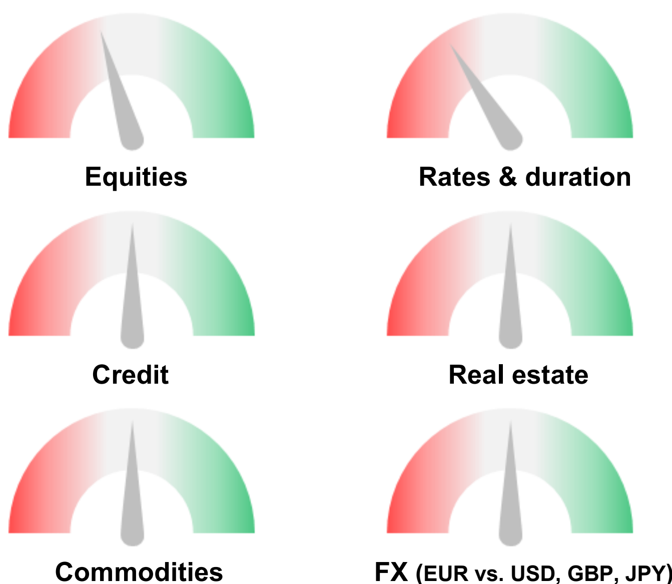
ASSET ALLOCATION QUARTERLY

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

CENTRAL BANKS ENGINEER A FRAGILE GOLDILOCKS



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SUMMARY

- **Dovish central banks –** After the US Federal Reserve's dovish turn in January and the renewed easing by Chinese policymakers, the ECB has now also shifted to a more dovish stance and the Fed cemented its dovish position in March.
- **Markets trading as they did in QE years –** Markets have responded positively to this monetary policy shift, with price action mimicking that of the years of quantitative easing – i.e. all assets have rallied in recent months. Lower real yields and higher breakeven inflation in fixed income is also telling on the market's interpretation of the current environment.
- **Downside risks persist –** We still believe we are in the latter stages of the economic cycle and that growth remains structurally challenged in Europe and China. Also, we see more downside than upside risks to our macroeconomic base case.
- **A fragile goldilocks –** To us, all this adds up to a goldilocks environment that is fragile since we believe a central bank-engineered goldilocks could be destabilised easily.

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- **Look to be long carry… –** The Fed's message, all else being equal, should continue to curtail volatility, lower real yields and revitalise the search for yield. We are currently looking for opportunities in carry space, with EM debt looking attractive.
- **…But don't chase growth assets –** Equities do not look attractive to us. A lot of the good news appears to be priced in and we see the asset class as vulnerable to growth setbacks. We have taken a tactical short position in developed market equities.
- **Exploiting asymmetries –** Our scenario analysis helps identify where asymmetries are building and where risk/reward is attractive.
- **Building robust portfolios –** Given the uncertain macroeconomic backdrop, we regard building robust portfolios and holding diversification trades as key at this point in the cycle. We hold several positions/RV trades with asymmetries.

MARKET REVIEW: Q1 2019

The first quarter of 2019 saw a sharp recovery in investor sentiment. All major asset classes rebounded in the first few months of the year, reversing the late 2018 sell-off (Figure 1). In particular, the risk-on mood led equities back to near their peaks and market volatility fell towards its lows.

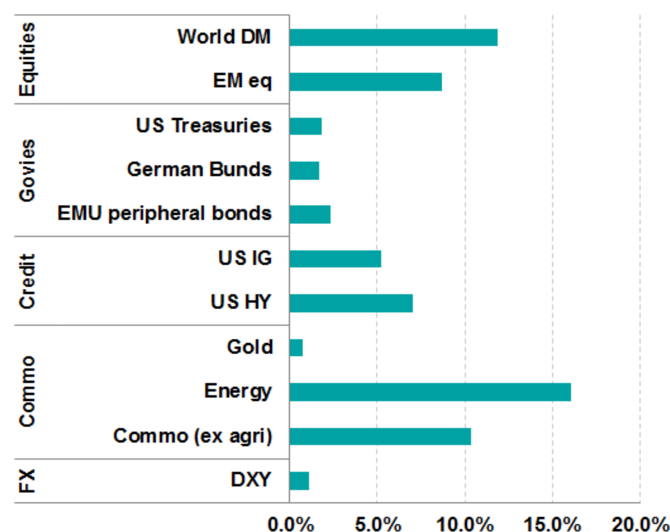
US equities gained roughly 12% since early January, supported in particular by the decision of the US Federal Reserve to hold off on tightening monetary policy. Indeed, the March FOMC meeting signalled to markets that interest rates will be unchanged for all of 2019 and that the shrinking of the Fed's balance sheet will slow from May and stop in September. The dovish policy tilt now adopted by the Fed also supported EMU and other developed market equities in Q1.

Bond markets were also affected by the Fed's decisions: US Treasuries did well over the quarter, as did Bunds and EMU 'peripheral' bonds. Here, the ECB's announcement of a new round of TLTROs was a major driver. We note that the US Treasuries yield curve is now basically flat and that the spread between 3-month and 10-year bonds inverted in late March. This was the first time in more than a decade (Figure 2) and reminded investors that the cycle is maturing.

Among currencies, the US dollar did poorly as the Fed shifted its monetary policy stance. Sterling gained on both the US dollar and the euro, fuelled by new hopes and expectations around Brexit.

