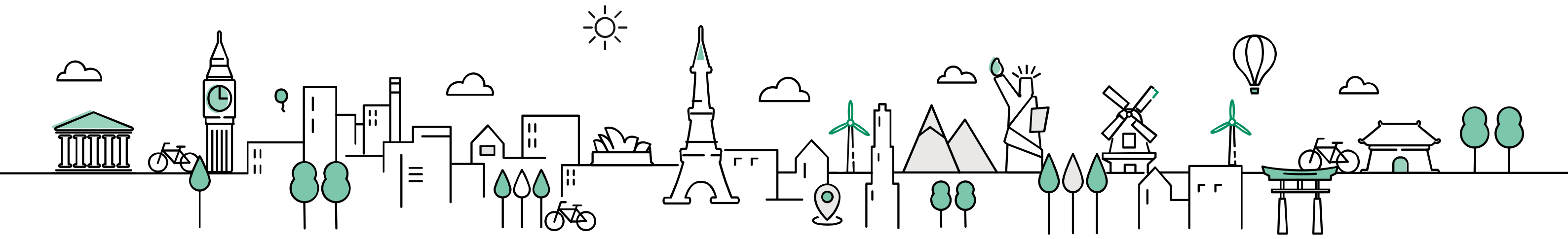

Asset Allocation Monthly

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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

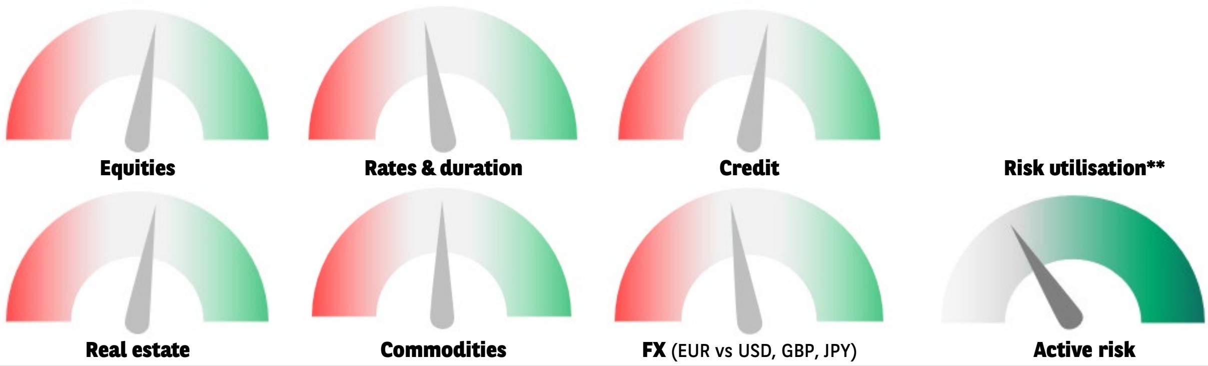
- Fundamentals and market dynamics suggest medium-term upside in risky assets
- Bullish technical signals are starting to appear in some equity markets, but our indicators still advocate caution, with sideways moves expected during early 2021

LET'S GET REAL

US real yields surged towards the end of February, spurring unpleasant memories of the 'taper tantrum' in 2013 when comments by Ben Bernanke, then Chair of the Federal Reserve, set off a 100bp rise in 10-year Treasury yields over several months. Now, as then, market expectations of the future level of policy rates have jumped sharply higher (see Exhibit 1). In contrast to 2013, however, the Fed has made it clear that it does not intend to tighten policy until the unemployment rate is much lower and inflation sustainably higher. The market's apparent disbelief stems perhaps from recently strong economic data including retail sales, news on greater vaccine availability, and anticipation of the USD 1.9 trillion stimulus package that has now been approved by the US House of Representatives.

Another source of market anxiety may be the significant increase in US Treasury issuance required to fund this stimulus. A disappointing auction of 7-year Treasury bonds on 25 February suggests there is some concern that the Fed's USD 960 billion quantitative easing (QE) programme might not be able to keep interest rates down in the face of this looming wave of supply. Uncertainty about the future level of interest rates has also jumped. Term premium on the 10-year Treasury has increased by 130bp since last August.

