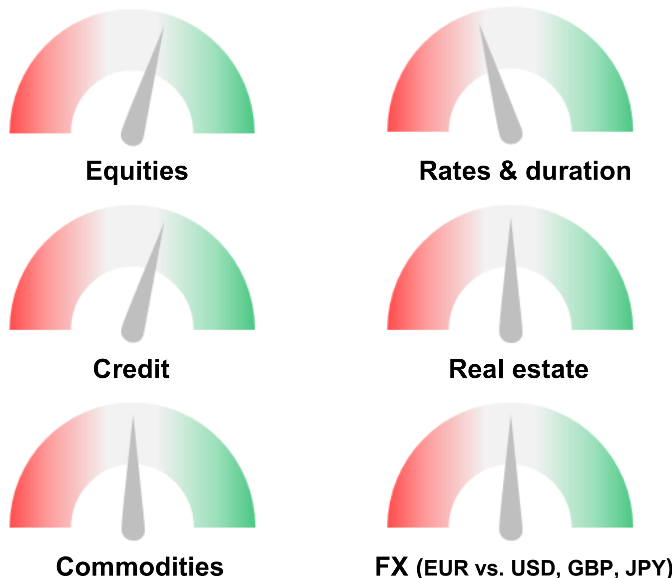
FOR PROFESSIONAL INVESTORS – 3 June 2019

ASSET ALLOCATION MONTHLY

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

CAUTIOUSLY CONSTRUCTIVE ON TRADE WAR RISKS



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SUMMARY

- **Trade war risks are back in focus –** Investors are grappling with another wave of Sino-US trade war angst and markets have suffered from renewed volatility.
- **De-globalisation is at the heart of the trade war –** We have long argued that there is more than trade to Sino-US tensions, and that de-globalisation is a medium to long-term theme. So, we are not surprised to see a flare-up in tensions.
- **'Fragile goldilocks': Is a slowdown becoming a bigger risk? –** While it is certainly a risk worth monitoring, our slowdown scenario probabilities already incorporate Sino-US tensions. If anything, given the goldilocks economic backdrop, the recent tensions have provided us with attractive entry points to add market risk in developed market equities (DM).
- **Fundamentals make the difference –** Not all assets/economies are equal and fundamentals are making the difference. We note the underperformance of emerging market (EM)/Chinese assets, where trade war risks are a bigger challenge to economic prospects. Developed market, and specifically US domestic, fundamentals have remained solid.

ASSET ALLOCATION

- **Buy the dip: long DM equities –** We used the recent correction to add market risk via US and EMU equities.
- **Long carry assets –** We still see the goldilocks backdrop as conducive to carry assets and are long EM hard currency debt (a high-carry, USD exposure), with REITS also on our radar to buy on dips.
- **Building robust portfolios –** While we are cautiously constructive on the resolution of the US-China trade tensions, we also hold diversifying trades to protect portfolios. A long in 5-year US bonds versus 5-year Germany, a long in USD vs. Asia FX and a RV long CAC/DAX in equities should help diversify trade war risks.

BNP PARIBAS
ASSET MANAGEMENT

The asset manager
for a changing
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MARKET REVIEW: MAY 2019

After briefly posting highs in April, global equities fell again in May. Growing tensions between China and the US affected equities globally (-5.7%); however, emerging markets underperformed quite strikingly (-6.6%).

While in April, it looked like a trade agreement between the US and China was likely, negotiations took a U-turn in May and President Trump put fresh pressure on China, threatening to impose higher trade tariffs. The situation escalated after Trump decided to increase tariffs from 10% to 25% on USD 200 billion of Chinese imports, and threatened to impose tariffs on a further USD 325 billion of imports. China retaliated, announcing tariffs on USD 60 billion of US goods (from 8%-9% to around 18%, starting on 1 June). Trump subsequently announced a delay in the 25% tariff on imported cars. However, tensions have remained high, especially after the administration's curb on a major Chinese telecommunication company's access to the US market and its ban on any business with US suppliers.

In fixed income, concerns over trade negotiations and risk aversion pushed investors to prefer investment-grade bonds rather than high-yield ones. In core government bond markets, yields dropped sharply and US Treasuries recorded a positive performance whilst German Bunds did better than EMU 'peripheral' bonds.

