ASSET ALLOCATION FLASH

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

OPPORTUNITIES IN THE CRISIS

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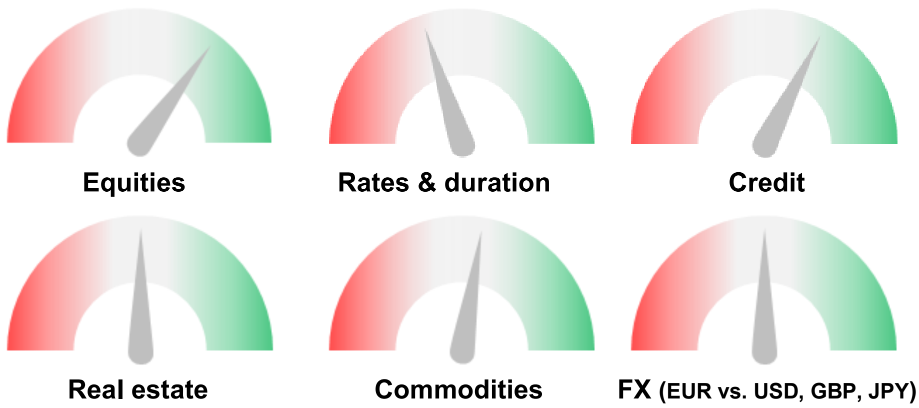
MONITORING THE VIRUS & ITS IMPLICATIONS

- **Tracking the virus:** Europe feels the full hit of the virus, but there are tentative signs of decelerating growth rates, especially in Italy. The US is now in the eye of the storm as new cases soar. In China and South Korea new cases remain low.
- **Economic disruption and resumption:** Latest data are showing the huge damage of the virus in the Western world. PMIs plummeted in Europe and the US. In the latter, initial jobless claims hit record highs. In China, economic activity is gradually resuming, with industrial production leading consumer activity.
- **Policy responses:** Huge monetary and fiscal packages in place in Europe and the US. The Fed announced 'unlimited' QE and the ECB announced a further EUR750bn QE programme. On the fiscal front, the US approved a USD2tn package and large programmes are also in place in Europe, but jointly-guaranteed debt remain elusive. China has so far committed USD344bn in measures.
- **Sentiment and systemic market stresses:** Sentiment measures showing early signs of consolidation. Indicators of systemic stress rose, but did not unhinge. Market volatility metrics starting to ease following colossal policy measures.

KEY VIEWS & ASSET ALLOCATION

- **Fundamental views:** Ultimately we expect a U-shaped recovery that will likely require 'learning to live with the virus' via innovations in testing and gradual economic resumption. The main downside risk is prolonged and intermittent shut-downs that prolong a global recession. Near term, the coronavirus is hitting the US with full force so Fed and fiscal efforts do not necessarily mark the bottom in stocks.
- **Strategy:** Valuations in US equities haven't adjusted as much as for other risky assets such as UK equities and commodities. We have more conviction on the latter two, also noting that commodity assets usually outperform after recessions are priced and should be supported in reflationary scenarios.
- **Asset allocation changes:** We cut our US equity conviction to neutral and replaced this with UK equites, global commodities and long AUD/USD. We also remain overweight EMU and EM equities. On rates, based on fundamental and market dynamics, we see higher yields, and remain underweight in EMU bonds.

Core asset class views*



Risk utilisation**

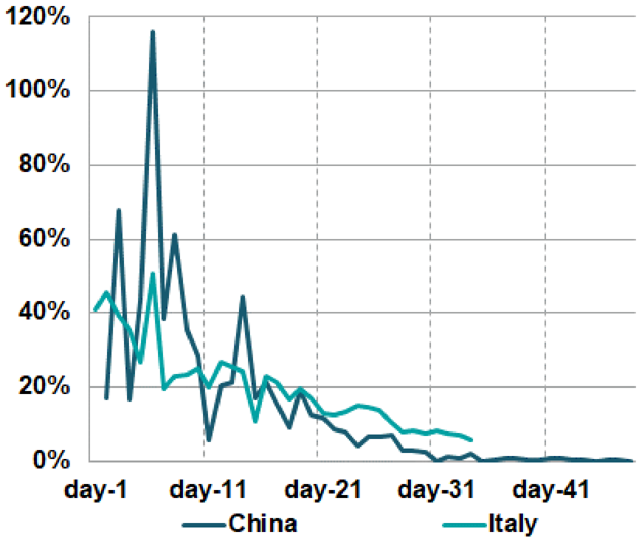
* The core asset class views dashboard reflects the key views of the Investment Committee of the Multi-Asset team at MAQS. Other specific/tactical trades may be implemented in addition and are listed at the end of this publication. ** Risk utilisation/active risk is a measure of the tracking error (as a % of maximum tracking error) of an unconstrained theoretical portfolio, derived from core asset class views and from additional specific/tactical trades.

