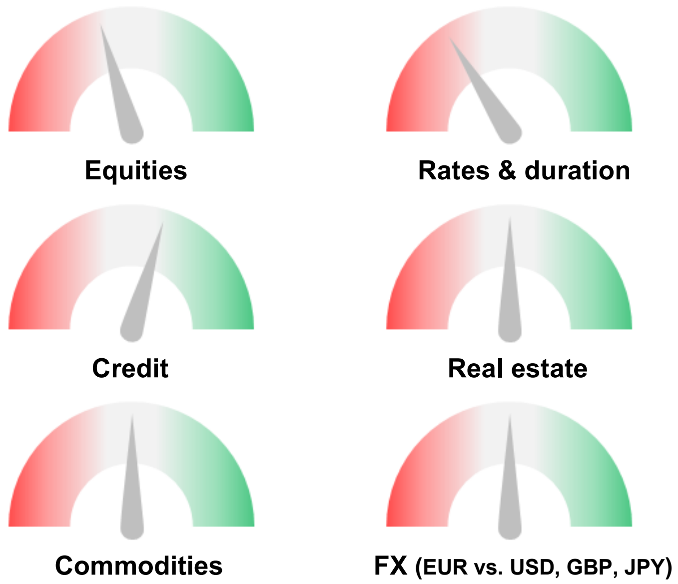
FOR PROFESSIONAL INVESTORS – 2 May 2019

ASSET ALLOCATION MONTHLY

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

BEWARE THE RISKS OF A FRAGILE GOLDILOCKS

Asset allocation overview



Maximilian MOLDASCHL
Senior Multi-Asset Strategist, MAQS
maximilian.moldaschl@bnpparibas.com
+44 20 7063 7247

Guillermo FELICES
Head of Research and Strategy, MAQS
guillermo.felices@bnpparibas.com
+44 20 7063 7196

SUMMARY

- **Goldilocks firmly in place –** Markets continue to price in a Goldilocks environment with equities making further gains. More stable, but generally moderate growth, contained inflation and dovish central banks underpin this environment.
- **But this remains a 'fragile' Goldilocks –** Two plausible scenarios could cause disruption: a global economic slowdown – this would hurt equities, but support government bonds – and an overheating US economy, forcing the Federal Reserve to resume tightening and likely causing both bonds and equities to suffer.
- **Asset markets currently reflect Goldilocks, but not its fragile nature –** Equities rallied again in April and are now up by roughly 15% so far this year, while the yield on 10-year US Treasury bonds is close to 20bp lower.
- **The US economy is still a bright spot –** Despite growth stabilising in major economies, markets are now more comfortable with the notion that more stable US growth is 'safer' than the tentative European or Chinese stabilisation.

ASSET ALLOCATION

- **Neutral developed equities and government bonds, but tactically short both –** Central banks are supporting markets, but this year's rally calls for caution in the face of prevailing risks. We are tactically short DM equities and 'core' EMU bonds.
- **Still favour being long carry –** The dovish tilt of the Fed and other major central banks continues to suppress market volatility, lower real yields and fuel investors' search for yield. We are currently long emerging market hard currency debt. This enjoys a high carry and is protected against EM currency weakness.
- **Exploiting asymmetries and building robust portfolios –** Given the uncertain macroeconomic backdrop, we favour building robust portfolios via diversification trades at this point in the cycle. We hold several positions/RV trades with interesting asymmetries such as long 5-year US Treasury vs. German bonds and long the French CAC vs. the German DAX.

MARKET REVIEW: APRIL 2019

Global equity markets did well in April (Figure 1). Developed market (DM) equities rose by 3.5%, led by EMU equities (+4.8%). Emerging markets (EM) lagged marginally developed equities. By contrast, government bonds in major markets were almost flat in April, and so were most major credit markets. This behaviour is consistent with tentative signs of growth stabilising, which appears to be putting a speedbump in front of the rally in fixed income markets in Q1.

In commodity markets, oil prices rose further mainly due to OPEC's decision to curb production, strengthening demand, and the end of the US waiver to let some countries import Iranian crude without sanctions. Oil markets boosted the entire energy sector (+5.7%). By contrast, gold fell in April after rallying in Q1.