Core asset class views*



BNP PARIBAS
ASSET MANAGEMENT

The asset manager for a changing world

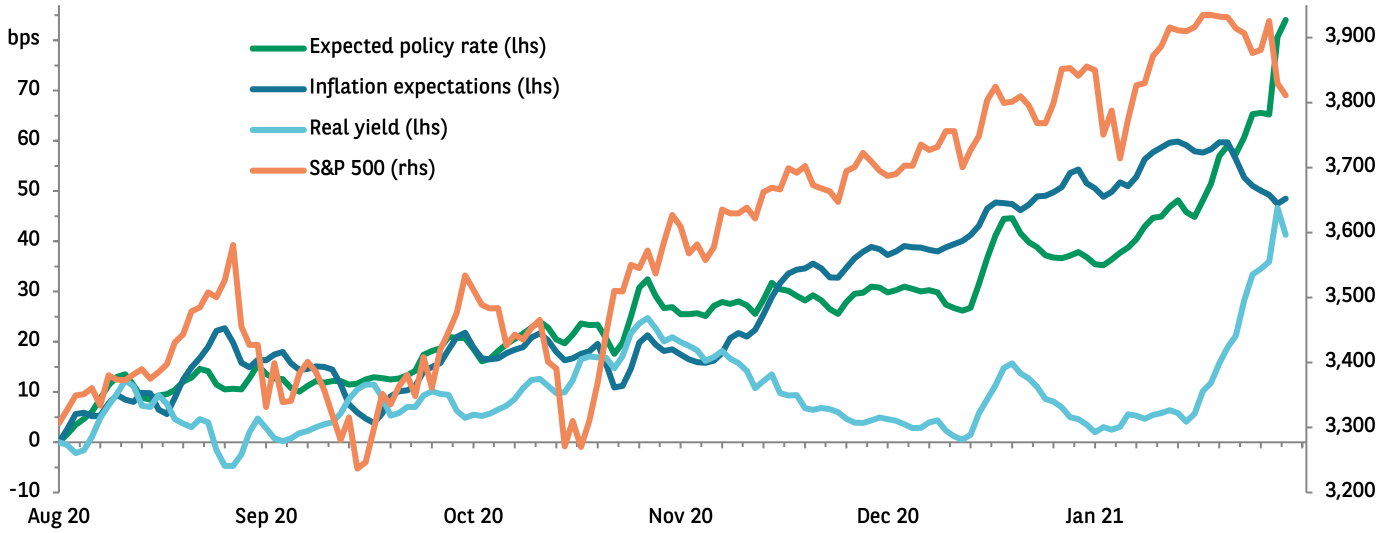
We expect the Fed to move quickly between now and the next FOMC meeting on 16-17 March to dampen any expectations of policy tightening. An expansion of the current QE programme looks unlikely at this point unless real yields continue to rise significantly while risk assets fall.

Equities have dropped over the last couple of weeks, although this is at least partly due to the fall in inflation expectations. We do not see price pressures waning quickly. Commodity prices are still rising and there is significant pent-up demand and cash in the economy even before the third round of stimulus cheques arrives. The main factors keeping demand in check are lockdown restrictions and consumer anxiety, but both should diminish as we move into spring.

Rising real rates and higher policy rate expectations do not necessarily threaten the rally in equities we have seen since last March. While higher interest rates mean a higher discount rate on corporate earnings, higher rates also reflect stronger growth and inflation. Historically, that benefit has outweighed any financial drag.

Exhibit 1: Change in the components of nominal Treasury yields and S&P 500

Yields indexed to the low in the US 10-year Treasury yield on 4 August 2020



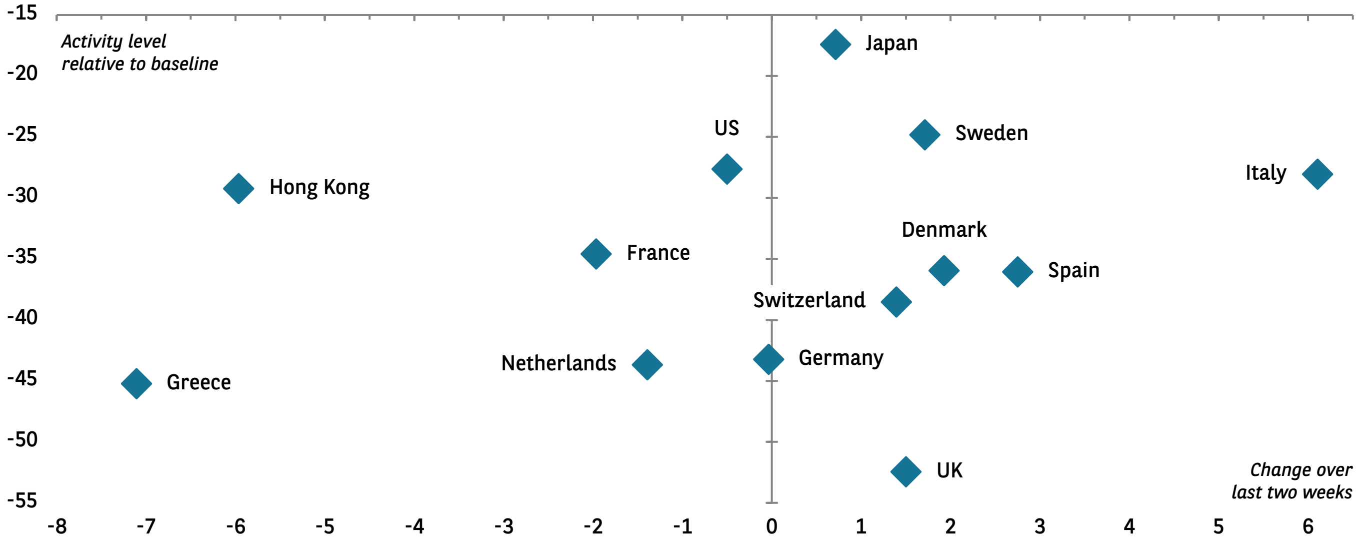
Data as at 28 February 2021. Sources: US Federal Reserve, Bloomberg, BNP Paribas Asset Management.

