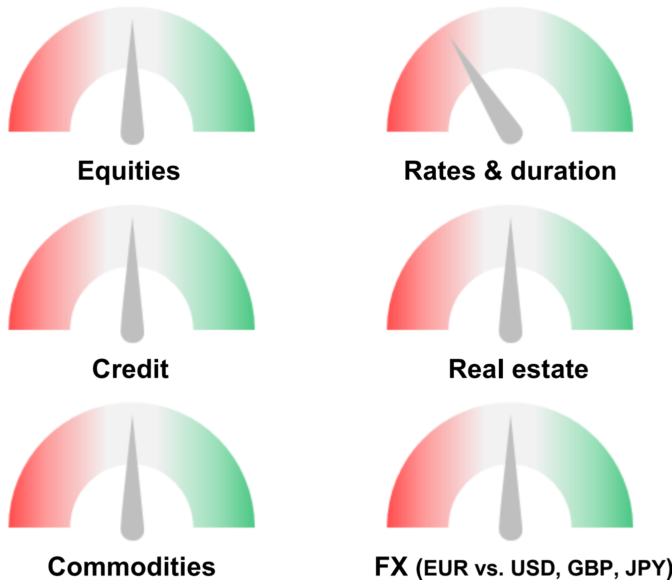
ASSET ALLOCATION MONTHLY

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

SWINGING FROM FUNDAMENTAL TO LIQUIDITY DRIVERS



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SUMMARY

- **Central banks turning dovish again –** Markets rallied further in February, with the perceived pause in US monetary policy tightening acting as a major driver; easing measures by Chinese policymakers added to the positive backdrop.
- **Remember 2016? –** We see similarities to late 2015/early 2016 when a pause in US tightening and Chinese easing measures caused risky assets and carry trades to outperform.
- **Downside growth risks persist –** The economic cycle has clearly matured since 2016 and we continue to see more downside than upside risks to our base case. Given the sharp rally in markets this year, we are not chasing the recent moves.
- **Fundamentals key medium term –** While investors have recently focused on the Fed's pause, we believe economic and corporate fundamentals will ultimately drive markets. We are monitoring corporate earnings trends closely.
- **Worse risk-adjusted returns ahead –** Despite the year-to-date market rally, we still expect a regime change towards lower returns and more volatility as the era of quantitative easing (QE) by central banks winds down eventually.

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- **Directional risk/reward unattractive –** With risk assets sat bang in the middle of our scenario analysis range and downside risks to our macroeconomic base case lingering, we find the directional risk/reward in stock markets unattractive.
- **Strategically neutral equities –** Our preferred long-term allocation to equity markets overall remains neutral.
- **Underweight fixed income –** We remain underweight EMU bonds, having added a further short in 10-year German Bunds after recent bullish price action. In the medium term, the outlook for EMU yields is skewed to the upside.
- **Building robust portfolios and diversifying –** Given the uncertain macro backdrop, we regard building robust portfolios and holding diversification trades as key at this point of the cycle. We hold several positions/RV trades with asymmetries.

BNP PARIBAS
ASSET MANAGEMENT

The asset manager for a changing world

MARKET REVIEW: FEBRUARY 2019

Over the past month, two hot topics affected the markets: the US Federal Reserve's suggestion of a pause in monetary policy tightening and progress in Sino-US talks on a trade accord.

On the first, FOMC policymakers kept US interest rates unchanged at their meeting on 31 January, released a dovish meeting statement and, importantly, dropped any references to further rate rises.

With respect to trade war fears, reports that the talks between the US and China were progressing fuelled new hopes of an agreement between the two leading economies, with a meeting between President Trump and President Xi tentatively announced at the time of writing.

These two drivers combined buoyed equity markets, but compared to January's strong rebound, February's returns were less stellar. Regionally, the US market rose further, with the S&P 500 index flirting with 2 800 points (a roughly 4% gain MoM). In Europe, EMU and UK equities rose in line with other developed markets. European markets were bid up especially after comments on a new round of TLTRO emerged from an interview with ECB board member Benoit Coeur. These were later confirmed by chief economist and board member Peter Praet (even though a decision still has to be taken). European banks outperformed on the back of this news in the second half of February.

Given the risk-on mood in stocks, major government bond markets traded broadly sideways to slightly higher in February, with the dovish central bank stances providing important support. EMU 'peripheral' bonds underperformed (posting a negative MoM return, but still up YTD) amid uncertainty over the outcome of Spanish elections and the impact of Italian populism. German Bunds did well, on the other hand.

