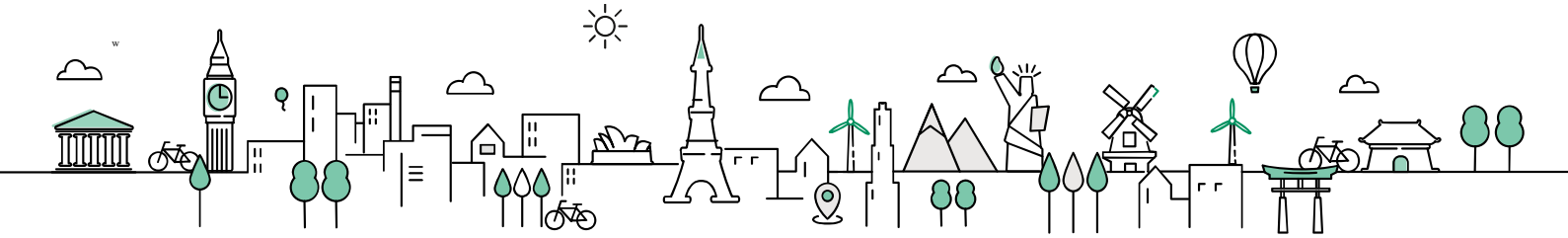

Asset Allocation Monthly

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KEY MARKET DRIVERS

- **Progress on vaccines and expectations for additional fiscal stimulus in the US**
- **New virus strains and delays in vaccine rollouts delay recovery**

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 cautiousness, with sideways moves expected during the first part of 2021**

CAUTIOUSLY OPTIMISTIC

The evolution of the coranvirus pandemic gives reasons both for optimism and for pessimism, albeit over different time frames. The pessimism is more in the near term as production bottlenecks hit vaccine supply, countries stumble in rolling out the vaccines they do have, and the latest mutations of the virus prove to be more contagious and less inhibited by existing restrictions. Further lockdowns loom.

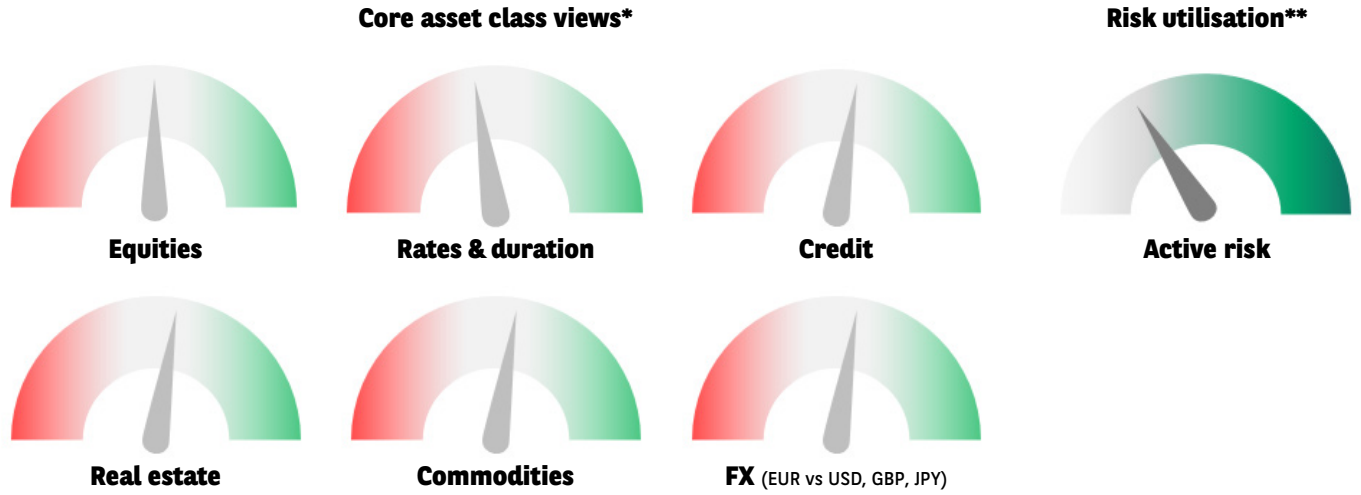
The impact of the measures reimposed this winter can be seen most clearly in European PMIs, which fell in all the major countries in January and are below 50 everywhere except Germany (and even there the composite PMI is only barely higher). Retail sales growth has decelerated, though income support in Europe has generally been more consistent than in the US.

