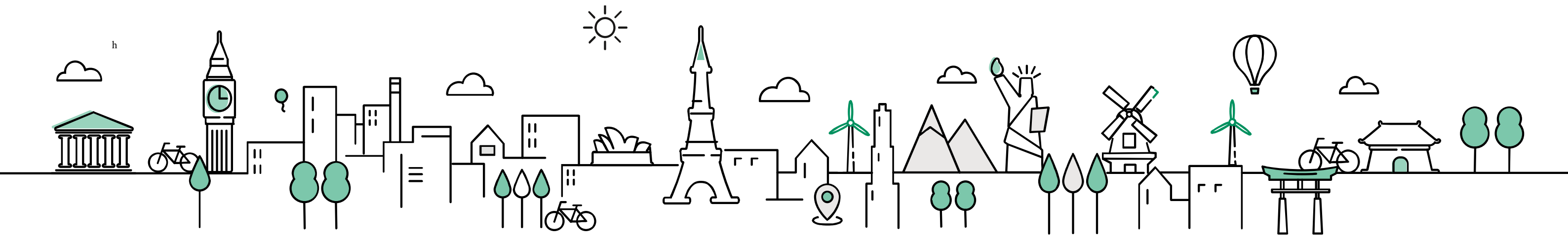

Asset Allocation Monthly 4/2021

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KEY MARKET DRIVERS

- Rising interest rates, with both higher real yields and inflation expectations reflecting stronger growth and supply constraints
- US and UK vaccine rollouts making progress, eurozone lagging behind

VIEWS & ASSET ALLOCATION

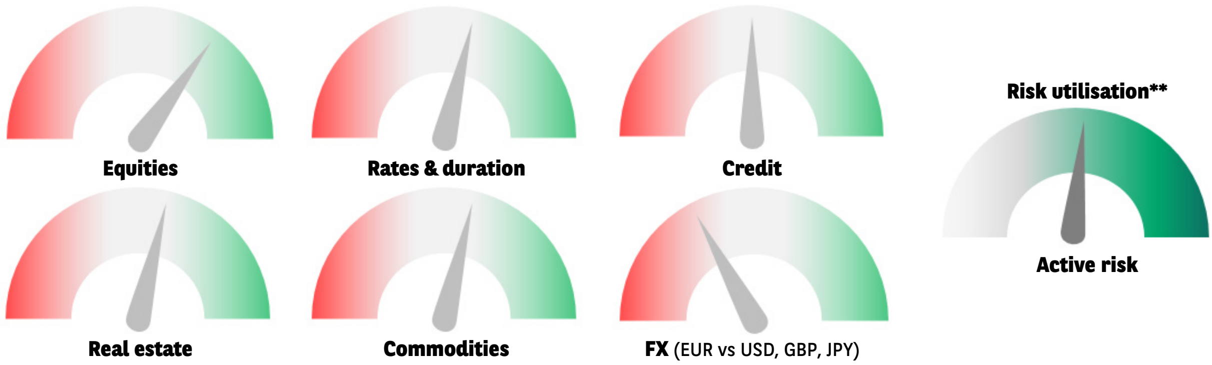
- Fundamentals and market dynamics suggest medium-term upside in risky assets
- Bullish technical signals have started to appear since early March in some equity markets, but our indicators still advocate caution, with sideways moves expected during H1 2021

EBB AND FLOW

The ebb and flow of US real interest rates, inflation expectations and the future level of policy rates remain the key drivers for asset returns globally. For example, local currency emerging market debt yields have largely mirrored those of the US, as has the relative performance of value versus growth stocks. Eurozone government bond yields, however, have retraced part of the February sell-off thanks to a more assertive European Central Bank.

The advance of US interest rates continued in March, albeit more slowly and with a different mix. Ten-year Treasury bond yields gained another 34bp after a similar jump in February, and the market's forecast for the future level of the fed funds rate also rose. The most significant change in the market dynamic was the balance between the contribution from real yields and that of inflation expectations: In February, most of the gains in medium-term nominal yields were from real yields, while in March, it was inflation expectations that rose the most (see Exhibit 1).