FUNDAMENTALS: MONITORING 4 PILLARS

Virus evolution

The virus is spreading from east to west and the eye of the storm is now in Europe. There are some signs of stabilisation in Italy. Notably, the daily growth rate of new cases has been well below 10% for a week or so (Figure 1). However, the number of new cases remains stubbornly high (+5,217 on Sunday vs +5,974 on Saturday, +6,368 a week ago), taking the total number of infections to 98,000 people.

Figure 1: Italy: daily growth rate of new cases falling



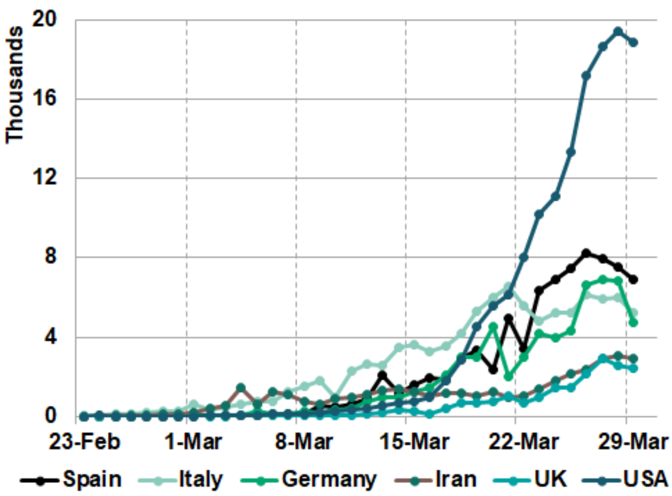
Source: worldometers.info and BNPP AM, as of 30/03/2020

Other European countries are a step behind. Spain reported +6,875 new cases on Sunday (vs +7,516 on Saturday, +6,368 a week ago). New infections are also rising rapidly in other large countries (Figure 2). Indeed, daily growth rates remain elevated in Germany (11%), France (7%) and the UK (14%).

The corona storm is also hitting the US with full force. Last week, the US overtook China in terms of confirmed cases, reaching more than 142k. New cases soared to a whopping +18,882 on Sunday (vs 19,452 on Saturday, +10,188 a week ago), with the growth rate slowing to 15% vs 30% a week ago.

In Asia, new cases remain contained and low. China reported 31 new cases this morning (vs +45 yesterday, +39 a week ago), and the growth rate remains stable and close to zero. In South Korea, +78 new cases were reported (vs +105 yesterday, +64 a week ago), and the growth rate remains low below 1%.

Figure 2: Most affected countries



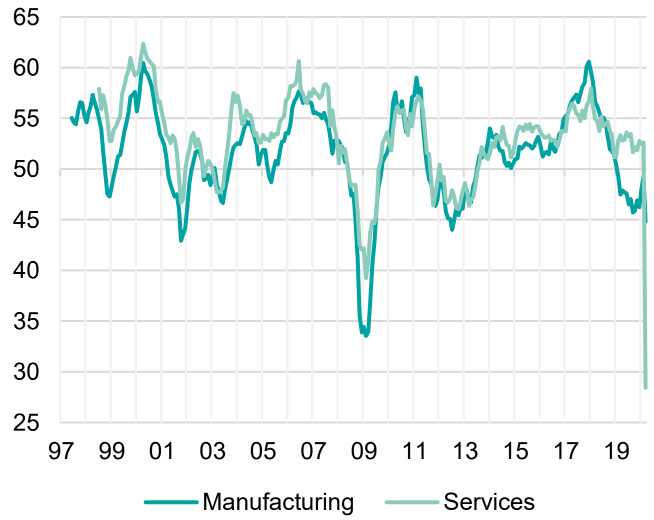
Source: worldometers.info and BNPP AM, as of 30/03/2020

We also remain attentive to a potential major breakthrough in terms of enhancing mass testing capabilities or finding and testing a vaccine. At the time of writing we had not identified any significant breakthroughs.

Macro disruption and business resumption

The latest economic indicators are showing the huge damage that the pandemic is exerting in the Western world. Surveys of economic sentiment (the so called PMIs) plummeted in Europe and the US. In Europe the services PMI fell below 30, the lowest print since records began. The manufacturing index was also hit hard (dropping to levels around 45), but stayed well above previous lows (Figure 3).

