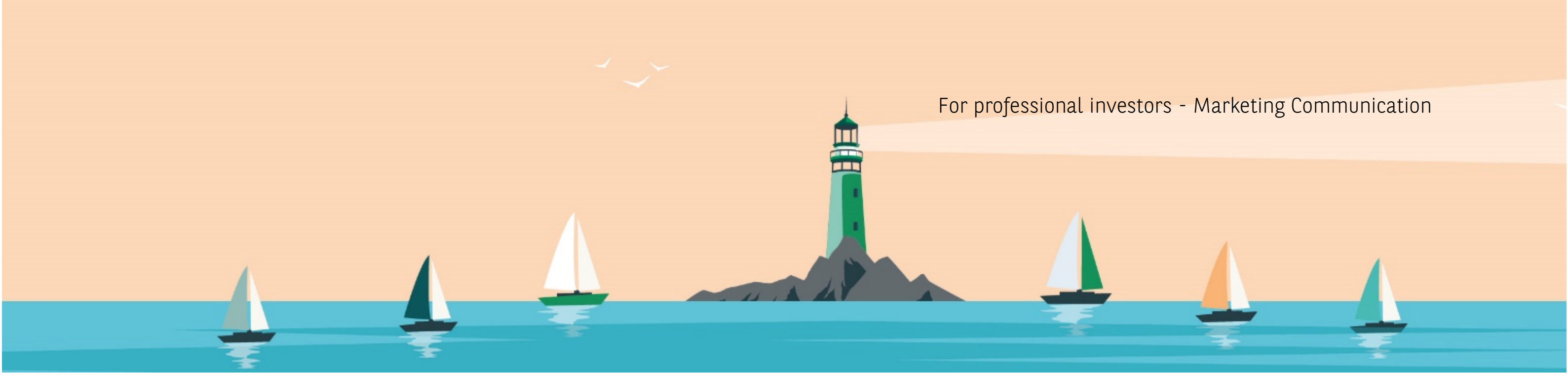

Asset Allocation Monthly • Jun 2021

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KEY MARKET DRIVERS

- Equity and bond markets have stalled over the last two months as US fiscal stimulus is priced in and details of a proposed infrastructure package remain unclear
- Markets are also waiting for more clarity on US labour market dynamics and hence the timing of any Fed tapering

VIEWS & ASSET ALLOCATION

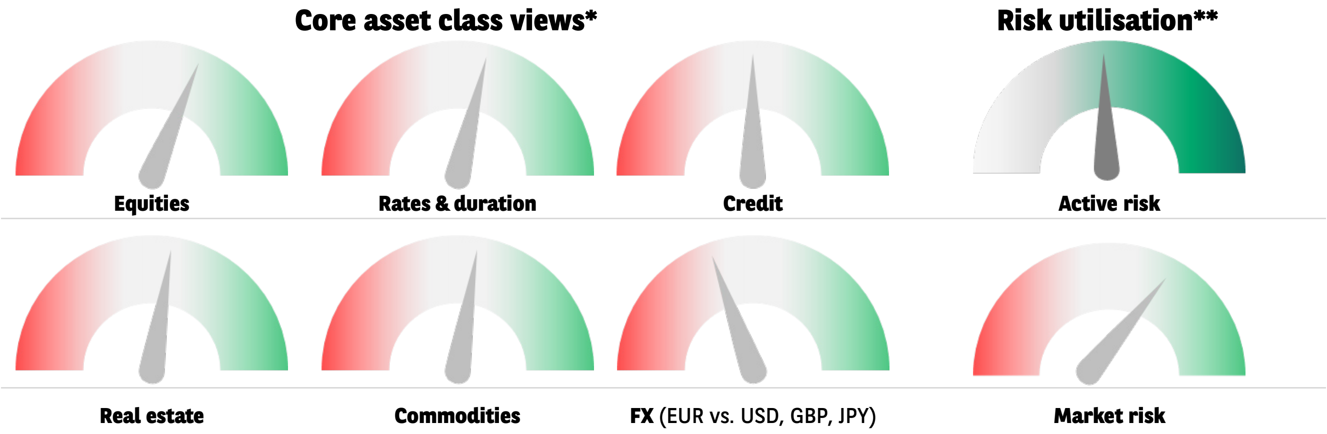
- Our medium-term scenario continues to favour risk and equities, given the fundamental factors and economic policy support