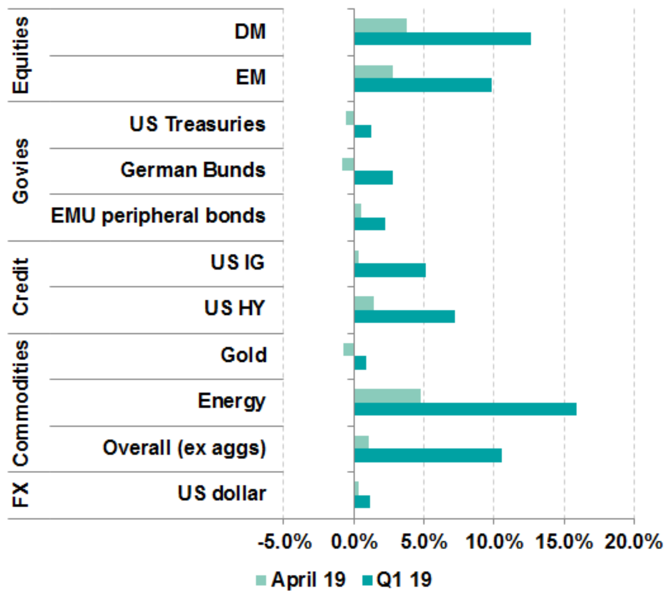
In currency markets, the US dollar gained on both sterling and the Japanese yen and was broadly stable versus the euro. Sterling dropped over the past month as uncertainty around the outcome of the Brexit process weighed on the currency.

Chaos continued to reign in UK politics despite talks between PM May and the opposition. After MPs could not agree by 12 April, the EU allowed the UK to stay in the bloc until 31 October, approving a six-month delay with a review of the process in June. Elsewhere, political and social tensions rose in Turkey, fuelled by the disputed results of local elections. The resulting political instability rattled Turkish markets.

Among central banks, the ECB left rates unchanged and pledged there would be no rate rises this year. President Draghi said the probability of a recession remained low, but tried to reassure markets by keeping all policy options open, including further cuts to already negative policy rates. However, details on new TLTROs were still lacking. As expected, Bank of Japan policy remained on hold.

On the macroeconomic front, Chinese data firmed decisively. PMIs published in early April were better-than-expected (manufacturing PMI 50.5 vs. 49.6 consensus). Retail sales (YoY 8.7% vs. 8.4% consensus) and GDP (YoY 6.4% vs. 6.3% consensus) also surprised to the upside, cooling market concern over growth. In the US, non-farm payrolls rose by a stronger-than-expected 196k (vs. 177k consensus), but average hourly earnings remained muted. In Europe, industrial production in the UK, France and Italy remained weak, but beat consensus expectations, reviving hopes of growth stabilising. The picture remained mixed in Germany: ZEW economic sentiment expectations improved (3.1 vs. 0.5 consensus), but the manufacturing PMI fell to its lowest level since 2013.

Figure 1: April 2019 vs. Q1 returns – equities and oil up

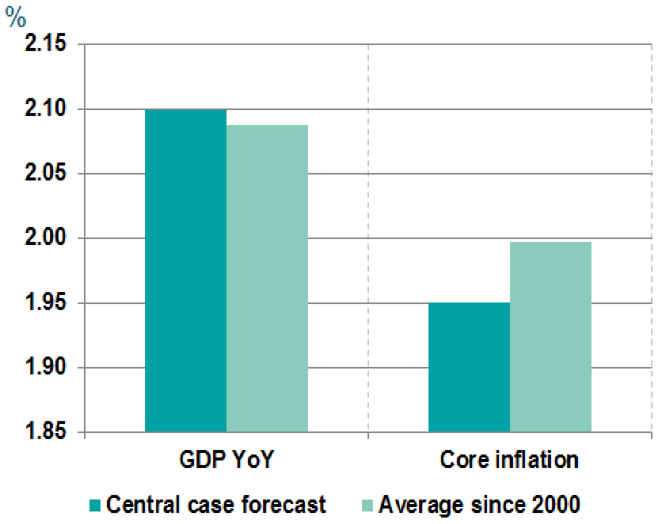


Source: Bloomberg and BNPP AM, as of 30/04/2019

GOLDILOCKS FIRMLY IN PLACE

Markets are firmly pricing in a 'Goldilocks' environment. On the macro side, solid but unspectacular US growth combined with moderate core inflation are reassuring investors that the Federal Reserve's dovish policy turn can be sustained for some time (Figure 2).

Figure 2: US growth and core inflation endorse Goldilocks



Source: Bloomberg and BNPP AM, as of 30/04/2019

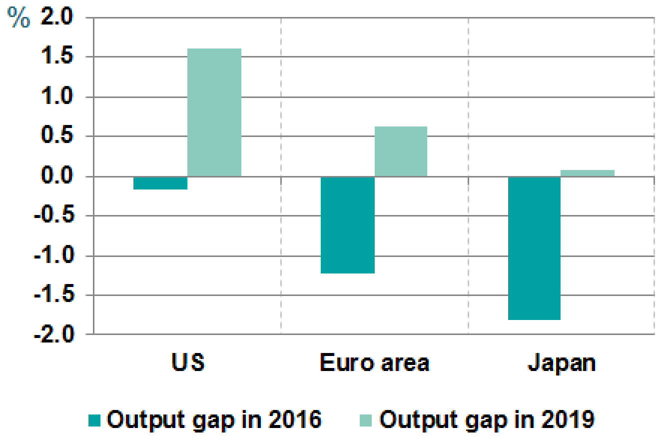
The Fed has acknowledged that it sees few inflationary pressures and has hinted that it will be more tolerant of inflation. Indeed, this is consistent with a potential change in its policy framework towards one where policy rates may need to be lower for longer to ensure that it hits its inflation target on average over time.

