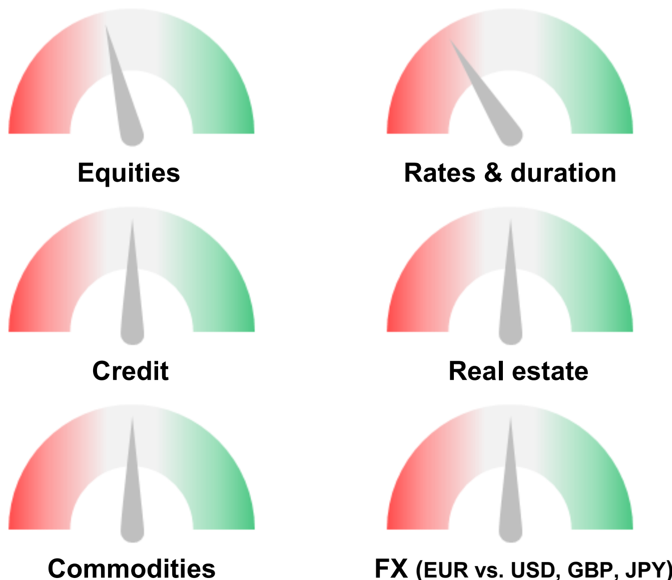
ASSET ALLOCATION MONTHLY

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

BETWEEN GROWTH FEARS AND POLICY SUPPORT



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SUMMARY

- **It's all about growth –** Markets have gone through violent swings lately, with the latter part of 2018 seeing a sharp re-pricing of economic growth assumptions juxtaposed by a strong rebound of risky assets more recently.
- **A lot of bad news in the price? –** Macro data has been weak but at face value, risky assets fell by more than was justified late last year. With consensus EPS expectations now cut sharply as well, the bar was arguably low for a bounce.
- **Central banks to the rescue? –** Dovish signals from the Fed and renewed stimulus in China have eased markets recently. With quantitative tightening (QT) on the cards in the medium term, we think that hopes that central banks will support markets beyond the short term are misplaced.
- **Earnings delivery will be key –** In this new paradigm, we see the scope for multiple expansion as limited and in such an environment, earnings will have to do the heavy lifting.
- **Downside risks still lingering –** We are in an atypical late cycle and the balance of risks around our base case economic outlook are to the downside still, not least because key issues such as QT and China-US trade tensions are far from resolved.

ASSET ALLOCATION

- **Strategically neutral equities –** More volatility is still our base case. With risk assets sat bang in the middle of our scenario analysis range, our structural directional conviction on equities remains low. Our preferred long-term allocation is neutral.
- **Underweight fixed income –** We remain underweight EMU bonds given the prospect of ECB monetary policy normalisation.
- **Aiming to be tactical –** We have adopted an ever more tactical approach, most recently entering a tactical short position in equities into the recent bounce.
- **Diversifying –** To build robust portfolios, we continue to hold positions and RV trades with asymmetries.

BNP PARIBAS
ASSET MANAGEMENT

The asset manager for a changing world

MARKET REVIEW: JANUARY 2019

In late 2018, many investors turned highly pessimistic after global equity markets were derailed sharply. As we summed up in our previous market review, this was linked to concerns over global, and more specifically Chinese, growth. But after December's correction, the bar was low for markets to rebound.

While uncertainties did not disappear and macroeconomic data remained mixed, investors reassessed their positions and turned more positive on risk assets, triggering a sharp catch-up in global equities in January (Figure 1).

The S&P 500 equity index is now back above 2600 points, regaining about half of the 20% loss it suffered between its peak in October and its trough in December. In Europe, the EuroSTOXX 50 returned more than 5% in January and the Japanese Topix gained about 4%.

This risk-on mood was also obvious in riskier credit assets. US high-yield credit rose by about 4%, returning to October 2018 levels. European high-yield also rallied, but to a lesser extent.

One key element that eased investors' concerns was the US Federal Reserve signalling a more dovish stance. After lowering its "dot plot" forecasts in December, the Fed adopted a more flexible tone. Markets are now pricing a pause in the US hiking cycle. Gold rallied further, trading above USD 1300 per ounce. Its outperformance in late 2018 was due to a risk-off environment. Its second leg-up in January was driven by expectations of lower rates and a weaker US dollar as investors discounted a pause in Fed tightening. Indeed, the dollar index is now about 1.75% lower than its December 18 peak.