Fears over an Italian populist coalition causing potential political instability triggered turbulence in BTPs. Deputy Prime Minister Salvini said Italy could break EU deficit rules, and as a result, the BTP-Bund spread widened in May.

Elsewhere, on the political front, European elections indicated an increasing consensus for populist parties. The results could have a major impact at a national level rather than on a European level. Indeed, traditional and pro-Europe parties still hold a large majority (over 67%) of the seats in the European Parliament, spread among the four main parties: EPP (centre-right), S&D (centre-left), ALDE (Liberal Democrats, supported by French President Macron's party) and Greens.

Elsewhere, the UK parliament is still in the spotlight. PM May scheduled a fourth vote on her Brexit deal for the beginning of June, but subsequently resigned as support faded. Former Foreign Secretary Boris Johnson is now seen as a top contender to replace May and the front-runner to lead the government, but analysts view this as the least market-friendly scenario.

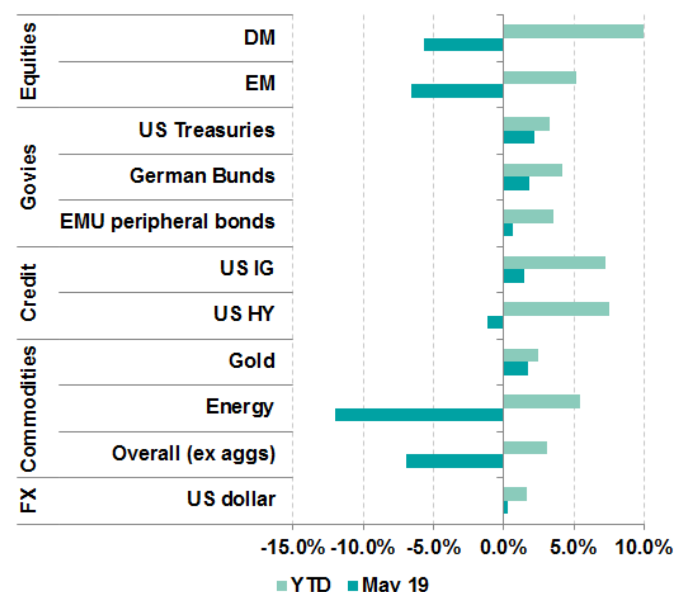
In FX, sterling dropped as the risk of a no-deal Brexit resurfaced. EM Asian currencies fell, mainly suffering from the trade tensions. Elsewhere, the US dollar strengthened as growing uncertainty pushed investors to move to safe havens.

Commodities had a poor May, led by the energy sector. Despite the strong performance so far this year, crude oil dropped by 12%. The attacks on Saudi tankers and pumping stations, claimed by Iranian rebels, lifted oil, but it fell back later to near USD 60/bbl (WTI) and USD 70/bbl (Brent) after unexpected increases in US oil and petrol stockpiles.

Among the macro data, Chinese industrial production, retail sales and fixed asset investment (FAI) all slowed, with YoY figures surprising to the downside (YoY IP 5.4% vs. consensus; retail sales 7.2% vs. 8.6% cons; FAI 6.1% vs. 6.4% cons). In Japan, GDP growth beat the consensus forecast (QoQ +0.5 vs. -0.1% cons, QoQ annualised +2.1 vs. -0.2 cons).

Data in Europe showed weaker confidence in the manufacturing industry (Markit PMI 47.7 vs. 48.1 consensus). Industrial production fell in France and Italy (MoM -0.9 vs. -0.5 cons and -0.9 vs. -0.8 cons, respectively). In the UK, despite the Brexit uncertainty, the labour market has remained solid (unemployment rate 3.8% vs. 3.9% cons and jobless claims change 24.7k vs. 29.3k prior). Industrial production improved (MoM 0.7% vs. 0.1 consensus). Elsewhere, the US economy remained strong: the jobs market tightened further with the unemployment rate down to 3.6% (vs. 3.8% consensus) and US GDP annualised QoQ showed a better-than-expected 3.1% growth rate (vs 3.0% consensus) despite the downwards trend (3.2% in prior release).