The Brexit saga continued, even as the UK is getting closer to the end-March deadline for departure from the EU. PM May suffered another defeat. Further votes are on the calendar as we write, and the situation remains fluid, although Brussels seems reluctant to discuss new conditions for Britain's exit.

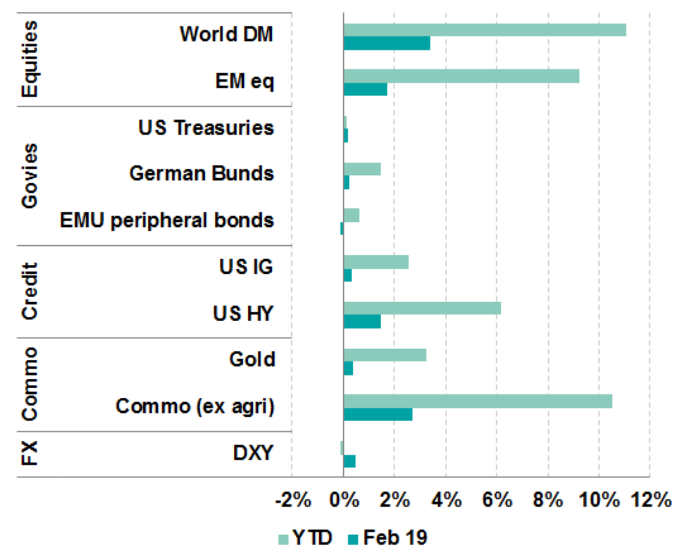
On the currency side, the USD was seemingly not affected by the Fed's decision to pause. The greenback gained marginally over the month. With FX being a relative price, weakness out of Europe was the main driver. The JPY, typically a risk-off asset, fell, but its historically positive correlation with gold turned negative. Indeed, since the start of the year, gold has been boosted mainly by lower real rates rather than risk sentiment.

Elsewhere, in commodities, energy outperformed in February. This boosted most other complexes too. Oil rallied in the second half of February amid political and social tensions in Venezuela, strong Chinese demand and OPEC output cuts led by Saudi Arabia.

Otherwise, on the macroeconomic front, some data pointed to a robust US economy. Weaker signals came from Europe, mainly the UK and Germany. The UK economy is clearly at risk of a no-deal Brexit (UK GDP Q4 0.2% vs. 0.3% consensus, industrial production -0.5% vs. 0.1% consensus). The slowdown in Germany (GDP Q4 0.1% vs. 0.0% consensus and industrial orders -1.6% vs. 0.3%) is a source of concern for the entire European economy given that Germany has been its growth engine for many years.

In the current corporate earnings season, results were mixed: US companies posted generally positive surprises, whereas Europe disappointed. With positive surprises overall, Japan falls somewhere in between the US and Europe.

Figure 1: February 2019 cross-asset returns – risk-on mood lingers on



Source: Bloomberg and BNPP AM, as of 28/02/2019

CENTRAL BANKS TURNING DOVISH AGAIN

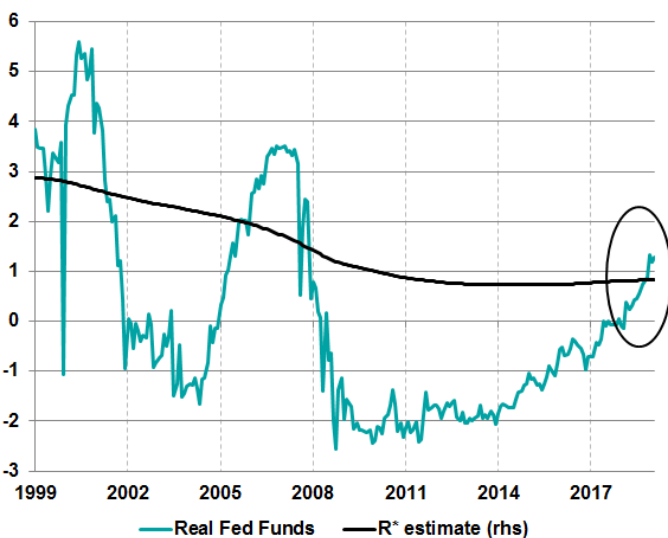
As said, global markets extended their gains in February, with the pause in tightening that the Fed had hinted at in late January a major driver. Additional support came from the pro-growth measures by Chinese policymakers (Figure 1).

The market's response to what looks like a small U-turn in monetary policy by the Fed is perhaps not that surprising given the sharp losses in December and investors' late-cycle/growth fears and worries about quantitative tightening.