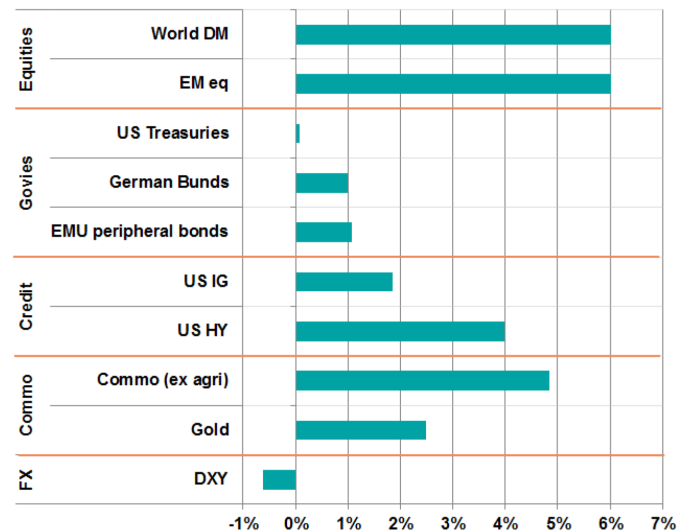
An easing of China-US tensions over trade also fuelled the rebound in risk assets. In the meantime, Chinese authorities appeared to ramp up efforts to stimulate the economy after weak macroeconomic data for December. The perceived stimulus drove a rebound in Asian equities with the CSI 300 index rallying throughout January. On the currency side, the CNH and AUD rose. Commodities rebounded, especially the prices of energy and industrial metals.

On the political front, uncertainties continued to weigh on markets. The Brexit saga remains unresolved. The gap between the 'remain' and 'leave' camps became even more blatant as PM May's negotiated deal was sharply rejected in parliament. A second vote paved the way for new negotiations with the EU. However, Brussels appears unwilling to reopen the talks. Sterling rallied on the outcome of the first vote as media headlines on a second referendum, a revocation of Article 50 or a prolonged transition period emerged.

In the US, the government shutdown became the longest in history amid disagreement over the funding of a border wall with the Democratic opposition. After 35 days of disruptions, both parties agreed to end the shutdown, at least temporarily, but there will be an economic and a political toll to pay.

Overall, the rebound in riskier assets looks like a normalisation after December's bout of pessimism. We believe that it does not reflect a high-conviction bullish turn in markets. We expect more volatility to be the new norm; accordingly, the investor focus will have to be on fundamentals going forward. The earnings season will likely prove instrumental in reconciling investors' sentiment with the actual state of the economy/corporates.

Figure 1: January 2019 cross-asset returns: risk assets rebound after December pessimism



Source: Bloomberg and BNPP AM, as of 31/01/2019

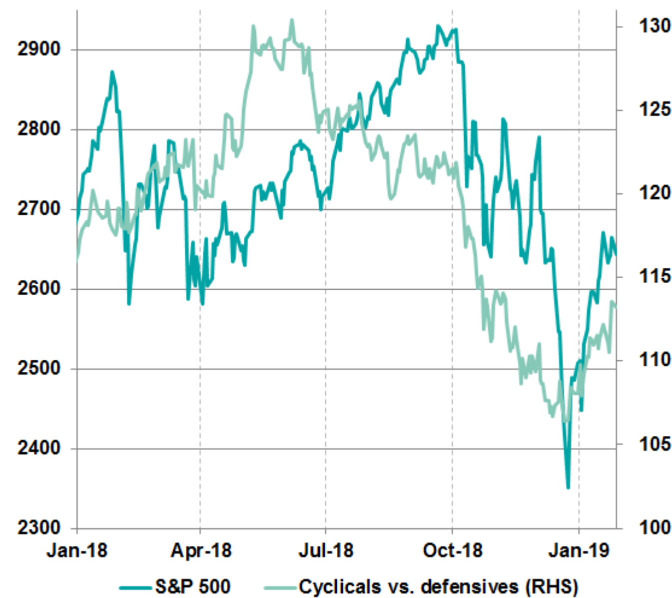
IT'S ALL ABOUT GROWTH

Markets have gone through violent swings lately, with the final weeks of 2018 seeing a sharp re-pricing of growth assumptions, countered by a strong rebound of risky assets more recently (Figure 2).