THE NEXT (RE-OPENING) WAVE

Investor attention is turning to where economic growth will accelerate next as vaccine rollouts allow more and more economies to reopen. The current leaders, the US and UK, will soon pass the baton to continental Europe and then to emerging markets later in the year.

In the US, the euphoria earlier this year due to fiscal stimulus has given way to the realisation that US growth is peaking. Disappointing non-farm payrolls, housing starts and retail sales figures, combined with higher-than-expected inflation, have added (temporary) stagflation worries to the mix.

The latest non-farm payrolls release confirmed a slower-than-hoped-for recovery in the US labour market. At the current pace, unemployment may not return to the pre-pandemic trend level until December 2022. The Fed has said it needs to see "substantial further progress" in meeting its employment targets



BNP PARIBAS ASSET MANAGEMENT

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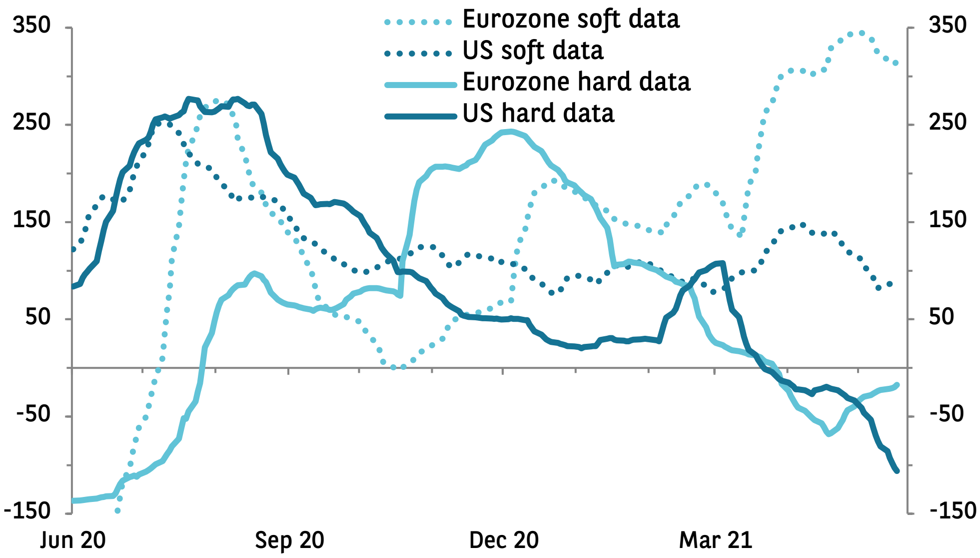
Exhibit 1: Economic surprise indices



Data as at 31 May 2021. Sources: Citigroup, BNP Paribas Asset Management.

