

ASSET ALLOCATION MONTHLY - APRIL 2023

Five key shifts

- **We have made five key changes to multi-asset portfolios:**
 - 1) Going short European duration to capture valuation dislocations
 - 2) Taking partial profits on our long in European investment-grade credit to benefit from market rallies
 - 3) We cleaned up our 'dry powder' in US equities, allocating instead to emerging market equities
 - 4) We shifted the funding leg of our long Japanese yen (JPY) to Swiss franc (CHF)
 - 5) As a result, we moved our overall risk taking into the neutral risk quintile for the first time since April 2022.
- **Of the factors for our short in European equities relative to emerging Asia, most still hold. They are:**
 - Very high earnings expectations for European companies relative to already depressed expectations for emerging Asian companies
 - Upside risk to discount rates in Europe compared to easing potential in EM Asia/China
 - Europe is more exposed to slowing global growth, while EM Asia/China recovers.



Maya Bhandari
Global head of multi asset



Daniel Morris
Chief market strategist



BNP PARIBAS
ASSET MANAGEMENT

The sustainable
investor for a
changing world

Since our last monthly report, fat tails to the distribution of expected growth outcomes have fattened further. Over the first quarter of 2023, markets swung through all four quadrants of the investment clock in a few short months, rather than over a period of several years. As concerns around the financial health of regional US banks have mounted, with tremors in European banks, too, after the collapse of Credit Suisse, the narrative in the markets now seems to have settled on global economic recession as being the most probable outcome. We are less convinced.

We do not *entirely* disagree – regional banks are hugely important in the US economy and a further tightening of lending is a real and tangible downside risk to growth. But it is less clear for emerging Asia or Europe, where growth, inflation, policy and banking sector dynamics are different.

We also have greater confidence in other areas. For example,

- The stickiness of inflation in Europe and the need for the European Central Bank (ECB) to continue to raise interest rates
- The prospect of regional decoupling, with emerging Asia particularly well placed compared with developed markets
- The investment opportunity in areas such as European investment-grade credit and commodities, where we remain long.

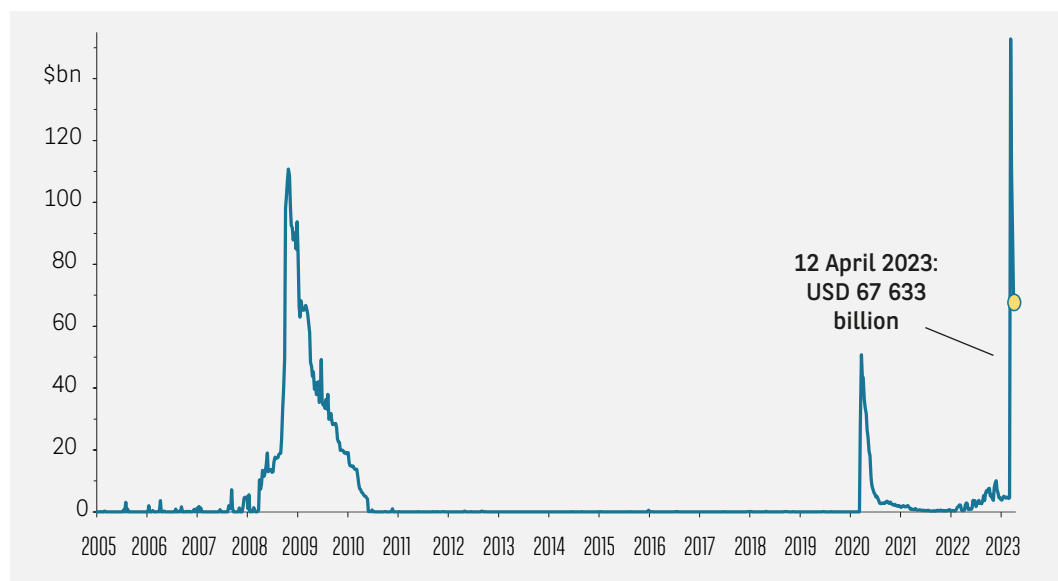
In recent weeks, we have made five key changes to multi-asset portfolios:

First, on 'Black Monday' (13 March), after sharp 5 to 12 standard deviation moves in bond markets on the news of the Silicon Valley Bank and Signature Bank failures, we went short European duration by 0.45 years. We subsequently deepened the position to 0.75 years. We are seeking to capture valuation dislocations on market concerns over banking sector contagion that seem overdone, particularly after sizeable policy responses. Also, European regulatory frameworks are much stricter. This crystallised a more cautious evolving view on European duration, in turn driven by:

- The trajectory of inflation, which is sticky and has yet to peak in Europe, a particular concern being rigid labour markets
- A hawkish ECB that is poised to continue to raise interest rates to address this
- The challenge of absorbing a large European bond supply in 2023 with fiscal expansion.