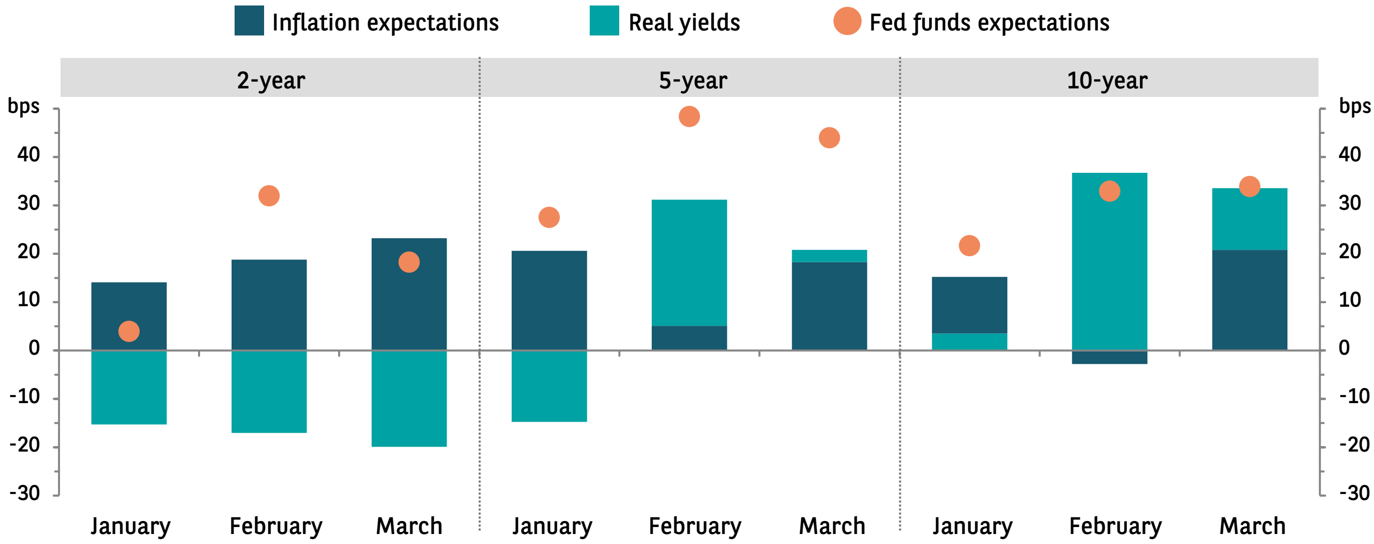
Core asset class views*



BNP PARIBAS ASSET MANAGEMENT

The asset manager for a changing world

Exhibit 1: Monthly change year-to-date in the components of nominal Treasury yields and fed funds expectations



Data as at 31 March 2021. Fed funds expectations based on Eurodollar swaps. Sources: Bloomberg, BNP Paribas Asset Management.

Not all the market moves are necessarily what the US Federal Reserve would like to see. On the one hand, the Fed has conveyed that it is unconcerned about the increase in market yields as this reflects stronger growth and inflation. Five-year/five-year inflation expectations have risen to 2.4%. While this is the highest level since 2018, it is still below pre-Global Financial Crisis levels of nearer 3%, which was not incidentally the last time the Fed achieved its inflation objective of 2% as measured by core PCE (personal consumption expenditures). The market expects much stronger inflation over the next year as the economy comes out of lockdown, the latest fiscal stimulus boosts growth, and supply chains remain disrupted. In the near term, inflation could well overshoot the Fed's target, but the market does not foresee a change in the pre-existing long-term disinflationary dynamics.

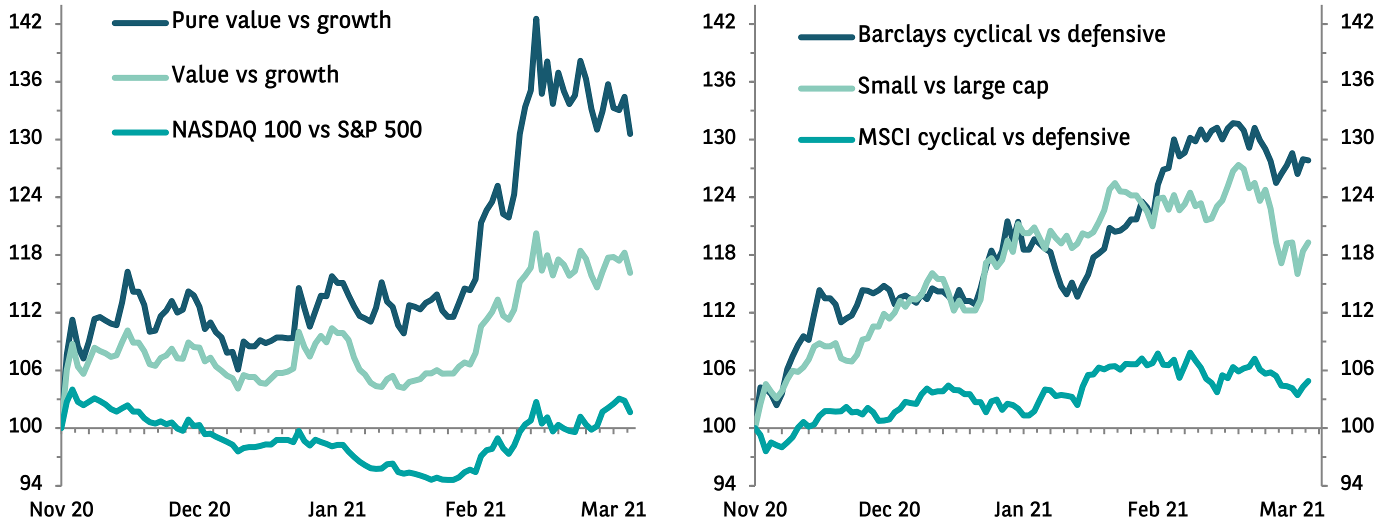
For all the lack of concern from the Fed about market interest rates, there is concern about the market expectations for the level of fed funds in two years' time and beyond. The latest 'dot plot' showed that only seven out of 18 Federal Open Market Committee (FOMC) members expect an increase in policy rates by 2023. The Fed has emphasised that an increase in rates would come only after quantitative easing (QE) purchases had ended. This is unlikely before 2023. The market nonetheless increased its forecast for the fed funds rate and is currently pricing in at least a 50bp increase within two years. This expected rise in policy rates may be another reason why medium-term forecasts for inflation have not increased further: despite the Fed's insistence that it will tolerate above-target inflation, the market appears to doubt it will be so indulgent. In its view, the expected increase in policy rates would slow growth and constrain inflation.