In commodities, the energy sector rebounded after its late 2018 drop. Crude oil led the rally, mainly supported by the OPEC's decision in February to cut output, later confirmed by the Saudi energy minister. However, some OPEC members said that given the uncertainties around Venezuela and Iran, further decisions were unlikely before May or June.

Figure 1: Q1 2019 returns – all assets up



Source: Bloomberg and BNPP AM, as of 29/03/2019

Apart from the Fed's move, two other major topics affected markets in Q1: Brexit and progress on the Sino-US trade talks.

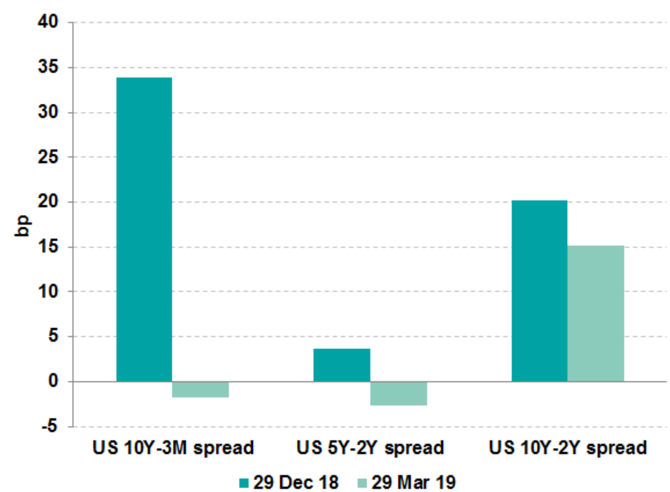
On Brexit, chaos seemingly rules in the UK Parliament. PM May has not been able to get MPs to approve her deal and the government is becoming weaker, especially after a number of defeats and the resignations of three ministers. Still, the EU granted the UK an extension of the deadline so that work could be done on a new deal or, alternatively, a no-deal Brexit.

On the US-China trade conflict, the situation appears to have improved, making a deal between Trump and Xi more likely.

Finally, on the macroeconomic side, data showed that the global economy remained on a downward trend. Indeed, concerns arose over manufacturing activity in all the developed countries given PMI releases (the US PMI fell to 52.5 from the 53.5 consensus forecast, the EU PMI slipped to 47.6 from 49.5). A drop in US housing starts has added to the concerns.

It is worth noting that the central bank response discussed at length below – across the major economies – is also a reaction to this weaker backdrop.

Figure 2: US fixed income: curve movements in Q1



Source: Bloomberg and BNPP AM, as of 29/03/2019

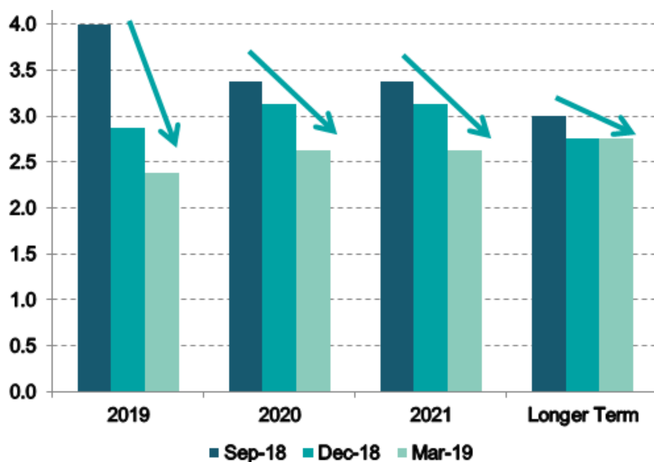
CENTRAL BANKS TURNED DOVISH…

After the Fed's pause in its tightening cycle in January and the renewed policy easing by Chinese policymakers (discussed at length in our previous monthly – see here), the ECB also shifted to a more dovish stance, while the Fed cemented its dovish position in March.

Put differently, the recent central bank pivot is real and now encompasses policymakers from the world's largest economies, although the shift to a more dovish stance differs in size and in its ability to deliver more:

- China: the PBoC has delivered several cuts in the reserve requirement for banks, notably of a bigger size than in 2015/2016. It could still ease policy on several fronts. Fiscal policy remains supportive too.
- Europe: the ECB issued dovish guidance in March and announced fresh TLTRO programmes to support the region's banks. Its scope to deliver much more is probably limited, especially if President Draghi is replaced by a hawk later this year. While there is room to ease fiscal policy, the political hurdles are high.
- US: the Fed signalled a pause and said it was ready to use its balance sheet if needed. At the March FOMC meeting, the Fed cemented its dovish position by: i) revising lower its 'dot plot' significantly, now showing no rate rises in 2019 and only one in 2020 (Figure 3); (ii) revising down its growth and inflation projections, and (iii) announcing that its balance sheet run-off would be tapered from May (from redemptions of USD 30 billion to 15 billion per month) and stopped altogether in September. Importantly, the press conference made it clear that the Fed is attaching greater weight to inflation, raising the bar for a more hawkish stance. In terms of its ability to deliver more, it is clear to us that the Fed is *the* central bank with the most 'ammunition' to ease policy if needed.

