FOR PROFESSIONAL INVESTORS – 3 December 2018

ASSET ALLOCATION OUTLOOK

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

2019 OUTLOOK: MANAGING AN ATYPICAL LATE CYCLE

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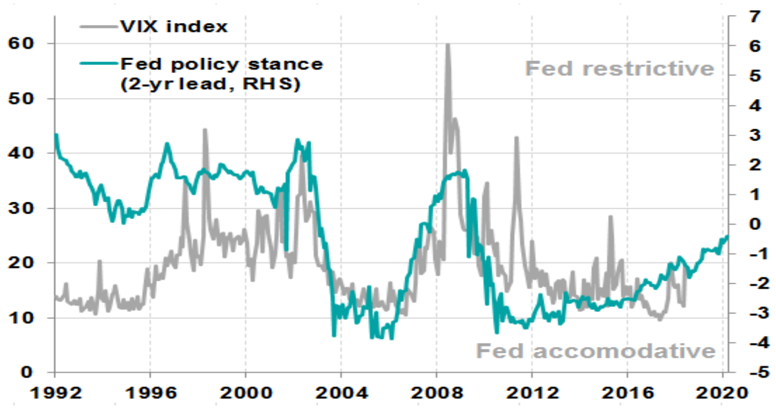
- **Macroeconomic views:** The global economy will likely face a more challenging environment in 2019. We expect growth to moderate in most regions and we see the balance of risks as having shifted to the downside. A contained slowdown in US growth should still make it the main bright spot versus other major economies: asynchronous growth is likely to remain.

- **Risks:** Unlike previous late cycles, this one will be marked by quantitative tightening, which could be exacerbated by the risk of overheating in the US. Other unusual challenges will be geopolitical in nature. Sino-US trade tensions are likely here to stay, but an escalation could be more disruptive. Tensions between the EU and Italy and the UK respectively are further risks to monitor.

- **Asset allocation:** We expect returns to be more dispersed and generally lower in risk-adjusted terms than in the immediate post-crisis years, given a more volatile macroeconomic and market landscape. Given the economic and political backdrop and the associated risks, we are now strategically neutral on equities. But remain underweight fixed income. Crucially, we are ready to add or reduce risk tactically depending of the evolution of the macro/political risks highlighted. Our tactical market dynamics indicators are a helpful tool to navigate markets.

Figure 1: A restrictive policy stance by the US Federal Reserve could lead to higher volatility



Fed policy stance calculated as the spread between the real fed funds rates and R* estimates
Source: Bloomberg and BNP Paribas Asset Management. Data as of 30 Nov 2018.

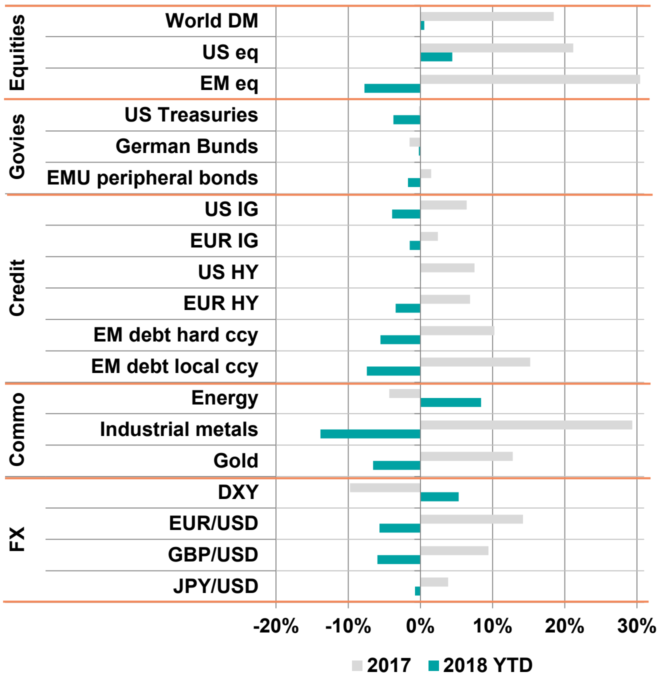
BNP PARIBAS ASSET MANAGEMENT

The asset manager for a changing world

LOOKING AHEAD TO 2019

2018 turned out to be a very different year to what most market participants had expected. Global growth was asynchronous and tighter monetary policy finally cast its shadow over asset markets. Rising inflation, especially in the US, also meant that investors lost faith in the so-called goldilocks environment. In addition, politics played a destabilising role with Sino-US trade tensions, Italian politics and Brexit weighing on markets. As a result, asset returns were poor across the board and thus almost the opposite of what investors experienced in 2017 and most other years since the global financial crisis (Figure 2).