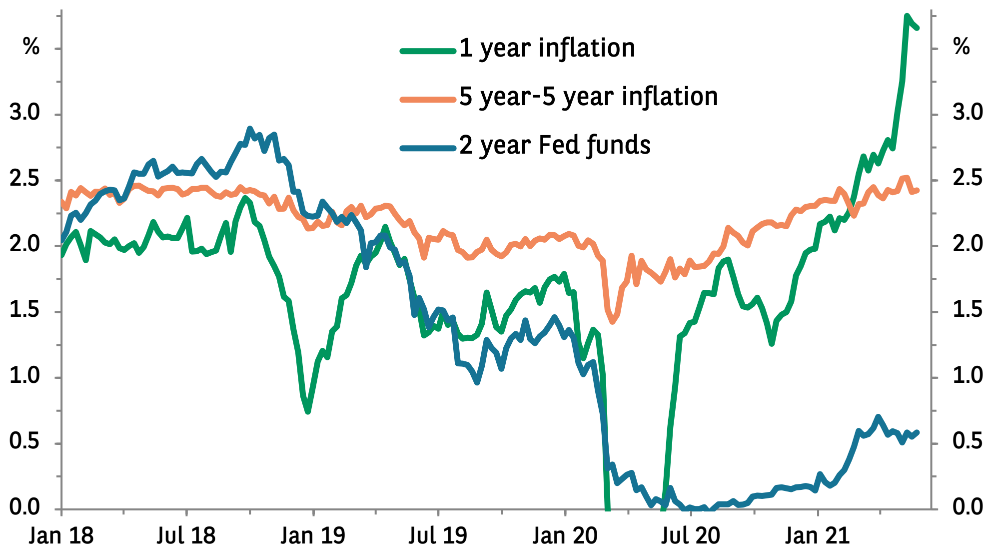
before it begins discussions on tapering Quantitative Easing (QE) purchases. Expectations for the future level of fed funds have fallen thanks to the disappointing payroll data. Whether the weakness is a result of generous government benefits or lingering lockdown restrictions, companies are facing robust demand thanks to economic reopening and consumers flush with cash. They may need to raise wages to attract enough workers to meet the demand, posing a threat to margins.

Economic data had already been coming in below expectations for several weeks, particularly in the US. The disappointments, though, have been concentrated in hard data such as retail sales and, in absolute terms, the figures still show a robust recovery. Soft, survey-based data like the Purchasing Manager Indices are still exceeding expections, even if the degree of surprise is inevitably falling (see Exhibit 1).

FIXED INCOME

The bigger-than-expected jump in US inflation in April (the Consumer Price Index (CPI) rose by 4.2% year-on-year compared to an expected 3.6% and after 2.6% in March, while the Personal Consumption Expenditures (PCE) index rose from 2.4% to 3.6%), leading to an immediate spike in inflation expectations over the next year. Importantly, though, medium-term inflation expectations have moved hardly at all, and expectations for the level of fed funds in two years have been similarly stable. This is in contrast to what occurred in February, when policy rate expectations rose along with those for inflation (see Exhibit 2).

Exhibit 2: Inflation and policy rate expectations



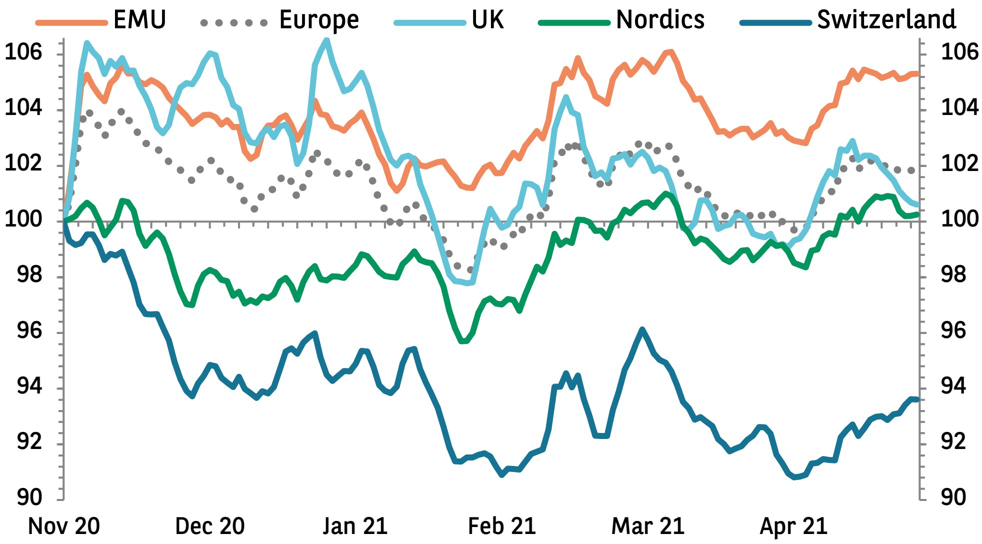
Data as at 31 May 2021. Sources: Bloomberg, BNP Paribas Asset Management.