At the same time, there is a risk of much higher headline consumer price inflation this summer. It could reach 3.5%. Market observers are well aware of this possibility as much of the gain is simply from base effects, but such high readings could still spook the market and lead to a bigger sell-off in government bonds. Similarly, if the Fed does manage to convince the market that it will be patient before tapering QE or raising rates, this would lower expected policy rates and then also real yields, but the fall in nominal yields could be more than offset by an increase in inflation expectations. We thus remain cautious about the outlook for interest rates and prefer assets that can benefit from the reflation trade.

EQUITY STYLE ROTATIONS

With the announcement of positive vaccine results last November, cyclical and small-cap stocks led the gains in US and global equities. Then after the passage of the latest US stimulus package, value versus growth took over the lead. As the recovery continues around the world, albeit fitfully in Europe, we would expect cyclicals and small caps to continue to outperform, but see greater near-term potential for value (see Exhibit 2).

Exhibit 2: US equity index relative performance
6 November 2020 = 100



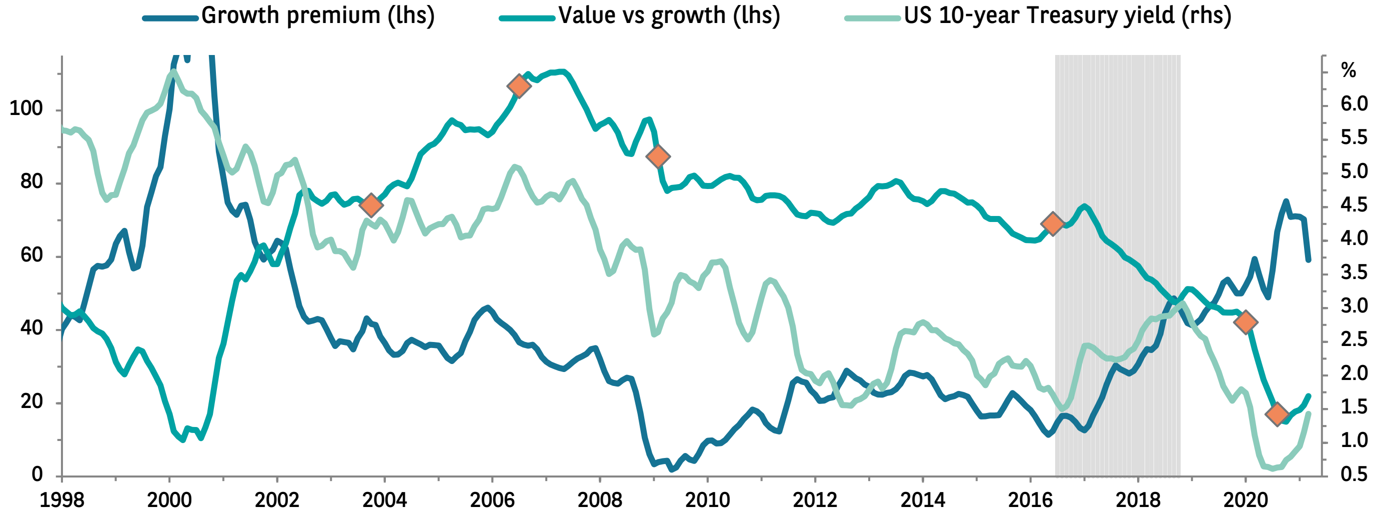
Data as at 31 March 2021. Note: Barclays cyclical = energy, materials, capital goods, transportation, automobiles & components, consumer durables & apparel, banks, diversified financials and semiconductors; defensive = food & staples retailing, food beverage & tobacco, healthcare equipment & services, pharmaceuticals, biotechnology & life sciences, telecommunication services and utilities. MSCI cyclical = consumer discretionary, financials, industrials, information technology, materials, real estate; Defensives = consumer staples, energy, healthcare, communication services and utilities. Pure value indices from Citigroup, value vs. growth defined by MSCI, small vs. large is Russell 2000 vs. S&P 5000. Sources: FactSet, Bloomberg, BNP Paribas Asset Management.