Financial markets continued to behave in line with the idea of 'Goldilocks'. Equities gained in April and fixed income markets were stable, following strong returns across all assets in Q1. This price action also suggests that investors are seeing signs of growth stabilising. However, they are yet to be convinced fully that these stabilisation forces are here to stay. Indeed, market expectations for Fed policy by the end of 2019 continue to price in rate cuts, suggesting that markets still see risks to growth.

But it remains a 'fragile' Goldilocks

In our previous monthly, we argued that the Fed and other major central banks that followed suit with a dovish tilt had engineered a 'Goldilocks' environment. But we described it as 'fragile Goldilocks' for various reasons. First, the global cycle is now more advanced than in previous periods when the Fed paused, notably after the growth scare of 2016 (Figure 3).

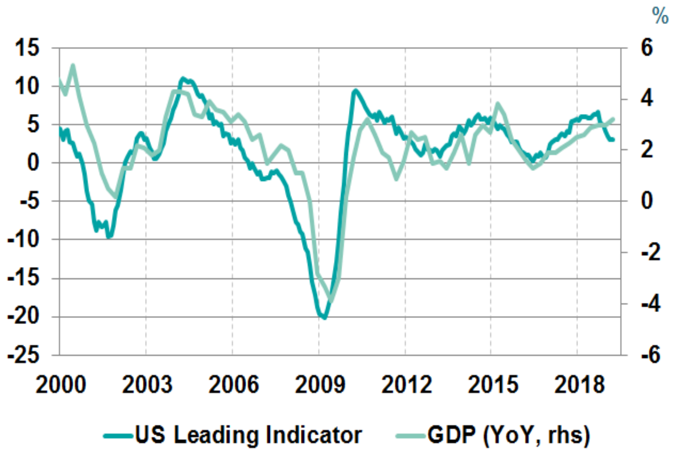
Figure 3: Positive output gaps suggest the global cycle is more advanced



Source: Bloomberg and BNPP AM, as of 30/04/2019

That means that further Fed tightening or negative shocks such as a renewed slowdown in China or Europe could tip the balance of the recovery, triggering a deeper slowdown or potentially a recession. Indeed, there are already some signs that the US economy could slow (Figure 4).

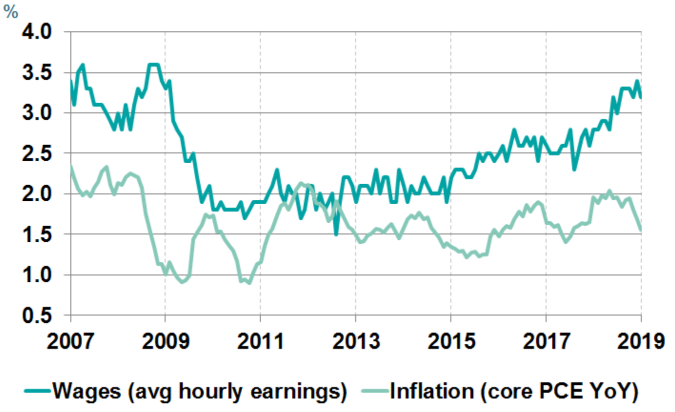
Figure 4: US leading Indicators and GDP growth



Source: Bloomberg and BNPP AM, as of 30/04/2019

Second, despite ongoing growth concerns, the US economy is expanding and the labour market continues to tighten. This is now more visible in prices (i.e. rising wage pressures) rather than quantities (the unemployment rate appears to be bottoming). So far, these wage pressures have not pushed core inflation higher (Figure 5). Yet, the overheating risk is still real, especially if higher oil prices contaminate inflation expectations and if the US economy continues to grow above potential.