Before laying out what the Fed news means for markets going forward, the first question is why the Fed paused in the first place. We think there are several aspects to understanding the Fed's reaction function.

Firstly, US data and the broader global growth backdrop had weakened and against this backdrop, Fed policy had already appeared to be in restrictive territory (Figure 2). So in simple terms, after already tightening for a while, a pause seemed to be justified in the context of a soft patch in the economy.

Figure 2: US Fed policy had become restrictive already

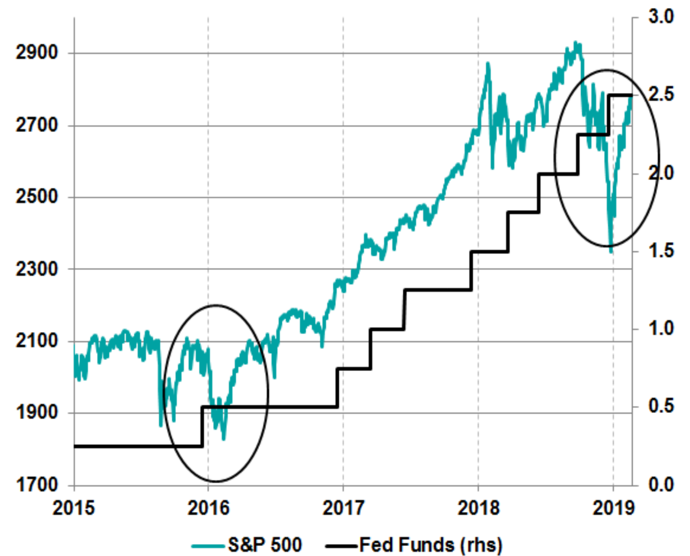


Source: Bloomberg and BNPP AM, as of 28/02/2019

As we have explored in prior editions of the *Asset Allocation Monthly*, historically, market volatility has often picked up when the Fed tightens 'too quickly' late in the cycle.

The sharp risk asset repricing late in 2018 and the associated tightening in financial conditions probably also gave the Fed food for thought. In fact, in many ways, the recent pause reminds us of the late 2015/early 2016 episode (Figure 3). Back then, macroeconomic data was also weakening and the Fed still raised rates in December 2015 (and signalled four hikes in 2016). This caused equities to accelerate to the downside and the Fed was 'forced' to take its foot off the pedal, raising rates only once in 2016.

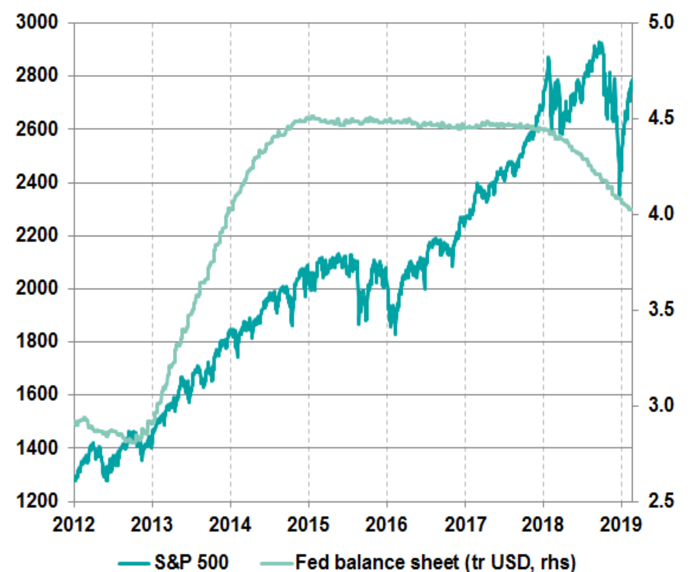
Figure 3: Fed pause triggered by financial conditions?



Source: Bloomberg and BNPP AM, as of 28/02/2019

Furthermore, we feel that the Fed's approach to trimming its balance sheet – i.e. unwinding years of QE on 'autopilot' regardless of the incoming data – was perhaps the real culprit. Notice how in Figure 4, equity market volatility commences in earnest only as the balance sheet starts to shrink.