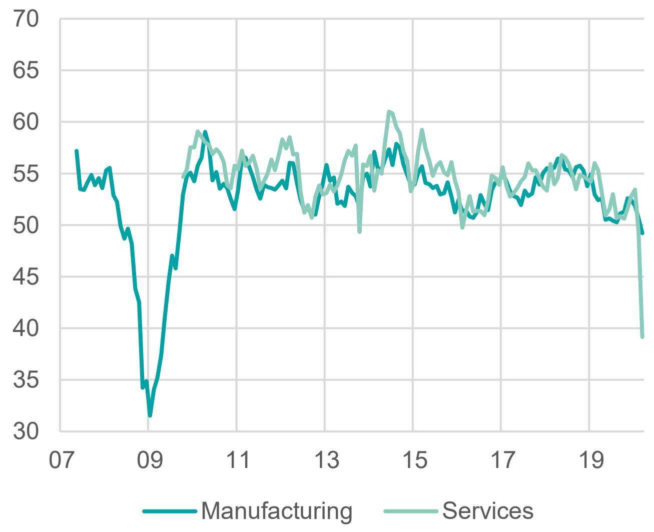
Figure 3: Drop in services PMIs in the Eurozone outpaced that in manufacturing



Source: Bloomberg and BNPP AM, as of 27/03/2020

We observed a similar pattern in the US with the services PMIs dropping to new record lows while the manufacturing series fell to cyclical lows but stayed above levels seen in the global financial crisis of 2008-09 (Figure 4).

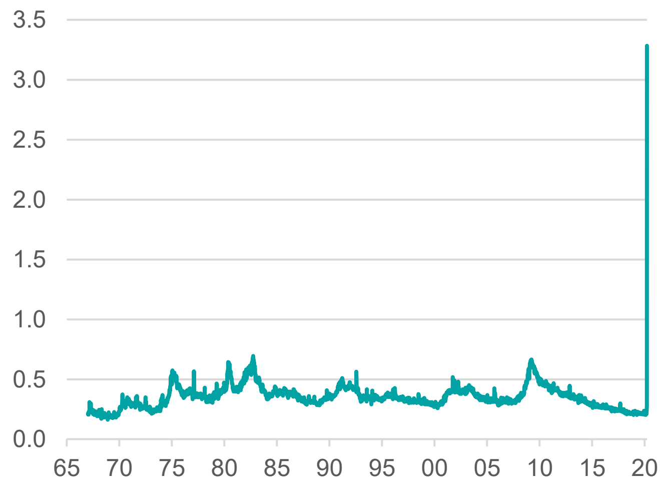
Figure 4: Services PMIs also dropped by more than manufacturing in the US



Source: Bloomberg and BNPP AM, as of 27/03/2020

Other macro indicators in the US also deteriorated markedly, notably initial jobless claims which soared to 3.3mn, its highest level on record (Figure 5). This highlights the very sudden shutdown of many business due to the virus as opposed to the more progressive layoffs that are normally seen in recessions. Pennsylvania and Ohio were particularly impacted (363k and 181k respectively compared with the prior week). In 2016, Trump won these two swing states by a thin margin, so this will likely affect Trump's support in these states and, in turn, could impact the upcoming election.

Figure 5: US initial jobless claims soared to a record 3.3mn



Source: Bloomberg and BNPP AM, as of 27/03/2020

Despite the huge economic hit in the western world, there appears to be light at the end of the tunnel in Asia.

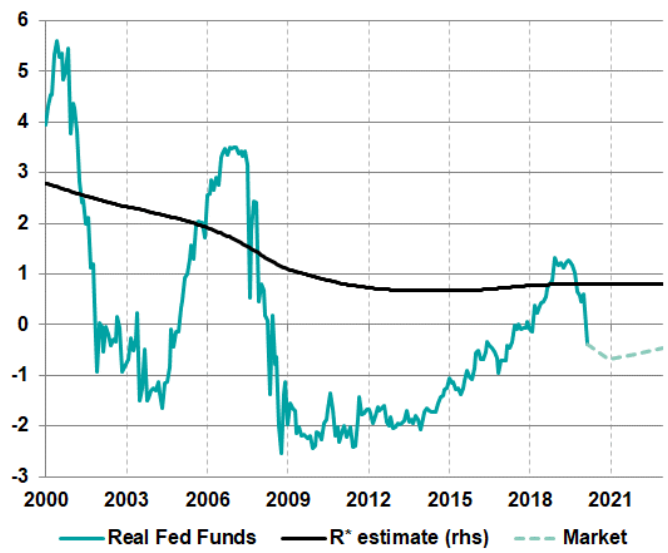
In China, for example, economic activity is gradually resuming. This is clearly visible in industrial production, but is happening to various degrees across sectors. For instance, Nomura's daily business resumption rate (BRR) for China continues to increase. According to its narrow BRR measure, which covers sectors that are extensively influenced by the epidemic (equivalent to 65% of GDP) activity is back to 86.1% of normal levels. And they expect the BRR to achieve its "new normal" in early April by stabilising at ~90%.

Policy responses

Policy responses have been huge over the past week, with monetary and fiscal packages of unprecedented magnitudes now in place in Europe and the US. The Fed announced 'unlimited' QE (including facilities to allow corporate purchase) and the ECB announced a new EUR750bn emergency bond purchase programme that has helped ease tensions in sovereign bond markets. As we can see on Figure 6, the Fed is now back in deep easing territory with policy rates effectively at zero and a massive QE programme that aims at keeping monetary conditions loose for the foreseeable future.

