffic, crude oil prices have continued to rise with the Brent reaching USD89/barrel. The OPEC+ commitment to add each month 400,000 barrels per day did not help (as hoped) because a number of its members were not able to bring to market as much as their quota permitted (Angola, Nigeria and more surprisingly Russia). Libya, not part of the OPEC+ deal was also out of the market for a while. Geopolitical issues e.g. drone attacks on Abu Dhabi from Huthis rebels and high natural gas prices in Europe added an unwelcome risk premium.

As a result, oil stockpiles are low, sitting well below their 5-year average. US shale oil production is increasing but remain far from the peak level of March 2020. Only Saudi Arabia and the UAE have sufficient spare capacity to meet the expected higher demand as the economies fully reopen post COVID. This is due to the low level of investment since the 2014 downturn in oil prices.

Tight supply management by OPEC+ members means that the crude price downside risk is limited. As demand continues to grow, USD100/barrel could be seen next year and even earlier should unforeseen supply disruptions occur.

High roll yield

The structure of oil prices in the futures market remains in strong backwardation (i.e. the further away the expiration date of the futures contract, the lower the futures price). In other words, "enhanced" ETFs and funds investing via futures benefit from an additional return generated by the rolling of mature contracts into a longer-term one. This return, known as the roll yield, is currently 10% in 1 year for Brent crude oil and 12% for WTI (as at 01/02/2022).

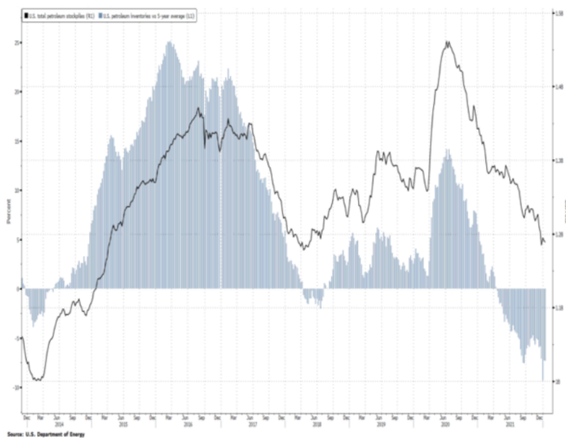
Oil & Gas Stocks remain attractive

In equities, we continue to like European oil & gas companies despite their recent rise. More selectivity is needed but overall, they are cheaper than their American counterparts.

Moreover, their investments in alternative energy are not (yet) valued at the same level as those of producers of exclusively alternative energy. Finally, they generate substantial cash flows and pay high dividends.

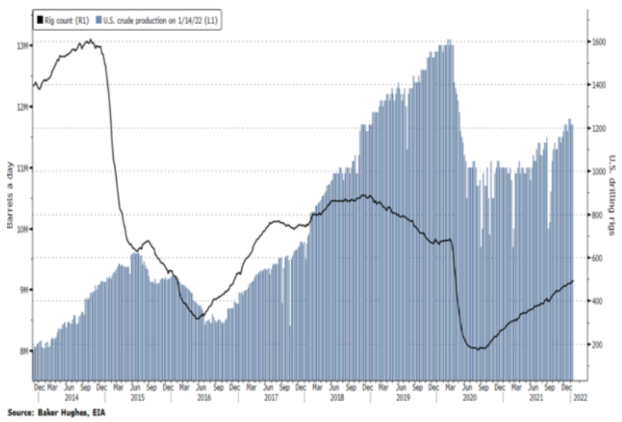
Xavier Timmermans

US OIL STOCKPILES VS 5-YR AVERAGE



Source: Bloomberg

US RIG COUNT & US PRODUCTION



Source: Bloomberg

The lack of investment in oil exploration since 2015 is the main reason why excess production capacities are low, and why price risks are skewed to the upside. We remain buyers of European oil majors and oil services stocks. Any price weakness in the coming weeks should also be seen as opportunities to buy crude oil ETFs/funds.

China Economic and Market Outlook

China the only major economy easing policy

The China economy weakened in 2022 due to the property downturn, Covid-19 restrictions affecting consumption growth, and regulatory pressures.