Figure 1: May 2019 returns – Risk-off price action



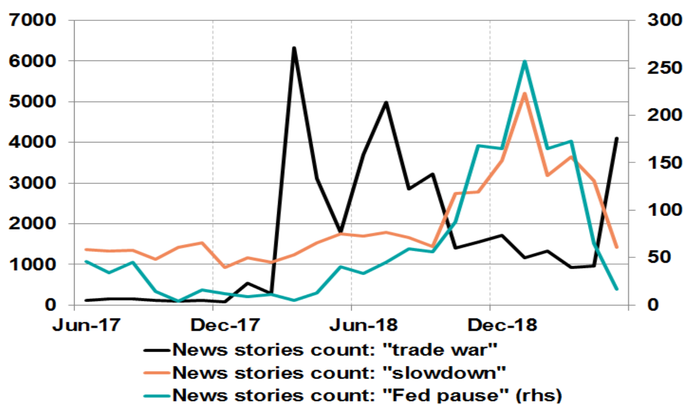
Source: Bloomberg and BNPP AM, as of 31/05/2019

FLUID TIMES: TRADE WAR RISKS ARE BACK

Markets have remained fluid, causing investors to shift their focus several times in recent months. From fearing recession in Q4 2018 when macroeconomic data weakened considerably to euphoria as the US Federal Reserve paused its policy tightening and amid the recent goldilocks conditions to fresh worries about a deepening Sino-US trade war (Figure 2).

With attention now on the import tariff increases and US bans on major Chinese firms, the recent wave of investor angst is understandable, but as we explore below, this is not a game changer for our outlook as we have already factored in de-globalisation risk as a medium to long-term theme.

Figure 2: Changing market focus – from recession risk to Fed pause to trade war…

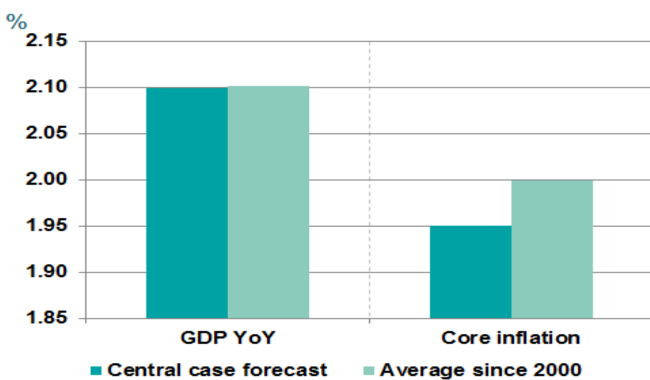


Source: Bloomberg and BNPP AM, as of 31/05/2019

'Fragile goldilocks': Is a slowdown becoming a bigger risk?

As we have explored in recent publications, the economic and policy backdrop still endorse a goldilocks environment. Figure 3 shows that robust, but more moderate growth is coupled with low inflation, meaning that the Fed "policy put" is credible. And the latest Fed meeting minutes have confirmed that policymakers are focusing on (low) inflation.

Figure 3: Moderate GDP growth and low inflation support a patient Fed and hence a goldilocks environment

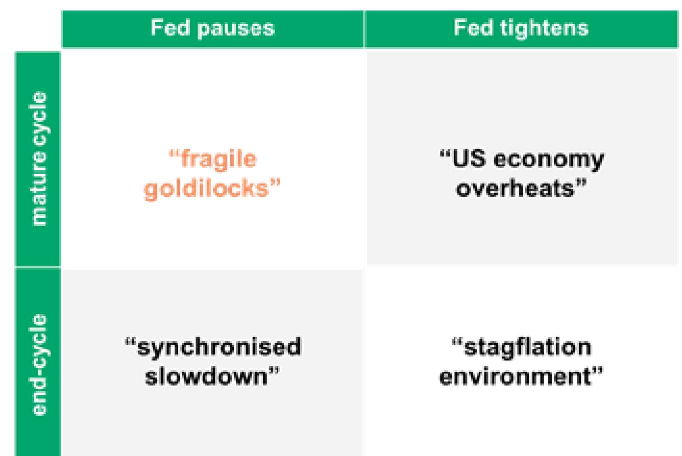


Source: Bloomberg and BNPP AM, as of 31/05/2019

That said, we have characterised the current goldilocks environment as a fragile one – i.e. one that could be destabilised quite easily. Regular readers will be familiar with our scenario matrix shown again in Figure 4. To us, the threat to goldilocks – and hence the current sweetspot for markets – is twofold: i) a material/sustained increase in inflation could force the Fed to tighten again (a push to the top right hand quadrant); ii) a slowdown in activity/recession where even renewed Fed easing does not stimulate growth enough initially (a slip to the bottom left hand quadrant).