Given that value stocks have underperformed growth stocks since the Global Financial Crisis, investors have become hopeful that the recent outperformance will be sustained. It is important to recognise, however, that the causes of the previous underperformance varied over time. The initial lag after the GFC simply reversed the gains during the US housing bubble. Subsequently, from 2012 until Trump's election, value stocks actually performed roughly in line with growth. Another period of significant underperformance followed Trump's election. This deepened through to the pandemic lockdowns. The turnaround we have seen since last summer has so far only partly reversed the pandemic-related underperformance (see Exhibit 3).

This performance deficit, however, is one of the factors that argues for continued gains. The first key driver for superior value returns is the shift in demand from lockdown beneficiaries such as technology to 'reopening beneficiaries' such as airlines. The second driver is higher interest rates. We expect this to persist, though one should not forget that the correlation between interest rates and value outperformance has not always been positive. There was a similar sell-off in Treasury yields during the first part of the Trump presidency when nominal 10-year yields rose from 1.4% to 3.2%, but value underperformed growth by 28 percentage points between July 2016 and October 2018.

A crucial difference between now and 2016 is valuations. At the beginning of the 2016 episode, growth stocks were arguably cheap compared to value. The forward price/earnings ratio for Russell 3000 growth stocks was just 20% higher than the multiple on value stocks and below the premium during the previous 15 years. By contrast, the multiple is now 64% higher. That is down somewhat from the lockdown peak of 80%, but still high, in our view (see Exhibit 3).

Exhibit 3: Value versus growth valuation premium, relative performance and 10-year US Treasury yield



Data as at 31 March 2021. Note: Russell 3000 indices. Valuation premium based on forward P/E. Sources: FactSet, Bloomberg, BNP Paribas Asset Management.

One factor that could further threaten the premium, particularly for technology stocks, is the prospect of increased taxation and regulation. Members of the Biden administration have previously called for a breakup of some of the dominant tech players. The administration wants to raise the corporate tax rate to help pay for the proposed infrastructure spending package. The technology sector did not benefit as much as others from the Trump tax cuts since a greater share of the sector's revenues comes from abroad. It might suffer less from a possible increase, but there are also proposals to impose a global minimum tax rate, which could affect the profits of companies in the sector much more.

COUNTRY-STYLE ALLOCATIONS

An alternative to allocating to value or cyclical stocks is to overweight countries or regions that are more correlated with those factors. Since last November's vaccine announcements, relative country and region returns have not matched the outperformance of cyclical stocks against defensive stocks, or value stocks against growth stocks. Of the countries listed below, the ones with the greatest outperformance relative to the MSCI World index in US dollar terms include the UK due to its greater exposure to commodity sectors and underexposure to technology and the eurozone in local currency terms. The UK's relative performance also has had the highest historical correlation to value vs. growth returns. To capture cyclical outperformance, one might look to Canada and emerging markets as they have had the strongest positive relationship in the past (see Exhibit 4).

Exhibit 4: Country/regional equity index relative returns and correlations with 'value vs. growth' and 'cyclical vs. defensive'

	Return vs MSCI World since November 2020		Correlation			
			Since November 2020		Since inception	
Index	US dollar	Local currency	Value vs growth	Cyclical vs defensive	Value vs growth	Cyclical vs defensive
Cyclicals	12.5					
Defensives	-8.8					
Value	8.4					
Growth	-7.9					
Australia	3.3	-2.5	31.4	32.1	4.3	31.9
Brazil	-2.4	0.5	3.1	16.6	10.0	36.7
Canada	6.5	1.9	48.4	46.7	-2.0	39.8
China	-15.5	-16.9	-53.5	-7.5	2.1	20.6
Emerging markets	-2.1		-26.3	14.7	-3.4	41.3
Europe	2.5	2.3	48.8	13.5	17.1	14.6
Eurozone	5.4	6.2	46.4	26.8	11.6	25.7
Germany	4.0	4.8	16.7	-7.3	4.4	27.3
Japan	-2.7	4.7	3.8	-0.5	-2.4	-0.9
United Kingdom	6.8	0.7	66.2	31.6	30.3	5.5
United States	-0.8		-49.9	-20.6	-8.8	-29.6