Exhibit 1

The US Federal Reserve is tapped as the lender of last resort



Data as at 17 April 2023. Sources: Bloomberg, BNP Paribas Asset Management.

Second, we took profits on around one third of our long position in European investment-grade credit in notional terms and around half on a risk basis, seeking to take advantage of market rallies. While we do not judge the woes of Credit Suisse and its AT1 debt to be systemic, and compensation for default risk remains generous, credit spreads have tightened meaningfully from when we were building positions at 230bp last autumn. We remain long euro IG, fully hedged – just less so than before.

Third, we see downside risks to US growth and earnings, in an economy where regional banks are particularly important and where tighter regulation and balance sheet issues will add to already tight credit conditions. Consequently, we cleaned up our ‘dry powder’ from when we downgraded the US as a region in mid-February. We allocated instead to emerging market equities, which we continue to favour on valuation and fundamental grounds. We remain neutral equities overall, with our short concentrated in Europe.

Fourth, we reset the funding leg of our long JPY, shifting it from EUR to CHF, while also deepening our positions. We still favour being long JPY on both fundamental and valuation grounds. The currency should benefit meaningfully from:

- An expected shift in Bank of Japan (BoJ) policy and an end to its yield curve control approach
- Good liquidity, for example, against Japanese government bonds
- Being a helpful risk hedge for portfolios.

We believe the yen is attractively valued across a range of metrics and with ‘favourable’ positioning (shorts). Our EUR funding leg, however, has been challenged by rates moves, and we have hit levels previously set for review. On balance, there are four key supports for switching to CHF:

- 1. Better risk-reward:** CHF/JPY and EUR/JPY are highly correlated (0.8), but the cost of carry is meaningfully lower with CHF: it is 37bp over three months compared with 85bp for the euro. Insofar as we are seeking to capture Bank of Japan policy shifts, both pairs have shown similar price action after the recent BoJ meetings. This included December’s surprise move and January’s decisions, which were seen as non-events.
- 2. Portfolio construction benefits:** CHF/JPY involves two safe-haven currencies; the pair also has a low(er) beta to oil and equity. The shift also removes the inverse link with our short core European rates position. Both are a benefit to portfolio construction and are net neutral on overall risk.
- 3. Policy preferences and timing:** The Swiss National Bank (SNB) and the ECB are both expected to raise rates further, but the SNB holds its next policy meeting only on 22 June. That is six weeks after any BoJ adjustments under its new leadership are expected to occur and after the wage negotiations period in Japan. The SNB may have a higher tolerance than the ECB for currency depreciation (notably given the franc’s strength). CHF deposit/bond holdings have surged to 20% of external liabilities since the Global Financial Crisis.
- 4. Valuations:** The franc is at historically high levels and CHF/JPY has been higher only three times in the last 50 years (based on quarterly data).

Fifth, as a result of these adjustments, our overall risk-taking moves into the neutral risk quintile for the first time since last April. Specifically, risk appetite can be thought of as the steepness of the line of best fit between expected risk and return across asset classes: the steeper the line, the more return expected per unit of risk and the greater our risk appetite. For target allocation funds, risk quintiles are calibrated between 0 and the max tracking error of the portfolio; for flexible funds, the low point is the maximum allocation to the least volatile asset and the high watermark is the maximum allocation to the most volatile asset class.

It is important to note that this is not directional to market risk as risk can be consumed by both positive and negative views. Today, our short European duration position consumes the highest proportion of tactical asset allocation risk-taking.

What is going on in Europe?

We have been short European equities for nearly a year, holding the position today as a relative value trade against emerging Asia. It has, admittedly, been a pain trade for multi-asset portfolios but we are sticking to our guns. Of the four factors that led us to be underweight, most still hold:

1. Downside to European earnings

Looking at valuations, analyst expectations for European earnings are high. This is the case when assessing the current estimates relative to the historical trend, taking into account where Europe is in the economic cycle, and comparing Europe with other regions. By contrast, expectations for emerging Asia have already fallen, discounting significant downside risk and hence leaving room for a bounce.

2. Upside risks to discount rates

In terms of the outlook for monetary policy and hence interest rates, we believe that stickier inflation (and notably its impact on wages), as well as a more expansionary fiscal policy, mean that there are upside risks for rates. By contrast, the outlook is for central bank rates in emerging Asia – and China – to be eased.

3. High cyclical gearing/operating leverage in Europe

We believe Europe is more exposed to the weaker global cycle than emerging Asia. Indeed, Asia stands to benefit from its links to a reopening Chinese economy. Furthermore, European earnings estimates are now at their highs, while forecasts for emerging market earnings are 15% below their highs. EM stocks are trading at 12x expected (and reset) earnings versus 13x for Europe – at peak forecasts.