Figure 2: Cross-asset returns broadly negative in 2018



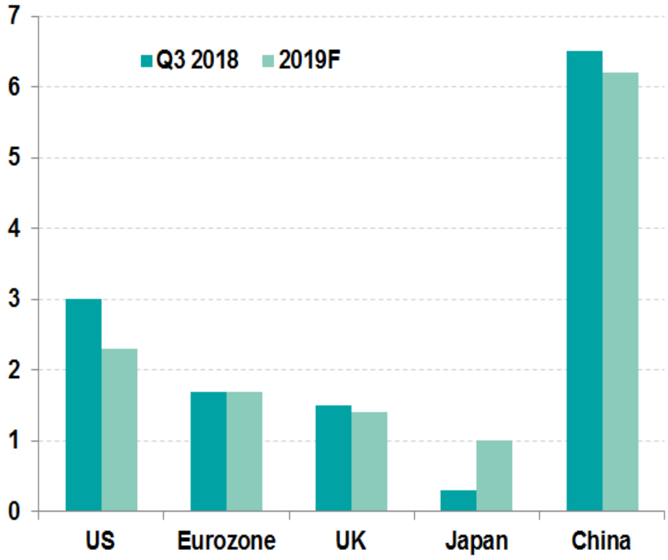
Source: Bloomberg and BNP Paribas Asset Management, as of 30 Nov 2018

Our central case is that investors face robust, but weaker global growth in 2019, with the recovery in the US more resilient than in other major economies. However, we see the balance of risks for growth and markets as skewed to the downside as investors face the risk of the US economy overheating, persistent growth challenges in Europe and ongoing trade tensions between the US and China.

A CHALLENGING MACRO ENVIRONMENT

As said, the macroeconomic prospects for 2019 are likely to be less rosy than they were in 2018, but still robust. Growth in the US has strong momentum, following a big fiscal push which turbocharged a recovery that has benefited from more than a decade of expansionary monetary policy. US growth is likely to be firm in 2019 at around 2.3%, but weaker than the impressive 3% seen towards the end of 2018 (Figure 3).

Figure 3: We expect robust, but slower GDP growth rates in our central case



Source: Bloomberg and BNP Paribas Asset Management, as of 30 Nov 2018

In the eurozone, both survey-based activity data and hard data such as GDP growth weakened in 2018. The latter has been slowing since the post-crisis high in late 2017 (growth of 2.8%), reflecting weaker global external demand. However, employment figures improved and domestic demand remained robust. The region should continue to expand at above its potential growth rate.

The Chinese economy is also slowing after several years of policy-induced robust growth. The deceleration is necessary as the authorities seek to reduce leverage and achieve 'higher quality' growth. In our central case, the slowdown is controlled thanks to policy measures that aim to support the economy without resorting to another rapid build-up of debt.

Overall, we see the US faring better than its chief counterparts, resulting in asynchronous growth. The main challenge will be maintaining the economic expansion as both fiscal and monetary policy become less supportive and as growth in the rest of the world slows.