On the fiscal front, the US is close to approving a USD2tn package, equivalent to c.10% of GDP (Figure 7). Large fiscal easing programmes are also in place in Europe, but jointly-guaranteed debt (so called Eurobonds) remain elusive. China has also eased fiscal policy by having committed so far USD344bn in economic measures to combat the corona crisis.

Figure 6: Fed easing: back in accommodative territory

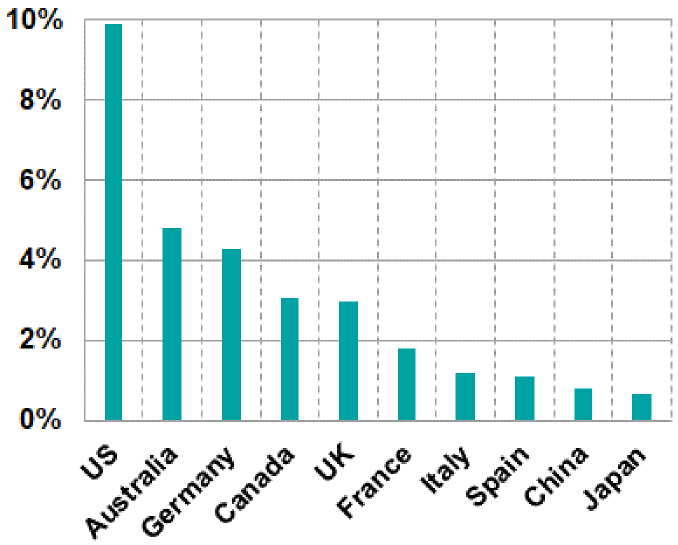


Source: Bloomberg and BNPP AM, as of 27/03/2020

However, as clearly seen in Figure 7, China's fiscal effort as a percent of GDP is more contained. This reflects the authorities concerns about excessive leverage. So far fiscal measures in

China have been more targeted, aiming to help SMEs, vulnerable populations/regions and supporting infrastructure projects such as accelerating the construction of smart cities.

Figure 7: Fiscal packages compared (% GDP)

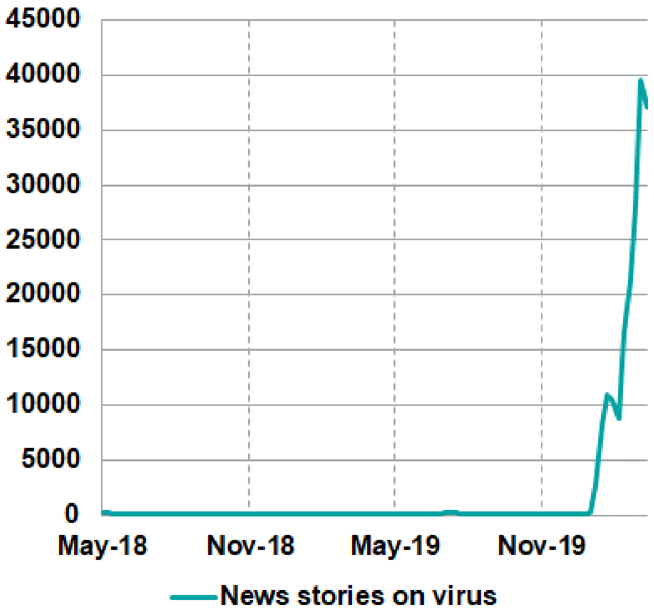


Source: Bloomberg and BNPP AM, as of 27/03/2020

Sentiment and systemic market stresses

Sentiment around the corona crisis is showing tentative signs of consolidation. Bloomberg 'virus' news stories have sky-rocketed since the outbreak began and have eased a bit very recently (Figure 8).

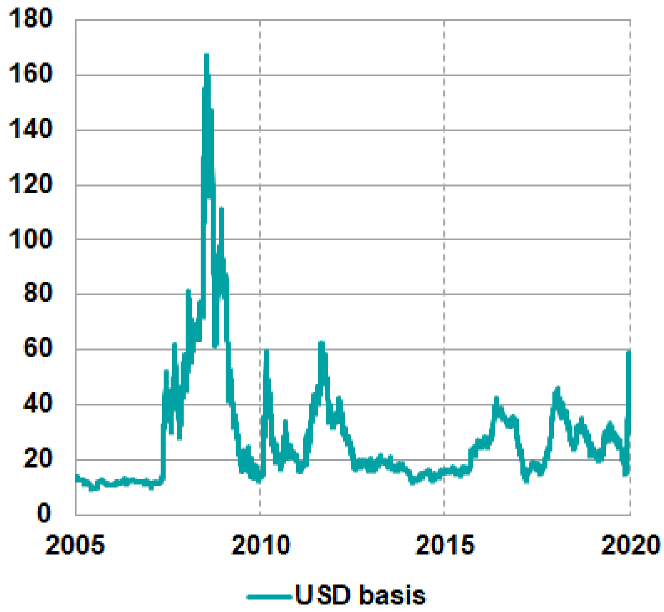
Figure 8: Bloomberg 'virus' news stories



Source: Bloomberg and BNPP AM, as of 27/03/2020

Indicators of systemic stress such as Libor-OIS spreads and USD shortage metrics ($ basis) have risen recently but they have not become completely unhinged as in the global financial crisis. This is partly due to the aggressive liquidity measures put in place by global central banks (Figure 9).