Governments are nonetheless making progress on vaccinations and fiscal stimulus will provide a crucial boost to economic activity. The post-pandemic world we all eagerly await has, one hopes, only been delayed.

US fiscal package

At her confirmation hearing, incoming Treasury Secretary Janet Yellen called for 'thinking big' on government spending given the risk of a long and deep recession. Perhaps as an echo of her role as chair of the US Federal Reserve, Yellen stressed that "with interest rates at record lows, the smartest thing we can do is act big".

President Joe Biden has spoken of a fiscal stimulus package of USD 1 900 billion. Adding this sum to the COVID-19 recovery bill approved in late December, 13% of GDP could be put on the table to support the economy (consumption and small businesses) in the short term. It is a colossal sum, and even if it is watered down by Congress, such a fiscal effort would still be remarkable.

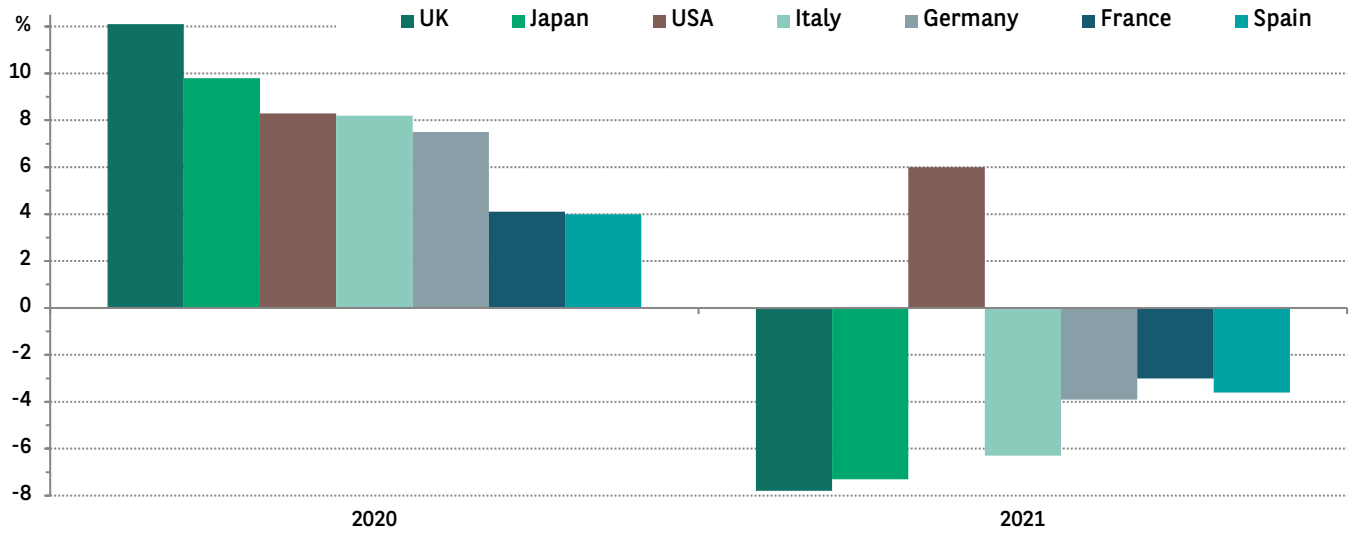


*The core asset class views dashboard reflects the key views of the Investment Committee of the Multi-Asset team at MAQS. Other specific/tactical trades may be implemented in addition and are listed at the end of this publication. ** Risk utilisation/active risk is a measure of the tracking error (as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

This new stimulus contrasts sharply with what is occurring in other developed markets. In 2020 the US package was commensurate with the stimulus in many other countries; in 2021 the US fiscal impulse will still be positive while it turns negative elsewhere (see Exhibit 1).

Exhibit 1 : Simple estimate of the fiscal impulse

Change in cyclically-adjusted primary balance, % of GDP



Data as at 2 February 2021. Note: US includes $900bn bill passed in December 2020 and proposed $1.9bn plan from the Biden administration. Sources: IMF, BNP Paribas Asset Management.