The recent Central Economic Work Council and Politburo meetings in December 2021, have resulted in a **focus on economic stability rather than deleveraging**. It was stated that fiscal policy will be front-loaded including boosting infrastructure spending. As a result, the recent moves by **China to boost both fiscal and monetary stimulus are important catalysts to monitor.**

In that regard, China had a second reserve rate cut in December as well as cut in policy rates including medium-term lending rate and loan prime rate in January. Furthermore, monetary policy is loosening with another reserve rate cut and more loosening forecasted in the coming quarter. If these conventional policies are not enough, loosening property curbs and boosting issuance of local government debt is possible. **The China economic surprise index is rising as well, confirming the bottoming of growth.**

When could the Property downturn end? The last four property downward cycles have ranged from 12 months on average from peak sales to trough sales and 8 months on average of negative year-on-year sales growth. In that regard, the peak sales was experienced in February 2021 and the first month with negative sales growth year-on-year was August 2021.
Hence, **based on previous cycle averages, the downturn could end in the second quarter of 2022 on these two metrics.**

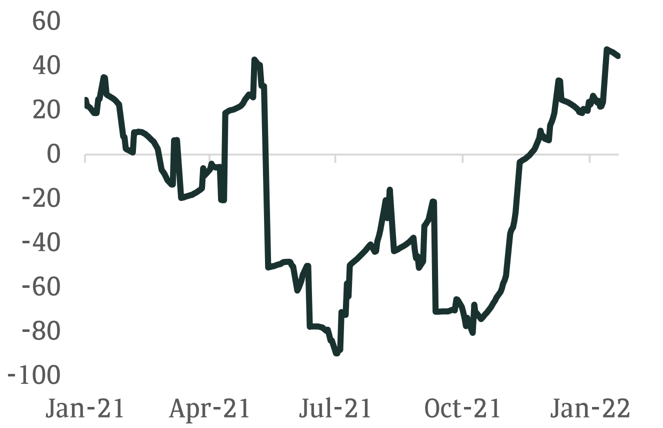
How to position in 2022?

How to position? While the easing will be incremental and gradual, it could put an end to further downgrades to economic growth in 2022.
Wildcards remain Omicron affecting local consumption in the first quarter and via factory shutdowns exporting supply chain inflation overseas.

Nevertheless, opportunities will develop for prudent investors in the coming quarters. We have been positioned defensively via China A-shares outperforming last year and China small/mid caps (CSI-500) up +17% in 2021 and leveraged to the common prosperity theme. **Opportunities will develop for broader China equities and selected China bonds for patient investors in 2022. Valuations are attractive.**

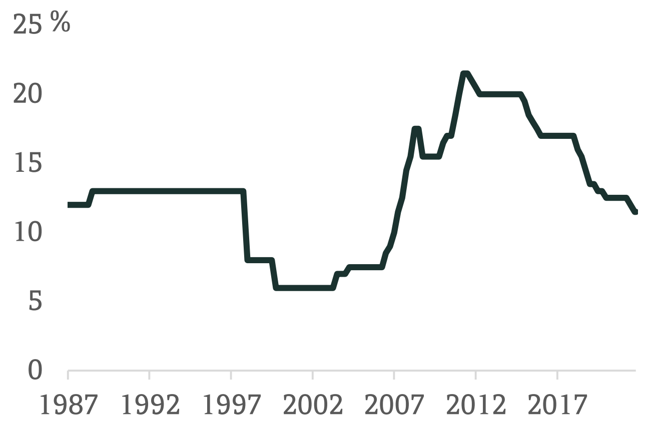
Prashant Bhayani

RISING CHINA ECONOMIC SURPRISE INDEX



Source: Bloomberg, BNP Paribas (WM), as of 26 Jan 2022

CHINA REQUIRED DEPOSIT RESERVE RATIO



Source: Bloomberg, BNP Paribas (WM), as of 26 Jan 2022

As China moves from deleveraging to economic stability, it will be the only major economy easing monetary and fiscal policy this year. We have been positioned defensively via China A-shares (which outperformed H-shares in 2021), and China small/mid caps (CSI-500) up +17% in 2021 and leveraged to common prosperity. Opportunities will develop for the broader China equity market and selected bonds for patient investors in 2022.