The lack of movement in fed funds explains why real yields, and hence nominal Treasury yields, have also move comparatively little over the last few weeks. We believe this relative calm in fixed-income markets (the MOVE Treasury volatility index has fallen to 52 from 71 at the end of March) will not last and that nominal rates will rise. Base effects mean headline CPI will likely remain above 2.5% through at least September and the next few CPI prints are likely to be around 4%. While 5 year-5 year inflation has returned to levels last seen in 2018, in the years immediately following the global financial crisis, when growth was weaker and the Federal Reserve was less tolerant of inflation overshoots, expectations at times topped 3.2%. Hence we believe expectations could move somewhat higher if the current supply-demand imbalances persist and the Fed sticks to its message of patience. Real interest rates could also move up as they remain low relative to the expected growth rate of the economy.

While US Treasury yields have declined by 15 bp over the last six weeks to the end of May, yields on German Bunds have risen by 10 bp. The modest sell-off in Bunds has been a function of positive economic data, a recovery in headline year-on-year inflation for the eurozone to 1.6% and 2.2% in Germany in April, and lower-than-expected asset purchases by the ECB. The recovery in yields brings them back to pre-pandemic levels but we see room for further increases due to eurozone reopening, rising inflation expectations and a still dovish ECB. EMU yields remain historically low, notably real rates in core countries like Germany.

EUROPEAN EQUITY BREAKDOWN

Exhibit 3: Returns relative to MSCI USA



Data as at 31 May 2021. Sources: FactSet, BNP Paribas Asset Management.

Most major equity indices have advanced only slightly since mid-April following the strong returns in the first quarter. Steadier interest rates and a more mixed growth outlook in the US has left markets looking for direction. While the prospect of additional infrastructure spending packages in the US could propel markets higher, negotiations are ongoing. It is still uncertain whether there will be a smaller, joint package agreed with the Republicans in the Senate or whether the administration will push on alone with its initial proposal. As important, the source of the additional spending, whose taxes will rise and by how much, remains unclear. This uncertainty may also have dampened enthusiasm for US equities.

As the marginal news in the US risks turning negative, European equities have begun to make up some of the ground lost relative to US equities over the last year. The modest outperformance since last November (just 1.8% in local currency terms) has primarily been driven by the outperformance of eurozone equities, while Switzerland has generally been a drag (see Exhibit 3).

The financial sector accounts for much of the underperformance of Swiss equities. The value-oriented UK market initially outperformed on the announcement of the positive vaccine results in November, but the subsequent strength of sterling, reflecting the successful rollout of the vaccines, has unwound most of the gains.

The near-term outlook for eurozone equities could well improve further. The distribution of Next Generation EU funds will finally begin, which should particularly benefit domestic-oriented small-cap companies.
High polling results for the Green party in Germany ahead of Bundestag elections to be held in September point to increased government spending, both for climate and social initiatives, in the event of a Green-led coalition. It could also result in a more permissive attitude towards EU-level spending in support of other eurozone countries.

"The outlook for eurozone equities could well improve further. Next Gen EU funds will be paid out and vaccination rates are rising."

The very strong earnings results for US equities in the first quarter, a period when the country still had some restrictions in place, bodes well for European results in the second quarter as countries in the region progressively loosen restrictions. Over the last month, earnings revisions have been rising faster than those in the US for both large and small caps, and that earnings growth still comes at an above-average discount to the US. While the outlook is positive, we nonetheless anticipate other countries and regions, such as Japan and emerging markets, offer better medium-term prospects.