PANDEMIC DEVELOPMENTS

The optimism that gripped the world with the announcement of positive vaccine trial results last November has now been tempered. More infectious virus mutations and delayed vaccine rollouts have pushed back the date when lockdown restrictions are expected to be lifted and people feel safe enough to return to work, shopping and recreation. Even as lockdown restrictions are reduced in some countries, activity remains subdued, particularly in the UK (see Exhibit 2).

Exhibit 2: Mobility indicators

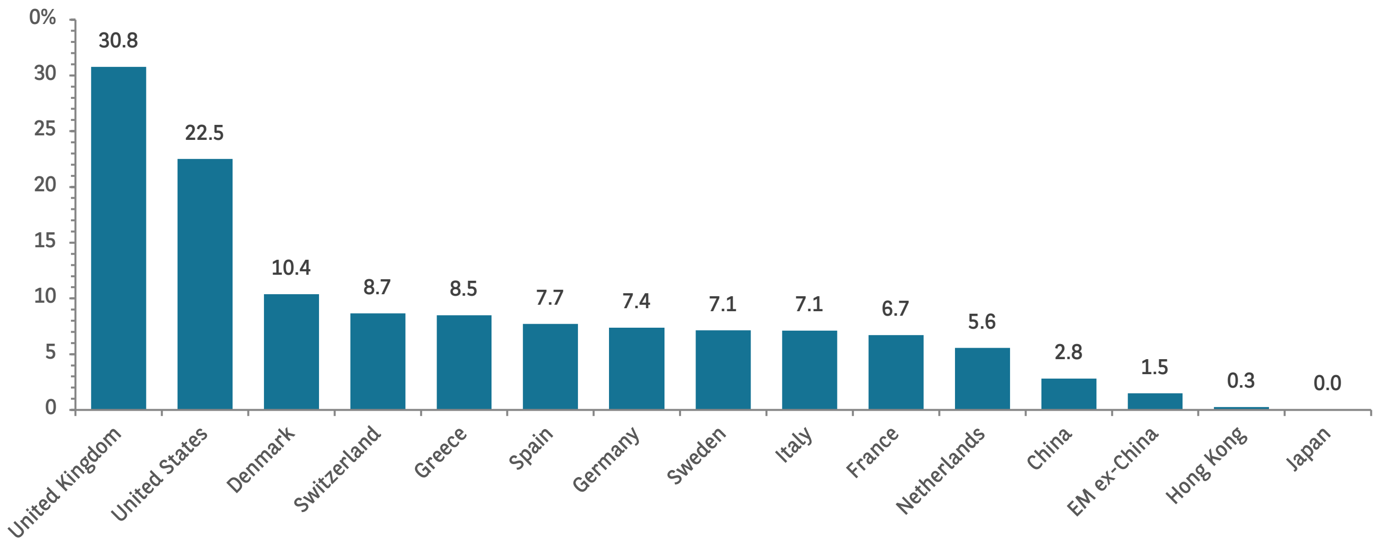
Activity relative to baseline; average of retail & recreation and workplace indicators



Data as at 28 February 2021. Sources: Google, BNP Paribas Asset Management.

However halting, progress is nonetheless being made: 30% of the UK population has now been vaccinated and nearly a quarter of the US population. Continental Europe continues to lag with just 7% immunised so far, but the pace should accelerate in coming months. A bigger concern is the slow pace of vaccination in emerging markets, which could delay the resumption in activity that investors hope to see in the second half of the year (see Exhibit 3).