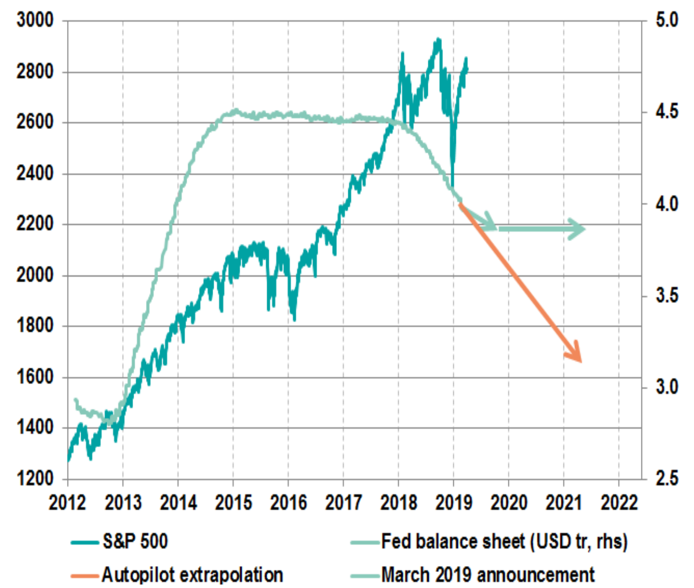
Figure 3: March FOMC: dovish shift in the 'dots'…



Source: Bloomberg and BNPP AM, as of 29/03/2019

The reversal in balance sheet policy by the Fed – away from a swift 'autopilot' reduction of its balance sheet to halting redemptions this year is a focal point for markets which were hurt in 2018 as quantitative tightening fears dominated. Indeed, as Figure 4 shows, equity markets were destabilised by the start of the balance sheet run-off. A key element of the Fed pivot is the much earlier end to the run-off than previously expected by markets.

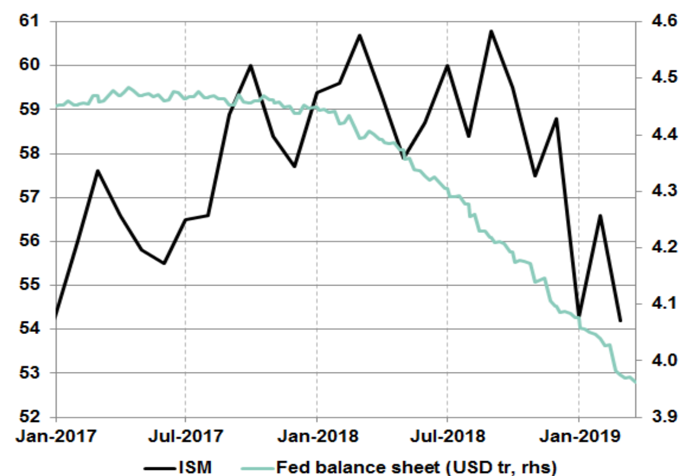
Figure 4: …and Fed balance sheet trimming 'autopilot' off



Source: Bloomberg and BNPP AM, as of 29/03/2019

Why have central banks flipped so quickly? Reiterating the points we made in our last monthly, we believe that (especially) the Fed realised that the combination of a slowing global economy and policy tightening was toxic for financial markets (Figure 5). Whether they like it or not, after almost a decade of quantitative easing boosting markets, central banks are now more sensitive to financial conditions than in prior cycles.

Figure 5: Weaker data and tighter policy equal a problem



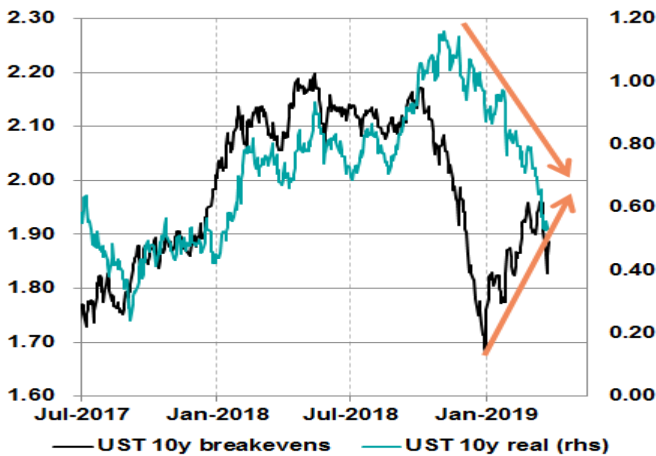
Source: Bloomberg and BNPP AM, as of 29/03/2019

Of course we have to acknowledge that only China is *actually* easing – the other major central banks have merely paused or sounded more dovish (see Figure 12 and the discussion below). Nonetheless, it appears that central banks have engineered a goldilocks-type environment: inflation is still low, growth is soggy, but not collapsing, and therefore the threat of policy tightening is low.

Markets trading as they did in QE years – all assets up

Markets have welcomed this shift in monetary policy, with price action mimicking that of the QE years – i.e. all assets have rallied in recent months (Figure 1). In fact, dissecting bond price action, we can witness reflationary price action this year – real rates have collapsed, while breakeven inflation rates have moved sharply higher (Figure 6). This is similar to the market reaction around QE announcements earlier in this cycle.