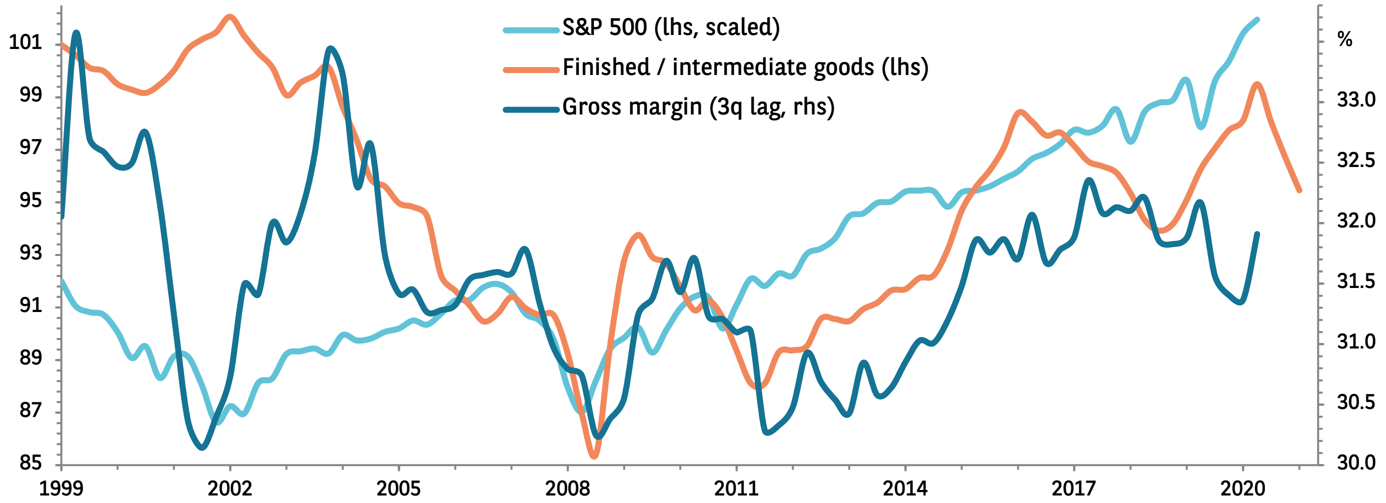
Data as at 31 March 2021. Note: Relative return calculated from 6 November 2020; total return in local currency except for regional indices that are in USD. All indices are MSCI's. Cyclical index defined as energy, materials, capital goods, transportation, automobiles & components, consumer durables & apparel, banks, diversified financials and semiconductors; Defensive defined as food & staples retailing, food beverage & tobacco, healthcare equipment & services, pharmaceuticals, biotechnology & life sciences, telecommunication services and utilities. Both are based on the underlying MSCI AC World indices. Correlations calculated in local currency total returns where possible, otherwise with US dollar returns, weekly since November 2020 and monthly since index inception. Sources: FactSet, Barclays, BNP Paribas Asset Management.

INFLATION RISK FOR EQUITIES

The 125bp increase in US Treasury yields since last June has not yet posed a problem for equities, though there is always the worry that further rapid increases could prove too much for them to bear. One reason investors have welcomed the increase is that the rise in real yields reflects expectations for higher growth. A rise in inflation should be reflected in higher nominal earnings.

Whether inflation proves to be so benign will depend on whether companies can pass on higher input costs to consumers. Intermediate goods costs have already been rising faster than finished goods prices, weighing on margins at US companies. Thanks to the pandemic, companies had already seen gross margins fall over the course of last year from 32.2% to 31.4% before rebounding recently (see Exhibit 5).

Exhibit 5: Relative price levels and S&P 500 corporate margins
Finished and intermediate goods; producer price indices (PPI)



Data as at 31 March 2021. Sources: BLS, FactSet, BNP Paribas Asset Management.

We do not, however, see a significant risk on this front. As the US economy reopens further, consumers will likely be more tolerant of paying higher prices for activities that were unavailable due to lockdowns. Competition will be limited as not every business will resume trading. In fact, some companies may be able to use the resumption in activity to restore their margins to at least pre-pandemic levels.