Exhibit 3: Cumulative COVID-19 vaccination doses administered per 100 people



Data as at 28 February 2021. Sources: Our World in Data, BNP Paribas Asset Management.

The US continues to reject lockdown measures largely and as a result, US mobility as shown in Exhibit 2 is nearly twice the level of that in the UK and almost 60% higher than in Germany. This has translated into better economic data: US purchasing manager indices (PMIs) are near 60 compared to sub-50 readings for much of Europe. The gap is greatest in the services sector; manufacturing in most countries is expanding. Another example is retail sales growth, which in the UK has plunged to -3.8%. In contrast, it has soared to 6.1% in the US with the arrival of government stimulus cheques; much more is likely to come.

The US Congressional Budget Office (CBO) expects that about USD 1.3 trillion of the proposed stimulus package will be spent in 2021, which is equivalent to 6% of GDP. The House of Representatives has approved the package and it now lies with the Senate. There will be greater disagreement there on the makeup of the plan and the USD 15 an hour federal minimum wage has already fallen by the wayside. The administration would like the bill passed by mid-March before the current emergency unemployment benefits expire.

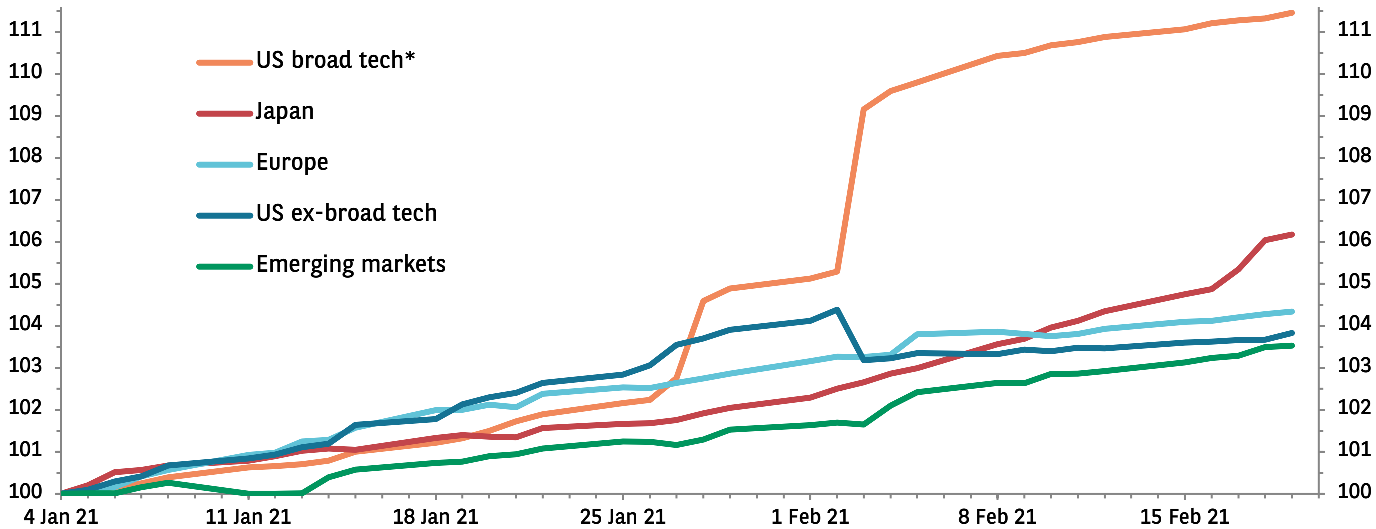
It is this significant additional boost to income, when real GDP is only 2% below pre-pandemic levels (compared to 10% in 2q20), that is prompting the surge we have seen in bond yields. The volatility we have seen both in equities and bond yields reflects a transition that is underway from liquidity-driven markets anchored by low real yields to growth-driven markets where earnings per share growth will drive equities.

EARNINGS SEASON TAKEAWAYS

At the most pessimistic point in August 2020, not long after the catastrophic second quarter GDP figures were released, year-on-year earnings by S&P 500 companies were forecast to fall by 10% for the fourth quarter of 2020. Things have turned out rather better. With 491 companies having reported, earnings have risen by 3.9% from same period 2019 levels with earnings surprises at 17%. European companies have done nearly as well with 3.1% earnings growth rather than the expected 14% fall.

As a result, estimates of forward earnings are rising, particularly for the US tech sector (see Exhibit 4). For continued positive earnings estimates, the full USD 1.9 trillion package proposed by the Biden administration will need to be passed and/or activity must rebound more quickly than currently expected.

Exhibit 4: Next-twelve-month earnings estimate



Data as at 28 February 2021. *Includes Information Technology, Internet Retail, Entertainment, and Interactive Media. Note: MSCI indices. Sources: FactSet, BNP Paribas Asset Management.