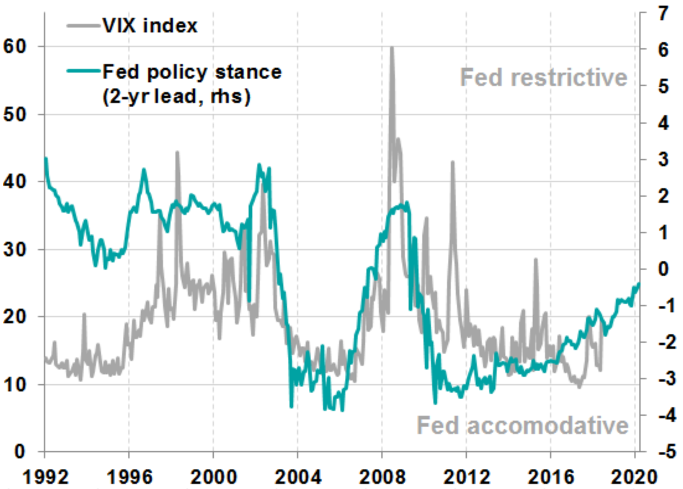
The risks of quantitative tightening

Several aspects of the current global economic expansion are quite atypical. First, the US recovery and the associated bull market in equities have both been one of the longest in recent history. Second, and perhaps more importantly, the aggressive and unconventional monetary policies of major central banks have been a major support for equities and other risky assets. These policies led to unusual distortions such as persistently low asset price volatility, high risk-adjusted returns and historically tight risk premia in both equity and fixed income markets. These imbalances look set to unwind as central banks trim their balance sheets and raise interest rates, in other words, as 'quantitative tightening' gathers momentum.

Major central banks are likely to continue to normalise their policies in 2019, even if inflation rises only modestly. Only a significant downturn would change their course. The US Fed is leading this trend and its policy stance is close to turning restrictive, with interest rates approaching 'neutral' levels.

Furthermore, the US economy runs the risk of overheating because spare capacity is now low and core inflation is near the Fed's 2% target. As interest rates continue to rise in 2019 and the effects of quantitative tightening becomes more visible, investors should brace for higher volatility (Figure 4).

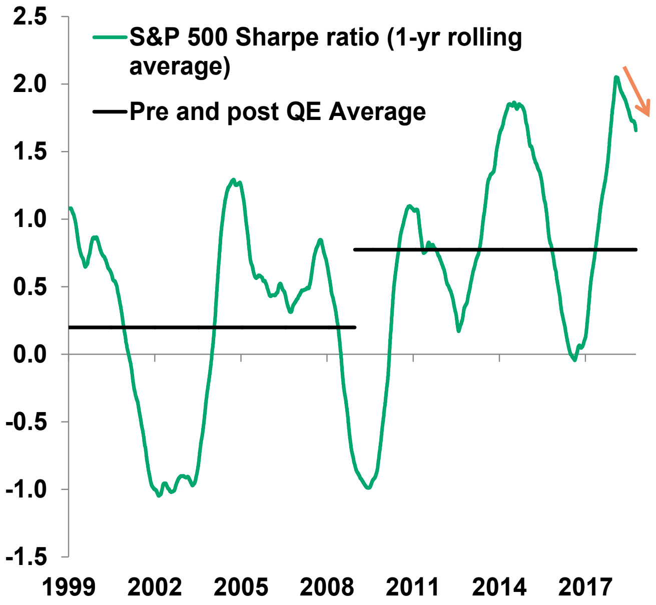
Figure 4: A restrictive Fed policy stance could lead to higher volatility



Fed policy stance calculated as the spread between the real fed funds rates and R* estimates. Source: Bloomberg and BNP Paribas Asset Management. Data as of 30 Nov 2018.

Given this backdrop, and with valuations in many markets looking more stretched and, crucially, no central bank support underpinning them, our buy-and-hold return expectations are also much lower for the foreseeable future. Combined with a more volatile environment, the result will be much lower risk-adjusted returns than many investors have become used to during the QE years. Indeed, we have already seen a fall from historically high Sharpe ratios (Figure 5).

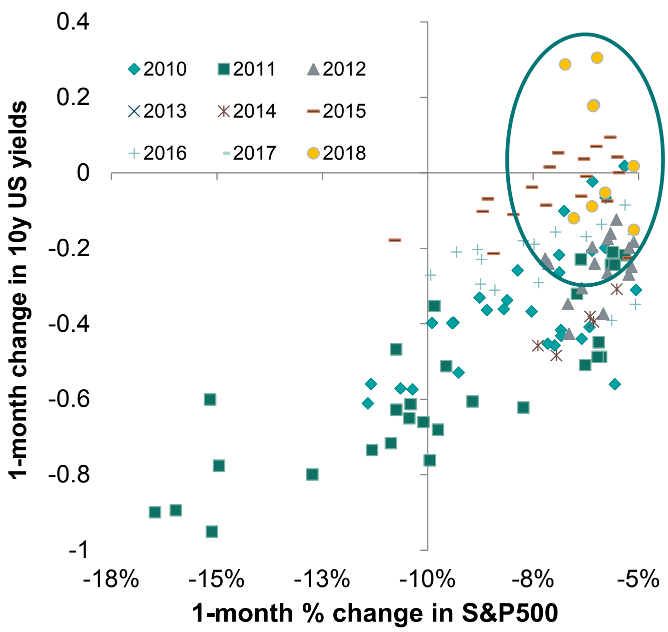
Figure 5: Sharpe ratios are already falling from QE highs



