

ASSET ALLOCATION MONTHLY - DECEMBER 2021

Economic and policy crosscurrents

KEY MARKET DRIVERS

The pace of global GDP growth may be starting to normalise, but economic and policy crosscurrents are still complicating life after Covid. Inflation expectations related to supply-chain disruptions, new variants of the virus, and spill-over effects from China's growth slowdown are the top concerns.

VIEWS & ASSET ALLOCATION

Our portfolio is long equities on the view that the latest Covid 19 variant may slow, but will not derail, the global economic recovery. Reflecting the expectation of an emerging market stock recovery, we have added to our portfolio a long position in global EM equities. We have also added a long position in US small cap equities and European large caps. We have added to our short position in US Treasuries as the Fed focuses more on taming not-so-transitory inflationary pressures.



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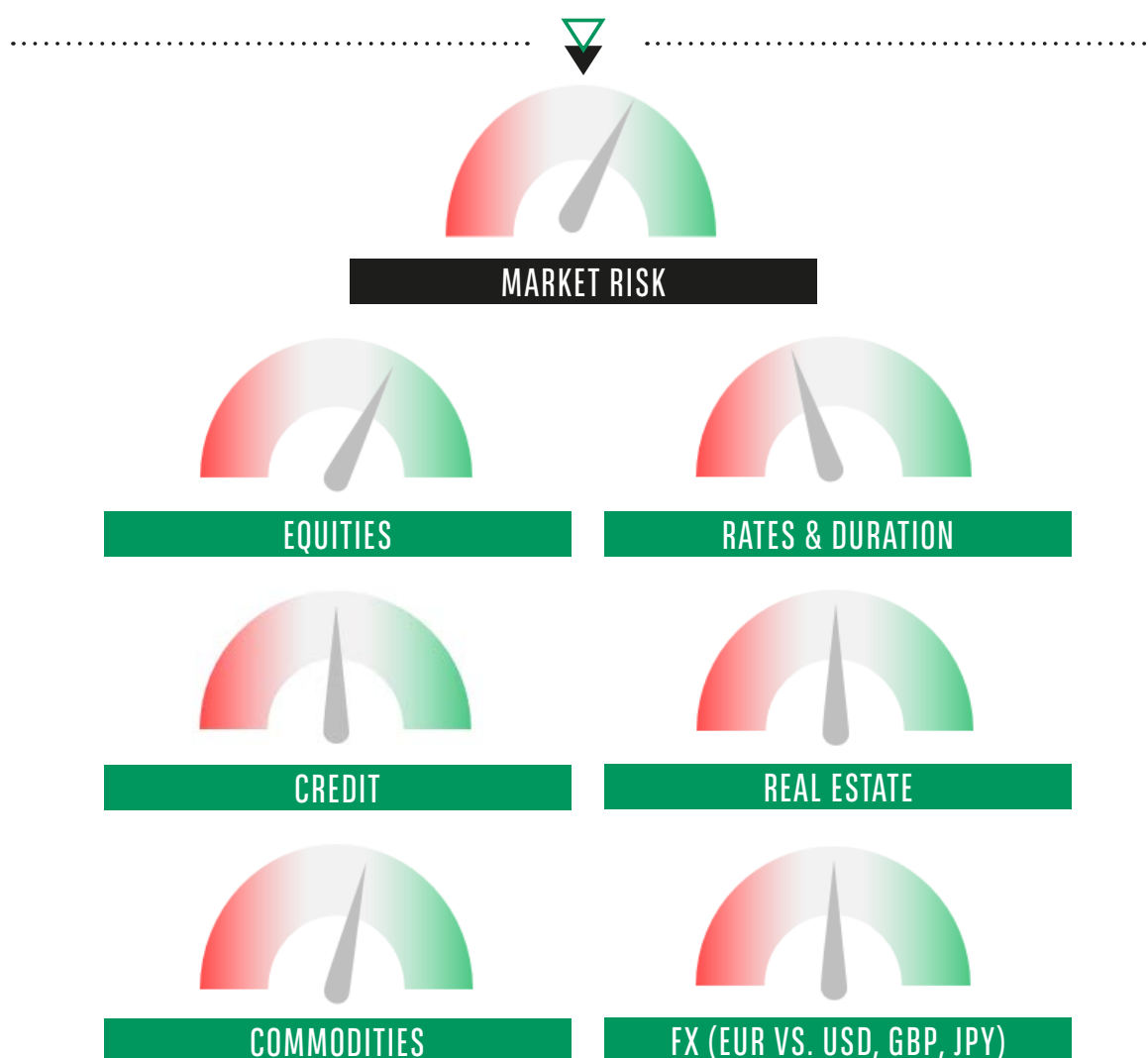
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ASSET MANAGEMENT