Revisions for Europe have not lagged significantly behind those for the US. While Europe has far less fiscal stimulus to look forward to, the comparatively low level of economic activity means the marginal change should be greater once a higher share of the population has been inoculated. Though vaccination rates in emerging markets are even lower than in Europe, as most countries have imposed far fewer restrictions and many adults are not able to work from home, activity has already started to recover.

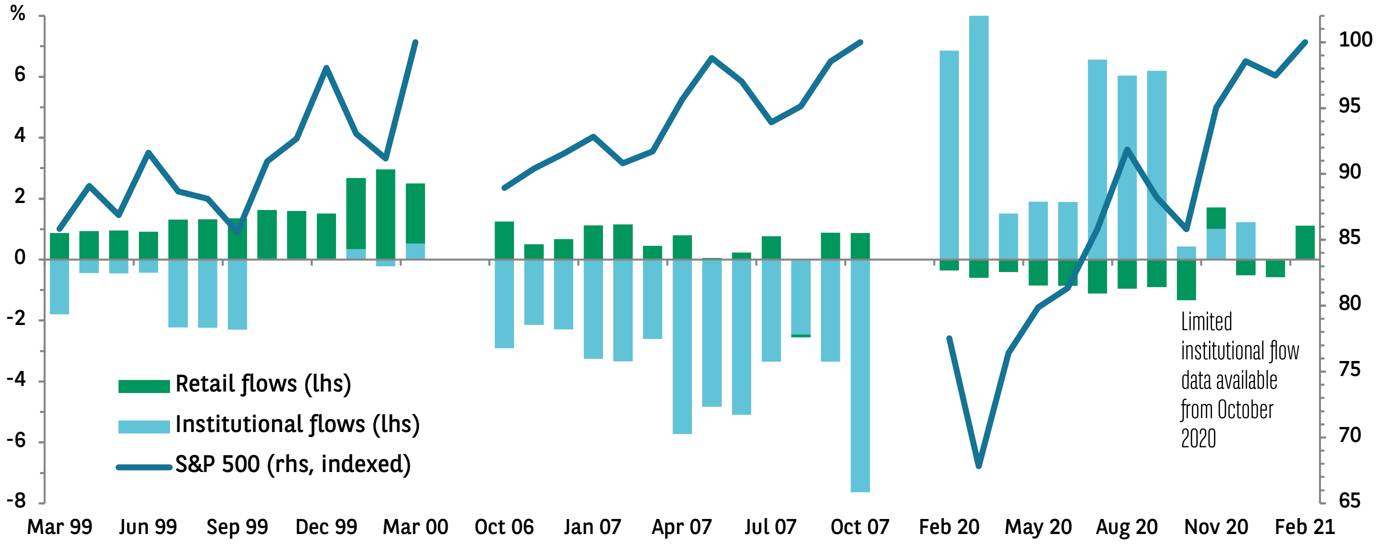
FLOWS AND SENTIMENT

One of the concerns about the current state of the stock market has been that investor sentiment is overly bullish and heavy fund flows were propping up the market. We too are cautious about the near-term dynamics of the market (see the Market Dynamics Inputs section below), but we believe some of these worries are overblown. Investor sentiment is high, but not obviously extreme, nor are allocations to equities. The latest survey from Investor Intelligence shows the ratio of bulls to bears at 3.3, in the 90th percentile of readings. An American Association of Individual Investors (AAII) survey has the ratio at 1.9x, in the 80th percentile. Given the accelerating economic recovery in the US, however, positive sentiment is not surprising even if future returns from equities may be below average.

Fund flows have been robust recently, but this follows outflows in January and in 11 out of 12 months in 2020. Over the last six months, cumulative flows stand at minus USD 100 billion. One should in any event be careful not to overestimate the impact of retail fund flows on the market. These flows are often overwhelmed by institutional flows. Finally, there is little correlation between fund flows and the timing of a market peak. In the months leading up to March 2000, there were strong inflows, while prior to October 2007, there were net redemptions thanks to institutional investors. While we have limited recent institutional data, the pattern over the last 12 months does not show either extreme optimism or pessimism (see Exhibit 5).