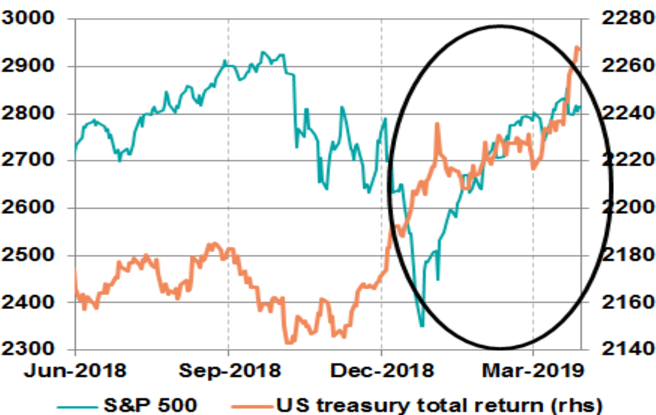
Figure 6: Fixed income: 'QE-like' price action



Source: Bloomberg and BNPP AM, as of 29/03/2019

Interestingly, correlations between assets have also increased again in a QE-like fashion, with bonds and equities rallying in tandem (Figure 7). The 2016 episode comparison we wrote about in our previous monthly also still comes to mind.

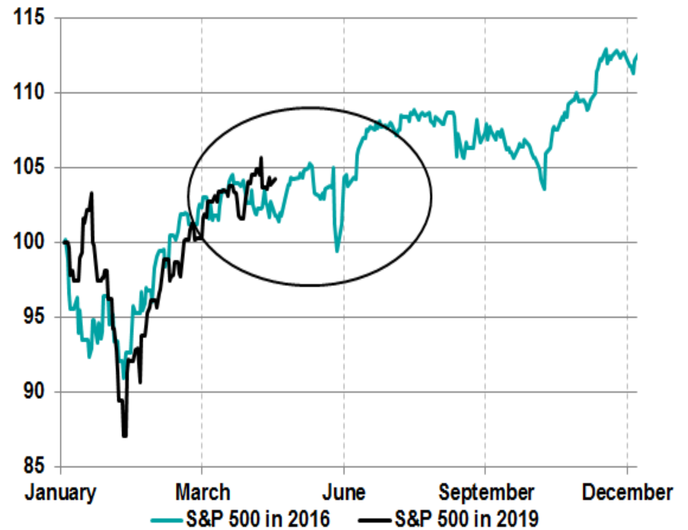
Figure 7: Correlations high again as all markets rally



Source: Bloomberg and BNPP AM, as of 29/03/2019

That said, in our last publication, we warned that the '2016 template' also suggests that the 'easy' upside on the back of this central bank pivot is largely priced in. This has come to fruition: volatility recently rose compared to the January/February 'one-way' price action (Figure 8).

Figure 8: 'Easy' upside already in the bag?



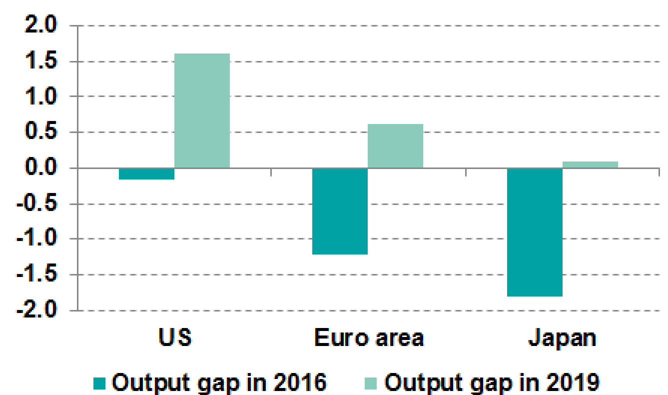
Source: Bloomberg and BNPP AM, as of 29/03/2019

…BUT DOWNSIDE RISKS LINGER

A more dovish stance by the major central banks is clearly supportive of markets and credible because of low inflation. But the key question is whether it is enough to support growth?

To us, the answer to this question is precisely what makes the current goldilocks environment fragile. We still believe that we are in the latter stages of the cycle (especially in the US – Figure 9), and growth remains structurally challenged in Europe and China. Furthermore, we see more downside than upside risks to our macroeconomic base case.

Figure 9: The cycle has clearly matured in recent years

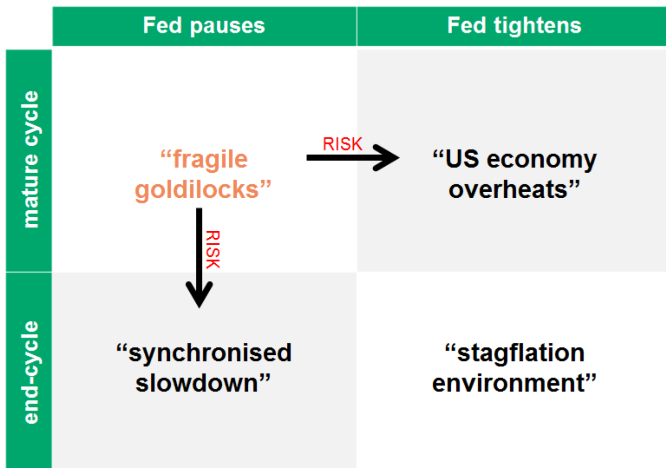


Source: Bloomberg and BNPP AM, as of 29/03/2019

Equally, while less likely in our view, sustained upside surprises on inflation are also a risk that needs to be considered since this could lead central banks to turn more hawkish again.