This fiscal divergence will lead to a widening gap in economic growth, as GDP forecasts are more likely to be revised upward for the US. Inflation expectations, and to a lesser degree nominal bond yields, have also reacted. One could consider the increase in yields, though, as arguably disappointing given the size of the stimulus to come. There are two possible explanations. One is Quantitative Easing, which is suppressing nominal yields. Second is the memory of inflation prior to the pandemic. Even when the US unemployment rate had fallen to 3.5%, inflation remained contained, so it may take considerable stimulus before inflation rises high enough for long enough for the Fed to hike policy rates.

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 part 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 other cyclical assets like commodities and EM 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. Following the correction in late January, bullish technical signals are starting to appear in some equity markets, notably emerging markets, but our indicators still advocate for cautiousness with sideways moves expected during the first part of 2021.

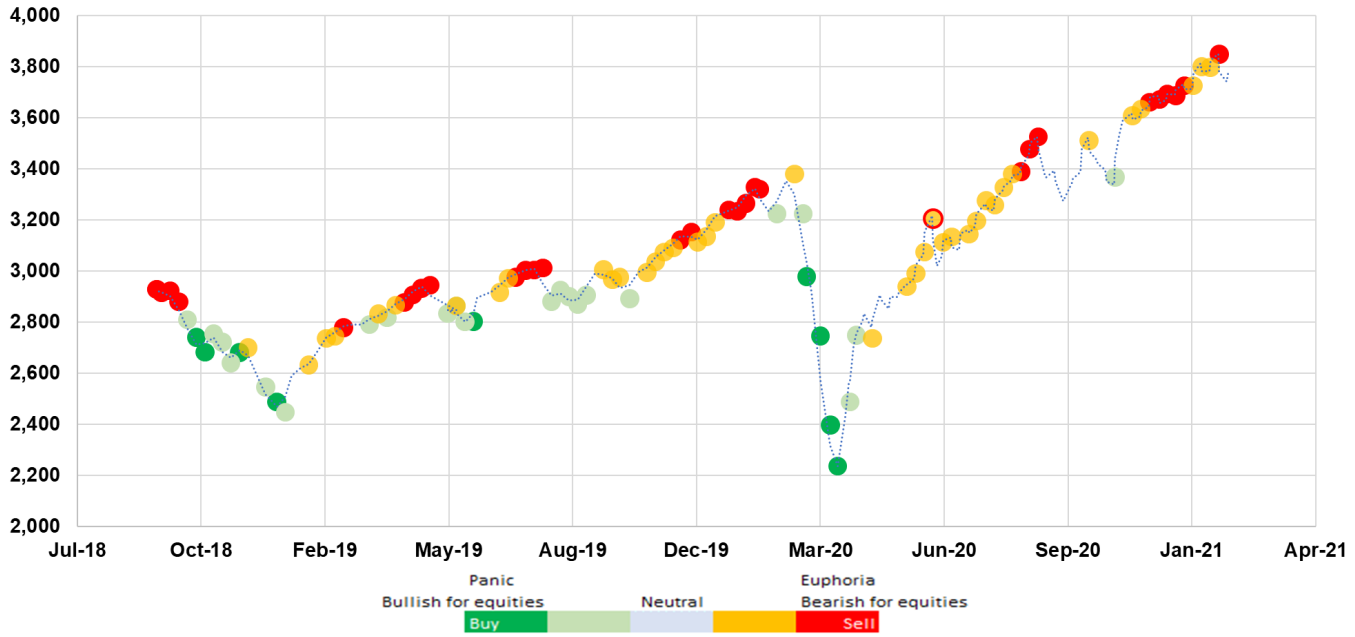
For core fixed-income markets, short-term technical signals pointed to the risk of some upside in yields at the beginning of the year, but are more neutral now. Medium to long term, they still flag upside for yields.

Finally, for the USD short-term signals suggest a limited reversal in the recent weakening USD, but the medium- to long-term signals are still bearish, consistent with further USD weakness.

Our blended 'market temperature' indicator moderated slightly in mid-January, only to turn back to 'red hot' in late January (see Exhibit 2). Overall, our temperature indicator has signaled some exuberance in the equity market since December last year. Equity market drawdowns are quite common follow several weeks of 'red' signals.

Exhibit 2 : Market temperature 'heating up' but not extreme

All termperatures shown except neutral



Data as at 2 February 2021. Sources: Bloomberg, BNP Paribas Asset Management.