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RISK UTILISATION*



CORE ASSET CLASS VIEWS**



* Risk utilisation/active risk is a measure of the tracking error (as a percentage of maximum tracking error) of an unconstrained theoretical portfolio, derived from core asset class views and from additional specific/tactical trades. **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.

Investors face key questions:

- 1) How long will high inflation last?
- 2) Will central bank tightening shift the balance of risks from inflation to growth?
- 3) Are emerging market (EM) assets cheap enough to tempt foreign investors back?
- 4) Can financial risk in China be contained?

We see the inflation spike as temporary and believe the rising vaccination rates should allow economies to continue to reopen, assuming the new Omicron variant does not turn out to be resistant to existing vaccines. The growth deceleration in China will likely remain manageable as Beijing shifts towards more policy easing. Major developed countries' fiscal stimulus should boost global growth. The normalisation of central bank monetary policy will likely proceed gradually without tipping the balance of risks from inflation to growth.

We believe this backdrop continues to favour risk assets (equities) over safe-haven instruments (bonds) as long as real yields remain low.

After Fed tapering

After months of careful communication, the US Federal Reserve (Fed) said in early November it would start tapering, reducing the pace of its monthly bond buying by USD 15 billion. This decision puts it on course to complete the taper process in June 2022. As policy rate increases will only follow once tapering is finished, the Fed's policies remain broadly supportive of the economy and are therefore equity positive in the short term.

The Fed's challenge now is to balance its three policy criteria – maximising employment, keeping inflation at 2% over the long term, but allowing it to moderately exceed 2% in the short term – when determining the timing and pace of future rate hikes.

Chair Powell has been sending clear messages that the Fed is approaching a policy inflection point of 'risk management', which would require it to balance the rise in inflation above the 2% target and the economy being shy of maximum employment. The recent surge in consumer price inflation to its highest level since the 1990s (at 6.2% YoY in October) is making this a precarious balancing act.

The main takeaways of the Federal Open Market Committee's statement after its November meeting were that

- 1) The FOMC still sees high inflation as transitory and due notably to supply-chain disruptions
- 2) The Fed will watch not only the unemployment rate, but also the level of employment as a key variable when assessing its policy path.

The Fed chair is hoping that Covid will continue to abate over the winter, allowing more people to get back to pre-pandemic employment and consumption patterns. This would help relieve stress on the supply side of the economy.



The jobs report
showed solid
gains but total
employment is
still low

However, he now seems less certain about the outlook for either inflation or maximum employment than he was a few months ago, when he was adamant that, given time, the labour market would return to its pre-pandemic state. Today, he is more cautious and is watching the data to gauge the job market changes and what those might mean for the Fed's interpretation of maximum employment.

The new Omicron variant is further complicating things for the Fed. On the one hand, it could make supply-chain disruptions last longer, and also delay the shift in demand from goods to services, both of which would add to inflationary pressure. On the other hand, it could delay the re-opening of the economy, leading to weaker growth and employment.