After the latest trade war news, the key question is whether the risk/probability of the synchronised slowdown scenario has increased?

Figure 4: A material escalation in US-China tensions risks a transition to a global economic slowdown



Source: Bloomberg and BNPP AM, as of 31/05/2019

De-globalisation at the heart of the trade war

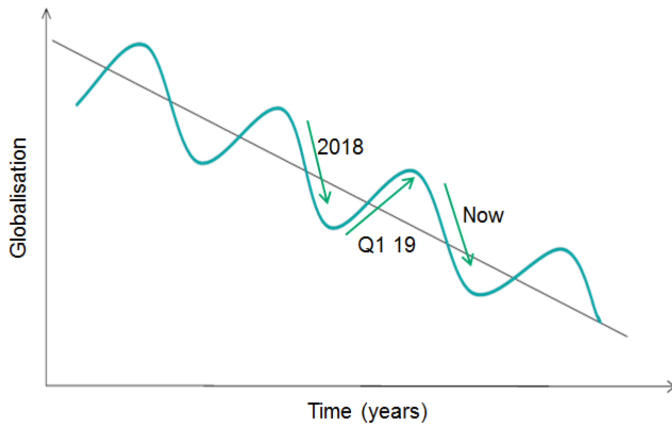
To us, de-globalisation trends are at the heart of the trade war between the US and China, and there are issues extending way beyond trade in this struggle for global power.

Indeed, as the recent US ban on a large Chinese telecommunication supplier has shown, IT dominance, strategic infrastructure, espionage, cyber security and intellectual property rights are equally important aspects of the Sino-US tensions.

As we have argued before, the medium to long-term trend is for a reversal of the globalisation forces of prior decades. But equally, there are shorter-term cyclical gyrations around this de-globalisation trend, as shows schematically in Figure 5. At times, tensions will ease (as they did in Q1 this year), and then rise again (as was the case in 2018 and again recently).

As such, the recent spike in tensions was no surprise to us, and if anything, has given us an entry point for buying DM equities which are less exposed to trade war risk than other assets (see the discussion below).

Figure 5: De-globalisation dynamics should oscillate back and forth along a downward trend



Source: BNPP AM, as of 31/05/2019

Overall, we hold a cautiously constructive view on US-China trade tensions. Our base case is that eventually, there will be a trade deal. We see three broad scenarios in the short term:

i. A rapid resolution of the tensions with a new deal agreed in a matter of days (very low probability)
ii. A slow resolution with prolonged/tense discussions ending in a trade deal in the weeks/months to come (medium probability)
iii. An escalation of tension and no eventual deal (low probability).

The key signs to follow for de-escalation are: i) a reversal of trade tariffs and ii) progress in the trade discussions ahead of the G20 meeting in Japan on 28-29 June, where President Trump appears to be willing to meet President Xi.

For sure, the process will be tense and may last for weeks/months, but for investors, it may open opportunities to add to market risk at better valuations such as the recent equity dip which we bought into (see the discussion below).

Of course we cannot be 100% sure, and with the situation rather binary, the risk of an escalation remains. We hold several portfolio diversifiers for such an event, including a long CAC vs. DAX RV trade in equities (the latter being more exposed to trade war risks), a long USD vs. Asian FX trade as a trade war hedge and a long in 5y US bonds versus 5y German bonds which has defensive characteristics and should protect portfolios in a risk-off shock (also see the asset allocation section below).