Of course market price action in late 2018 did not occur inside a vacuum – the data had been weak for some months, notably PMIs, concerns over a trade war were front and centre, and the Fed was sounding more and more hawkish nonetheless.

More recently, the rhetoric over Sino-US trade has sounded more hopeful and central banks – notably the Fed – have indicated a pause in policy tightening. With some of the immediate investor concerns removed, markets unsurprisingly rebounded sharply YTD.

Figure 2: Violent swings in the market's growth perception



Source: Bloomberg and BNPP AM, as of 31/01/2019

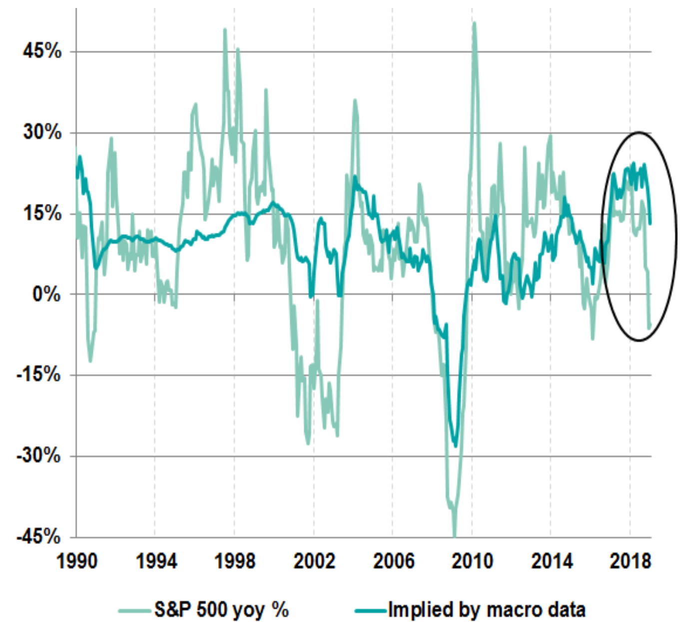
Below we explore the key drivers behind the recent market gyrations, analyse what markets have priced in and crucially, outline where we think markets will go from here.

A lot of bad news in the price?

As we mentioned above, the sharp sell-offs in risky assets in Q4 2018 did not take place in a vacuum – the growth backdrop was weakening considerably.

Yet a peak-to-trough fall of 20% in the S&P 500 looks excessive to us. Indeed, regressing our aggregate US macro data quant index with year-on-year changes in US equities clearly shows that incoming macroeconomic data warrant lower equity returns, but crucially, by far less than the recent setback to equities (Figure 3).

Figure 3: A lot of bad news in the price: equity returns based on aggregate macro data

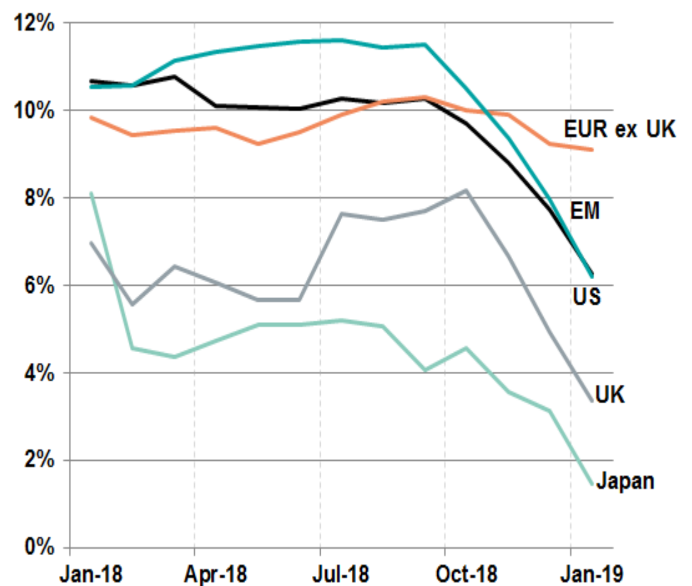


Source: Bloomberg and BNPP AM, as of 31/01/2019

Coinciding with these bearish trends, consensus EPS growth forecasts were downgraded aggressively – notably across all regions (Figure 4).