Figure 4: The Fed's balance sheet autopilot the real culprit



Source: Bloomberg and BNPP AM, as of 28/02/2019

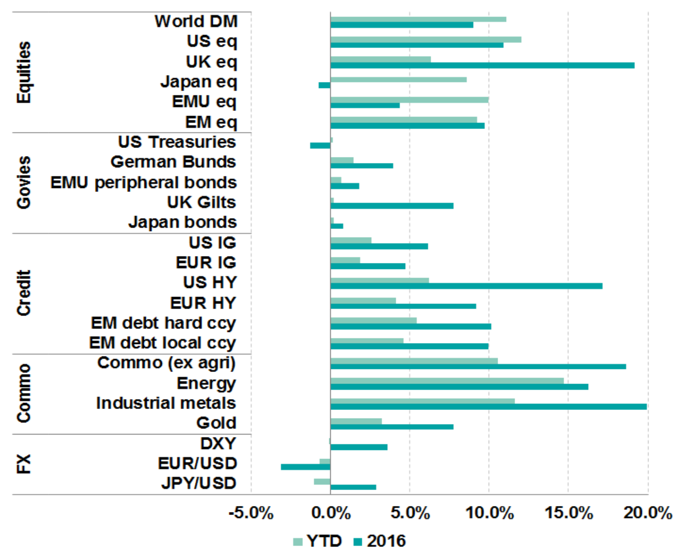
Either way, to us, the hurdle for a renewed shift in Fed policy is high. While we think the move towards renewed easing is also unlikely, the current pause could last several months. This is an important development for global markets.

Remember 2016?

While there are differences between late 2018/early 2019 and late 2015/early 2016 – most notably the stage of the economic cycle (see below) – we find the comparison intriguing, especially because we are also seeing more signs of easing in China (as we did back then).

In market terms, there are many similarities. Back in late 2015, risk assets sold off aggressively, commodities (especially oil) had just dropped too and after the Fed indicated a pause, risk assets bounced back quickly, carry assets did well and emerging markets were in vogue. Sound familiar (Figure 5)?

Figure 5: Cross-asset returns: 2016 as a 2019 template?

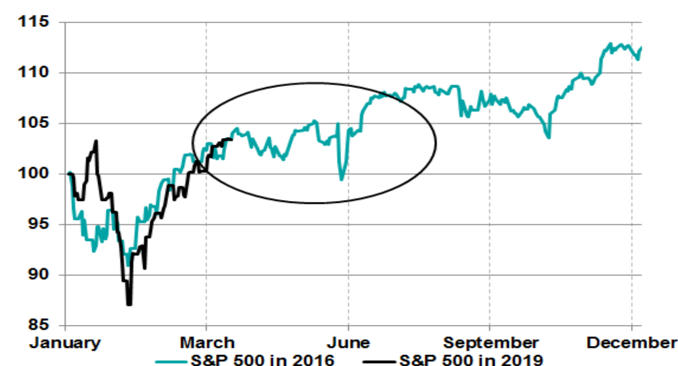


Source: Bloomberg and BNPP AM, as of 28/02/2019

So, 2016 could be somewhat of a template for the here and now – at least while Fed policy is on hold. That said, the 'easy' part of the risk-on move may already be over.

As we show in Figure 6, which compares the S&P 500 price action in 2016 to the one YTD, the path from here on could be tougher. After a similarly fast rebound early in 2016, more volatility ensued (albeit in an upwards trend).

Figure 6: 'Easy' upside already in the bag?



Source: Bloomberg and BNPP AM, as of 28/02/2019

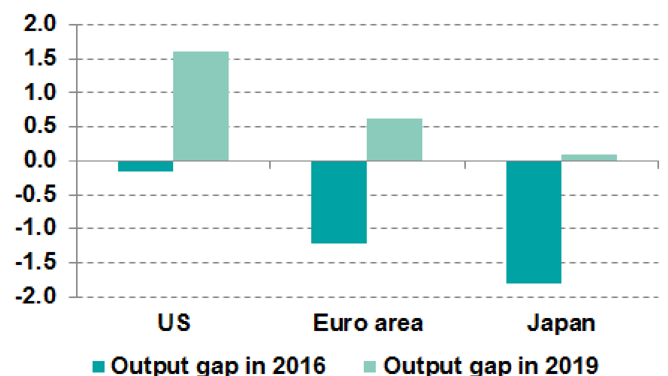
Given the extremely sharp reversal in equity markets, this historical "template", and moreover lingering fundamental worries (see below), we are not chasing recent moves now. We view medium-term directional risk/reward as unattractive.

DOWNSIDE GROWTH RISKS PERSIST

Clearly, the main difference to 2016 is the fact that the economic cycle has matured significantly since then. This can be seen in many ways, with the moves in output gaps in recent years a case in point (Figure 7). Indeed, we still believe that we are in the latter stages of the cycle and see more downside than upside risks to our macroeconomic base case.

Moreover, the willingness and ability of major central banks to ease aggressively as they did in prior years is no longer a given. And if the macro data improves over coming months, investors could quickly face the risk of quantitative tightening again.