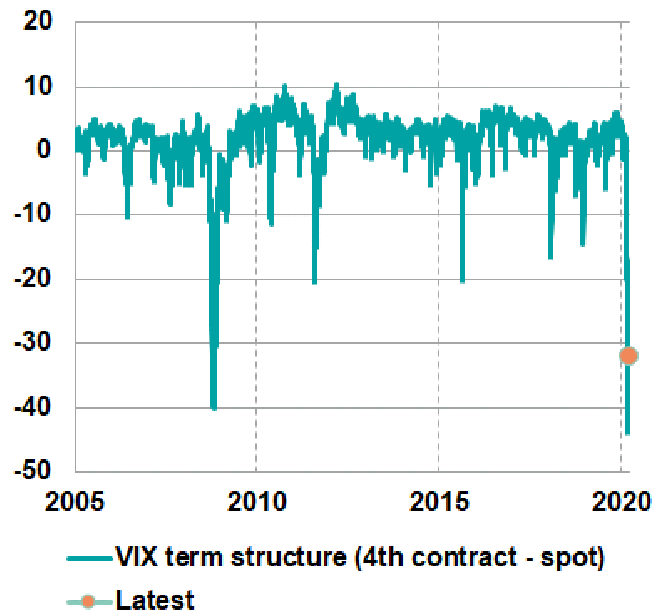
Figure 9: USD shortage ($ basis) manageable



Source: Bloomberg and BNPP AM, as of 27/03/2020

Finally, implied volatility metrics that signal market stress, such as the VIX term structure (long minus short term futures contracts) are starting to ease, also supported by the massive policy measures put in place in major economies (Figure 10).

Figure 10: VIX term structure inversion easing



Source: Bloomberg and BNPP AM, as of 27/03/2020

MARKET DYNAMICS INPUTS

Besides our fundamental views, our 'market dynamics' inputs form the other major pillar in our investment process. This pillar is split into our proprietary 'market technical' and 'market temperature' inputs, forming a helpful addition in timing markets alongside our fundamental views.

Overall, 'market dynamics' are suggesting that risk/reward for risky assets has become attractive again after the recent sell-off.

Market technicals

In our market technical toolbox, we monitor markets through the price dynamics in multiple time frames.

For equity markets, medium to long term time frames had been bullish for some time, and continue to be so for now. On daily dynamics, most markets have reached critical levels during the accelerated sell-off of late, and are starting to exhibit short term bottomish configurations. For the medium to long term outlook, the next monthly close will be important to validate/invalidate the medium term trend.

For commodities and commodity related markets, our technical signals have started flagging interesting opportunities, as they suggest a high likelihood of a major reversal ahead and thus a medium term opportunity to buy commodity assets (crude oil, copper) and commodity currencies (especially the AUD vs. USD). The long term bearish cycle on commodities wasn't completed during the China hard landing fears in 2016, but is now showing signs of exhaustion. Interestingly, in equity RV space, technicals also see an opportunity to be long UK equities vs other DM markets, especially US stocks – which is in line with the trends seen for commodity markets.

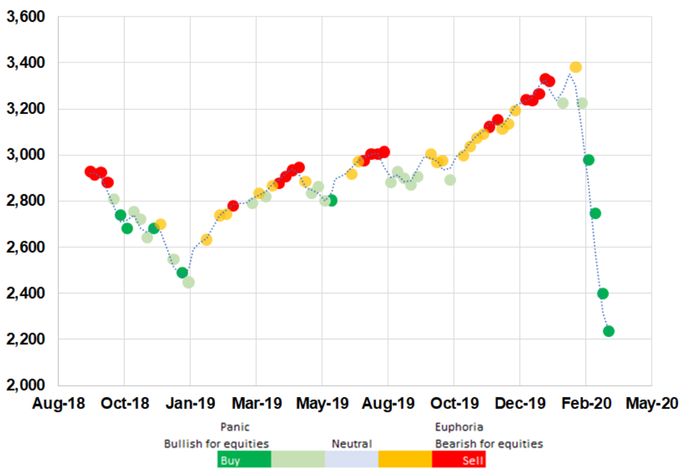
Market temperature

Sentiment, positioning and other statistical indicators underpin our 'market temperature' framework.

Regular readers will recall that we had warned not to chase markets higher in January, as our assessment of the market's temperature was 'hot', or dark red – usually an environment prone to corrections.