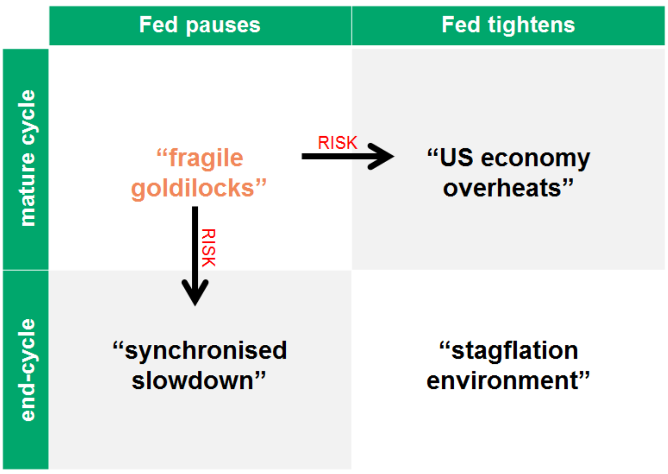
Figure 5: Rising US wage pressures should put upward pressure on inflation



Source: Bloomberg and BNPP AM, as of 30/04/2019

Last month, we explained the Goldilocks 'fragility' with Figure 6. The Fed pause has pushed markets firmly into the upper left hand quadrant, but we believe the risks of sliding towards a global slowdown (bottom left) or to an overheating US (top right) remain alive and real.

Figure 6: Cycle and Fed policy – scenario analysis



Source: BNPP AM, as of 30/04/2019

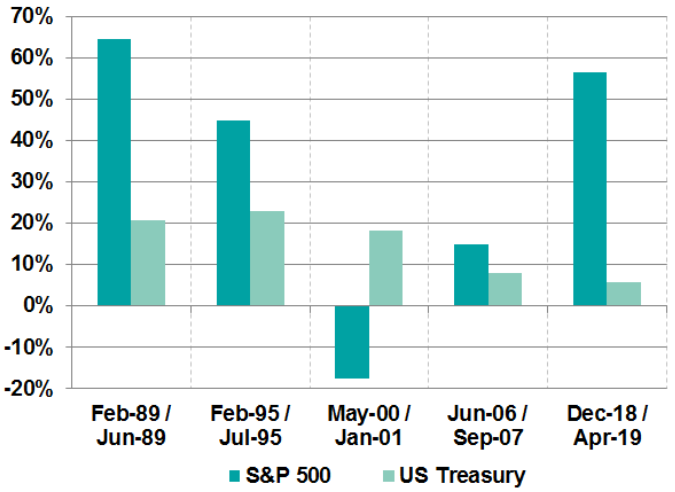
Is Goldilocks already in the price?

One of the most heated debates among market participants is whether the current Goldilocks environment has already been priced in. In other words, are the 15% rally in global equities and the 20bp fall in UST 10-year yields since the beginning of the year already capturing the Fed pivot and the economic fundamentals? A firm answer is difficult, but overall, there are reasons that make us cautious about chasing this rally.

We will investigate several issues that can help shed light on this question. Firstly, the typical asset price moves around the end of Fed tightening cycles. Secondly, equity valuations versus those of bonds. Thirdly, the risk of a market melt-up as cautious participants are sucked into the rally. Finally, the possibility that economic fundamentals/earnings deliver more positive news.

As for asset valuations, it is instructive to analyse how US equities and government bonds have behaved during end-cycle Fed pauses (i.e. those that are followed by rate cuts). Since the mid-1980s, end-cycle pauses have generally been associated with equity market rallies (Figure 7). Only in the 2000 pause did the rally peter out before the Fed started cutting. In the case of fixed income, US Treasuries generally rallied during pauses and continued to do so as the Fed cut rates. This year's sharp equity gains suggest caution when considering whether to chase the rally.

Figure 7: US equities and UST bonds generally do well during Fed pauses* (total annualised returns, %)



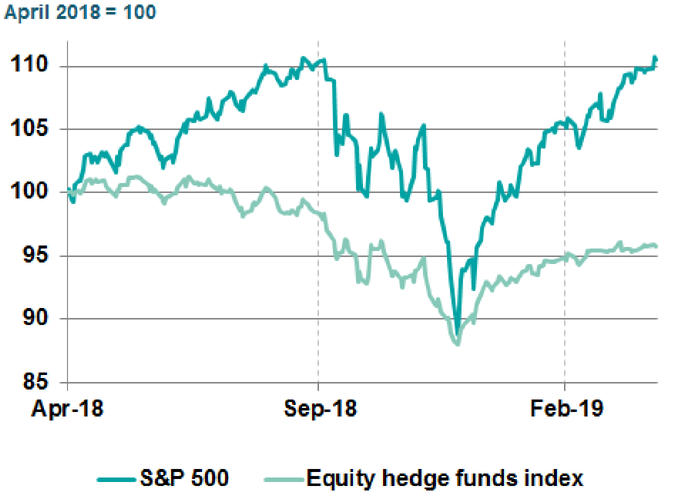
*Measured from the last Fed rate rise in the cycle to the first cut. The current episode is from the Dec 2018 rate rise to now.

