

Asset Allocation Monthly

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Taking profits on short duration

- Financial markets have continued to gyrate between growth and inflation concerns. We have taken advantage of volatile market moves to neutralise our short duration views. This was a high-conviction view held in portfolios through much of 2022.
- With US yields near 4% – some distance from 1.75% where portfolios were building positions earlier this year – the risk/reward from being short sovereign bonds is meaningfully reduced. This is a valuation-led move rather than a shift in our fundamental assessment.
- Within fixed income, we remain long highly rated, defensive EUR corporate bonds that are priced for defaults that are many multiples of what we anticipate. Positions are mostly duration hedged.
- Equity premiums have ticked higher recently, but are still considerably below where they were in June or, indeed, where recessionary growth might imply they should be. While equity prices have fallen, earnings expectations have held (surprisingly) steady.
- We have reduced our allocation to Japanese equities, which have held up remarkably well this year. We remain long Japan along with China, offset fully by caution towards European equities. We share a deep dive on Chinese equities below. Portfolios are neutral equities overall.
- Overall risk consumption is cautious, at just below a third of permitted ranges for asset allocation.



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Portfolio perspectives

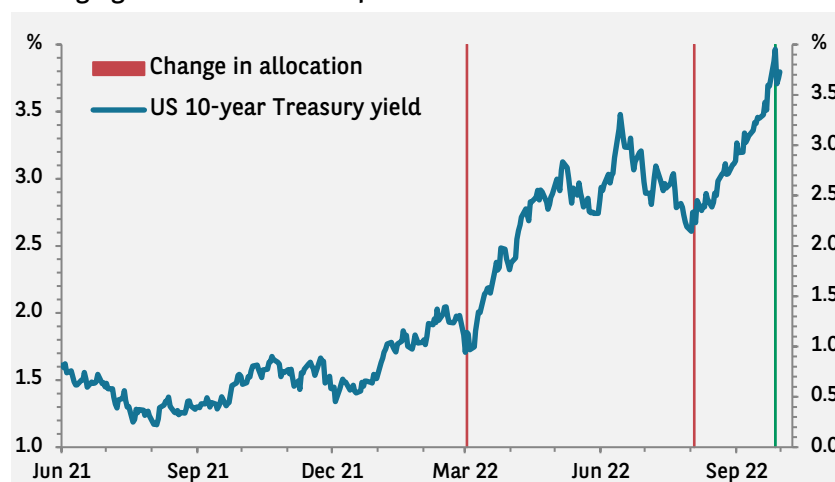
With US yields near 4% – some distance from 1.75% where the investment committee (IC) was building positions earlier this year (see Exhibit 1) – we took profits on our short US duration view, lifting government bonds and US bonds to neutral in our asset allocation grid (see table at end).

This is a move led chiefly by valuation, with the risk/reward from being short duration at these levels less clear to us. Notwithstanding the shift in the policy paradigm that is underway (and being felt intensely in the UK), financial conditions have tightened notably. As concerns over the growth outlook come back into focus, this should cap the upside in yields.

Within fixed income, we remain long highly rated defensive EUR corporate bonds, mostly duration hedged. We have reduced our allocation to Japanese equities, which have held up remarkably well this year, so that they are on par with Chinese equities. We are holding onto China as strong policy stimulus belatedly comes through. Both positions are fully offset by caution towards European stocks, leaving us neutral equities overall. Overall, our risk consumption remains cautious and within the ‘dislike’ quintile.