Exhibit 5: Fund flows during previous bull market tops

S&P 500 indexed to market peak; fund flows as a percentage of total equity value

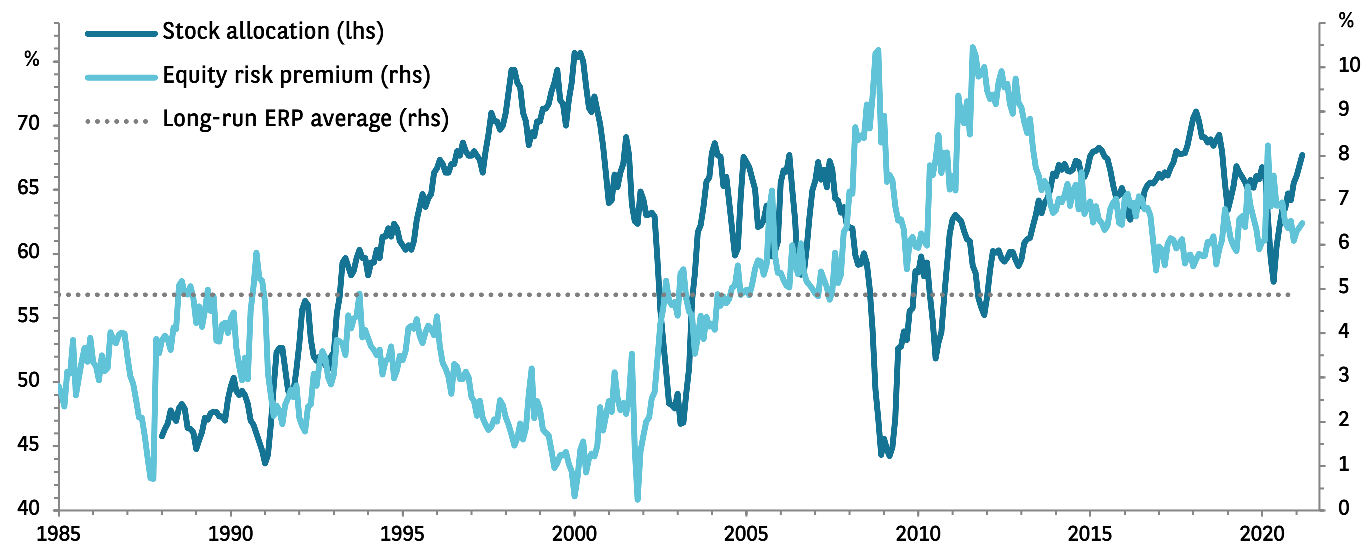


Data as at 28 February 2021. Sources: US Federal Reserve, Investment Company Institute, US Treasury, BNP Paribas Asset Management.

With low and rising interest rates, it is not surprising investors anticipate higher total returns from equities than from bonds and have commensurately allocated more funds to equities. The latest AAII survey shows an allocation to equities of 68%, only modestly above average. Given the gap between equity earnings yields and real bond yields, we believe this allocation is appropriate. Our estimate of the difference in yields – one measure of the equity risk premium – is 6.5%, still 160bp above average (see Exhibit 6).

Exhibit 6: Equity risk premium and portfolio allocation to stocks

ERP calculated as expected earnings yield on equities less expected-inflation-adjusted Treasury yield



Data as at 28 February 2021. Sources: IBES, University of Michigan, American Association of Individual Investors, BNP Paribas Asset Management.

MARKET DYNAMICS INPUTS

Our market dynamics tools are showing signs of consolidation in major equity markets both in the short and medium term. 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 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. After the correction in late January, bullish technical signals are starting to appear in some markets, notably emerging markets, but our indicators still advocate caution with sideways moves expected in the first part of 2021.

