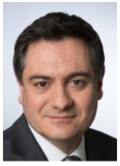
ASSET ALLOCATION MONTHLY – FEB 2018

7 February 2018

BNPP AM – Multi Asset, Quantitative and Solutions (MAQS)

FOR PROFESSIONAL INVESTORS



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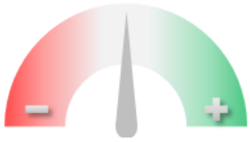
Asset allocation overview:

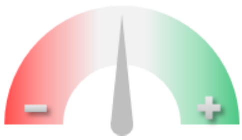

Equities


Commodities


Rates & duration


Real estate


Credit


FX (EUR vs. USD, GBP, JPY)

SUMMARY:

- **Global equities sold off aggressively** as higher bond yields finally dented the strong January risk rally
- The sell-off was triggered by strong hourly earnings data in the US, but its magnitude appears to be **exacerbated by market technicals**
- **Solid growth fundamentals** and limited contagion from the equity volatility to other markets such as rates, currencies and emerging markets (EM) are consistent with a technical dislocation in markets

ASSET ALLOCATION:

- We **remain constructive on equity** markets where the fundamentals are strong such as Europe, Japan and EM
- We **remain underweight fixed income** structurally given the risk of higher inflation and higher rates, but we have **taken profits tactically** after the sharp selloff in Bunds
- We have taken profits on our long US versus UK inflation

BNP PARIBAS ASSET MANAGEMENT

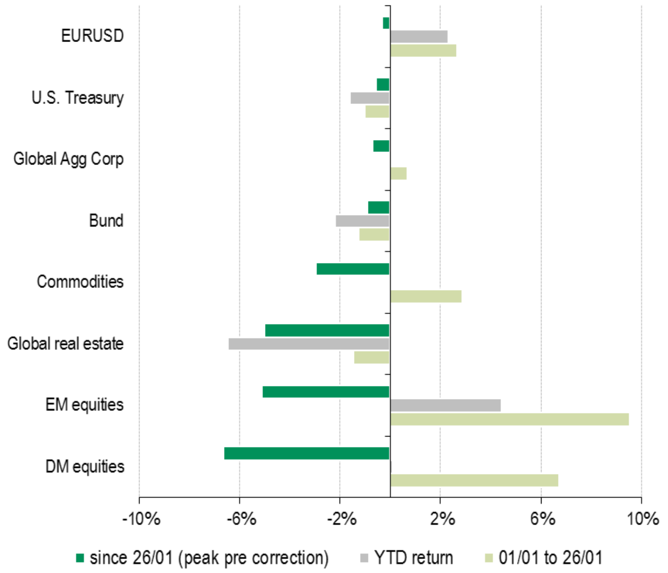
The asset manager for a changing world

A TECHNICAL RATHER THAN FUNDAMENTAL CORRECTION

2018 began on a very strong footing as financial markets priced in a reflation environment with both risky assets and bond yields rising for most of January. Most major equity markets started correcting in late January, but it was not until Friday 2 February that the correction in risky assets deepened. This followed an upside surprise in the latest date on average hourly earnings in the US, which rose to 2.9% YoY, beating consensus estimates of 2.6%.

The correction has been aggressive but it has been concentrated in global equity markets (Figure 1). Indeed, the sell-off in other risky assets has been orderly. Government bonds had been falling over the course of the month and the equity plunge has so far not led to a typical ‘flight to bond safety’ as seen in recent years. The 4% fall in the S&P 500 equity index on 5 February is the largest daily drop since August 2011 and the spike in US implied equity volatility (as reflected in the VIX index) was the biggest since April 2009.