Source: Bloomberg and BNP Paribas Asset Management, as of 30 Nov 2018

Investors will also have to get used to the idea that government bonds will not necessarily protect portfolios against equity downturns (Figure 6). In other words, the correlation between government bonds and equities is at risk of shifting into positive territory after years of being negative.

Figure 6: Bonds less of a hedge to equity corrections



Source: Bloomberg and BNP Paribas Asset Management, as of 30 Nov 2018

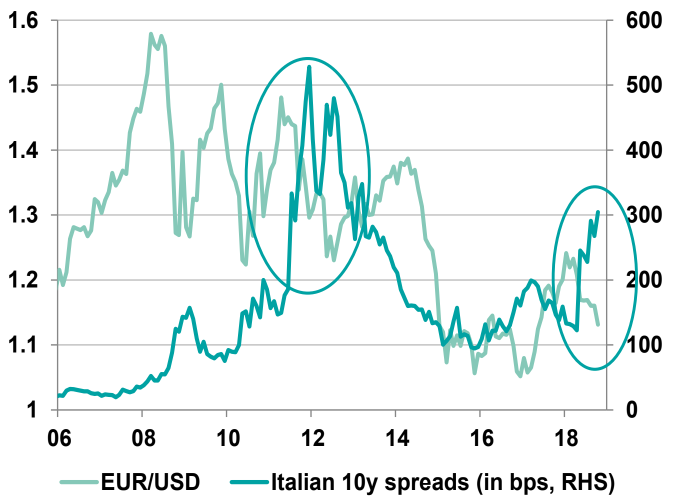
Geopolitical tectonic shifts

Geopolitical developments have led to a wider dispersion of asset returns in 2018: US-China trade tensions, Italian political risk and Brexit.

We believe that the Sino-US tensions are rooted in a struggle for global hegemony and not just in trade imbalances. The trade tensions are a reflection of that struggle and are therefore structural in nature. But tensions are likely to escalate and de-escalating over time, which is the risk scenario which needs monitoring. Should they lead to further market stress and pressure on trade volumes, it is global growth, and emerging market growth in particular, that could suffer.

In Europe, the dispute between Italy and Brussels needs to be monitored closely too. The main risk here is that Italian sovereign debt suffers to the point where investor concerns over debt sustainability or anti-euro political rhetoric revive eurozone break-up talk. This would be damaging for the region's growth prospects and the valuations of European risky assets, including the euro, as was the case during the 2011 sovereign crisis (Figure 7). On the flipside, the news on Italy could also improve quite quickly – put differently, the timing/horizon of the Italian situation is less clear at this juncture, but the issue is likely not structural in nature.

Figure 7: The euro typically suffers when 'peripheral' sovereign debt concerns rise



Source: Bloomberg and BNP Paribas Asset Management, as of 30 Nov 2018

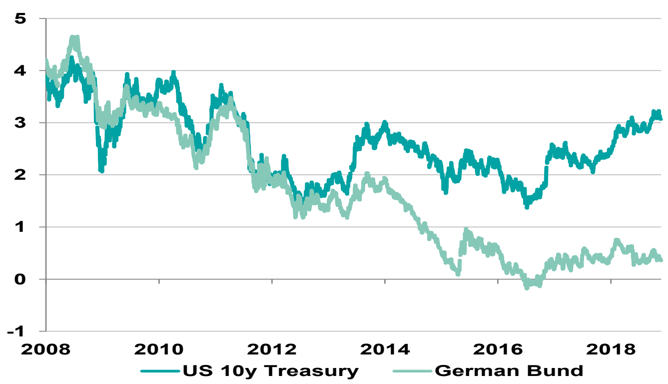
A FLEXIBLE ASSET ALLOCATION

For most of 2018, our main mantra was to be structurally long equities and underweight fixed income. In light of our current central scenario expecting weaker global growth and the balance of risks skewed to the downside, all else equal, we now prefer to be structurally neutral on equities, where we see greater volatility as the new norm. We remain underweight fixed income given our view of gradually rising inflation and monetary policy normalisation. But more volatility can equate to opportunities, so we are ever more tactical and reactive around our main structural proposition. This 'late cycle' environment, especially given its atypical nature, also means markets may experience material reversals, so we need to be ready to turn more defensive if needed.