Figure 7: The cycle has clearly matured compared to 2016



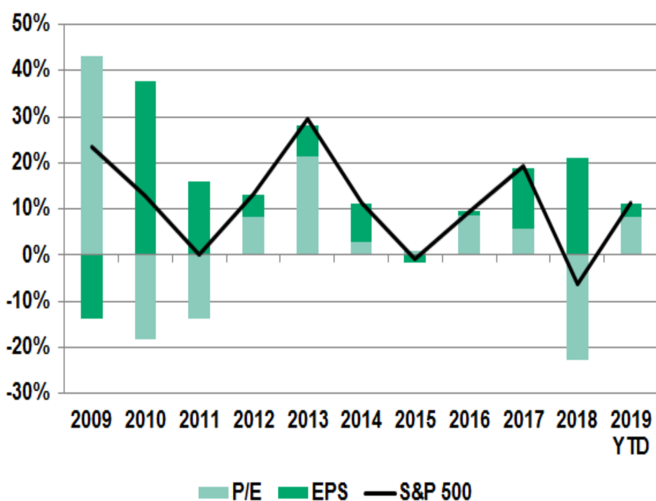
Source: IMF, Bloomberg and BNPP AM, as of 28/02/2019

Fundamentals will be key in the medium term

While the Fed's policy pause has grabbed the attention of markets in the here and now, we believe fundamentals will ultimately have to become the main driver again.

As we have often shown, quantitative easing significantly propelled markets in recent years, and in some episodes even when there were no positive fundamentals. In fact, many of the QE years saw equity market multiples expanding, without earnings growth being strong (Figure 8).

Figure 8: QE caused P/E expansion; earnings needed now



Source: Bloomberg and BNPP AM, as of 28/02/2019

Over the medium to long term, we do not expect this to persist. Or put differently: earnings will have to do the heavy lifting over the medium to long term.

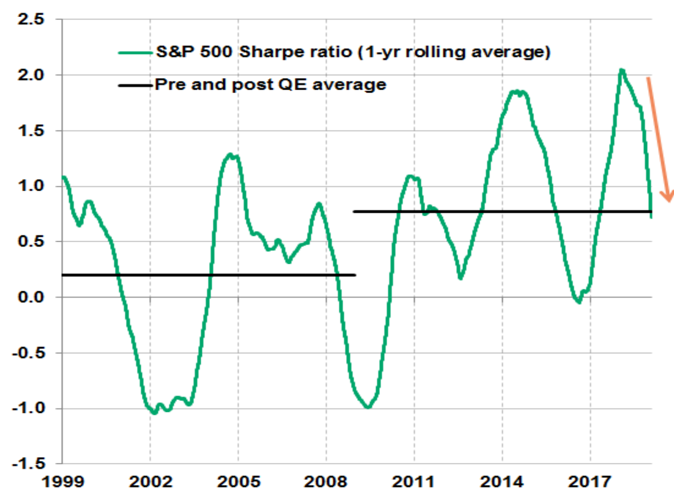
Get used to poorer risk-adjusted returns

Year-to-date market price action certainly does not reflect our medium to long-term view. In fact, the equity markets' stellar recent recovery has seen little volatility.

That said, we still expect a regime change towards lower returns and more volatility – i.e., worse risk-adjusted returns. Historically, the QE years were a clear aberration in terms of Sharpe ratios and this will have to reverse.

In fact, when abstracting from the recent short-term price action, this trend is already clearly visible (Figure 9).

Figure 9: Expect lower risk-adjusted returns



Source: Bloomberg and BNPP AM, as of 28/02/2019

NAVIGATING THE SHIFT FROM FUNDAMENTALS TO LIQUIDITY

One way to pull all this together and to conclude with a road-map for the battle between fundamentals and liquidity is via the simple scenario matrix presented in Figure 10.

Here we show generic expectations for major markets on the basis of the two key pillars driving markets at the moment: Fed policy and the stage of the cycle.

Interestingly, in the last couple of quarters, we have cycled through three of the four quadrants in our matrix. In mid-2018, markets were in the top right-hand quadrant where equities rallied and bond yields rose. As growth fears increased, but the Fed still tightened, we transitioned to the bottom right-hand corner where equities suffered and bond yields eventually fell. Finally, this year, we have switched to the top left-hand quadrant: with the Fed on hold and growth fears stabilising, risk assets were bid and bond yields traded sideways as real yields fell (unwinding of QT fears) with breakeven inflation rates higher on reflation hopes.