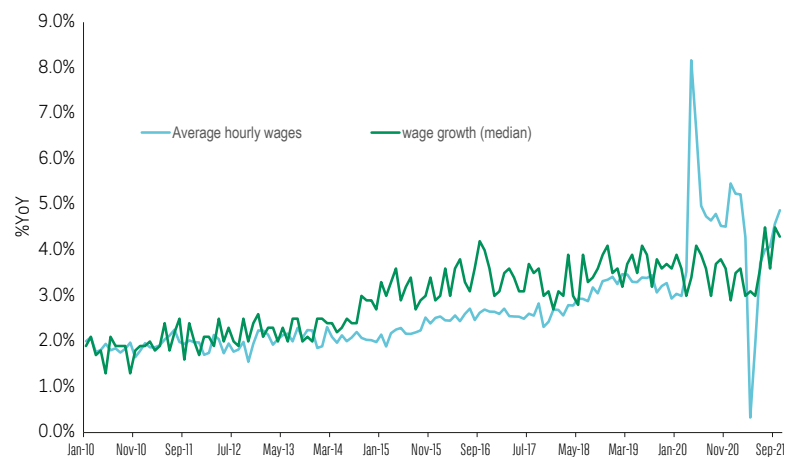
Labour market data is giving out mixed signals. The recent jobs report showed solid gains, but total employment is still around 7.5 million below the pre-pandemic trend, with weak labour force participation (Exhibit 1). Meanwhile, wage growth has been strong (Exhibit 2), suggesting demand for workers is outstripping supply. Whether this combination of weak participation and strong wage growth will continue into the first half of 2022 will significantly impact the path of inflation and the outlook for monetary policy.

Exhibit 1: US labour force participation rate remains weak (%)



Data as of 21 November 2021, sources: Haver, BNP Paribas Asset Management

Exhibit 2: US wage growth is trending up



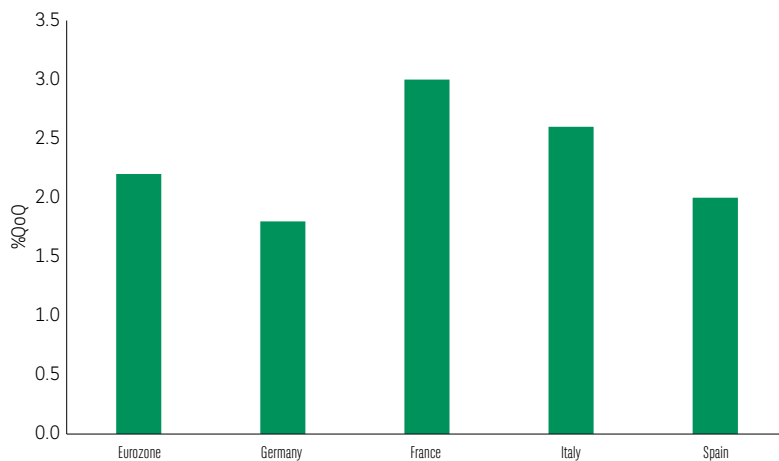
Data as of 21 November 2021, sources: Haver, BNP Paribas Asset Management

Other major central banks, notably the Bank of England and the Bank of Canada, are shifting to a more hawkish stance. This adds pressure on the Fed to reconsider the timing of its own rate hikes. If inflation pressures in the coming months are more intense than currently expected, the Fed could speed up the tapering process, implicitly clearing the ground for an early rate increase.

ECB doves, UK hawks

So far, the stance of the ECB is dovish relative to the other major central banks, except for the Bank of Japan. GDP growth in the eurozone averaged just over 2% QoQ in the last two quarters, but with big differences between the major countries (Exhibit 3). Germany and Spain grew more slowly and Italy and France, faster. France had almost bounced back to its pre-pandemic GDP level in Q3 this year, but Italy, Germany and Spain were still some 1.5%, 2.0% and 6.5%, respectively, below.

Exhibit 3: GDP growth diverges across eurozone countries



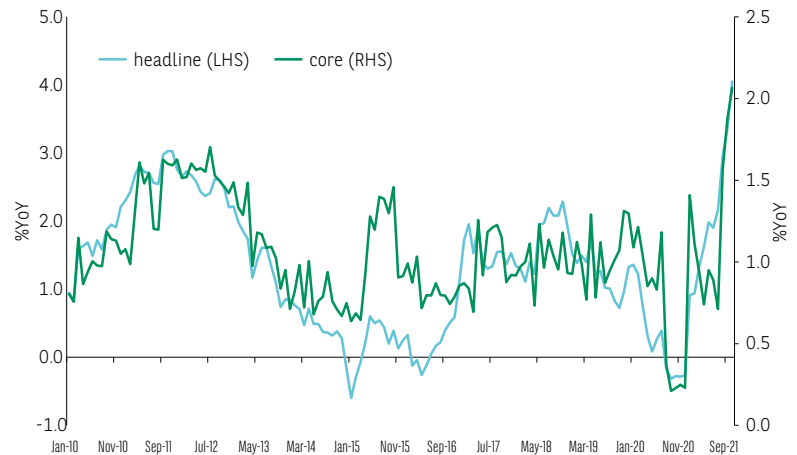
Data as of 21 November 2021, sources: Haver, BNP Paribas Asset Management