Taken together, a weaker growth outlook has now been incorporated into the consensus (macroeconomic forecasts and earnings). As a consequence, risky assets have also repriced. Put differently, the bar for earnings per share (EPS) surprises is quite low in the current earnings season.

Figure 4: 2019 consensus EPS growth: slashed everywhere



Source: FactSet and BNPP AM, as of 31/01/2019

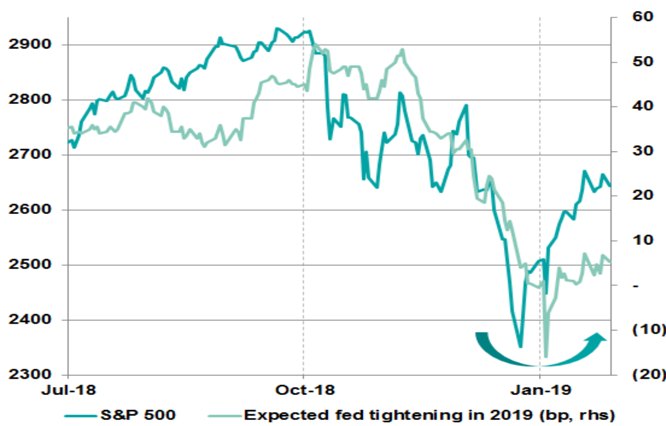
Central banks to the rescue?

With central banks – and their exceptional monetary policies – underpinning markets for many years, understandably markets are now grappling with the start of quantitative tightening (QT) and what this new regime means for assets. As we have argued many times before – all else equal – the removal of quantitative easing should lead to higher volatility going forward (see below and Figure 10).

But in the short term, we note two key (dovish) developments on the central bank front – and this has helped fuel the rebound in risky assets since early January.

First and foremost, the Fed has clearly indicated a pause in its tightening cycle and Fed speakers have signalled that the policy-setting FOMC is no longer on a pre-determined monetary tightening path. As shown in Figure 5, when the rates market priced out Fed tightening expectations, risk assets stabilised.

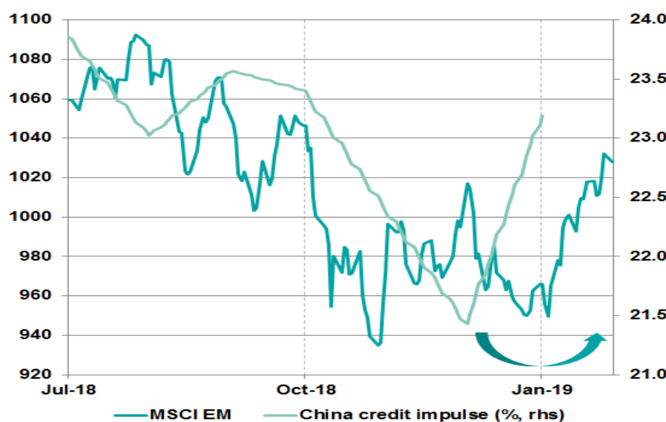
Figure 5: Market bottoms as Fed indicates pause…



Source: Bloomberg and BNPP AM, as of 31/01/2019

Secondly, policymakers in China have recently provided more stimulus again. Figure 6 shows how China's credit impulse is on the rise again, helping put in a floor under EM equities in the here and now.

Figure 6: …and as China stimulus increases



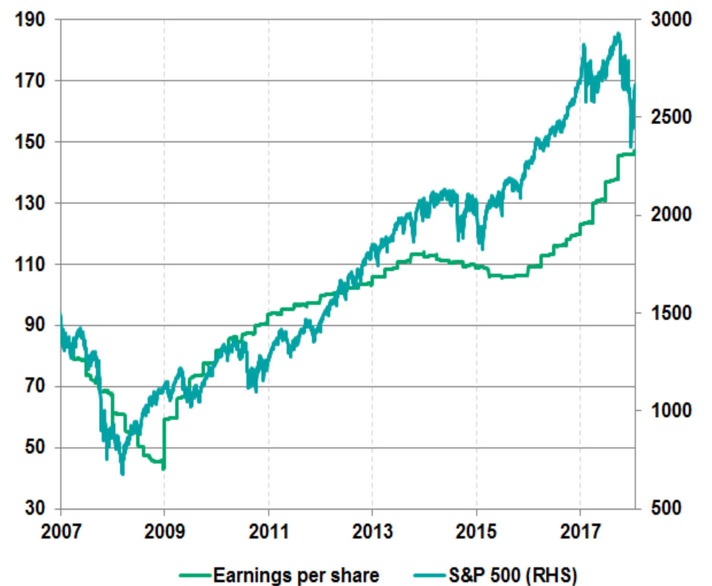
Source: Bloomberg and BNPP AM, as of 31/01/2019