Source: Bloomberg and BNPP AM, as of 30/04/2019

It can also be useful to examine the relative valuations of equities and bonds by comparing their real yields. After the global financial crisis, for instance, real UST yields fell sharply, but so did equity yields (measured as trailing earnings over price). After the recent recompression in relative valuations, equities are no longer materially more attractive than bonds in terms of yield.

One of the main bullish arguments is that the recent rally has not enjoyed broad investor participation. If that is the case, investors could be sucked into long positions if fundamentals do not deteriorate. The lack of participation can be gauged by the limited returns of some investor types such as equity hedge funds versus the S&P 500 (Figure 8).

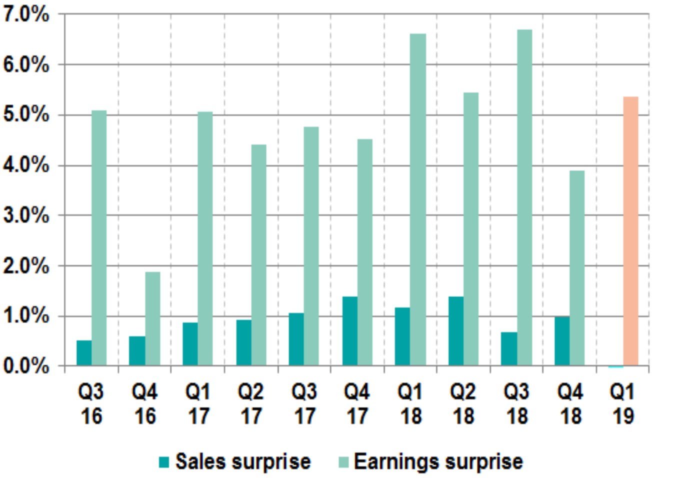
Figure 8: Long/short equity hedge fund returns are lower than those of the S&P 500 so far this year



Source: Bloomberg and BNPP AM, as of 30/04/2019

Finally, company earnings are still surprising to the upside, but one has to question how much longer this can last if labour costs continue to rise and inflation remains contained. This should eventually compress corporate margins in the absence of strong productivity gains (Figure 9).

Figure 9: S&P 500 earnings generally surprise to the upside

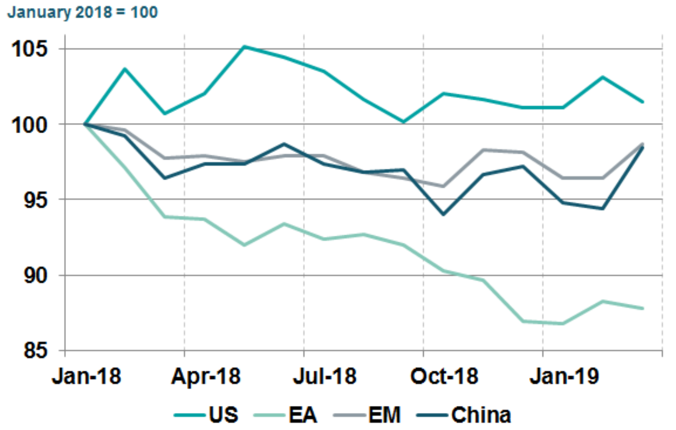


Source: Bloomberg and BNPP AM, as of 30/04/2019

US ECONOMY: STILL A BRIGHT SPOT AS DATA STABILISES

There are signs that activity data are stabilising after the growth worries around the turn of the year (Figure 10). It is also fair to say that those growth concerns have not abated. However, despite lingering growth worries about the US economic outlook, the outlook of other major economies remains fragile too.

Figure 10: PMIs: US, eurozone, emerging markets & China



Source: Bloomberg and BNPP AM, as of 30/04/2019

European growth, for instance, has remained weak overall. We expect growth of around 1.4% this year and the latest PMI data is still consistent with an expansion in activity, but only marginally so. Manufacturing, notably in Germany, has been the linchpin. Across countries, Italy has been the main area of weakness.

In China, economic activity is also starting to stabilise after weakening since mid-2017. This largely reflected weakness in manufacturing ("old China") rather than in the more dynamic services sector ("new China"). This stabilisation largely follows both monetary and fiscal stimulus as well as the prospect of a trade deal with the US (Figure 11). The reacceleration that followed policy stimulus in 2015-2016 was solid and had material and persistent spill-over effects on emerging market and eurozone growth.

This time, there are question marks over such spill-overs because the stimulus has focused on cuts in consumption tax and infrastructure spending, which tend to be less supportive of the global cycle than when the efforts are directed at the housing market which, unlike 2015, is not in distress.