Eurozone inflation has surprised on the upside, rising to a 12-year high of 4.1% YoY in October. Core inflation, though more contained, also rose to above 2.0% (Exhibit 4). Soaring energy prices and supply-chain disruptions were to blame. While base effects and high energy prices should keep inflation above the ECB's 2% target in the coming months, ECB President Christine Lagarde appears to be even more certain than Fed Chair Powell that the inflation spike is transitory.



Lagarde has
rebuffed strongly
the expectation of
ECB rate increases
in 2022

Exhibit 4: Eurozone inflation has surprised to the upside



Data as of 21 November 2021, sources: Haver, BNP Paribas Asset Management

President Lagarde has also rebuffed strongly (if not convincingly enough for many market players) the expectation of ECB rate increases in 2022 to quell fast-rising prices. The market expects the ECB to announce in December the end of the Pandemic Emergency Purchase Programme (PEPP) in March 2022, reverting to the Asset Purchase Programme (APP) after that, perhaps at a higher purchasing pace.

The ECB's stance contrasts sharply with that of the BoE, which is more concerned with inflation risk than the slowdown in GDP growth. The level of UK output has yet to return to pre-pandemic levels, but the BoE expects it to do so in early 2022.

Even so, evidence has been mixed on the UK growth outlook. Retail sales have declined for five months in a row since May, but the latest business surveys have shown activity holding up, especially in the services sector. A combination of higher inflation, supply-chain disruptions and the risk of more Covid infections in winter could drag growth down in the coming months. However, survey evidence such as the Report on Jobs' permanent staff salaries index shows that wage pressures have been building.

Central bank governor Andrew Bailey currently sees rising inflation as the dominant risk, warranting an increase in interest rates. The only reason, according to him, for the BoE not to have raised rates in October was that it wanted to investigate further the effects on the labour market of the end of the furlough scheme.

However, one could also argue that a transitory increase in the level of costs should lead to a transitory, not permanent, increase in the level of prices. When the bottlenecks ease, supply chains recover and costs fall back, consumer prices will as well.

The BoE concedes that this transitory inflation scenario might play out, but its hawkish stance seems to show it anticipates a more permanent inflation scenario. Nonetheless, if the current price pressures turn out to be a transitory global cost shock, and inflation falls back further and faster than the BoE expects, interest rates may not need to rise by much after all.

How will EM central banks react?

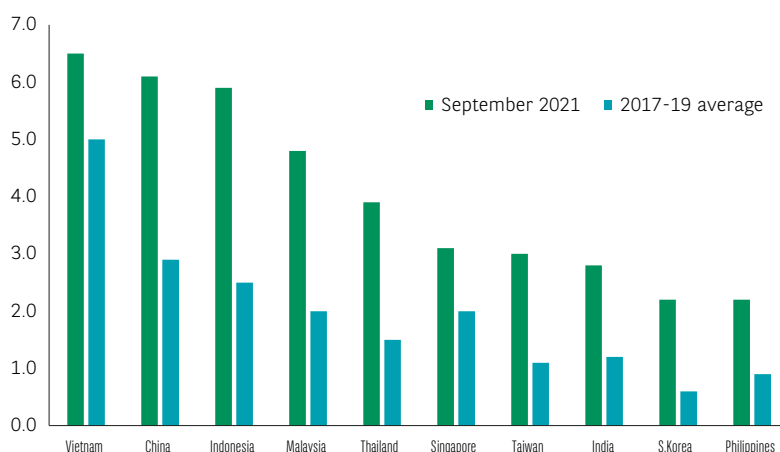
In general, how emerging market (EM) central banks respond to US monetary tightening and its impact on capital flows will depend on their economic fundamentals. Those countries with weaker fundamentals (especially twin deficits, high inflation and heavy foreign debt burdens) will likely see more capital outflows and greater downward pressure on their currencies. They would be forced into rate increases along with the US. When the US rate-rising cycle starts, markets typically favour those economies with stronger fundamentals, saving them from being forced to follow the US move into a cycle of rate increases.