However, in the medium term, we believe that hopes that central banks will continue to support asset markets indefinitely are misplaced. Indeed, we still foresee policy tightening in our outlook.

Earnings delivery will be key

In a QT world, market drivers – and with it, the focus of investors – will have to change too. The recovery since the GFC has been marked by impressive low volatility rallies and significant multiple expansion. Indeed, as Figure 7 highlights, equity markets rallied during QE, even when earnings growth was absent. This was purely on the back of the market's perception of central bank support and, related to this, corporates supporting their own share prices by engaging in (QE-induced cheap) debt financed share buy backs and M&A.

Figure 7: QE: equities up even when earnings growth was absent



Source: Bloomberg and BNPP AM, as of 31/01/2019

With central banks removing accommodation, corporate re-leveraging running out of steam and eventually possibly even higher inflation to boot, we believe the new environment we are entering is unlikely to see significant multiple expansion. In such an environment, earnings will have to do the heavy lifting.

All eyes are thus on the current earnings season. With some 25% of the S&P 500 having reported, so far, we have seen positive earnings surprises overall (Figure 8). But compared to history, these are relatively small, which is disappointing in the context of the recent sharp fall in earnings expectations, i.e. the bar was low. This does not leave us extremely optimistic for now.

Figure 8: Q4 earnings season: S&P 500 companies posting small upside surprises so far

Source: Bloomberg and BNPP AM, as of 31/01/2019

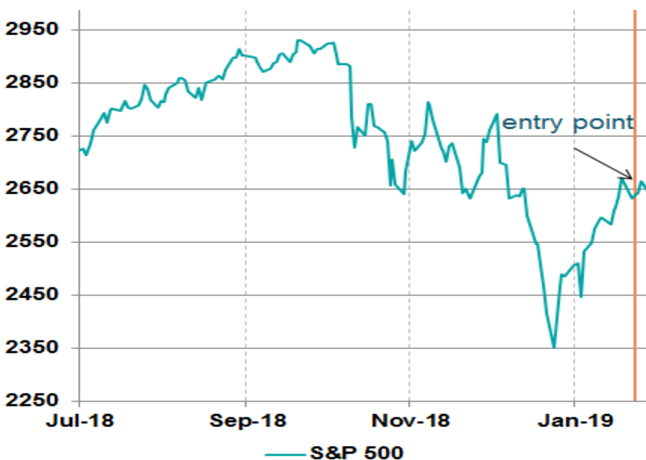
Downside risks still lingering

One of the key themes of our annual outlook revolved around prevailing risks. Our view was that the balance of risks around our base case economic outlook was to the downside. This is still our view, not least because key issues such as quantitative tightening and China-US trade tensions are far from resolved.

Put differently, we are in an atypical late cycle. Due to the changing macro backdrop – and as explained in our recent publications – we have adopted an ever more tactical approach.

In this light, we recently elected to tactically short equities into the bounce (Figure 9). As explained above, key issues are unresolved and the market has rallied quite quickly on only a few positive headlines. Structurally, we have less conviction on equity market direction from current levels (see below).