Indeed, we added a tactical long position in developed market equities after the October correction and have added to this in the renewed correction since then. We expect tactical upside to equity markets in late 2018/early 2019, but we are more cautious further out as the combination of tighter monetary policy and fading US fiscal stimulus could be a headwind for stocks.

In fixed-income markets, our basic proposition is that as the US business cycle matures and the Fed continues to withdraw policy accommodation, interest rates rise further. We prefer to express our underweight fixed-income exposure in eurozone government bonds as we see scope for a greater upward correction in yields than in the US. This is due to the stark valuation difference (Figure 8) as well as the fact that the ECB distorted the European bond market much more than the Fed did in the US. As such, we see the skew of risks being higher in European fixed income as the ECB begins to withdraw accommodation.

Figure 8: German yields have decoupled from US yields



Source: Bloomberg and BNP Paribas Asset Management, as of 30 Nov 2018

We would also underweight high-yield credit at this stage of the cycle, especially in the US. Relative to historical levels, spreads are tight and as an asset class, credit is vulnerable to quantitative tightening and slower growth.

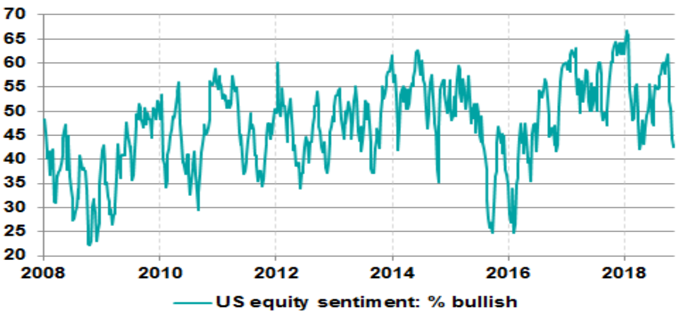
Tools to navigate a changing tide

Unusual times call for agile portfolio management. In 2018, equity markets felt the sting of higher US interest rates in January and October, and this was in a context where market participants knew that US macroeconomic fundamentals were robust. Such violent swings should become more common as quantitative tightening lowers the global liquidity tide. And this process could accelerate if the risk of higher US inflation materialises.

For this reason, we are closely watching our in-house technical indicators and market dynamics analysis as they help us identify potential moves that may not be visible in macro fundamentals. For example, in September, we reduced risk as a host of indicators and our technical analysis toolkit flagged vulnerabilities such as overoptimistic sentiment and the diminishing breadth in the US equity rally[1] (Figure 9 and Figure 10). Similar indicators now suggest the sell-off may be overdone. This is one of the reasons for our recent tactical long.

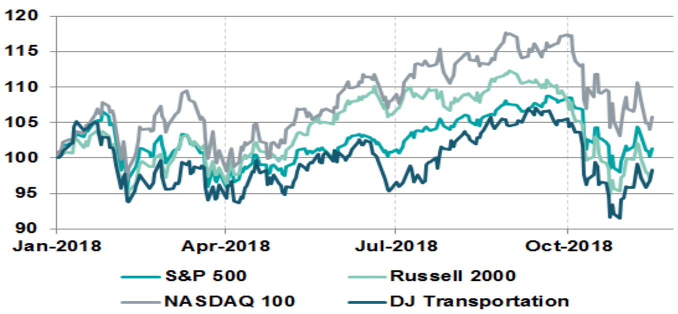
The potential for sudden market dislocations means that we will adjust our portfolios accordingly and if needed to much more defensive or aggressive positions.