Figure 10: Liquidity vs. fundamentals – scenario analysis

	Fed Pause	Fed Tightens
Mid-Cycle	Equities – UP Bond yields – RANGY Real yields – DOWN BEs – UP EM – UP	Equities – RANGY/UP Bond yields– UP Real yields – UP BEs – RANGY/UP EM - DOWN
End-Cycle	Equities – DOWN Bond yields– DOWN Real yields – DOWN BEs – DOWN EM - DOWN	Equities – DOWN Bond yields–RANGY/UP Real yields – DOWN BEs – UP EM – DOWN

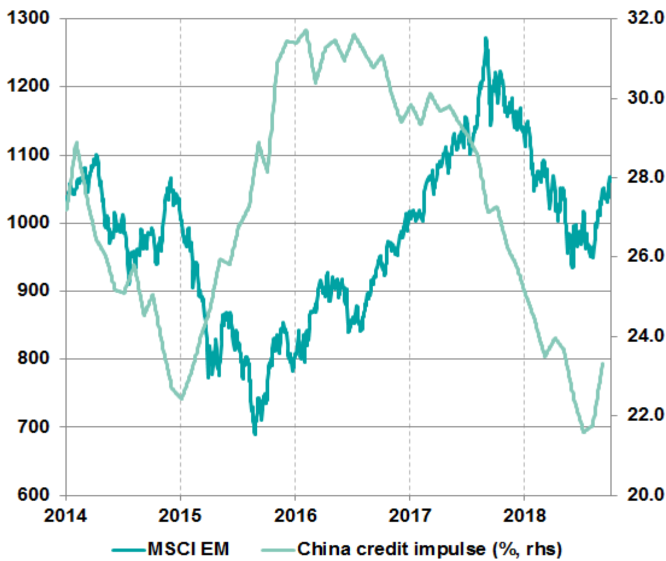
Source: BNPP AM, as of 28/02/2019

Emerging market assets are also at an interesting juncture, given China has started easing policy again. In our matrix, the top left-hand quadrant should see EM do well given an on-hold Fed, rangy bond yields and broader risk appetite recovering.

Again, in many ways, we are reminded of the 2016 episode where after a sharp underperformance (with commodities also weakening) heading into the Fed pause, EM did well as China's easing measures came through powerfully (Figure 11).

Here too, we are not chasing recent moves however. Flows into EM have been strong so far this year and while developments on the China-US trade relations have been positive, nothing firm has been agreed as of yet and the trade tensions could rise swiftly again. Put differently, here too, risk/reward is not attractive now.

Figure 11: China providing more stimulus again



Source: Bloomberg and BNPP AM, as of 28/02/2019

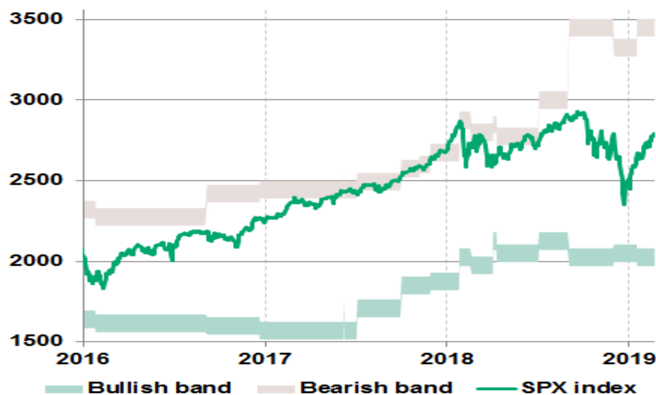
ASSET ALLOCATION

Structural views – directional risk/reward unattractive

With market expectations quickly shifting between several different states of the world, we find directional exposure to risky assets unattractive. This is especially true given that stocks continue to sit in the middle of our scenario analysis ranges (Figure 12). The fact that we view the macroeconomic downside risks as bigger than upside risks also makes equities less attractive. Indeed, you should note that in the matrix shown in Figure 10, equities are at risk outside of the current Fed pause 'sweet spot'.

We prefer maintaining a structural neutral on the equity asset class, tactically trading around this core view. Note that in this light we closed our tactical equity short earlier this month following the Fed news, but we are not keen on chasing any further upside.