Figure 11: Uptick in Chinese activity data follows stimulus

Source: Bloomberg and BNPP AM, as of 30/04/2019

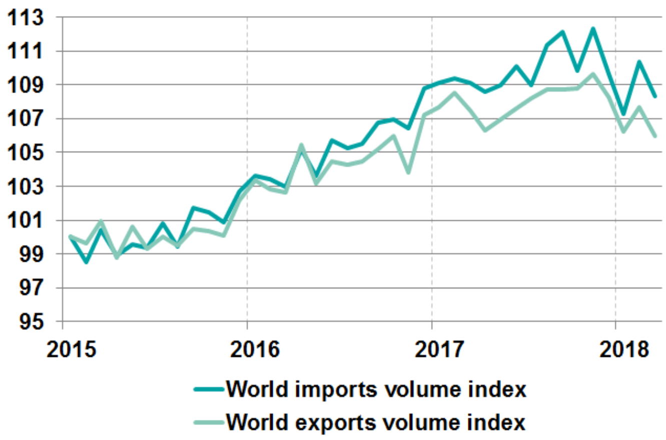
Looking ahead, the risk is that we reach a saturation point along the three dimensions that we have monitored to gauge the prospects of EM and China-linked assets: Chinese policy stimulus; US-China trade tensions; and Fed policy support.

Firstly, Chinese authorities have recently been quite vocal about not wanting to provide further stimulus. In fact, they have worried about over-leveraging since the 2015-2016 stimulus round.

Secondly, the US and China appear to be close to signing a trade deal. If anything, such a deal could disappoint markets in terms of the details. And this is happening in a context where global trade continues to be weak (Figure 12). Further, as we have discussed in the past, tensions between the US and China are likely to continue beyond trade (e.g. around intellectual property and information technology).

Finally, market participants already expect Fed cuts towards the end of the year, so unless the Fed delivers them and signals more easing, China-linked markets are likely to remain challenged.

Figure 12: World import and export volumes



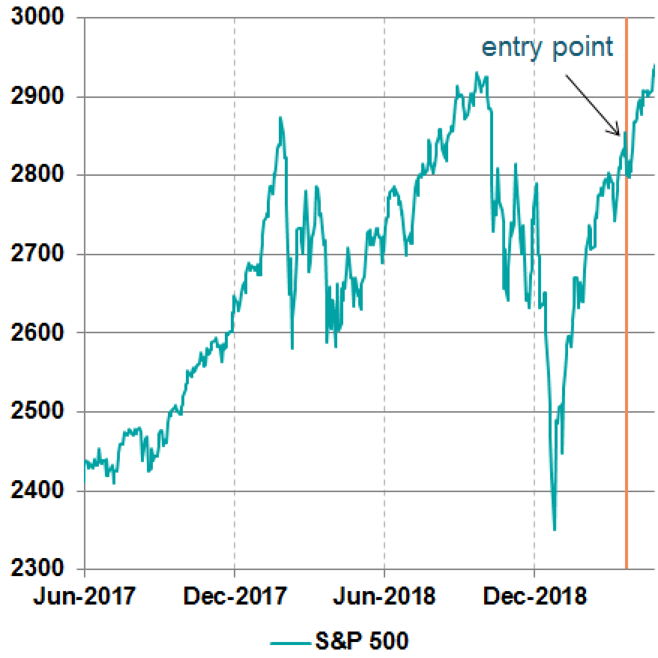
Source: Bloomberg and BNPP AM, as of 30/04/2019

ASSET ALLOCATION

Neutral DM equities and government bonds, but tactically short on both

The dovish tilt by central banks YTD is supporting markets, but the sharp rally in equities and bonds now calls for caution in the face of the risks of a global slowdown and US overheating. These risks may not seem imminent given the recent macroeconomic data and central bank support, but markets are not priced for them. The risk/reward looks tilted towards weaker equities and higher bond yields. For these reasons, we are tactically short DM equities and 'core' EMU bonds (Figure 13).

Figure 13: Good news priced in – tactically short equities



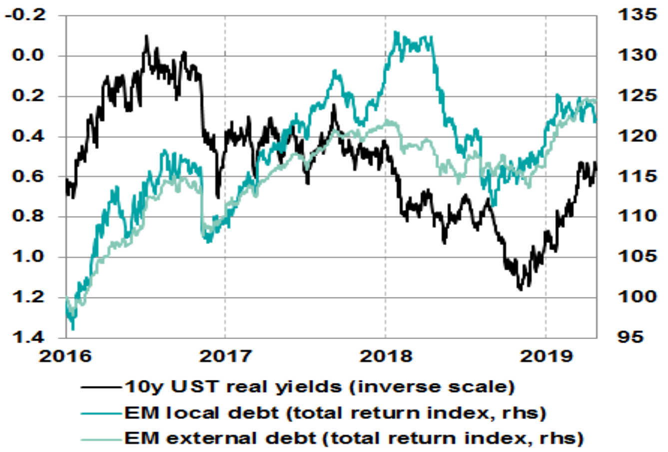
Source: Bloomberg and BNPP AM, as of 30/04/2019

Look to be long carry

The dovish stance by the Fed and other major central banks should continue to squeeze market volatility, lower real yields and thus revitalise investors' search for yield. In our view, this environment favours being long carry assets.