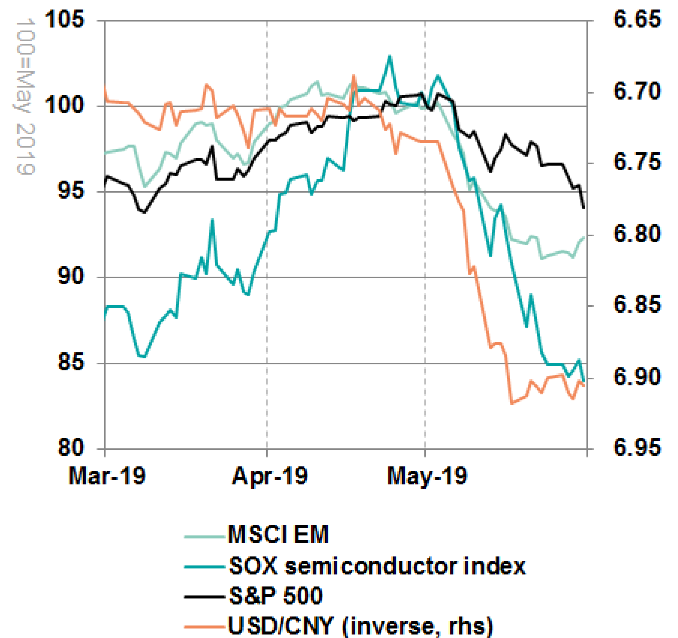
FUNDAMENTALS EVER MORE IMPORTANT

As explored above, news headlines and markets have remained volatile around Sino-US tensions. But digging beneath the broad picture and looking at an array of global assets, we find that the market is actually differentiating substantially (Figure 6).

Assets more exposed to the risk such as emerging market equities and the Chinese yuan have underperformed, with broad DM/US equities holding up better. On a sectoral basis too, semiconductors have underperformed meaningfully.

Put differently, fundamentals matter and distinguishing between the various fundamental drivers remains important.

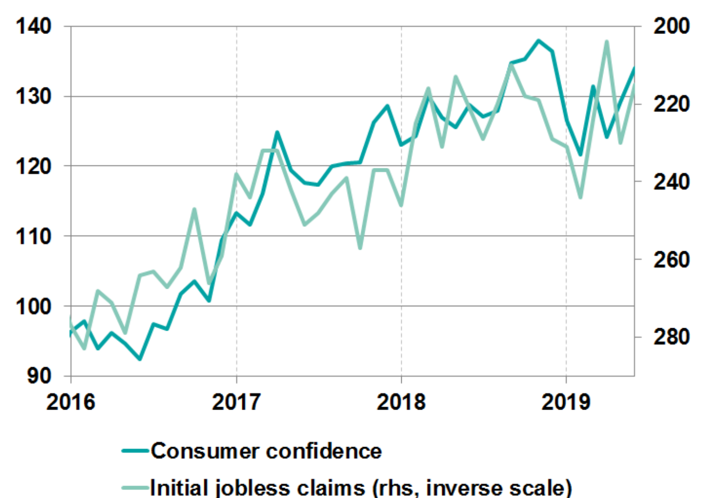
Figure 6: Trade war risks – not all assets are equal



Source: Bloomberg and BNPP AM, as of 31/05/2019

In this light, DM economic trends have continued to recover from the Q4 soft patch. Especially in the US, the domestic picture has remained healthy with consumer confidence picking up and the labour market still strong (Figure 7).

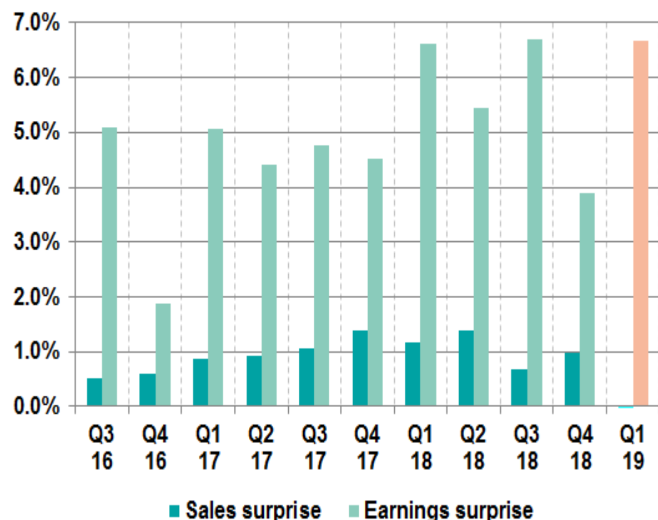
Figure 7: US economy still looking strong domestically



Source: Bloomberg and BNPP AM, as of 31/05/2019

Earnings trends have been upbeat too, with the current earnings season ending with notable surprises in EPS results (Figure 8).