Some EM central banks, especially in Latin America and eastern Europe, have already started to tighten policy, driven by inflation fears rather than the risk of capital outflows. EM currencies have been relatively weak and inflation pass-through to consumer prices has increased, but the overall situation looks manageable.

Latin American and eastern European central banks are likely to be more hawkish than in Asia because Asian economic fundamentals are better, with stronger current account balances, larger currency reserves and lower inflation than during the 'taper tantrum' in 2013. Moreover, the cyclical economic backdrop of the region is soft, owing largely to low vaccination rates and a growth slowdown in China. That leaves Asian central banks in no hurry to follow any monetary tightening in developed countries.

Real yield differentials between EM Asia and the US have remained large, with the current spread wider than the 2017-2019 average (Exhibit 5). Assuming inflation does not change real yields significantly, even moderate fed funds rate increases would leave Asia with a comfortable real rate buffer. In a world of low yields, strong fundamentals and high real yields should keep Asian central banks from being held hostage to US rate policy. Any indiscriminate selling at the onset of any US tightening would present investors with significant yield pick-up opportunities in Asia.

Exhibit 5: Real rate* differentials between Asia (ex. Japan) and the US, %



* deflated by core CPI. Data as of 21 November 2021, sources: CEIC, HSBC, BNP Paribas Asset Management

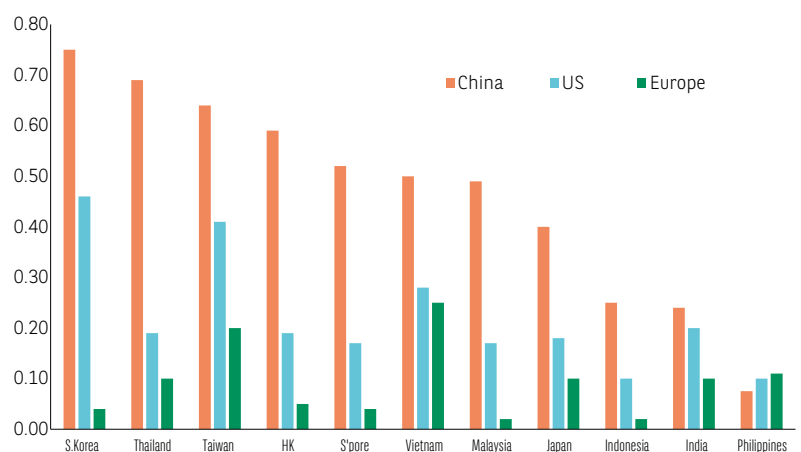
How big is the China risk?

China's crackdown on its highly indebted real-estate sector has caused the number of defaults to soar recently. This has led investors to worry about a property market crash triggering a systemic crisis and sending seismic shocks across the global system.

We believe the probability of this happening is low thanks to the fragmented nature of China's housing market, strong Chinese bank balance sheets, and Beijing's track record in containing financial crises. However, a possible China shock warrants monitoring and should be on investors' risk management radars.

The world is worried about a property market crash because the resultant shock to Chinese growth could in turn dampen global growth and inflation pressures. Asian is especially worried because evidence shows that the pace of growth in Asia is more sensitive to changes in GDP growth in China than to changes in European and US growth (Exhibit 6).