MARKET DYNAMICS INPUTS

Our market dynamics tools point to sideways moves in the first part of the year. Over the longer term (through the second half of 2021), they continue to suggest an uptrend in equity markets.

For equity markets, the medium to long-term signals have been bullish for some time and the long-term ones continue to be so now. For cyclical assets such as commodities and emerging market local currency debt, the long-term signals are also bullish.

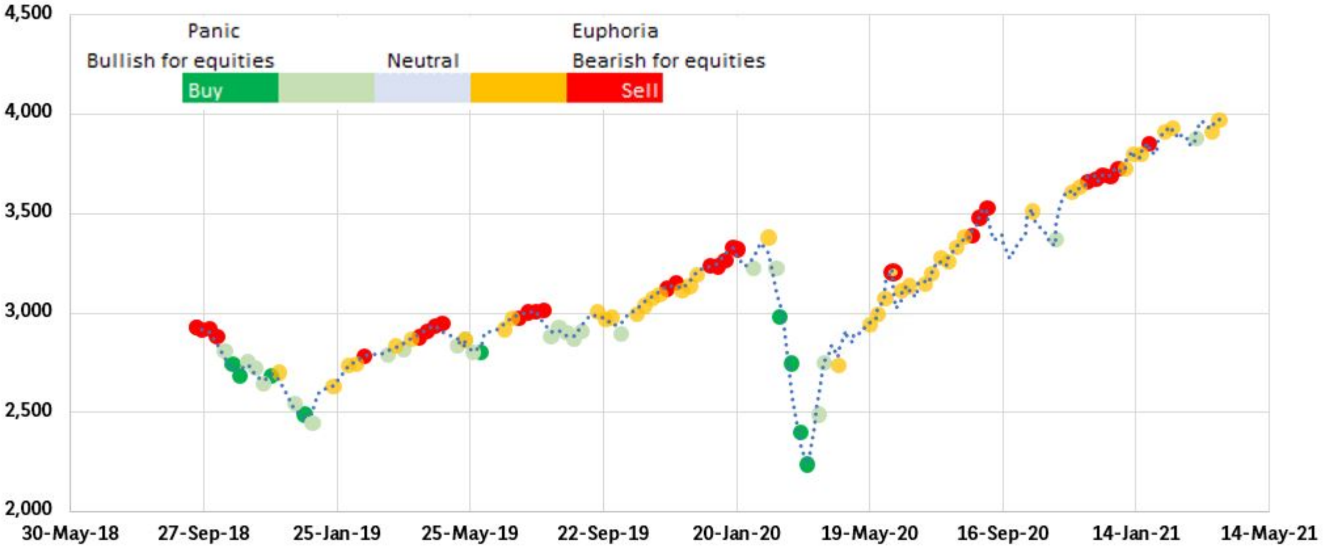
Short and medium-term technical signals showed strong signs for a near-term correction in the US and other major equity markets in mid to late January. In early March, our indicators turned more bullish in the short run after the expected consolidation.

For core fixed-income markets, short-term technical signals pointed to the risk of some upside in yields at the beginning of the year, but they are more neutral now. In the medium to long term, they still flag upside for yields.

Finally, for the USD, short-term signals suggest a continuation of a limited reversal in its recent weakening, but the medium to long-term signals are still bearish, consistent with further USD weakness.

Our blended 'market temperature' indicator was 'red hot' in late January, but turned neutral late in February after the equity market correction.

Exhibit 6: Evolution of market temperature since July 2018 (S&P 500)
All temperatures shown except neutral



Data as at 30 March 2021. Sources: Bloomberg, BNP Paribas Asset Management.

ASSET ALLOCATION

The cyclical recovery expected for this year will be delayed, but not cancelled, by the ongoing challenges of the coronavirus pandemic. Our medium-term scenario favours risk and equities given the fundamental factors and economic policy support.

We expect the cyclical recovery to gain further traction later this year. So far the recovery has been led by the US given its progress on vaccinations, aggressive fiscal stimulus and pent-demand. Growth in other major economies that have been hit by COVID-19 (e.g. Europe and EM ex Asia) should accelerate as vaccinations lead to re-openings. Our medium-term scenario continues to favour risk and equities given the fundamental factors and economic policy support.

The investment committee has gradually increased its risk exposure, mainly via regional equities and more recently by restoring a long commodities allocation. The regional equity exposure seeks to find a balance between 'growth/quality' and 'value/cyclical' styles that helps provide some insulation against rates volatility while providing a diversified allocation. The current active risk is slightly above half the maximum risk tolerance levels, giving plenty of room to add on dips.