The simple scenario matrix we introduced in our previous publication is a helpful rough guide for navigating the current environment. Rather than showing the likely asset moves in each scenario again, this time we name the environments to portray the tricky or unstable nature of the current engineered goldilocks sweet spot (Figure 10).

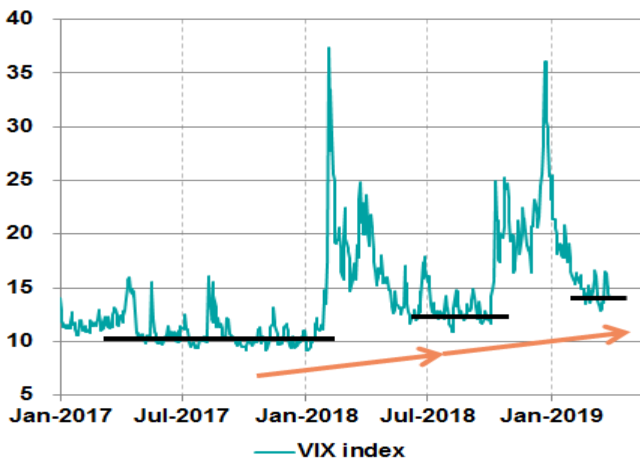
Figure 10: Liquidity vs. fundamentals – scenario analysis



Source: BNPP AM, as of 29/03/2019

Interestingly, while financial markets have posted strong returns recently, investors appear to be simultaneously pricing in the unstable nature of the goldilocks environment. Looking at implied equity volatility, this has typically fallen rapidly after risk-off shocks in recent years, but crucially, the lows after each stock market sell-off are at higher levels (Figure 11). To us, this step-like price action in the VIX index highlights the uncertainty investors face.

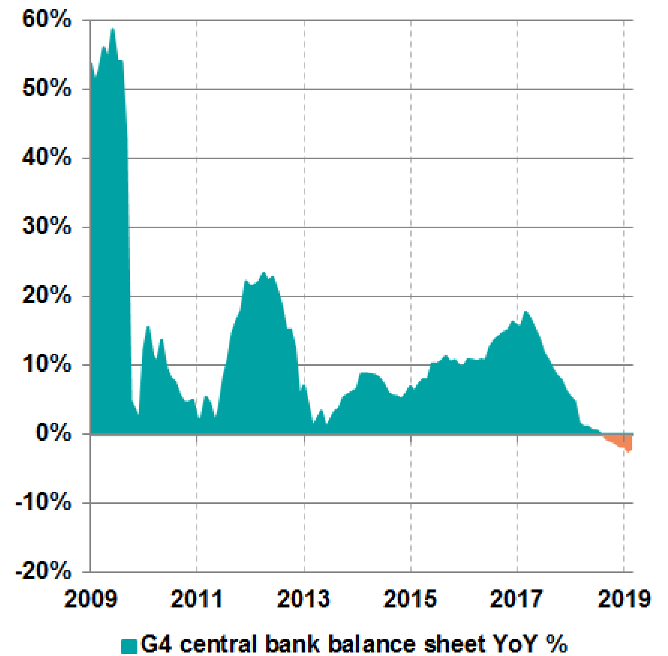
Figure 11: Equity volatility compressing, but settling at higher levels



Source: Bloomberg and BNPP AM, as of 29/03/2019

Lastly, as noted above, bar China, the world's main policy makers have not actually eased policy and the aggregate G4 central bank balance sheet is still contracting. Furthermore, the willingness and ability to actually ease policy is significantly less than in prior years – given many are still near the zero-bound and have almost fully exhausted QE programs.

Figure 12: While central banks have paused, QE is over



Source: Bloomberg and BNPP AM, as of 29/03/2019

An uncomfortable sweet spot

In our view, all this adds up to a fragile goldilocks state – a central bank engineered goldilocks that could be destabilised easily. To us, this is a crucial difference to prior episodes and it needs to be taken into account when allocating assets for the medium to long term.

Broadly speaking, we still do not regard the risk/reward of chasing upside in growth-linked assets as attractive. We are focusing on building robust portfolios instead.

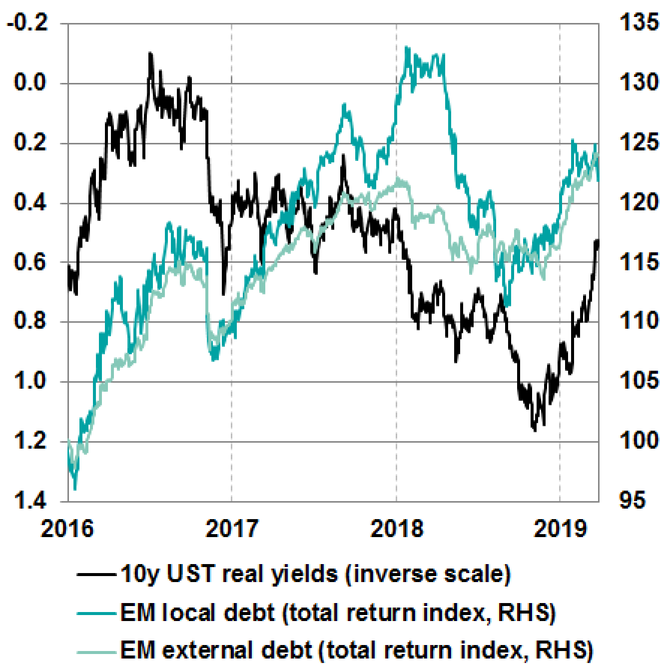
ASSET ALLOCATION

Look to be long carry

The central bank pivot – and especially the Fed's message – should continue to squeeze market volatility, lower real yields and thus revitalise investors' search for yield.