Exhibit 1

Managing our short-duration position

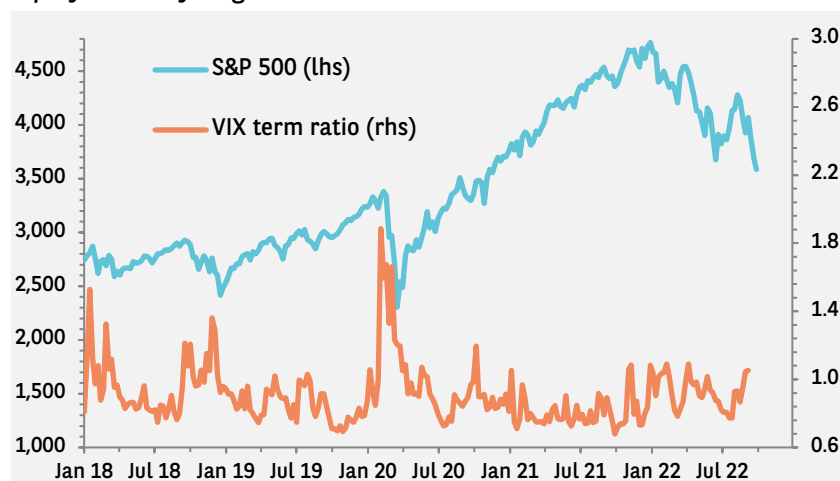


Data as at 30 September 2022. Sources: FactSet, BNP Paribas Asset Management.

Staying constructive on China

The reaction of financial markets to higher-than-anticipated US inflation data was intense, with outsized falls in equities, notably in levered exchange-traded funds. Profit warnings amplified the moves.

While investors are cautious, with higher short-dated volatility (see Exhibit 2) and elevated put-to-call ratios, we see meaningful risk still of a sharper equity drawdown led by earnings adjustments. For instance, a return to trend earnings for US equities would point to a 20% fall in total returns; a halfway move to trend would suggest 12% or so. With European equities facing the largest downside to earnings, this remains our favoured short position.

Exhibit 2**Equity volatility: Higher VIX vs. term ratio**

Data as at 30 September 2022. Sources: Bloomberg, BNP Paribas Asset Management.

Against this, Chinese (and Japanese) equities have a fair bit of caution already built in. The Investment Committee has been long Chinese equities from the March nadir – a position that has treaded water against global stocks after an initial pop higher. Insofar as each of the five chief supports for Chinese equities remains firm or has strengthened somewhat, particularly in relative terms versus the rest of the world, we remain constructive.

Running through these supports in turn:

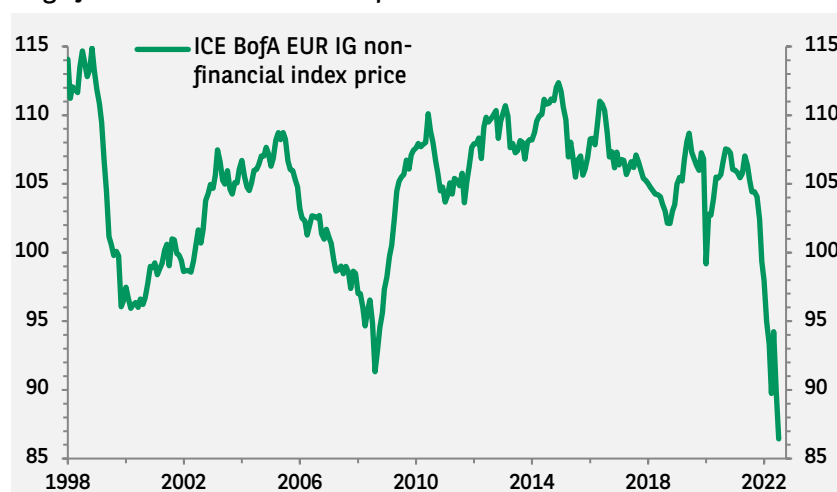
- Policy easing, while monetary policy in the rest of the world is tightening, has arrived. Although property market measures had perhaps disappointed expectations, action is now coming through thick and fast and our central macro research team has become more constructive recently.
- A step back in regulation: this was particularly important for the tech-heavy MSCI indices. Relaxation has perhaps exceeded market expectations. For example, gaming licences are now being approved after a long pause amid a more pro-business stance broadly from both regulatory and cybersecurity bodies. Most US-listed American depositary receipts (ADRs) are now fungible.
- Decent earnings expectations have remained in place, with earnings growth estimates at 9.5% for this year and 15.5% for next year. Earnings expectations for Chinese companies fell ahead of the rest of the world and are now inflecting higher much sooner, with meaningful caution built in to buy-side estimates. Our macro research colleagues are constructive.
- Attractive valuations: after a torrid 2021, the MSCI China forward price/earnings ratio relative to the broad ACWI index had fallen to a six-year low in March. Valuations have recovered since as Chinese earnings momentum has been weaker, but reasonable – and investor positioning is still considerably underweight.
- A strong bottom-up picture: our bottom-up analysts have reaffirmed their bullishness from April. China's zero Covid policy has been the wild card. The signs are now positive with Hong Kong recently reopening and President Xi travelling abroad again. Here too, our research colleagues are turning incrementally more positive.