Figure 9: Investor sentiment towards equities at extremes



Source: Bloomberg, Investors Intelligence and BNP Paribas Asset Management, as of 30 Nov 2018

Figure 10: Rising dispersion between US equity indices



Source: Bloomberg and BNP Paribas Asset Management, as of 30 Nov 2018

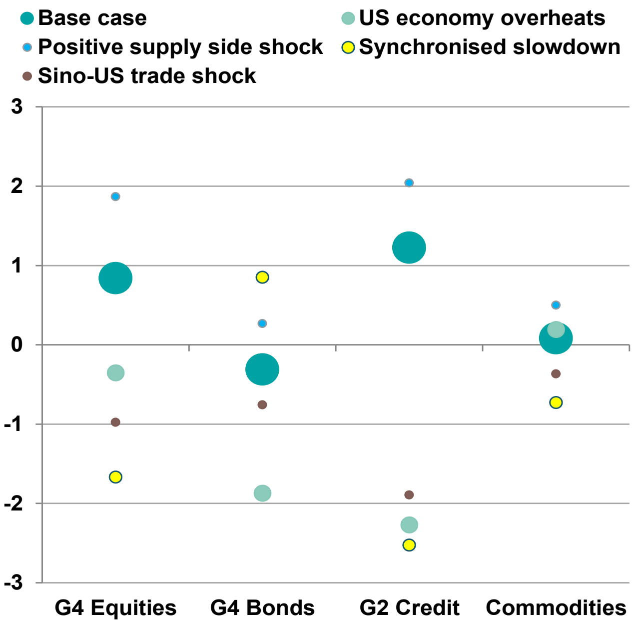
[1] Other examples of the components in our toolbox are sentiment readings/surveys, investor positioning data, dispersion within equity markets, implied volatilities, option market skews and volumes, dynamic technical analysis tools, etc.

A robust allocation that helps diversify risks

Our macroeconomic scenario framework models plausible states of the world given available information and the potential evolution of various factors. In addition to our market dynamic and technical toolbox, our allocation is based on the most likely macroeconomic scenario, but it also considers the balance of risks around it. In other words, our scenario framework helps us to build robust portfolios.

This is particularly useful when investors face a plethora of risks that may lead to very different market outcomes. As we explained above, currently some of these risks are political in nature and are rooted in de-globalisation forces that are unlikely to disappear soon. Instead of trying to forecast these political events, our scenario forecasts give us a sense of the distribution of market outcomes in such risk environments (Figure 11). In particular, we have positions that could improve the performance of our portfolios should an alternative scenario materialise or become discounted by investors.

Figure 11: Main assets and scenario forecasts (risk-adjusted returns)



Source: Bloomberg and BNP Paribas Asset Management, as of 30 Nov 2018

For instance, we have been short EUR versus USD for several months: should fiscal turmoil in Italy become a systemic issue for the eurozone, it could threaten the single currency, while in the US, faster-than-anticipated Fed tightening to contain inflation would support a stronger USD. For the same 'stronger USD' risk and to reduce our exposure to renewed trade tensions, we are long USD versus a basket of Asian currencies. We are also long CAC 40 versus DAX as Germany is more exposed than France to de-globalisation.