Figure 1: February correction erases January performance mainly for equities



Source: Bloomberg, BNPP AM

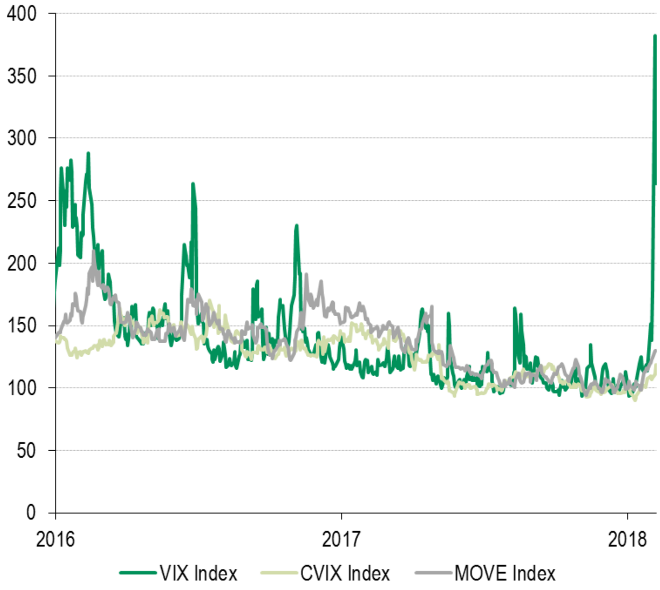
There are various reasons that make us believe that this correction is technically driven.

First, volatility in other markets has not spiked in a similar fashion. Rates and FX volatility, for example, had risen in January but remain contained compared with the VIX (Figure 2). Other ‘high-beta’ assets such as commodities, EM currencies and bonds do not appear as dislocated.

Second, there is evidence that systematic strategies such as volatility targeting, risk parity, CTAs and short volatility are facing outflows as volatility rises.

Third, macroeconomic fundamentals remain on the whole robust. The strength in activity data is broad-based, with US and European purchasing managers’ indices (PMIs) posting cyclical highs recently and EM GDP growth catching up with that in the developed world.

Figure 2: Implied equity volatility (VIX) spiked sharply, but rates and FX volatility remain contained (index=100 on 01/01/2018)



source: Bloomberg, BNPP AM

Inflation data has remained low, but markets have fundamentally reassessed the inflation outlook. Under our central scenario (‘Goldilocks’), we assume inflation in the US will close the year at 2.0%, while our main alternative scenario (‘inflation surprise’) assumes US inflation rises to 3.0% by the end of 2018. Given the recent compression of core yields, we believe some re-rating of fixed-income yields was inevitable, even in our central scenario.

We flagged the tension between robust fundamentals and fragile market dynamics in our 2018 Investment Outlook. We noted that such tension could lead to sharp corrections and potentially a more defensive stance.

Following this correction, our view remains that it is too early to shift away from our central scenario or to call an end to the late-cycle expansion. We are still constructive on risk assets and would cautiously take the current correction as an opportunity to add long equity exposure in our portfolios.

In particular, we would be looking for opportunities in equity markets where the correction is material and the fundamentals are strong such as in European equities. The EuroSTOXX 50 index is near technical levels that look appealing to us. The monthly series, for example, is close to the 20-month moving average (Figure 3). We also favour Japanese and EM equities. We remain underweight fixed income structurally given the risk of higher inflation and higher rates, but we have taken profits tactically after the sharp sell-off in Bunds.

Figure 3: EuroSTOXX 50 down to 20 MA (monthly basis)

Source: Bloomberg and BNPP AM

WHY HAS THE USD BEEN SO WEAK?

An interesting development so far this year has been the weakness in the USD despite rising concerns about higher US inflation and the rise in differentials between US Treasury and German Bund yields (Figure 4). There are several reasons that help us reconcile this apparent discrepancy.

First, the evolution of **balance of payments** flows matters over the long run and they have shifted in favour of the euro and away from the USD. It is well understood that the US current account deficit is a drag on the USD, while the surplus in the eurozone is positive for the EUR. But there is more to these flows than the current account. **Portfolio flows** are starting to shift towards the EUR and so is **foreign direct investment** (FDI).

Figure 4: EUR/USD has decoupled from interest-rate differentials

Source: Bloomberg, BNPP AM

Relative monetary policy also matters for currencies and sometimes it can be words and not necessarily actions that move markets. Some major central banks that embarked on aggressive unconventional stimulus programmes, such as the ECB and the BoJ, are unlikely to ease financial conditions further. If anything, the growth and inflation backdrop is improving in Japan and the eurozone. Their central banks are slow to signal a shift to a less dovish stance, but that change has been enough to support their currencies. On the other hand, the US Federal Reserve continues to tighten policy gradually and market expectations have largely been priced in.