Our asset class views

	Strong dislike	Dislike	Neutral	Favour	Strongly favour
PRR/risk appetite			X		
Asset allocation		Government bonds	Equities Real Estate Cash	Commodities Credit	
Equity regions		Europe ex-UK	US Japan UK EM ex-Asia	EM Asia	
Equity style/size			EU large cap EU small cap US large cap US small cap		
Sovereign bonds		Europe	US Japan EM local Australia UK Linkers		
Credit			EMD US IG US HY EU HY	EU IG	
Commodities				Energy Base metals Precious metals	
FX		CHF	EUR, USD, AUD, GBP, EM FX	JPY	

Views as at 19 April 2023

Please note that articles may contain technical language. For this reason, they may not be suitable for readers without professional investment experience. Any views expressed here are those of the author as of the date of publication, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may take different investment decisions for different clients. This document does not constitute investment advice. The value of investments and the income they generate may go down as well as up and it is possible that investors will not recover their initial outlay. Past performance is no guarantee for future returns. Investing in emerging markets or specialised or restricted sectors is likely to be subject to a higher-than-average volatility due to a high degree of concentration, greater uncertainty because less information is available, there is less liquidity or due to greater sensitivity to changes in market conditions (social, political and economic conditions). Some emerging markets offer less security than the majority of international developed markets. For this reason, services for portfolio transactions, liquidation and conservation on behalf of funds invested in emerging markets may carry greater risk.

BNP PARIBAS ASSET MANAGEMENT France, "the investment management company", is a simplified joint stock company with its registered office at 1 boulevard Haussmann 75009 Paris, France, RCS Paris 319 378 832, registered with the "Autorité des marchés financiers" under number GP 96002.

This material is issued and has been prepared by the investment management company.

This material is produced for information purposes only and does not constitute:

1. an offer to buy nor a solicitation to sell, nor shall it form the basis of or be relied upon in connection with any contract or commitment whatsoever or
2. investment advice.

This material makes reference to certain financial instruments authorised and regulated in their jurisdiction(s) of incorporation.

No action has been taken which would permit the public offering of the financial instrument(s) in any other jurisdiction, except as indicated in the most recent prospectus of the relevant financial instrument(s), or on the website (under heading "our funds"), where such action would be required, in particular, in the United States, to US persons (as such term is defined in Regulation S of the United States Securities Act of 1933). Prior to any subscription in a country in which such financial instrument(s) is/are registered, investors should verify any legal constraints or restrictions there may be in connection with the subscription, purchase, possession or sale of the financial instrument(s).

Investors considering subscribing to the financial instrument(s) should read carefully the most recent prospectus and Key Information Document (KID) and consult the financial instrument(s)' most recent financial reports.

These documents are available in the language of the country in which the financial instrument(s) is authorised for the distribution and/or in English as the case may be, on the following website, under heading "our funds": <https://www.bnpparibas-am.com/>

Opinions included in this material constitute the judgement of the investment management company at the time specified and may be subject to change without notice. The investment management company is not obliged to update or alter the information or opinions contained within this material. Investors should consult their own legal and tax advisors in respect of legal, accounting, domicile and tax advice prior to investing in the financial instrument(s) in order to make an independent determination of the suitability and consequences of an investment therein, if permitted. Please note that different types of investments, if contained within this material, involve varying degrees of risk and there can be no assurance that any specific investment may either be suitable, appropriate or profitable for an investor's investment portfolio.

Given the economic and market risks, there can be no assurance that the financial instrument(s) will achieve its/their investment objectives. Returns may be affected by, amongst other things, investment strategies or objectives of the financial instrument(s) and material market and economic conditions, including interest rates, market terms and general market conditions. The different strategies applied to financial instruments may have a significant effect on the results presented in this material. Past performance is not a guide to future performance and the value of the investments in financial instrument(s) may go down as well as up. Investors may not get back the amount they originally invested.

The performance data, as applicable, reflected in this material, do not take into account the commissions, costs incurred on the issue and redemption and taxes.

You can obtain this by clicking here:

www.bnpparibas-am.fr/investisseur-professionnel/synthese-des-droits-des-investisseurs a summary of investor rights in French. BNP PARIBAS ASSET MANAGEMENT FRANCE may decide to discontinue the marketing of the financial instruments, in the cases covered by the applicable regulations.

"The sustainable investor for a changing world" reflects the objective of BNP PARIBAS ASSET MANAGEMENT France to integrate sustainable development into its activities, although not all funds managed by BNP PARIBAS ASSET MANAGEMENT France fulfil the requirement of either Article 8, for a minimum proportion of sustainable investments, or those of Article 9 under the European Regulation 2019/2088 on sustainability-related disclosures in the financial services sector (SFDR). For more information, please see www.bnpparibas-am.com/en/sustainability.

VIEWPOINT



BNP PARIBAS
ASSET MANAGEMENT

The sustainable
investor for a
changing world