Since then, market temperature has turned dark green, usually a contrarian buy signal (Figure 11). Indeed, the selloff of late has all the ingredients of a panic event with several indicators reaching multi-year records. The current configuration is comparable to the one seen in November 2008, with several signs of capitulation emerging across markets.

Figure 11: Market temperature moving into dark green



Source: Bloomberg and BNPP AM, as of 27/03/2020

KEYS VIEWS & ASSET ALLOCATION

Our base case is unchanged and we still see an economic 'U shape' recovery medium term as the virus wanes and policy support kicks in. But needless to say, the situation remains very fluid. Indeed, the downside risks of the COVID-19 shock morphing into a systemic crisis and hence a more prolonged global slowdown/recession have clearly increased.

As such we remain nimble in our approach, utilising both the fundamental and market dynamics pillars of our investment process for identifying opportunities, both in the short and medium term horizons.

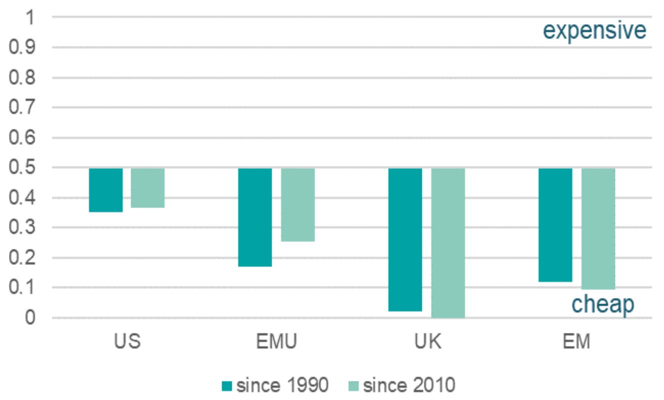
Recent changes to positioning

Since our recent *Asset Allocaiton Flash* note, we tweaked the regional/asset class focus of our risk asset exposure last week.

We expect the combination of Fed unlimited QE (including a new facility to buy corporate debt) and the USD2tn+ fiscal package to be market supportive, but not necessarily to mark the bottom of the cycle for US equities in the short term. Indeed, as discussed above, the coronavirus is hitting the US with full force and will likely raise further concerns about the US economic outlook.

In addition, valuations in US equities, while below historical averages, haven't adjusted as much as for other risky assets such as UK equities (Figure 12).

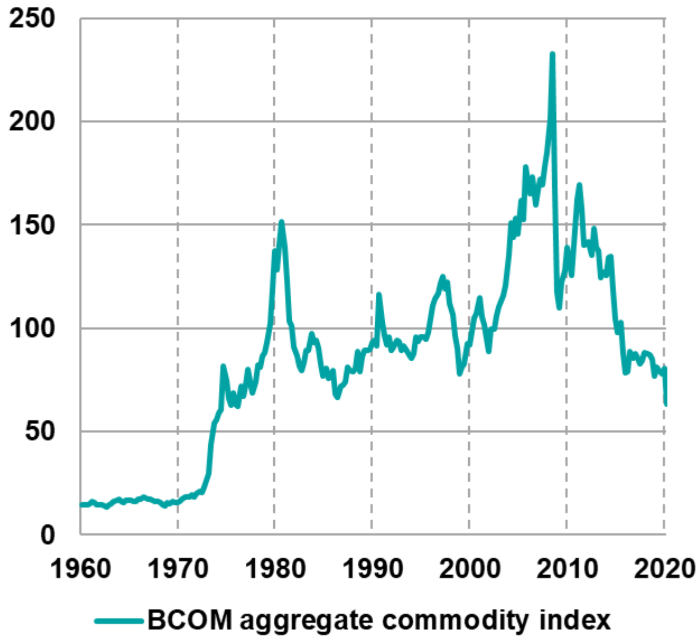
Figure 12: Cyclically adjusted P/Es for major equity markets (percentile rank: 1 = expensive, 0 = cheap)



Source: Bloomberg and BNPP AM, as of 27/03/2020

We therefore have more conviction on UK equities and also on cyclical commodities – which after the recent violent price action are at levels not seen since the 1970s (Figure 13). Note that commodities also usually outperform in early stages of a recovery and commodity assets would also be supported in reflationary scenarios. Put differently, commodity related assets exhibit better risk reward than US equities at this juncture, especially considering the likelihood of worse news on the virus situation in the US in the coming days and weeks. Interestingly, as noted above, our market technicals toolbox is in perfect alignment with our fundamental assessment.

Figure 13: Commodities at levels not seen since 1970s



Source: Bloomberg and BNPP AM, as of 27/03/2020

In light of this, the Multi-Asset Investment Committee decided to take its US equity conviction to neutral and replace this into UK equites, into global commodities (ex Ags), and into a long AUD/USD trade.

Note that this adds exposure to the *Emerging markets & commodities* factor in our new portfolio optimiser – MFA (see below for more information). The factorisation process in adapting a holistic view to all our portfolios, will mean that even portfolios which cannot trade e.g. commodities outright, will buy assets linked to this factor.