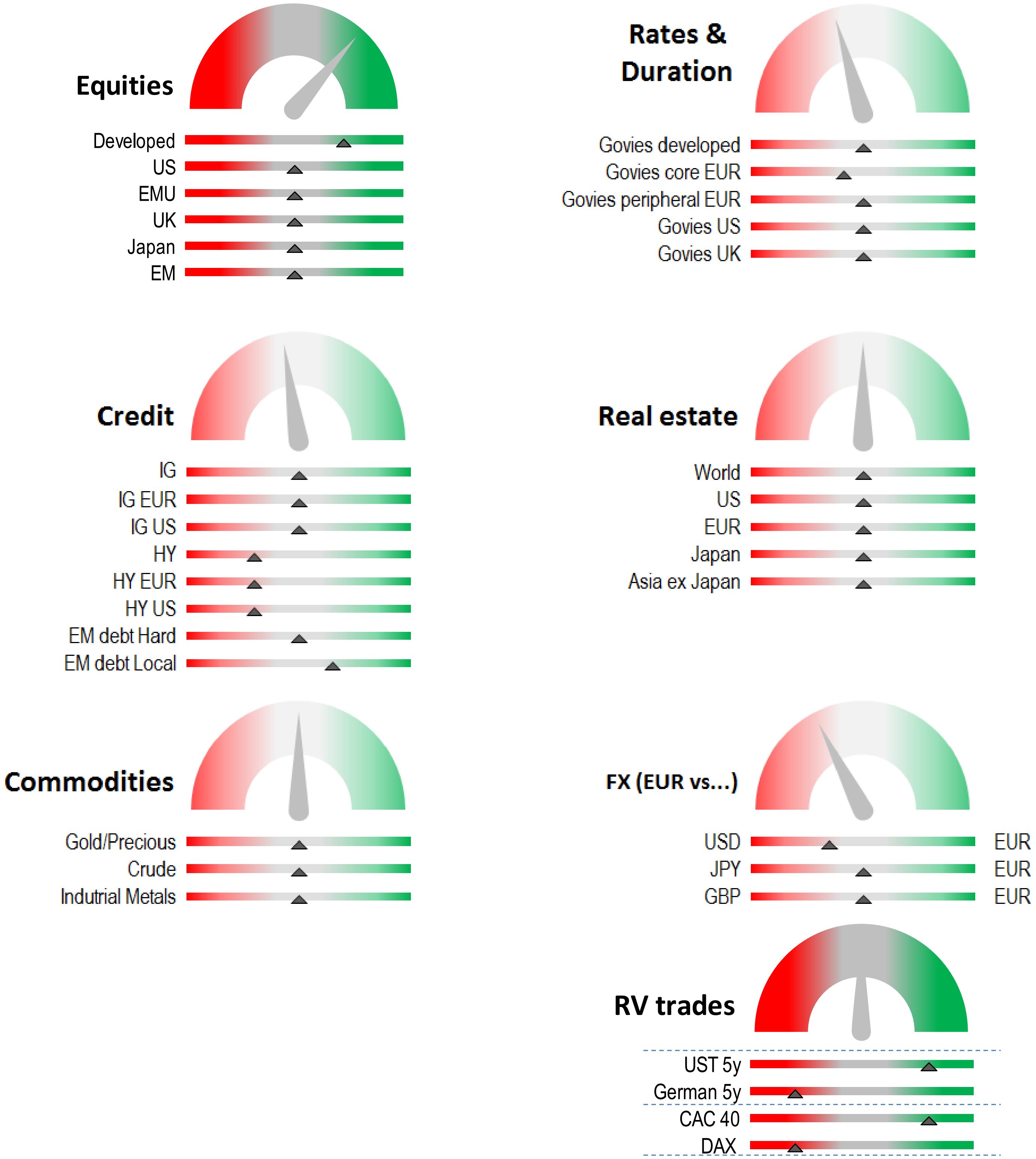
CONCLUSIONS: A FLEXIBLE APPROACH FOR AN ATYPICAL END-CYCLE

The macroeconomic environment does not flag material worries in terms of growth, inflation and policy prospects at this point. However, slower, albeit above-trend, growth and gradually rising inflation may tip the balance as the US recovery and the associated bull market face reduced central bank accommodation. In addition, this atypical late cycle faces geopolitical risks which have been proving disruptive.

This calls for a strategically neutral allocation to equities and an underweight allocation to government bonds. But we acknowledge that we need to be tactical around this mantra as markets face higher volatility and potentially disruptive shocks.

Our scenario framework and our market dynamic analysis should help us navigate these atypical late cycle challenges. For now, this means tactically managing our exposure around our strategically neutral equity stance and our underweight in fixed income. But it may also involve adopting a more defensive stance if needed in the future.

ASSET ALLOCATION DASHBOARD[2]



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

STRATEGIC OVERVIEW OF KEY POSITION CHANGES IN NOVEMBER 2018

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

NOVEMBER 2018:

LONG DEVELOPED MARKET EQUITIES INCREASED 21/11/18

- We took advantage of November's renewed market correction to add further to our tactical equity exposure.

SHORT NASDAQ VERSUS S&P 500 CLOSED 07/11/18

- After a good performance, we took profits on this relative value trade.

Views expressed are those of the Investment Committee of MAQS, as of December 2018. 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 December 2018.