It is also likely that a rising political/policy risk premium in the US is hurting the US dollar. In January, the protectionist rhetoric of US officials became louder and the US Treasury Secretary's comments endorsing a weak US dollar added to the rise.

This trend may well continue over the year, but we foresee less of an impact as developments were already largely priced into EUR/USD in 2017. In our central scenario, we expect EUR/USD to remain at around USD 1.20-1.25.

ASSET ALLOCATION

We remain constructive on risky assets, especially in markets that have experienced material corrections and where we see upside for earnings growth such as Europe, Japan and EM. In fixed income, we remain structurally underweight, but given the recent rapid sell-off, we have tactically reduced our duration underweight. Below we summarise the main decisions taken since the beginning of the year.

Long European and Japanese equities

We opened a long position on European and Japanese equities at the beginning of January. This was motivated by robust global growth, muted inflation and accommodative central bank policies supporting global equities. For both Europe and Japan, we forecast above-consensus earnings growth (11% vs. 9% and 14% vs. 9%, respectively) backed by their exposure to the global economic cycle, but also improving margins and pricing power as demand picks up.

When it comes to FX, a strong euro was a material headwind for European equities in 2017. The euro appreciated by close to 8% on a trade-weighted basis in 2017 (and EUR/USD was up by 14%), but we see little chance of material upside for the euro in the coming months. In Japan, the correlation between equities and the yen broke down in 2017 as equities powered ahead amid demand-led earnings growth rather than just currency effects. This is a healthy development and while the yen will still influence earnings, we expect the more important driver to be demand.

Reduced underweight EMU duration

January was characterised by a sharp rise in yields across the globe. The US 10-year government bond yield rose by about 30bp, matched by a similar move in Bunds and gilts. The only fixed-income market that was relatively well behaved was the Japanese government bond market, where 10-year yields rose by a comparatively small 5bp. One of the key factors has been accelerating global growth. Another driver has been the sharp rally in energy prices, which helped push up inflation expectations. A delayed reaction to the now-approved US tax plan added fuel to the fire. Investors have started to discount a less dovish monetary policy on both sides of the Atlantic. We believe that the reflation repricing is better justified in the US than in the eurozone, where core inflation dynamics remain subdued and certainly not helped by a stronger euro. This is why we used the sell-off as an opportunity to reduce our structural underweight in eurozone duration for bond-heavy portfolios. In the medium term, we see limited upside on core term rates, although we acknowledge a higher likelihood of an inflationary scenario repricing in the US compared to other parts of the world.

Profit taken on US vs. UK inflation

Over the month, we took profits on our long US vs. UK inflation trade as the position reached its target. We established the strategy in April 2017 when the differential in inflation expectations between the two markets was close to all-time lows. In our view, this was not justified given a realised inflation differential at below the historical average along with our bullish expectations of the effects of US tax reform and oil prices. On the UK side, we were bearish on inflation given our view on the negative effects of Brexit on demand and the limited downside for sterling.

GBP/USD has moved to USD 1.42 from 1.28 since then, putting downward pressure on UK inflation break-evens which tend to be rather sensitive to currency moves given the high degree of openness of the UK economy. The oil price has rebounded by over 20% since the inception of our trade, supporting US break-evens that have historically shown a higher sensitivity to energy dynamics. The effects of Brexit on demand have been reflected in deteriorating consumer confidence and housing market dynamics. These could continue in the medium term. Last but not least, tax reform has revived the reflation trade in the US, at least temporarily. We decided to use this opportunity to take profits on the strategy as most of the rationale has played out and our target level was reached.

STRATEGIC OVERVIEW OF KEY POSITION CHANGES IN JAN 2018

In January 2018, the BNPP AM MAQS team made the following strategic calls:

LONG EUROPEAN EQUITIES **OPEN** **05/01/2018**

- Above-consensus forecasts in a robust macroeconomic environment

LONG JAPANESE EQUITIES **OPEN** **12/01/2018**

- Above-consensus forecasts in a robust macroeconomic environment

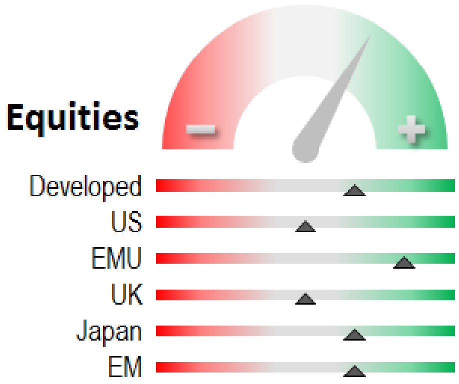
LONG US VS. UK INFLATION **CLOSED** **24/01/2018**