EMERGING MARKET CYCLICALITY

The rising significance of the Chinese equity market has changed the dynamics of the whole emerging market index. From just 5% of the index market capitalisation 20 years ago, China today accounts for nearly 40%. As the Chinese economy has industrialised, the sector make-up of the index has evolved. Previously, telecommunications and industrials dominated the index, whereas now internet retail and interactive media do so.

Consequently, the MSCI emerging market equity index has become less cyclical and more growth oriented. From the inception of the index, the correlation of the relative performance of emerging market equities vs. developed market equities, and the performance of cyclicals vs. the broad market was 41.2%; since last autumn as the global economy has come out of lockdown the correlation has been just 10.9%. The long-term correlation of the performance of growth vs. value, which had been near zero, has more recently been -16.9% (see Exhibit 4).

Exhibit 4: Relative return and correlation with 'value vs. growth' and 'cyclical vs. defensive'

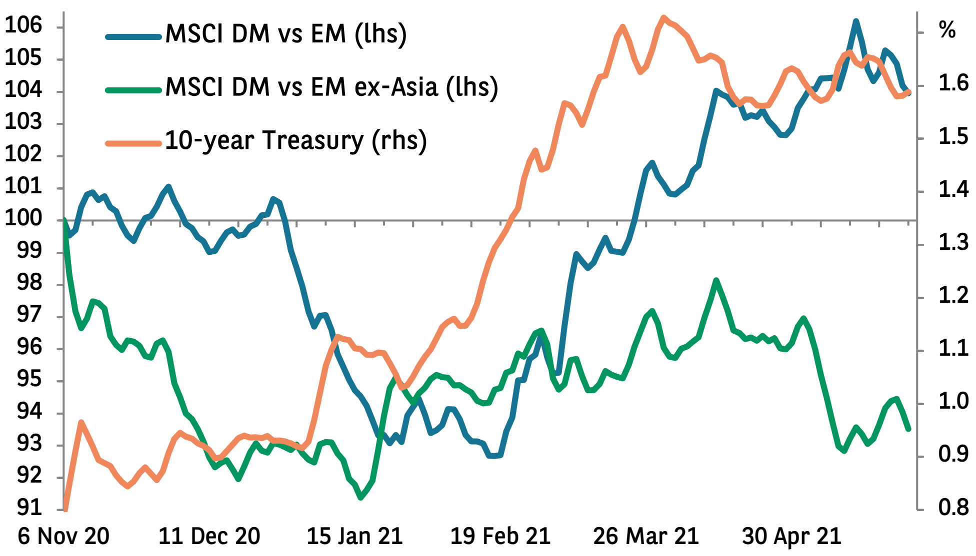
			Correlation with MSCI World			
			Since November 2020		Since inception	
Index	Weight	Relative return*	Value vs growth	Cyclical vs defensive	Value vs growth	Cyclical vs defensive
Emerging markets		-6.4	-16.9	10.9	-0.1	41.2
EM Asia	79.1	-9.4	-24.4	7.0	-6.6	32.4
EM ex-Asia	20.9	6.3	33.8	21.9	7.0	38.2

Data as at 31 May 2021. *Total return vs. MSCI World since 6 November 2020. Sources: FactSet, BNP Paribas Asset Management.

The altered dynamics of the index help explain why emerging market equities have underformed developed markets since February, which was when the sell-off in US Treasury yields began. As growth stocks globally have suffered from rising rates, the growth orientation of the emerging markets index relative to developed markets caused the EM index to lag, offsetting the benefit from the EM index' greater cyclicality.

The greater sensitivity to growth and lower sensitivity to cyclicals is concentrated in the Asian region, however. As shown in the table above, the correlations with EM ex-Asia are strongly value and cyclical. Consequently, even as developed markets outperformed emerging markets as rates rose, they underperformed the emerging markets ex-Asia index (see Exhibit 5).

Exhibit 5: Relative performance of DM vs. EM equities and US Treasury yields



Data as at 31 May 2021. Sources: Bloomberg, BNP Paribas Asset Management.