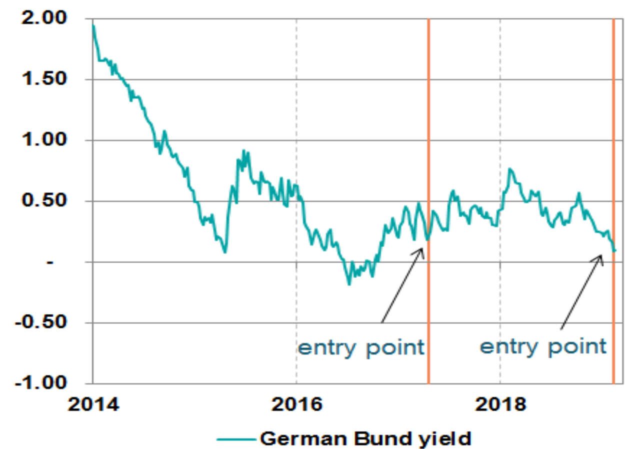
Figure 12: S&P 500 scenario analysis



Source: Bloomberg and BNPP AM, as of 28/02/2019

In fixed income, we continue to hold a broad underweight in European bonds given our view of gradually rising inflation and monetary policy normalisation by the ECB. Given the bullish price action in Bunds, we added a further short in 10-year German bonds to our bond-heavy portfolios. With Bund yields at 0.10%, the asymmetric outlook is further skewed to the upside in yields. As such, we regard current levels as attractive entry points (Figure 13).

Figure 13: FI underweight increased via Bunds short



Source: Bloomberg and BNPP AM, as of 28/02/2019

Building robust portfolios and diversifying

Given the uncertain macroeconomic backdrop, we believe building robust portfolios and holding diversification trades is key. So, we hold positions and relative value trades with asymmetries to our scenario analysis, but also trades which are geared to thematic views.

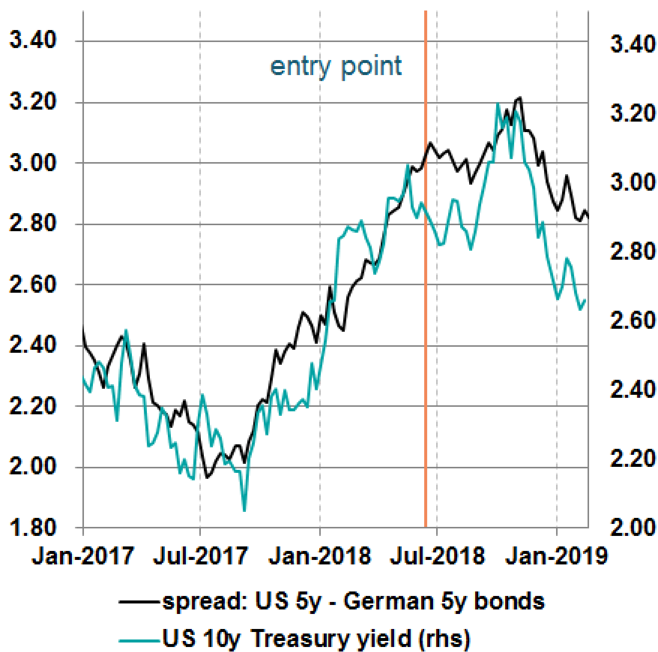
One such trade is a long in the French CAC 40 equity index versus the German DAX. We believe Germany is more exposed than France to de-globalisation and this RV trade aims to reduce our exposure to possible renewed trade tensions between China and the US. This trade has done well in recent months (Figure 14).

Figure 14: Long CAC/DAX has worked well recently

Source: Bloomberg and BNPP AM, as of 28/02/2019

Another trade we believe adds diversification elements to portfolios is a long in 5-year US bonds versus their German counterparts. Stretched valuation differences and our view that European fixed income is more vulnerable to a correction as the ECB eventually begins to withdraw policy accommodation are the main drivers. As Figure 15 shows, the trade also has good defensive characteristics in risk-off environments. This makes it a good portfolio diversifier.

Figure 15: 5y US vs. Germany has defensive characteristic



Source: Bloomberg and BNPP AM, as of 28/02/2019

STRATEGIC OVERVIEW OF KEY POSITION CHANGES IN FEBRUARY 2019

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

FEBRUARY:

TACTICAL SHORT EU & US EQUITIES CLOSED 13/02/19

- Given the Fed's policy pause, we see no supportive factors for our tactical short in equities in the short run and have elected to close this position.