Current asset allocation stance

To summarise, our main views are:

- **Equities:** we are long UK, EMU and EM equities and aim to remain nimble. We hold call spread options for flexible portfolios
- **Carry trades:** we are long emerging market USD debt and EMU REITs
- **Rates:** we are short core EUR bonds, we are long US breakeven inflation, short USTs via options and in USD curve steepener via options
- **Long commodity assets:** we are long aggregate commodities (ex Ags) and are long AUD/USD. Separately, we still see gold as an attractive asset and are long the yellow metal

PORTFOLIO CORNER

Risk utilisation

The active risk in our portfolios is currently at around 64% of our target (Figure 14). In recent days our risk utilisation increased as we added UK equities, commodities and AUD/USD instead of our previous US equity overweight.

Figure 14: Current level of active risk*

* Risk utilisation/active risk is a measure of the tracking error (as a percentage of maximum tracking error) of an unconstrained theoretical portfolio, derived from core asset class views and from additional specific/tactical trades.
Source: BNPP AM, as of 27/03/2020

Core views and resulting factor exposures in MFA

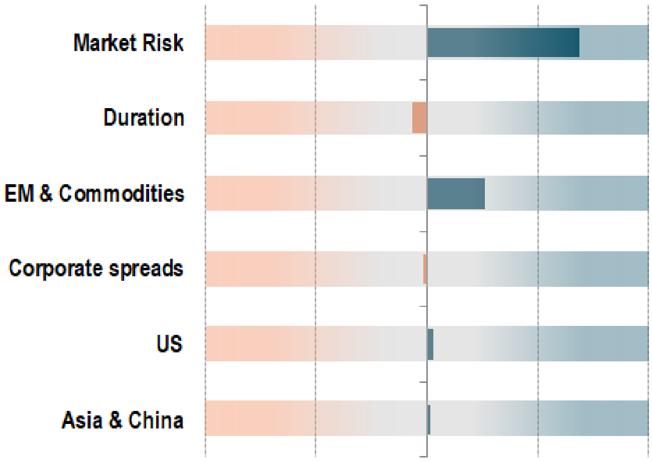
The main factor exposures of our core views is clearly tilted towards ***Market Risk*** (Figure 15), and driven by our equity overweights, as well as by the newly added longs in commodities and AUD/USD.

These new trades also drive an increase in ***EM & Commodities***, which is now more clearly overweight.

Duration is slightly underweight, even though our EMU bond short is counteracted with our EMD HC overweight.

Other factors are more muted, given the offsetting factor profiles of some trades.

Figure 15: Current factor exposures* from core asset views



* The factor exposure shown is for an unconstrained theoretical portfolio and derived from core asset class views. These factors will be projected onto individual portfolios considering constraints. Additional specific/tactical trades may be implemented and these will not be visible in the factor profile. They are listed at the end of this publication.
Source: BNPP AM, as of 27/03/2020