Even if US rates continue to rise, we are expecting the cyclical factor behind a global growth recovery to become the dominant theme, particularly as US growth slows and re-opening momentum shifts to Europe and then to emerging markets. Chinese equities in particular will benefit from the government's ambitious 2030 sustainability goals, high end manufacturing ('Made in China 2025') and investment in R&D and automation. Consequently, we anticipate emerging markets will make up the lost ground in the months and quarters ahead.

MARKET DYNAMICS INPUTS

In the short run, momentum has been deteriorating. Our indicators are signalling that the trend in global equities is complete and due for a breather. Performance across indices, regions or even sectors is well dispersed. Corrections have already started in some markets, while others are still close to the highs. We continue to see corrections as a buy opportunity in the long-term bullish trend.

In recent months, we have seen signs that the rise in US yields was due for a pause, while European yields continued their upward trend. We expect both US and European yields to rise in coming months.

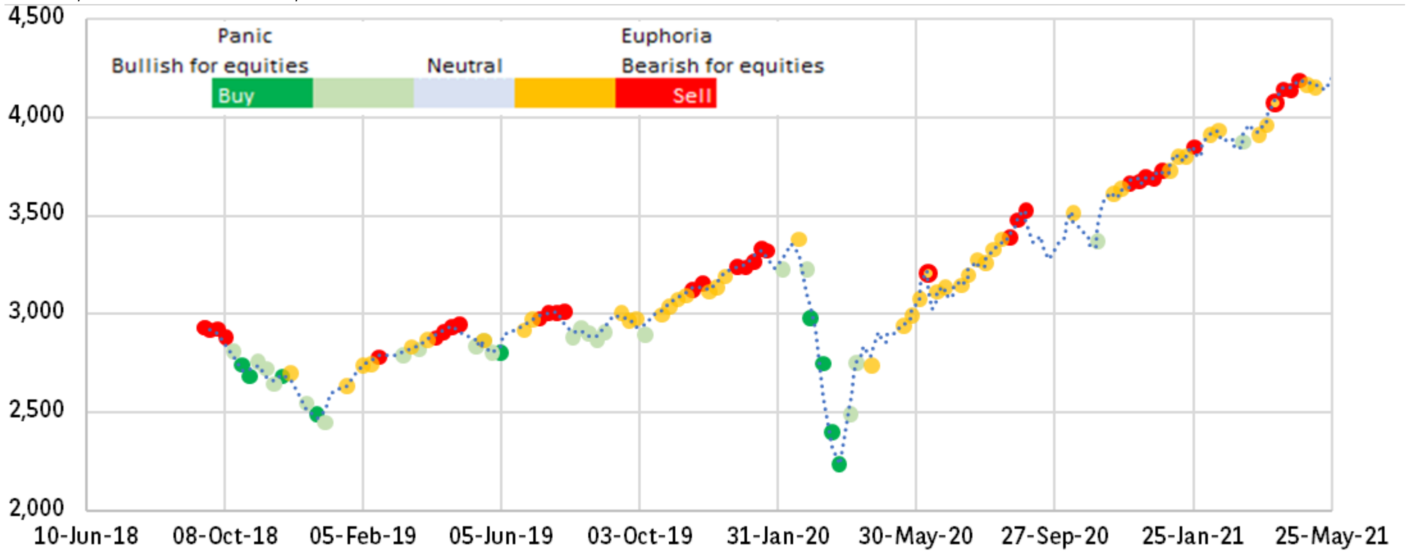
The US dollar has resumed its bearish trend. While, in the short run, it could pause and unwind some of the recent losses, our indicators are pointing to further USD weakness in coming months.

Our blended 'market temperature' indicator is back to neutral. In May, the excesses highlighted at the end of last month gradually normalised. This has so far resulted in only a pause in the uptrend. Both investor sentiment and the market temperature are at neutral levels, without any signs of capitulation so far. Consequently, this correction is not yet complete and volatility could start to rise again.