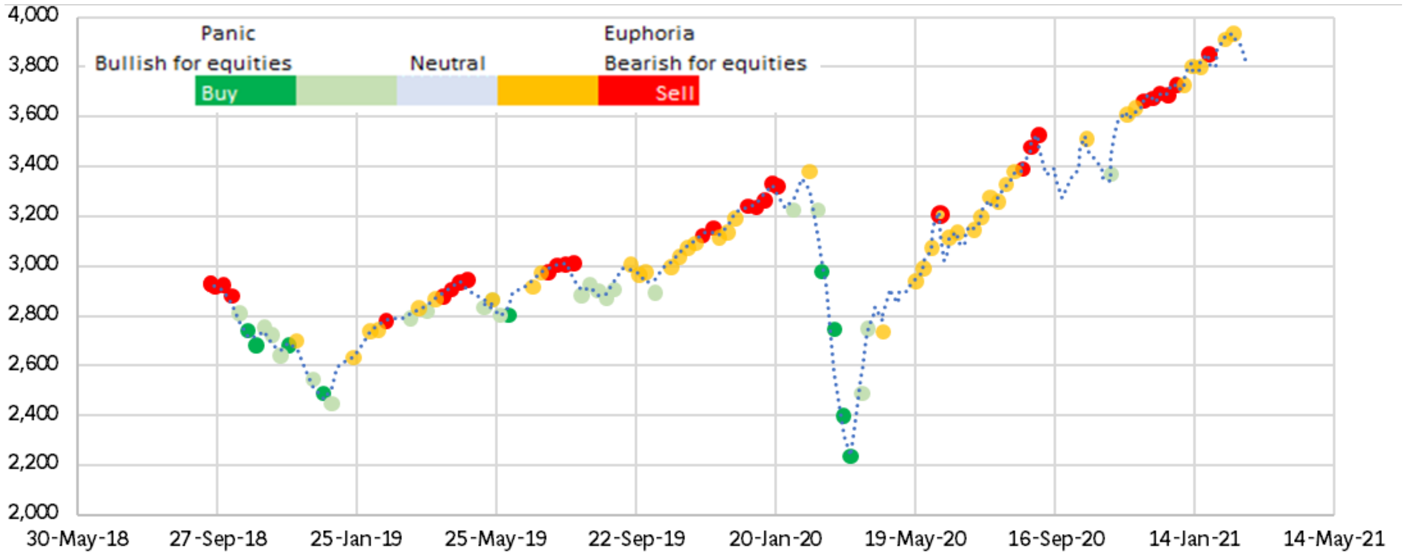
For core fixed-income markets, short-term technical signals pointed to the risk of some upside in yields at the beginning of the year, but they are more neutral now. In the medium to long term, they still flag upside for yields.

Finally, for the USD, short-term signals suggest a 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 7: Evolution of the market temperature since July 2018 (S&P 500)

All temperatures shown except neutral



Data as at 25 February 2021. Sources: Bloomberg, BNP Paribas Asset Management.

ASSET ALLOCATION

The cyclical recovery expected for this year will likely 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.

In a tactical move, we reduced our exposure to risk for market-technical reasons and given the uncertainties over the evolution of the COVID-19 pandemic. In the context of our flexible approach to asset allocation, any market consolidation in the short term can be seen as a buying opportunity.

Equities ↑ (new)
The investment committee decided to take an overweight position in Italian equity relative to eurozone equity. 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 slightly 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. We took profits on our positions in US and Japan equities on 11 January in the context of stretched technical indicators and uncertainties over the course of the pandemic.

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 ↓ (unchanged)
We are short EMU bonds, long EUR inflation-linked debt, and we have a USD curve steepener via options.

Core yields are near historical lows. 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 PEPP programme. As a result, EMU yields look asymmetric to the upside in the event of a cyclical recovery in the eurozone. Being long EUR inflation-linked debt while being short EMU bonds gives our portfolios upside in reflationary environments as effectively we are long breakeven inflation in the eurozone.

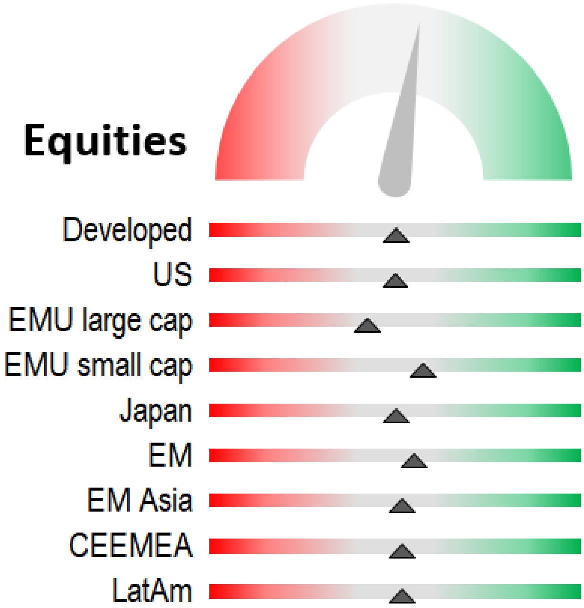
Credit ↑ (unchanged)
We are long emerging market local currency debt. We see room for further spread compression in the current search for yield. As for currencies, we see plenty of room for appreciation, especially if the USD resumes its downtrend.