ASSET ALLOCATION

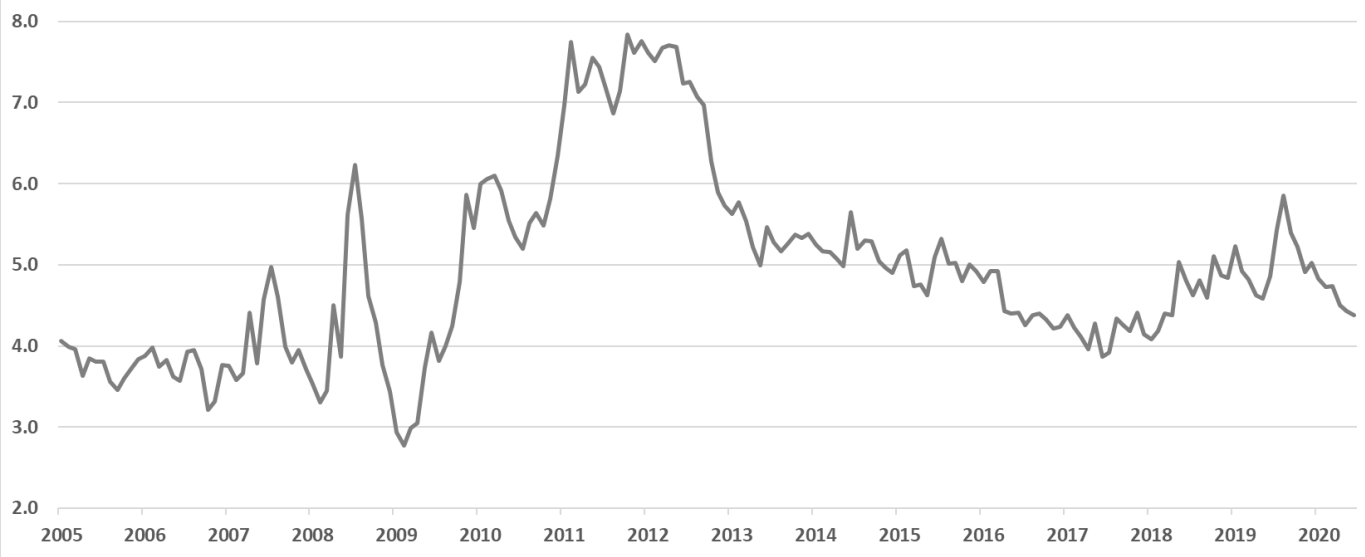
The cyclical recovery expected for this year will likely be delayed, but not cancelled, by the ongoing challenges of the coronavirus pandemic. Our medium-term scenario is favourable for risk and for equities, given fundamental factors and economic policy support.

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)
We are neutral on equities overall with an overweight in EMU small caps relative to EMU large caps. We took profit on our positions in US and Japan equities on 11 January in the context of very stretched technical and uncertainties surrounding the evolution of the Covid-19 pandemic.

The rollout of vaccines, 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 premia are still high relative to real bond yields in the US, so equities should remain an attractive option even if their absolute valuations (e.g. P/Es) appear high (see Exhibit 3).

Exhibit 3 : Equity risk premia attractive due to ultra-low bond yields
US earnings yield minus US long real bond yields



Data as at 2 February 2021. Sources: Bloomberg, BNP Paribas Asset Management.

We continue to be long EMU small caps versus large caps. Small caps are likely to continue to outperform in an environment of economic recovey. Small caps should benefit from being high beta and from more attractive valuations than 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, given the improved economic outlook following vaccine availability. Bond yields in the eurozone already price in an expansion of the ECB PEPP programme. As a result, EMU yields look asymmetric to the upside in the event of a cyclical recovery in the euro area. 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 EM local currency debt. On the rates side we see room for further compression given the current search for yield environment. As for FX, 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. Recent news on fundamentals in our view contradicts the consensus view. Thanks to fiscal stimulus in the US while in Europe there are extended lockdowns and delayed vaccine rollouts, we expect the US economy to significantly outperform Europe in 2021. Consequently we are turning tactically bullish on the dollar against the Euro, while recognizing that in the medium term the dollar may once again come under pressure due to valuations and the continuing large twin deficits.