We believe emerging market debt looks interesting from a carry perspective (Figure 14). Indeed, we entered a long EM hard currency debt position a few weeks ago. This is a USD exposure with high carry (roughly 6%) and it is benefiting from higher oil prices. We still prefer hard currency debt at this juncture. Local currency debt has been hurt by a strong US dollar vs. EM currencies recently. 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 14: Stable/lower real yields to support carry assets



Source: Bloomberg and BNPP AM, as of 30/04/2019

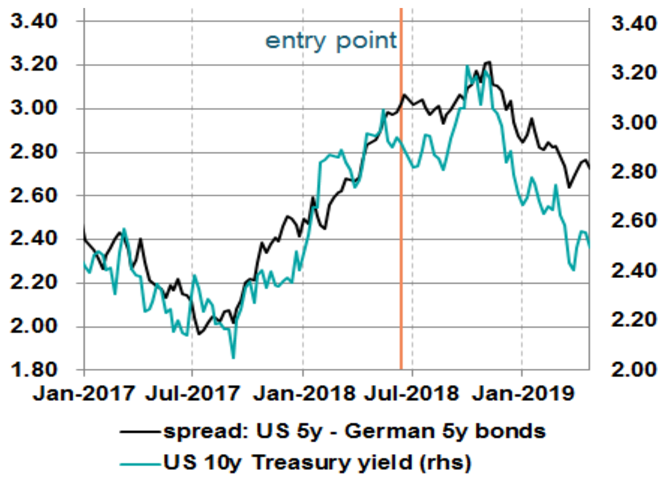
Of course, there are other sources of carry than EM debt. For instance, European real estate (REITs) can be an interesting alternative given its attractive valuation relative to net asset value (NAV) and high carry versus government bonds. We are looking for better entry points before adding a position in REITS.

Exploiting asymmetries & building robust portfolios

Given the uncertain macroeconomic backdrop, we believe that building robust portfolios and holding diversification trades is key. In government bond markets, for instance, the differential between US and German yields is still high, so we continue to be long 5-year US bonds versus 5-year Bunds.

This is not just attractive because of stretched valuation differences; it also has good defensive characteristics in risk-off environments (Figure 15), with US yields having "more room to drop" in a slowdown scenario. We believe this makes the this relative value trade a good portfolio diversifier.

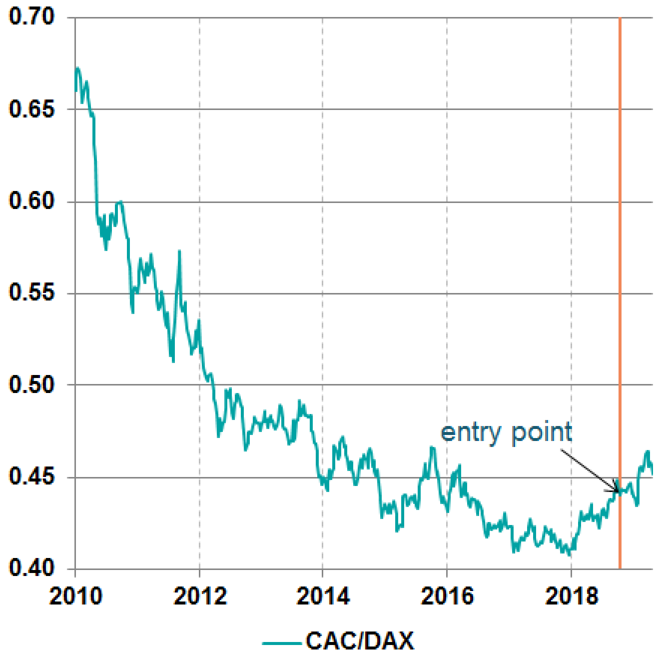
Figure 15: 5y UST vs. Bunds has defensive characteristics



Source: Bloomberg and BNPP AM, as of 30/04/2019

Elsewhere, to build robust portfolios, we are continually exploring trades which are geared to thematic views. Blinded by the prospects of a trade deal, investors have seemingly forgotten about further China-US tensions. We continue to think that 'old China' remains challenged, and that protectionist 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, having recently added to the trade. As Germany is more exposed than France to de-globalisation, this relative value trade aims to reduce our exposure to possible renewed trade tensions. Notably, the trade has done well in recent weeks (Figure 16).