Equities ↑ (new)
The investment committee decided to take an overweight position in Italian equities relative to eurozone equities. The prospect of a more unified and technocratic Italian government led by Mario Draghi should act as a catalyst for a continued reduction in Italy's risk premium and for unlocking further gains in the 'value'-oriented FTSE MIB.

We are long on equities overall. We are long emerging market equities given our view that China/Asia growth will remain strong. EM ex Asia is cheaper and should benefit from a cyclical recovery and the fact that, in our view, valuations are not onerous. In early March, we profited from the correction to buy Chinese, US and Japanese equities.

The rollout of vaccines, the reduction of lockdown restrictions, expectations of further stimulus in the US and continued ample monetary stimulus should support equities over the medium term. Equity risk premiums are still high relative to real bond yields in the US, so equities remain an attractive option even if absolute valuations (e.g. P/Es) appear high.

We remain long EMU small caps versus large caps. Small caps are likely to continue to outperform in an economic recovery. They should benefit from being high beta and from their more attractive valuations relative to large caps.

Government bonds ↑ (new)
Early March, we used the fixed income capitulation to take profit tactically on our short EMU bonds. We are still long EUR inflation-linked debt, and we have a USD curve steepener via options.

Core yields are still historically low despite their recent rise. Policy rates are at close to the zero bound and central bank asset purchases are containing yields. Term yields are likely to see upside pressure, however, as the economic outlook improves on the back of vaccination campaigns. Bond yields in the eurozone are already pricing in an expansion of the ECB's pandemic emergency purchase programme (PEPP). As a result, eurozone bond yields look asymmetric to the upside in the event of a cyclical recovery in the bloc in the medium run. Being long EUR inflation-linked debt while being short eurozone bonds gives our portfolios upside in reflationary environments as we are effectively long breakeven inflation in the eurozone.

We are long emerging market local currency debt. We see room for further spread compression in the current search for yield. As for currencies, we see plenty of room for appreciation, especially if the USD resumes its downtrend.

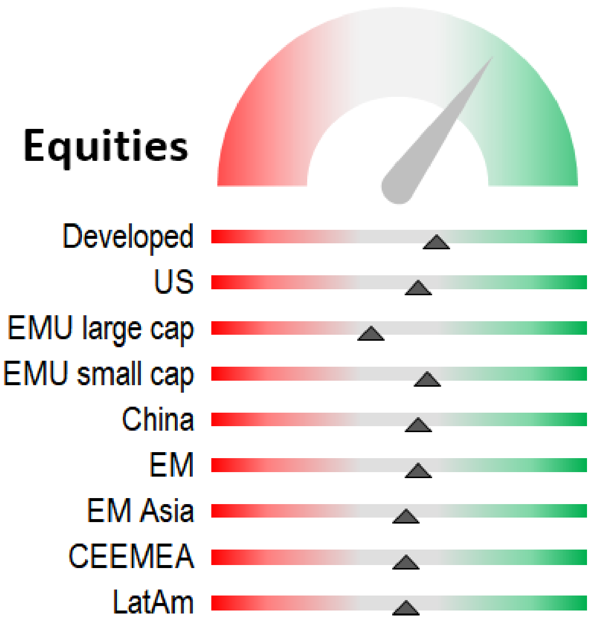
Credit ⇔ (unchanged)

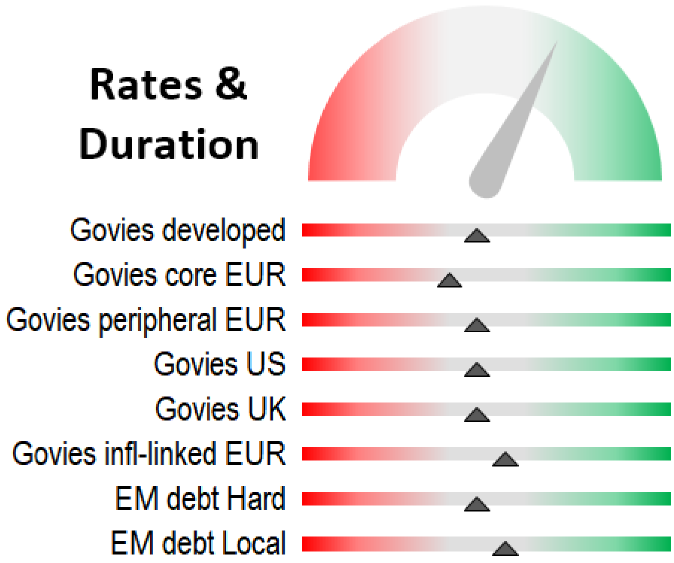
Currencies € ↓ (unchanged)
Since late 2020 we were worried that the consensus view of a weaker US dollar had become crowded. We believed the news on the fundamentals was contradicting this consensus assessment. Thanks to fiscal stimulus in the US, while in Europe there are extended lockdowns and delayed vaccine rollouts, we expected the US economy to outperform Europe significantly in 2021. Consequently, we turned tactically bullish on the US dollar against the euro, while recognising that in the medium term, the US dollar may come under pressure due to its high valuations and the prospect of an acceleration in growth outside of the US.