Exhibit 6: How a 1ppt change in GDP growth in China, Europe and the US impacts Asian growth

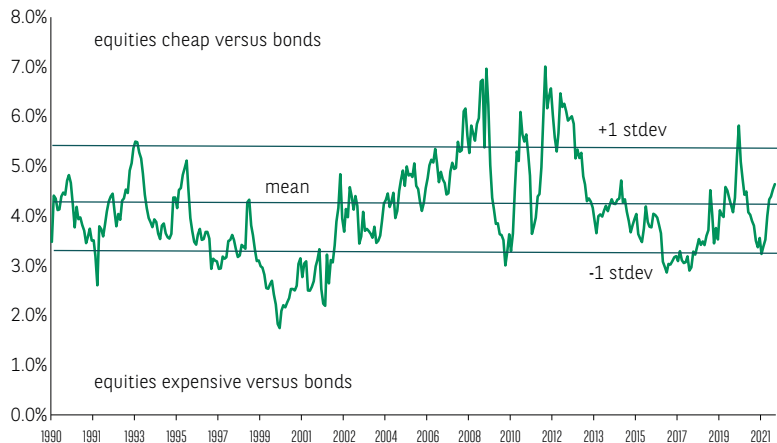


Data as of 21 November 2021, sources: CEIC, HSBC, BNP Paribas Asset Management

If growth in China were to slow sharply, even strong growth in Europe and the US might not be able to offset the drag on Asia.

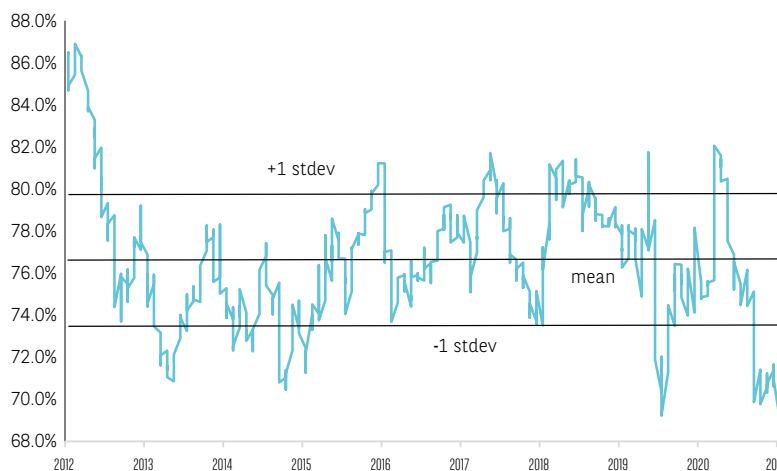
Markets

In the coming months, financial markets can expect to see central bank policy shift from aggressive quantitative easing (QE) to tapering balance sheet expansion and eventually boosting interest rates in the face of rising inflation. However, if the fundamentals are supportive, this policy normalisation may not necessarily hurt the markets, as seen in 2012, 2014 and 2016-17, when central bank balance sheet shifts also occurred. The good news for 2022 is that growth should be solid. The bad news is that monetary policy will likely tighten. But as long as inflation is transitory and real yields are low, the macroeconomic backdrop still favours equities over fixed income. The S&P 500 equity risk premium is above average and rising, reflecting the flattening of the US yield curve (Exhibit 7).

Exhibit 7: The S&P 500 equity premium is above average and rising

Data as of 21 November 2021, sources: Bloomberg, BNP Paribas Asset Management

Meanwhile, emerging market equities (including China) are becoming attractive, although market views still differ on short-term positioning. After underperforming the MSCI World index for most of this year, the 12-month forward P/E ratio of EM equities relative to global equities has fallen to a 10-year low (Exhibit 8), suggesting that emerging markets are offering good value now.