In recent weeks, our proprietary 'market dynamics' toolbox – consisting of 'market technicals' and 'market temperature' signals – has suggested that the risk of a pullback in the short run remains.

Exhibit 6: Evolution of market temperature since July 2018 (S&P 500)

All temperatures shown except neutral



Data as at 27 May 2021. Sources: Bloomberg, BNP Paribas Asset Management.

ASSET ALLOCATION

The near-term outlook for risky assets still reflects the tension between strong growth expectations and the prospect of higher US yields. Ultimately, we see a strong global growth recovery anchored by progress on vaccine rollouts and economies reopening, a multi-trillion dollar US fiscal expansion, and easy monetary policy supporting risky assets over the medium term.

We expect the cyclical recovery to gain further traction later this year. So far, the recovery has been led by the US, given its progress on vaccinations, aggressive fiscal stimulus and pent-up demand. Growth in other major economies that have been hit by Covid (e.g., Europe and EM ex Asia) should accelerate as vaccinations lead to reopenings.
Our medium-term scenario continues to favour risk and equities given the fundamental factors and the economic policy support.

The multi-asset investment committee has kept its allocation to risk broadly unchanged over the past month at the level of its long-term risk target. The committee's net equity exposure remains long via positions in US value, EM equities, Chinese equities and Japanese equities against a short position in EMU large caps. The regional equity exposure seeks to find a balance between the 'growth/quality' and 'value/cyclical' styles that helps insulate against rates volatility, while providing a diversified allocation.

Elsewhere, the investment committee is long other risky assets such as commodities and EM local debt, and holds other positions to diversify portfolios such as long gold and long European real estate investment trusts (REITs).

"The near-term outlook for risky assets reflects the tension between strong growth expectations and the prospect of higher US yields."

Equities ↑ (new)

We are long equities. We are long EM equities given our view that China/Asia earnings growth will remain supported by a dynamic technology and e-commerce sector as well as a strong high-end manufacturing sector. Both are part of Beijing's strategy for a 'new China' and should benefit other EM MSCI index heavyweights such as South Korea and Taiwan. EM ex Asia is cheaper than the broad index. It should benefit from a cyclical recovery and the fact that, in our view, valuations are not onerous. Japanese equities are well placed to benefit from a broadening global recovery, a cash-rich corporate sector and valuations that still look cheap.

In the US, we see the rollout of vaccines, the reduction of lockdown restrictions, expectations of further stimulus and continued ample monetary stimulus supporting equities over the medium term. Equity risk premiums are high relative to real bond yields, so equities remain an attractive option even if absolute valuations (e.g., P/E ratios) appear high. We express our bullish US view via US value stocks, which are cheaper than the mega-cap heavy S&P 500 and have room to catch up.

We are 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 ↓ (new)
In April, we added to our underweight position in EMU bonds given our view that EMU yields should continue to rise, supported by the eurozone reopening, rising inflation expectations and a dovish ECB. EMU yields are historically low, notably real rates in core countries such as Germany.

We are long emerging market local currency debt. We see room for further spread compression in the current search for yield. Higher US real yields are a risk, but we expect the Fed's dovish approach to tapering to limit the upside. As for EM currencies, we see plenty of room for appreciation, especially if the US dollar resumes its downtrend.

Credit ⇔ (unchanged)

Currencies € ⇔ (unchanged)

Commodities ↑ (new)
We are bullish on commodities over the medium term. We believe crude oil is supported by recovering global demand and constrained supply from OPEC and the US shale industry. We like base metals given the ongoing electrification and clean energy transition and the limited supply responses, especially in copper. We are long gold, but we have cut our tactical long exposure. Gold can 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 ↑ (new)
This month, we added a long position in US infrastructure via a basket of stocks that should benefit from President Biden's infrastructure spending plans. This adds to our positions in various investment themes: Global environment, energy transition and artificial intelligence.

From cover page: *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. ** 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.

DISCLAIMER