Figure 9: Initiated a tactical short in equities



Source: Bloomberg and BNPP AM, as of 31/01/2019

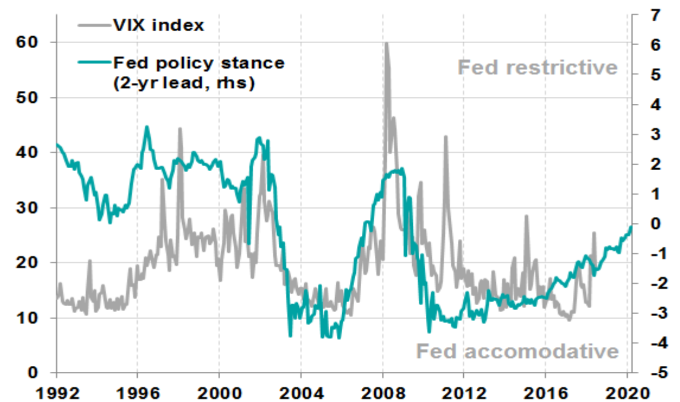
ASSET ALLOCATION

More volatility on the horizon – be tactical

Overall, we still see the shifts in the macro backdrop to fuel higher volatility going forward – most notably due to central banks embarking on QT (Figure 10).

Indeed, in recent years, the unconventional policies of the main central banks led to unusual market distortions, such as persistently low asset price volatility, high risk-adjusted returns and historically tight risk premia in both equity and fixed-income markets. It is these imbalances which look set to unwind as central banks tighten policy.

Figure 10: Expect more volatility as the Fed tightens

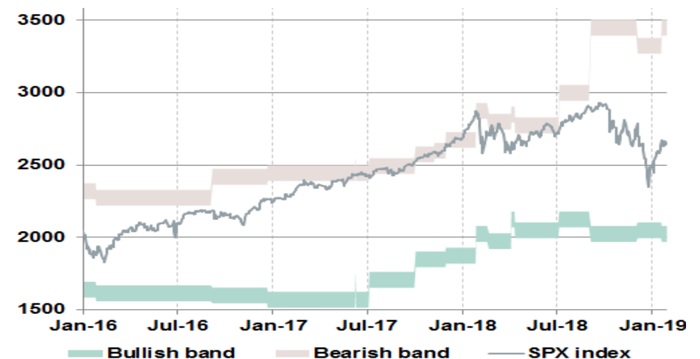


Fed policy stance: spread between the real fed funds rates and R* estimates. Source: Bloomberg and BNPP AM, as of 31/01/2019

With risk assets sat bang in the middle of our scenario analysis range, structural directional conviction on equities remains low and our preferred medium to long term allocation remains neutral (Figure 11). Especially if we see more volatility as the new norm, current market pricing does not present attractive entry points either way.

We still aim to deploy our tactical views and tools (such as dynamic technical analysis and market temperature indicators) around our main mantra, and in this light we recently entered a short position on US/EA equities.

Figure 11: S&P 500 scenario analysis



Source: Bloomberg and BNPP AM, as of 31/01/2019

Structural views & diversification

Elsewhere, our structural underweight in fixed income is unchanged given our view of gradually rising inflation and monetary policy normalisation.

To be able to build robust portfolios, we continue to hold positions and relative value trades with asymmetries to our scenario analysis. We are long five-year US bonds versus German bonds, reflecting valuation differences. We believe European fixed income is more vulnerable to a correction as the ECB begins to withdraw policy accommodation. We regard being long US Treasuries as a good defensive position in risk-off markets.

To reduce our exposure to renewed trade tensions between China and the US, we are long USD versus a basket of Asian currencies. We are long the French CAC 40 equity index versus the DAX since we believe Germany is more exposed than France to de-globalisation.

Finally, we have a tactical short in CAD/NOK since valuations and the relative central bank policy outlooks look supportive.

STRATEGIC OVERVIEW OF KEY POSITION CHANGES IN JANUARY 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.

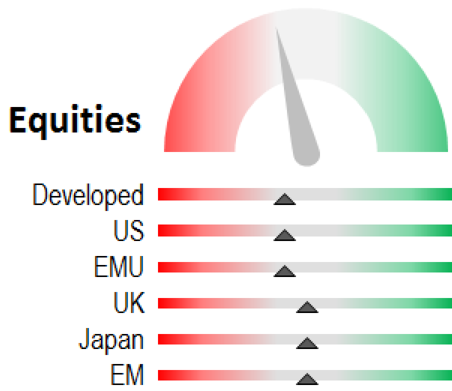
SHORT CAD/NOK OPENED 09/01/2019

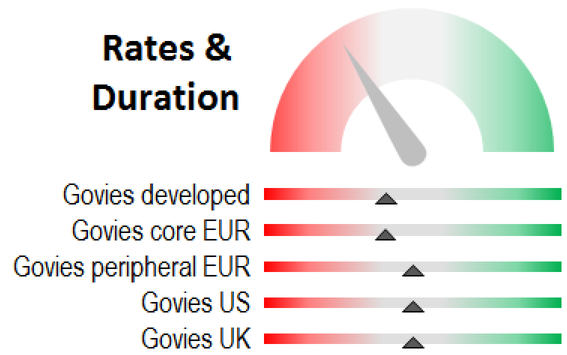
- We believe valuations and the relative central bank policy outlooks look supportive of a drop in CAD/NOK.