Specific/tactical views implemented outside of MFA

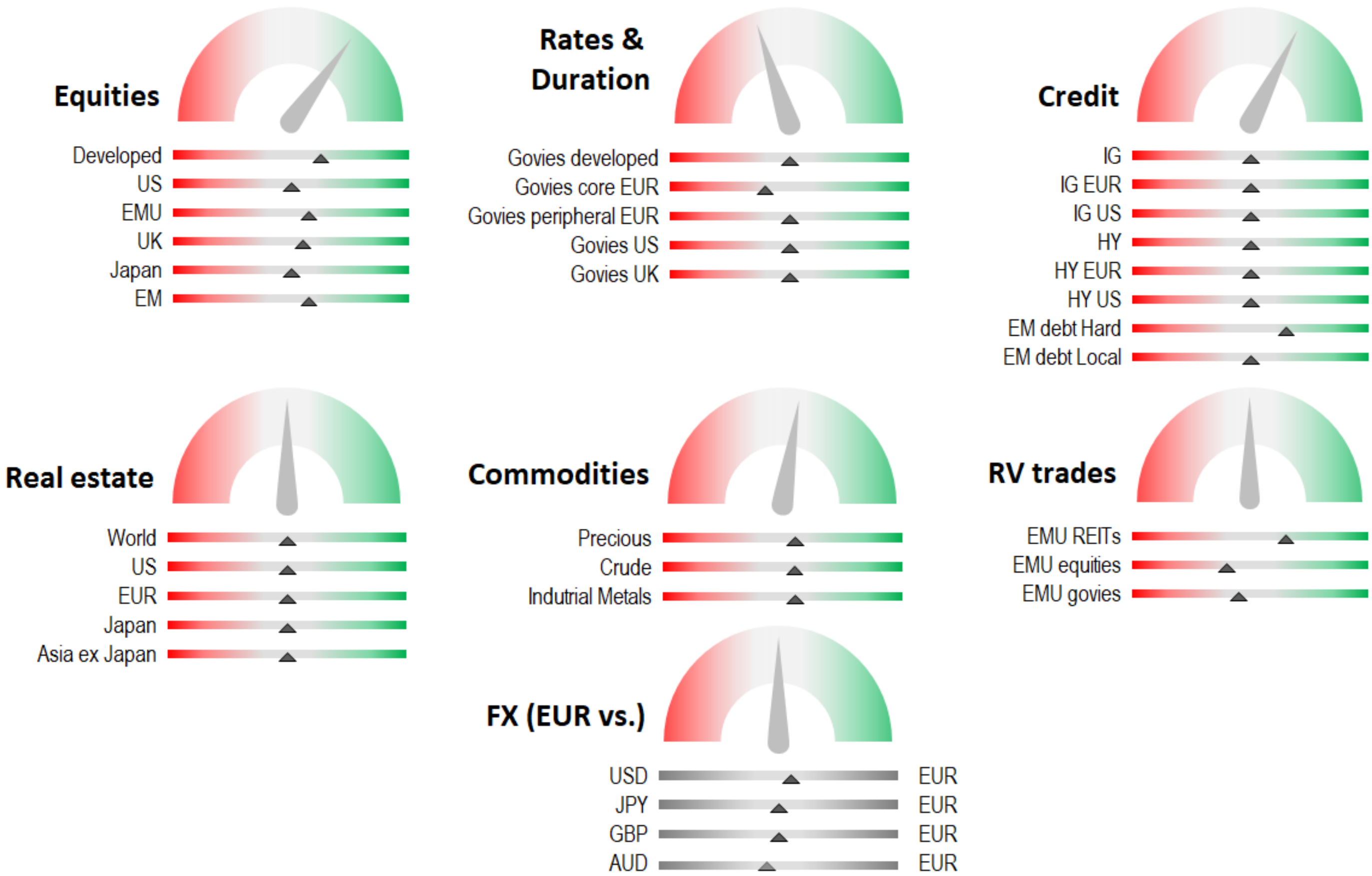
We implement some trades outside of our MFA portfolio optimiser. Such trades are either tactical or specific (i.e. we do not want a trade to be factorised across the book of business) or the asset in question is out of the scope of our optimiser.

These trades are listed at the back of this publication.

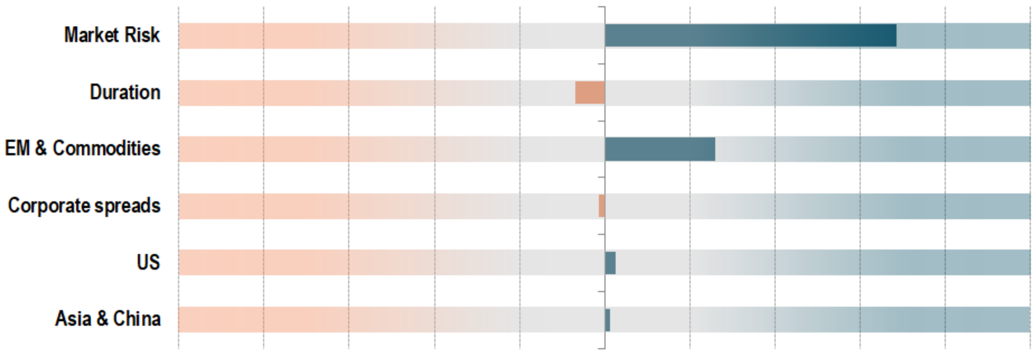
RISK UTILISATION[1]

CORE ASSET CLASS VIEWS & FACTOR EXPOSURE

Core asset class views[2]



Factor exposure[3]



[1] Risk utilisation/ active risk is a measure of the tracking error (as a % of maximum tracking error) of an unconstrained theoretical portfolio, derived from core asset class views and from additional specific/tactical trades.
[2] The core asset class views dashboard reflects the key views of the Investment Committee of the Multi-Asset team at MAQS.
[3] The factor exposure shown is for an unconstrained theoretical portfolio, derived from core asset class views. These factors will be projected onto individual portfolios considering constraints. Other specific/tactical trades may be implemented in addition and will not be visible in the factor profile

SPECIFIC/TACTICAL TRADES[4]

Trade	Asset class	Specific/Tactical
Long US Breakeven inflation	Rates & duration	Tactical & specific
Long gold	Commodities	Specific
Long puts on US treasuries	Rates & duration	Specific
Long call spreads on S&P 500 and Eurostoxx	Equities	Tactical & specific
Long USD 2s10s steepener via CMS spread caps	Rates & duration	Specific

[4] Specific/tactical trades are implemented in addition to the core asset class views and will not be visible in the factor profiles shown elsewhere in the document.

Views expressed are those of the Investment Committee of MAQS, as of March 2020. Individual portfolio management teams outside of MAQS may hold different views and may make different investment decisions for different clients.

DISCLAIMER