Summary of our main recommendations

	Current Recom	Prior Recom	Constituents	We like	We avoid	Comments
EQUITIES	+	+	Markets	EU, UK, Japan, EM: S Korea, Brazil, Russia.		Historically low long-term real rates and accommodative financial conditions are supporting the upward trend in global stocks. We continue to recommend a more defensive sector stance for now.
			Sectors	Financials, Real Estate, Healthcare, Semicond, Construction Precious/ battery metals, EU Energy	Airlines, aeronautics, travel & leisure	We have become more defensive in our sector allocation. We continue to recommend a more defensive sector stance for now, biased towards quality dividend/dividend growth strategies.
			Styles/ Themes	Megatrend themes		
BONDS	-	-	Govies	EM bonds (USD + local currency)	US long-term Treasuries and German Bunds	
			Segments	Eurozone convertibles. Rising Stars		
			Maturities	Lower than benchmark		
CASH	=	=				
COMMO-DITIES	+	+		Gold, Base metals		Gold faces headwinds (higher real rates, strong USD) but supply demand dynamics remain favourable and it remains our preferred hedge asset. Industrial metals – We upgrade to positive on strong demand dynamics combined with limited supply growth
FOREX			EUR/USD			We retain our EUR/USD target of USD1.12 (value of one euro) for the next 12 months.
REAL ESTATE	+	+		REITs, warehouses, healthcare, UK		BNP Paribas REIM favour healthcare property exposure given strong demographic drivers, a lack of good quality assets. UK to outperform Continental Europe,
ALTERNATIVE UCITS				Macro and event-driven		

Economic, FX forecast tables

BNP Paribas Forecasts

GDP Growth %	2020	2021	2022	2023
United States	-3.5	5.5	4.7	2.8
Japan	-4.7	1.7	2.6	1.6
United Kingdom	-9.8	7.1	5.4	2.1
Eurozone	**-6.7**	**5**	**4.2**	**3**
Germany	-5.1	2.6	3.6	3.6
France	-8	6.7	4.2	2.5
Italy	-8.9	6.3	4.9	3
Emerging				
China	2.3	7.9	5.3	5.5
India*	-7.2	8	11	6
Brazil	-4.1	4.8	0.5	2
Russia	-4.5	4.5	3	1.8

* Fiscal year
Source: Refinitiv - BNP Paribas - 03/12/2021

BNP Paribas Forecasts

CPI Inflation %	2020	2021	2022	2023
United States	1.2	4.7	4.6	2.1
Japan	0	-0.2	0.7	0.5
United Kingdom	0.9	2.5	4.5	2.1
Eurozone	**0.3**	**2.5**	**3.1**	**2**
Germany	0.4	3.1	3.4	2.2
France	0.5	2	2.5	2.1
Italy	-0.1	1.8	2.9	1.7
Emerging				
China	2.5	0.9	2.1	2.5
India*	6.1	5.4	5.7	5
Brazil	3.2	8.3	8.3	4.3
Russia	3.4	7	6.3	4.1

* Fiscal year
Source: Refinitiv - BNP Paribas - 03/12/2021

	Country		Spot 02/01/2022	Trend	Target 3 months (vs. EUR)	Trend	Target 12 months (vs. EUR)
	United States	EUR / USD	1,14	Neutral	1,12	Neutral	1,12
	United Kingdom	EUR / GBP	0,84	Neutral	0,84	Neutral	0,84
	Japan	EUR / JPY	130,95	Positive	124	Positive	124
	Switzerland	EUR / CHF	1,04	Negative	1,06	Negative	1,08
	Australia	EUR / AUD	1,56	Neutral	1,53	Neutral	1,53
	New-Zealand	EUR / NZD	1,66	Positive	1,60	Positive	1,60
	Canada	EUR / CAD	1,44	Positive	1,40	Positive	1,40
	Sweden	EUR / SEK	10,30	Positive	10,00	Positive	10,00
	Norway	EUR / NOK	10,03	Positive	9,75	Positive	9,60
Asia	China	EUR / CNY	7,25	Neutral	7,28	Neutral	7,28
	India	EUR / INR	84,53	Neutral	85,12	Negative	87,36
Latam	Brazil	EUR / BRL	6,33	Positive	6,16	Positive	5,88
EMEA	Russia	EUR / RUB	85,30	Positive	80,64	Positive	80,64

THE INVESTMENT STRATEGY TEAM

FRANCE

Edmund SHING
Global Chief Investment Officer

ASIA

Prashant BHAYANI
Chief Investment Officer, Asia

Grace TAM
Chief Investment Advisor, Asia

BELGIUM

Philippe GIJSELS
Chief Investment Advisor

Alain GERARD
Senior Investment Advisor, Equities

Xavier TIMMERMANS
Senior Investment Strategist, PRB

LUXEMBOURG

Guy ERTZ
Chief Investment Advisor

Edouard DESBONNETS
Investment Advisor, Fixed Income

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