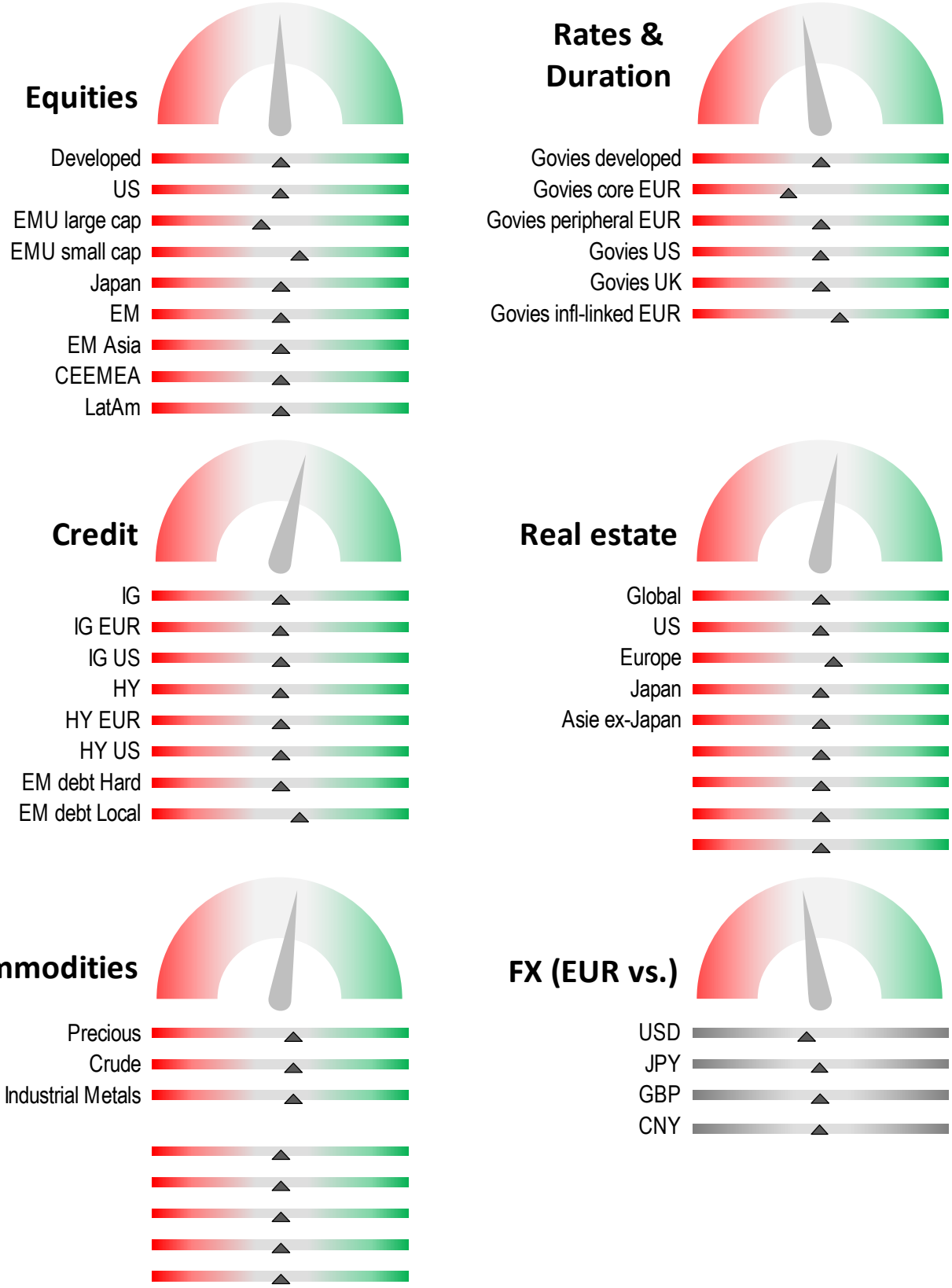
Commodities ↑ (unchanged)
We remain long aggregate commodities (excluding agricultural). Separately, we are long gold as a risk diversifier.

Cyclical commodities usually outperform in the early stages of a recovery. The demand picture has improved as a COVID-19 vaccine will unlock demand in the developed world. On the supply side, production cuts by OPEC and consolidation among large US shale

producers should also support oil prices.
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. We remain long after adding in December to take advantage of lower prices.

Thematics ↑ (new)
We have initiated a position in thematic investments, distributing the risk budget evenly among three themes (Global Environment, Energy Transition, and Artificial Intelligence). We funded the investments out of the current global equity allocation of the portfolios. The current investment is a first step and we have the ambition to allocate more risk to thematic investments in the future, and also to broaden the spectrum of themes.

CORE ASSET ALLOCATION DASHBOARD



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