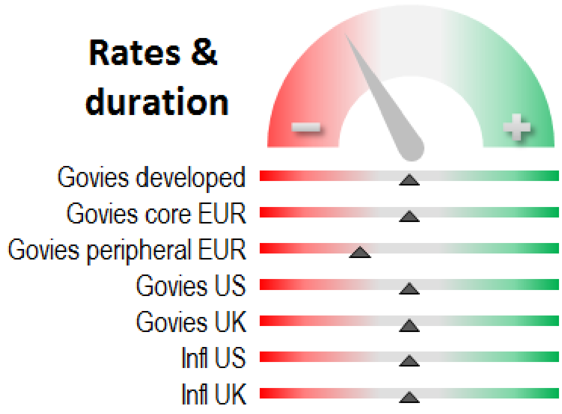
- We took profits as the position reached the target level. Opened on 19/04/2017

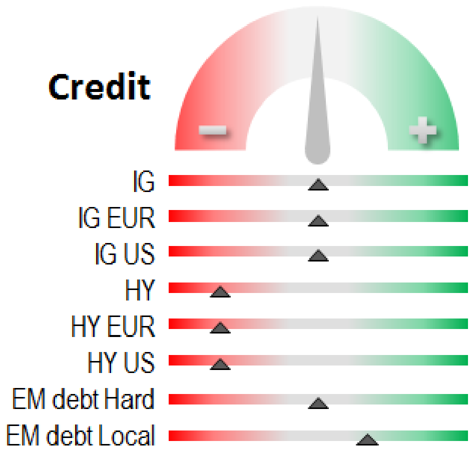
UNDERWEIGHT EMU DURATION **REDUCED** **31/01/2017**

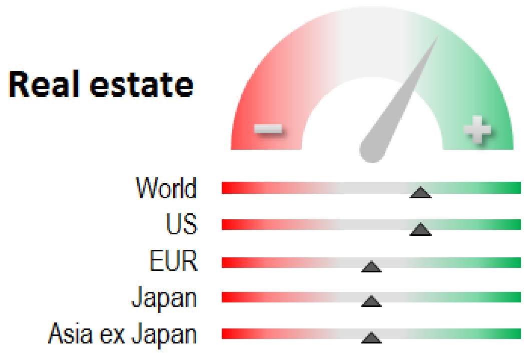
- We took partial profits on our underweight duration following the sharp rise in yields.

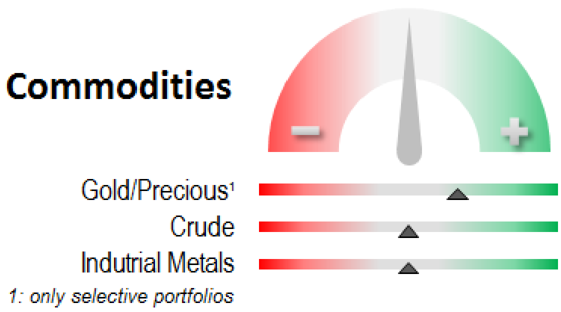
ASSET ALLOCATION DASHBOARD[1]

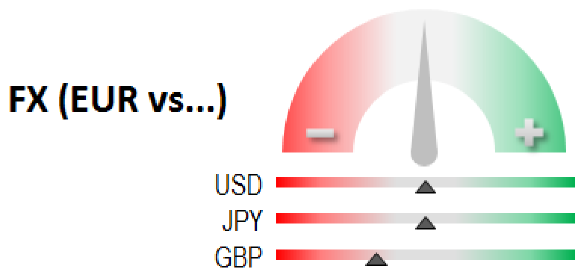












[1] The dashboard shows the asset allocation in our portfolios and reflects the decisions of the Investment Committee of the Multi-Asset team at MAQS.

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