We are currently looking for carry opportunities. Emerging market debt looks interesting from a carry perspective (Figure 13). Whilst we have a preference for hard currency debt at this juncture, from a currency perspective, given that the US dollar appears to be overvalued and the Fed has paused its policy tightening, EM local debt may at some point offer additional value.

Figure 13: Stable/lower real yields to support carry assets



Source: Bloomberg and BNPP AM, as of 29/03/2019

Don't chase growth assets higher at this juncture

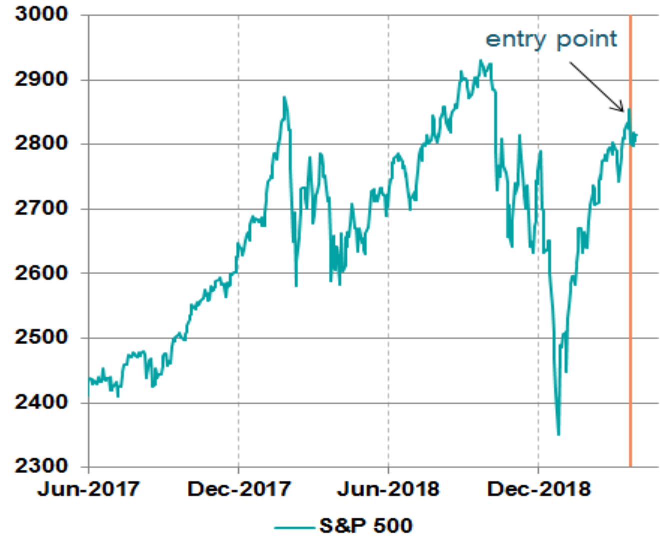
While selective carry trades look attractive, chasing risky assets higher at this juncture does not, in our view.

We have been structurally neutral equities for some time now – previously arguing that the combination of downside risks to the macroeconomic outlook and equities priced mid-range in our scenario analysis made the asset class unattractive.

With stocks rallying further in recent weeks, however, a lot of the good news appears to be priced in now and an asymmetry to the downside is starting to open up (Figure 15).

Put differently, we see equities as vulnerable to growth setbacks and have recently established a tactical short in developed market equities (Figure 14).

Figure 14: Good news priced in – tactically short equities

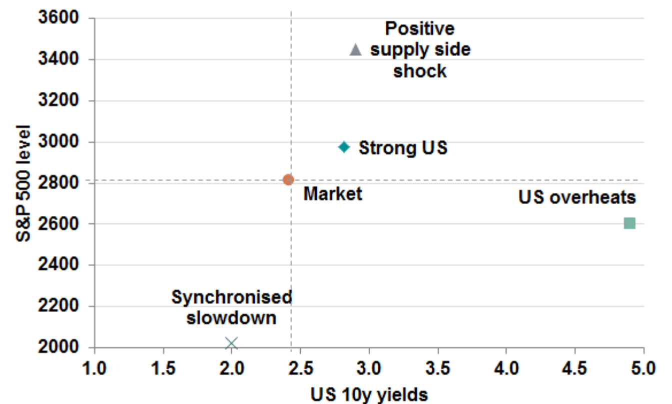


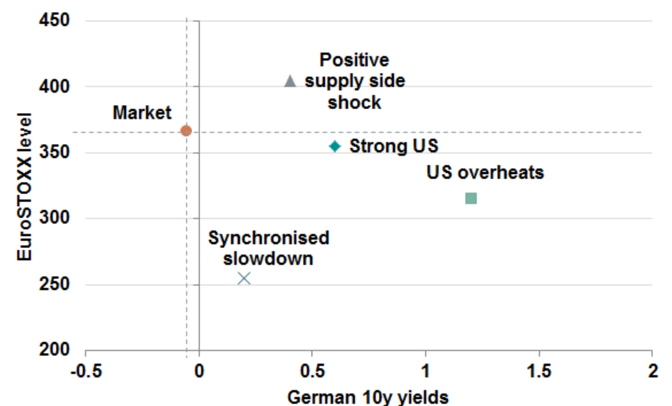
Source: Bloomberg and BNPP AM, as of 29/03/2019

Exploiting asymmetries & building robust portfolios

Given the uncertain macroeconomic backdrop, we believe that building robust portfolios and holding diversification trades is key. Our scenario analysis is useful in this regard as it helps us identify where asymmetries are building and hence where risk/reward is attractive (Figure 15).