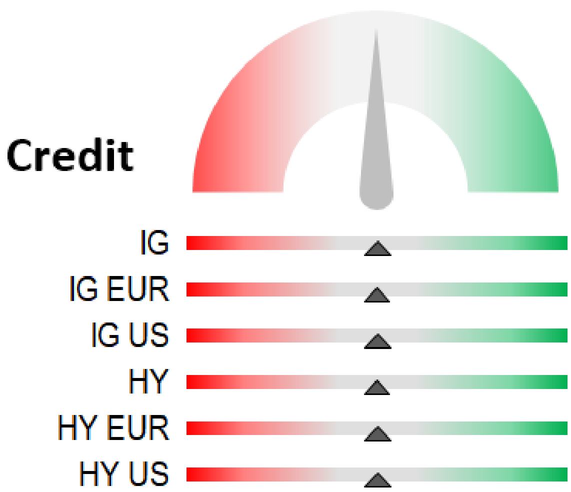
Commodities ↑ (new)
We bought back commodities in the March consolidation as we are still bullish in the medium term. We remain long gold but we have cut part of the exposure. Gold should be seen as a currency that cannot be debased by central banks and one that is a good hedge against the risk of inflation.

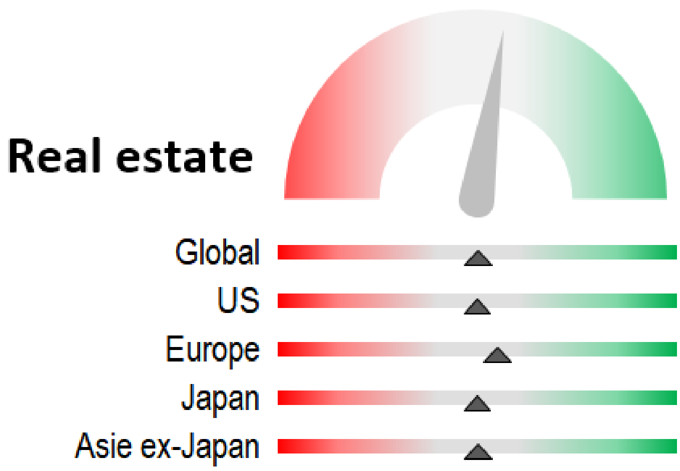
Thematics ↑ (unchanged)
We have a position in thematic investments: global environment, energy transition and artificial intelligence. We regard the current investment as a first step and we aim to allocate more to thematic investments, and to broaden the spectrum of themes invested in.

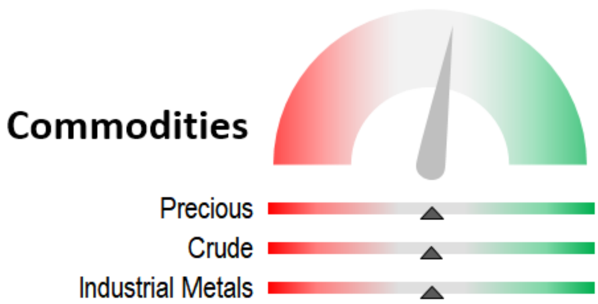
CORE ASSET ALLOCATION DASHBOARD

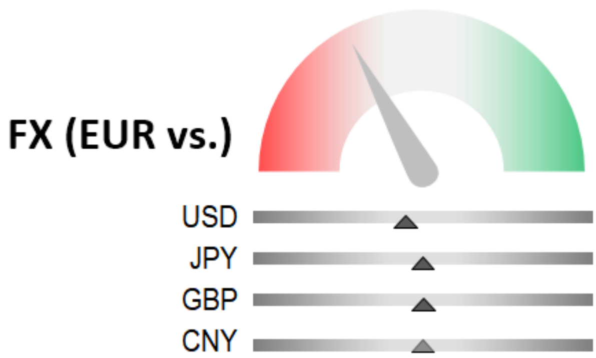












*The core asset class views dashboard reflects the key views of the Investment Committee of the Multi-Asset team at MAQS. Other specific/tactical trades may be implemented in addition and are listed at the end of this publication. ** Risk utilisation/active risk is a measure of the tracking error (as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

DISCLAIMER