Figure 16: Long CAC/DAX recently worked well



Source: Bloomberg and BNPP AM, as of 30/04/2019

STRATEGIC OVERVIEW OF KEY POSITION CHANGES IN APRIL 2019

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

APRIL

LONG EM HARD CURRENCY DEBT — OPENED — 01/04/19

- Given the search for yield and China's stimulus efforts, we opened a long EM hard currency debt position (30% conviction).

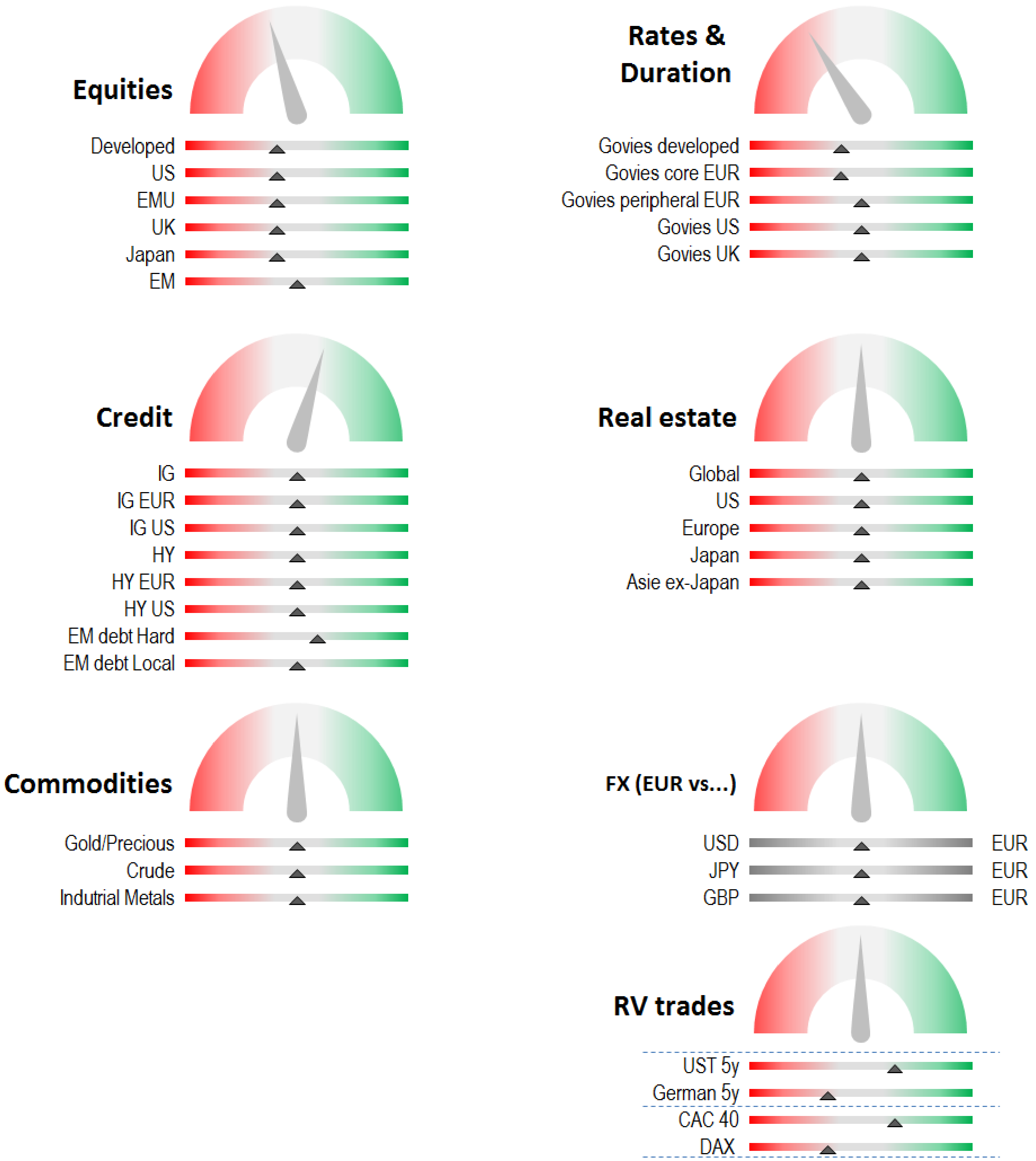
SHORT BUNDS — CLOSED — 01/04/19

- We reduced the size of our overall underweight fixed income position, cutting the tactical underweight in Bunds we took in mid-February for bond heavy portfolios.

LONG CAC/DAX — INCREASED — 10/04/19

- Consolidation might be over and the overall picture is still strategically bullish, therefore we added 25% conviction, bringing the overall exposure to 50%.

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. Views expressed are those of the Investment Committee of MAQS, as of May 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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As at May 2019.