Figure 15: Scenario analysis: FI vs. equities asymmetries



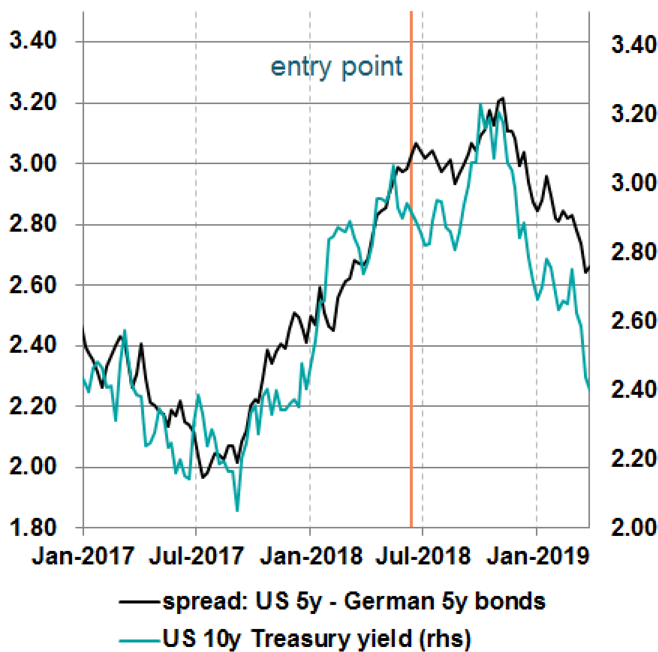


Source: Bloomberg and BNPP AM, as of 29/03/2019

Inspecting Figure 15, in addition to the highlighted equity market asymmetry developing to the downside, a few interesting opportunities arise in fixed income, which we are positioned for.

There remains a stark valuation differential between US and German bond yields and we remain in a relative value trade long 5y US bonds versus 5y German bonds. This trade is not just attractive because of stretched valuation differences; it also has good defensive characteristics in risk-off environments (Figure 16), with US yields having 'more room to drop' in a slowdown scenario. This makes the RV trade a good portfolio diversifier.

Figure 16: 5y US vs. Germany has defensive characteristic



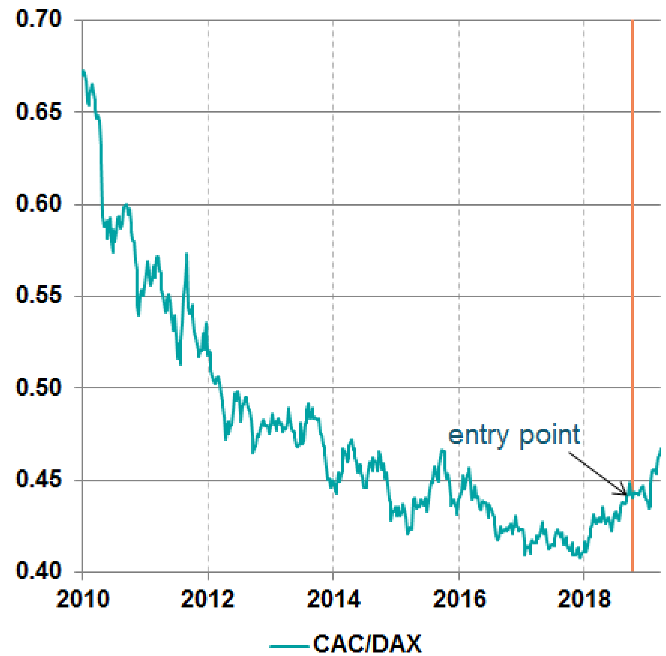
Source: Bloomberg and BNPP AM, as of 29/03/2019

In terms of duration, we are still underweight EMU bonds. Recent price action has questioned our trade rationale (stabilisation in growth, gradually rising inflation and monetary policy normalisation by the ECB), especially given weakness in recent data releases, notably the recent PMI prints in Europe. Whilst Bund yields continue to exhibit an asymmetric outlook to the upside in most of our scenarios, the triggers to unlock this value are becoming less clear. We are currently reviewing both our tactical and strategic position, looking to possibly reduce our exposure.

Elsewhere, to build robust portfolios, we are continually exploring trades which are geared to thematic views.

After a lot of angst not too long ago, investors have seemingly forgotten about China and protectionism risks. We continue to think that 'old China' remains challenged, and that protectionism forces are here to stay (albeit also improving and deteriorating in short term cycles around the long term deteriorating trend). We believe recently weak data from Germany and other major manufacturing economies reflects these forces. Thus, we remain long the French CAC 40 and short the German DAX. As Germany is more exposed than France to de-globalisation, this relative value trade aims to reduce our exposure to possible renewed trade tensions between China and the US. Notably, the trade has done well in recent weeks (Figure 17).

Figure 17: Long CAC/DAX recently worked well



Source: Bloomberg and BNPP AM, as of 29/03/2019

STRATEGIC OVERVIEW OF KEY POSITION CHANGES IN Q1 2019

The BNPP AM MAQS team took the following asset allocation decisions:

JANUARY:

SHORT HY CREDIT — CLOSED — 09/01/2019

- This trade did well in Q4, but after equity markets bounced, it was at risk in the short term.

SHORT CAD/NOK — OPENED — 09/01/2019

- We believe valuations and the relative central bank policy outlooks look supportive of a drop in CAD/NOK.

SHORT US & EU EQUITIES — OPENED — 23/01/2019

- In light of the recent sharp bounce in equities, and with macro risks still skewed to the downside, we took a tactical short position on US/EU equities.

FEBRUARY:

TACTICAL SHORT US & EU EQUITIES — CLOSED — 13/02/2019

- Given the Fed's policy pause, we see no supportive factors for this tactical short in the short run and have closed it.