Meanwhile, four pillars supporting European high-grade corporate credit – a growing conviction long

Year-to-date returns in European investment grade (IG) credit have been – by many multiples – the worst in recent history (see Exhibit 3), offering portfolios attractive valuation opportunities to deepen favourable positions. To be sure, the fundamentals are stronger than they have been for many years and European IG is long where our conviction is growing.

Exhibit 3

Huge falls in EUR IG cash bond prices



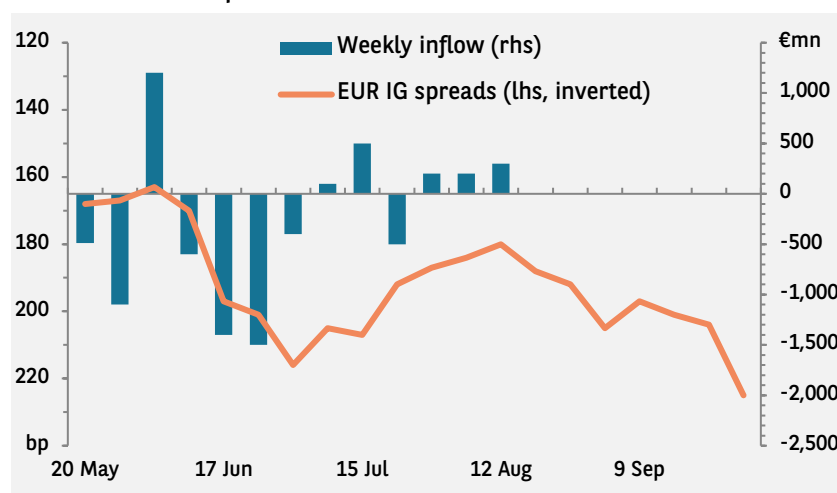
Data as at 30 September 2022. Sources: FactSet, BNP Paribas Asset Management.

Since July, we have seen four principal supports for European high-grade corporate credit. All remain in place or strengthened modestly in September (notably, valuations):

- **Fundamentals:** Leverage is down generally, interest coverage is high and corporate balance sheets are firm, even in the more vulnerable sectors such as chemicals and cars. Our research colleagues foresee a mild 2001-style recession, which might suit European IG bonds.
- **Valuations:** Spreads are near 2020 crisis levels: European IG has an implied default level of 9% (40% recovery). That is twice the worst 5-year rate and 10 times the average rate. This seems extreme to us. Expected European high-yield defaults are at below 2%. We believe European IG is attractively valued versus equities.
- **Technicals:** Outflows have stabilised, and indeed there are early signs of inflows (see Exhibit 4). Many companies have extended their debt maturities. It is possible that governments and the European Central Bank (ECB) will provide support (e.g. in sectors such as utilities), notwithstanding any monetary support withdrawal.
- **Macroeconomic cycle:** Perhaps this cycle should be different. Indebtedness is falling and cash balances are high as we enter the slowdown phase, so any pressure to deleverage, which tends to dent credit, is conspicuously absent.

Exhibit 4

A better technical picture



Data as at 30/9/22. Sources: Bloomberg, Macrobond, BNP Paribas Asset Management.

Asset class views

	Strongly dislike	Dislike	Neutral	Favour	Strongly favour
Risk appetite*		X			
Asset allocation			Government bonds Equities Real estate Cash	Credit Commodities	
Equity regions		Europe ex-UK	US UK Emerging markets ex-Asia	Japan EM Asia	
Equity style/size			EU large cap EU small cap US large cap US small cap		
Sovereign bonds			US Europe Japan EM local Australia UK Inflation-linked bonds		
Credit			US IG US HY EU HY EM debt	EU IG	
Commodities				Energy Base metals Precious metals	
FX			USD, AUD, GBP, EUR, JPY, EM currencies		

* Risk appetite/return to risk - Data as at 4 October 2022. The views reflect those of the Investment Committee of the Multi-Asset team at MAQS. Other specific/tactical trades may be implemented in addition.

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