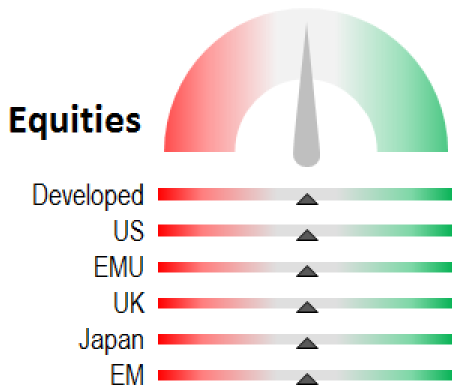
SHORT BUNDS OPENED 13/02/19

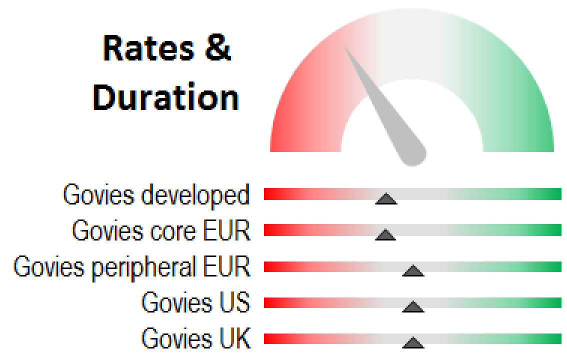
- We regard recently lower yield as a good entry point to add to our bond underweight. We decided to add a short in Bunds to bond-heavy portfolios.

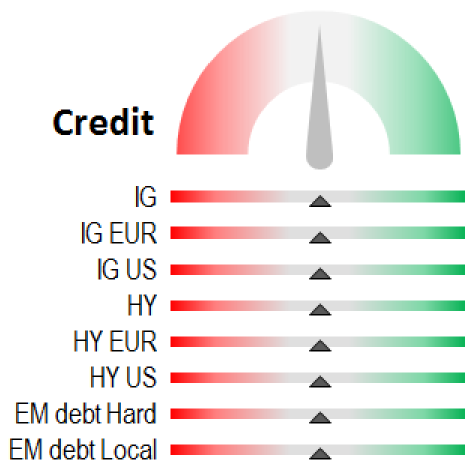
LONG CAC/DAX REDUCED 20/02/19

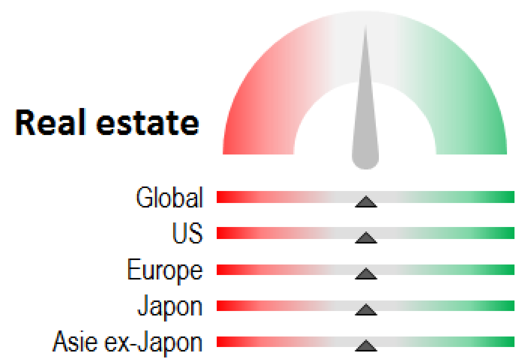
- After decent performance over a short period of time, and given that technical indicators are looking stretched, we took profits on half of our CAC/DAX trade.

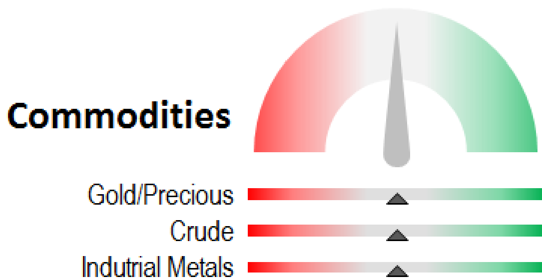
ASSET ALLOCATION DASHBOARD[1]

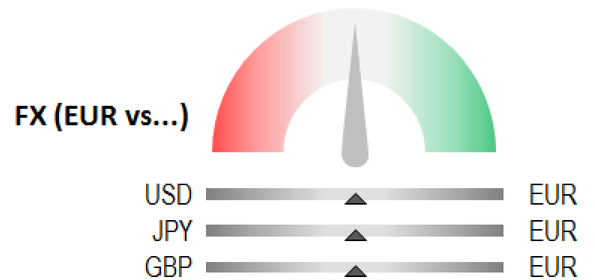


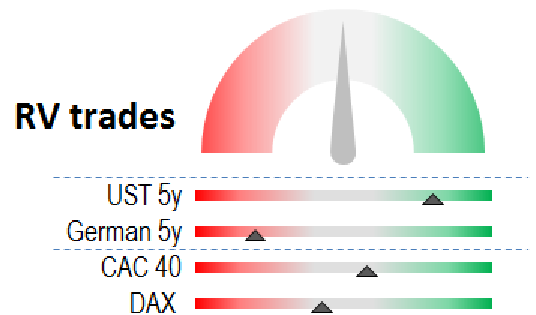












[1] The dashboard shows the asset allocation in our portfolios and reflects the decisions of the Investment Committee of the Multi-Asset team at MAQS.

Views expressed are those of the Investment Committee of MAQS, as of March 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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