SHORT BUNDS — OPENED — 13/02/2019

- We regard recently lower yield as a good entry point to add to our bond underweight. We added a short in Bunds to bond-heavy portfolios.

LONG CAC/DAX — REDUCED — 20/02/2019

- After reasonable performance over a short period of time, and given that technical indicators are looking stretched, we took profits on half of our CAC/DAX trade.

MARCH:

SHORT DM EQUITIES — OPENED — 22/03/2019

- With equity markets increasingly pricing in the good news after the recent central bank shift to a more dovish stance, and in light of the downside macro risks, we took a tactical short position in developed market equities.

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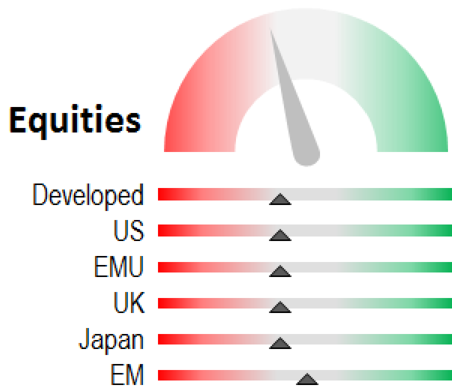

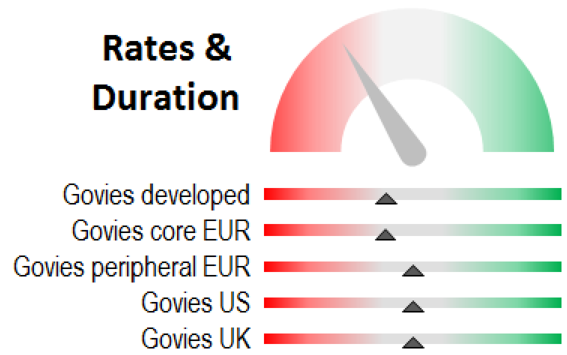

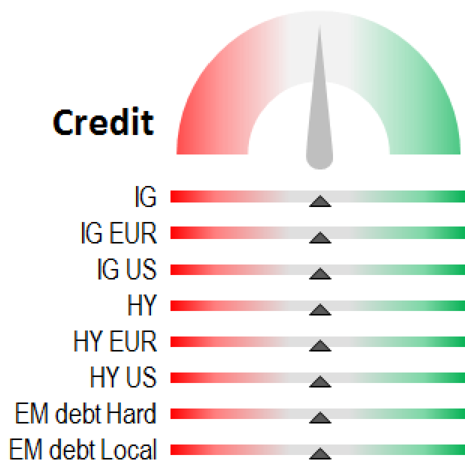

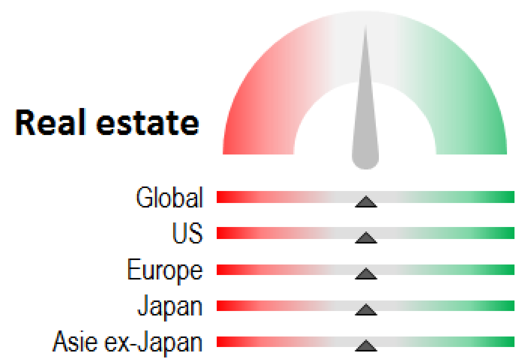

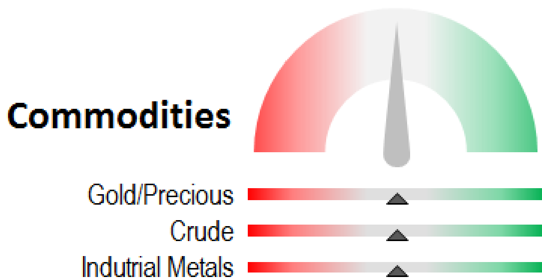

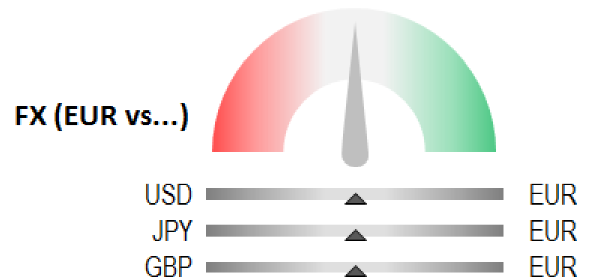

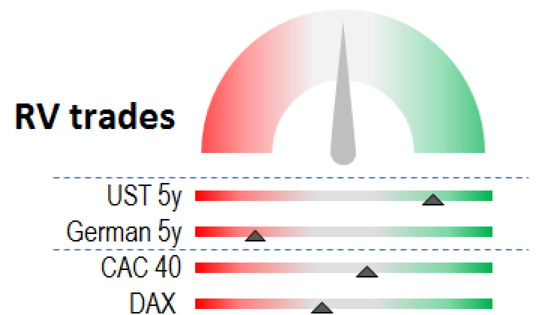

[1] The dashboard shows the asset allocation in our portfolios and reflects the decisions of the Investment Committee of the Multi-Asset team at MAQS. Views expressed are those of the Investment Committee of MAQS, as of April 2019. Individual portfolio management teams outside of MAQS may hold different views and may make different investment decisions for different clients.

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