Exhibit 8: 12-month P/E emerging markets relative to global equities

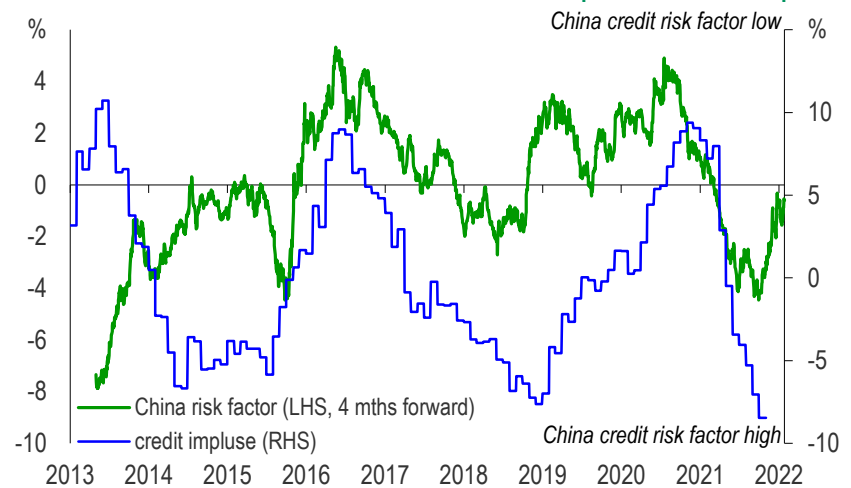
Data as of 21 November 2021, sources: Refinitiv, MSCI, I/B/E/S, BNP Paribas Asset Management

China risk appears to have stabilised, with the market now pricing in most of the bad news, especially on the regulatory front. Our proprietary Chinese sentiment indicator has started to rise and has decoupled from China's credit impulse indicator (Exhibit 9). This suggests that the China market might be approaching an inflection point, as policymakers step up easing measures, albeit selectively, to boost growth and contain financial stress.



The BoE's
response is
a test of the
new reaction
functions

Exhibit 9: China's risk indicator and the credit impulse have decoupled



Data as of 21 November 2021, sources: Bloomberg, BNP Paribas Asset Management

For fixed income, given the mounting near-term concerns over inflation and changing expectations on how central banks will respond, markets are pricing in more rate rises at the front end than at the back end. The more uncertain and worried investors are about near-term inflation risks, the higher policy rate expectations could potentially go. This process has already led to inversion of the Treasury yield curve. But for now, the markets still have confidence in the main central banks, as evidenced by moderate long-term inflation expectations.

The Bank of England's response to higher inflation is a test of the new central bank reaction function narratives. The BoE has indicated its intent to raise interest rates soon. The market expects the BoE to deliver a couple of rises and then start quantitative tightening (running off its balance sheet) while carrying on with its rate raising policy. As for the Fed and the ECB, their responses to higher inflation are expected to come later because they want to taper their QE programmes first. Investors will be evaluating which response manages best to moderate inflation without damaging growth.

ASSET ALLOCATION

Our portfolio is still long equities. Reflecting the expectation of an emerging market stock recovery, we have added to our portfolio a long position in global EM equities at the expense of (by reducing) our long US equities position. This market is facing the prospect of near-term upward pressure on real yields.

In our developed market equity positions, we have reduced European small caps and added North American small-cap and European large-cap stocks. The former is a cyclical play, with attractive valuations, upward earnings revisions and less sensitivity to US yield changes. Since we believe Europe is entering the early stages of its economic recovery, European large caps should have more 'legs' than other large-cap stocks.

We have kept our long Japanese equities position, but are monitoring the market dynamics for possible adjustments as the recent political changes have injected a dose of uncertainty into the direction of reforms in Japan. Furthermore, Japanese stocks have delivered disappointing earnings relative to US and European stocks.

Although from a research perspective, we are not bond bears yet, the prospect of higher yields makes US Treasuries look precarious in the near term. Hence, we have added to our tactical short position in US 10-year Treasuries. With UST yields so low, the balance of risks looks skewed towards the upside in the medium term. However, the market still appears to lack conviction as to the catalyst for a major correction. We should know more when the impact of the supply-chain disruptions on prices becomes clearer.

Developed market currencies are being driven by common factors reflecting the supply-chain disruption shock and monetary policy challenges. We are not in the camp that foresees a persistently strong US dollar during the Fed's policy normalisation process, as the currency is now much more expensive than it was in 2013 and net long positions are crowded. We foresee bouts of appreciation, but are avoiding being short carry.

We are overweight in commodities, but we are not adding to the position given the strong moves seen already. Oil still appears to be supported by both valuations and fundamentals, while metals face challenging dynamics, especially from China's weak growth momentum.

On thematics, we have made no changes to the allocation: Equity 73% and fixed income 23%. The main contributors to returns are disruptive technology, artificial intelligence and the energy transition.

This report was finalised on 1 December 2021

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