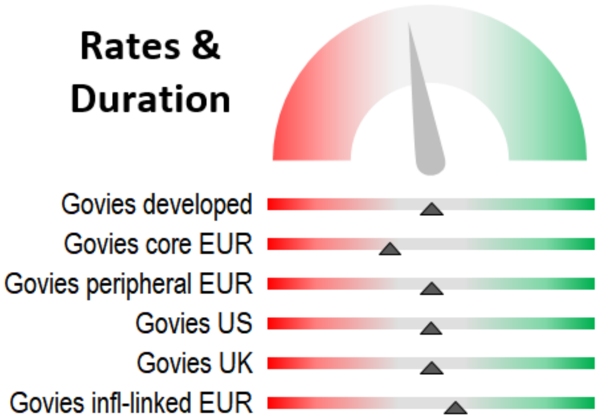
Currencies ↓ (new)
We are worried that the consensus view of a weaker US dollar has become crowded. We believe recent news on the fundamentals is contradicting this consensus assessment. Thanks to fiscal stimulus in the US while in Europe there are extended lockdowns and delayed vaccine rollouts, we expect the US economy to outperform Europe significantly in 2021. Consequently, we are turning 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 country's continuing large twin deficits.

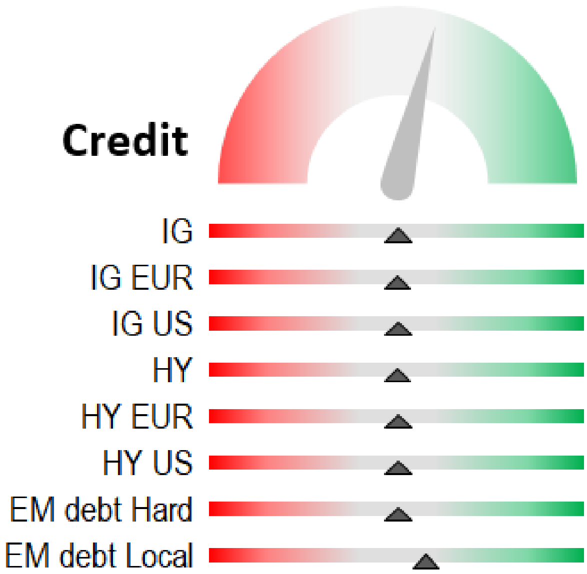
Commodities ⇔ (new)
We have cut our commodities long tactically, but still like commodities in the medium term. We remain long gold. Gold should be seen as a currency that cannot be debased by central banks and one that is a good hedge against the risk of inflation.

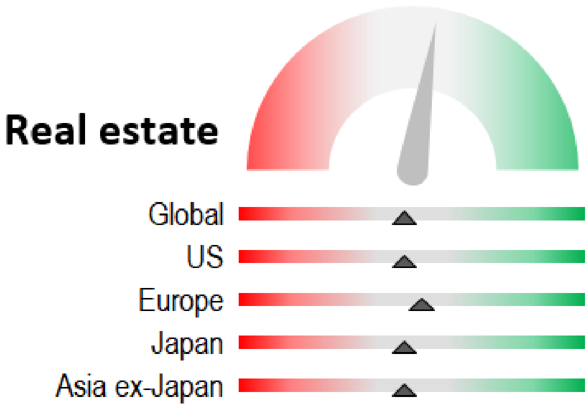
Thematics ↑ (unchanged)
We have a position in thematic investments: global environment, energy transition and artificial intelligence. We regard the current investment as a first step and we aim to allocate more to thematic investments, and to broaden the spectrum of themes invested in.

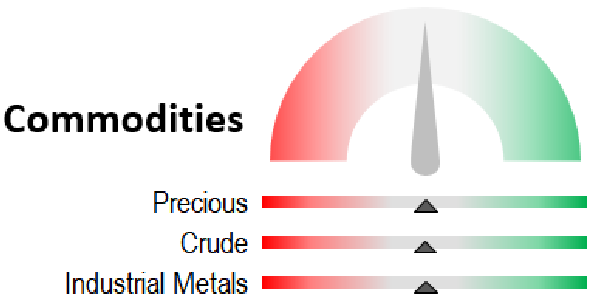
CORE ASSET ALLOCATION DASHBOARD

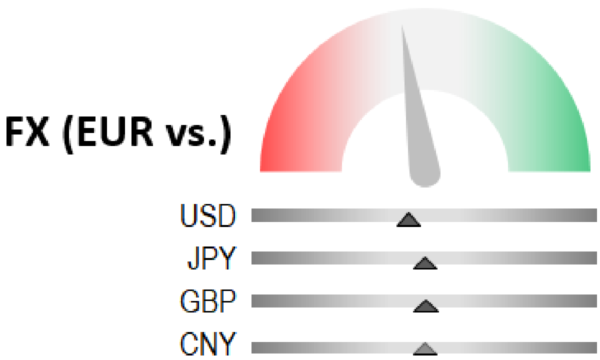












*The core asset class views dashboard reflects the key views of the Investment Committee of the Multi-Asset team at MAQS. Other specific/tactical trades may be implemented in addition and are listed at the end of this publication. ** Risk utilisation/active risk is a measure of the tracking error (as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

DISCLAIMER