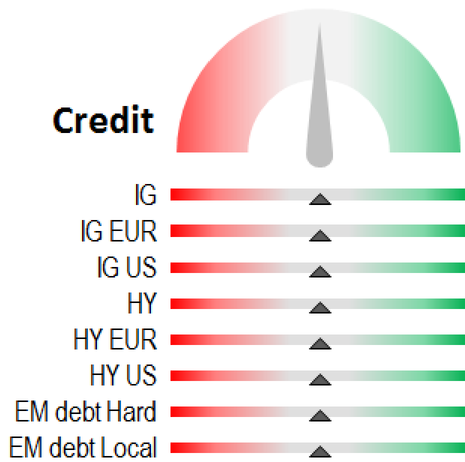
SHORT US/EU EQUITIES OPENED 23/01/2019

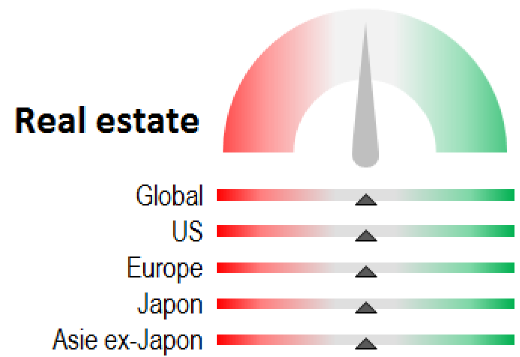
- In light of the recent sharp bounce in equities, and with macro risks still skewed to the downside, we took a tactical short position on US/EU equities.

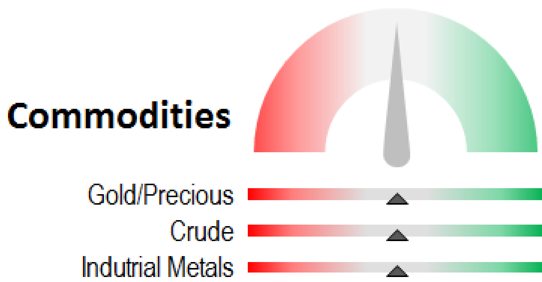
ASSET ALLOCATION DASHBOARD[1]

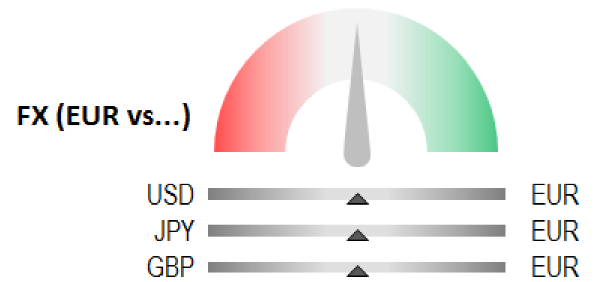


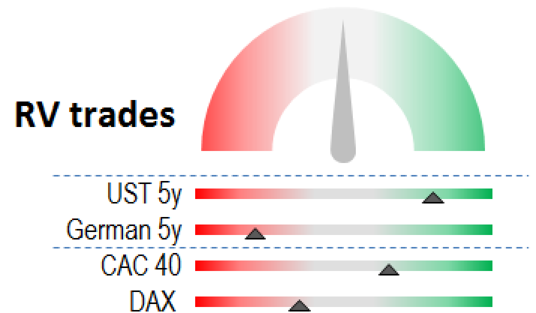












[1] The dashboard shows the asset allocation in our portfolios and reflects the decisions of the Investment Committee of the Multi-Asset team at MAQS.

Views expressed are those of the Investment Committee of MAQS, as of January 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 January 2019.

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