Figure 8: Earnings surprises in the US have been strong



Source: Bloomberg and BNPP AM, as of 31/05/2019

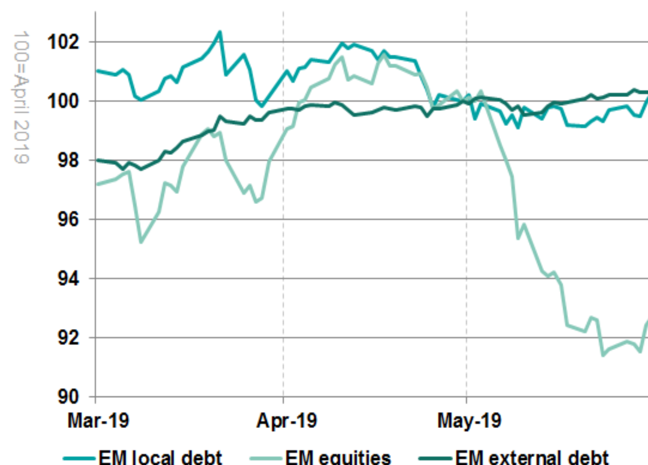
Of course, that is not to say that the China-US trade war is not a risk for developed market economies, but absent this externality, the domestic picture has remained robust.

Emerging market 'circuit breakers' wobbling

The same cannot be said about emerging markets anymore. We had previously flagged that the three 'circuit breakers' that led to EM asset stabilisation at the turn of the year were quite advanced. The 'circuit breakers' were: Fed support, China policy stimulus and US-China tensions. As a result, we are not surprised that the escalation of Sino-US tensions has so far been more detrimental on EM than DM risky assets.

The Federal Reserve turned from hawkish to dovish in January and rates markets are now pricing in one interest-rate cut by end-2019 and another in 2020. While a patient Fed should generally be supportive, EM assets have already had a lot of good news on the Fed front in the price. We have argued that Chinese policy stimulus evolved from limited and targeted to a more aggressive monetary and fiscal effort in late 2018. Again, a lot of this good news is already in the price. Finally, trade tension risk was benign until April with most market participants expecting a deal soon. Of course, this last circuit breaker has now been derailed and EM assets, especially those most linked to China's growth prospects, such as EM equities have been hurt the most (Figure 9).

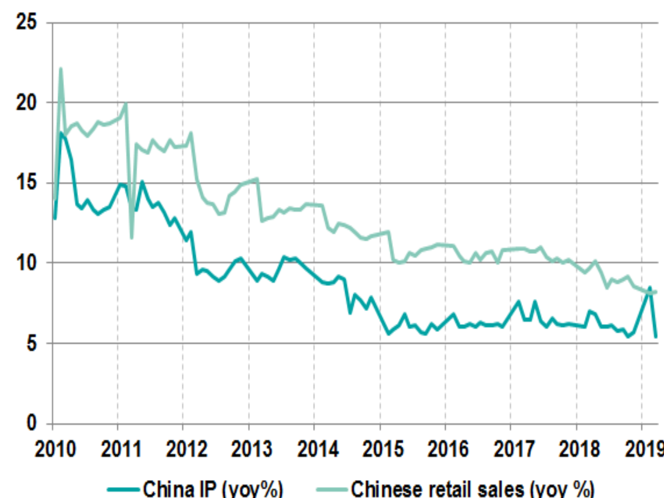
Figure 9: Intra EM – equities have been the main victim of trade tensions so far



Source: Bloomberg and BNPP AM, as of 31/05/2019

One of the key concerns over the escalated tensions is how big a blow this could be to China's growth prospects. Our initial assessment is that China was already in a difficult position before the escalation. First, growth indicators had picked up in March, but only to give up some gains in April, even before the tensions flared-up (Figure 10). Second, stimulus measures had been less aggressive than in prior easing cycles because the authorities wanted to avoid excessive debt, especially after the huge credit expansion of 2015-16. Finally, China already faces structural headwinds such as shifting from manufacturing/ exports-led growth to services/consumption-driven growth.

Figure 10: Stabilisation in Chinese activity had been tentative even before US-Sino tensions flared up



Source: Bloomberg and BNPP AM, as of 31/05/2019

As a result, we think there is a material risk that the tensions will hurt China's nascent recovery, especially if there are no renewed stimulus measures. Ultimately, if sentiment

deteriorates significantly, the Chinese authorities may be forced to embark on more monetary and fiscal stimulus.

Taking all of this together, we prefer DM equities, notably the US where fundamentals are still solid and where the Fed is hugely supportive. The picture is weaker in China and other EM economies.

ASSET ALLOCATION

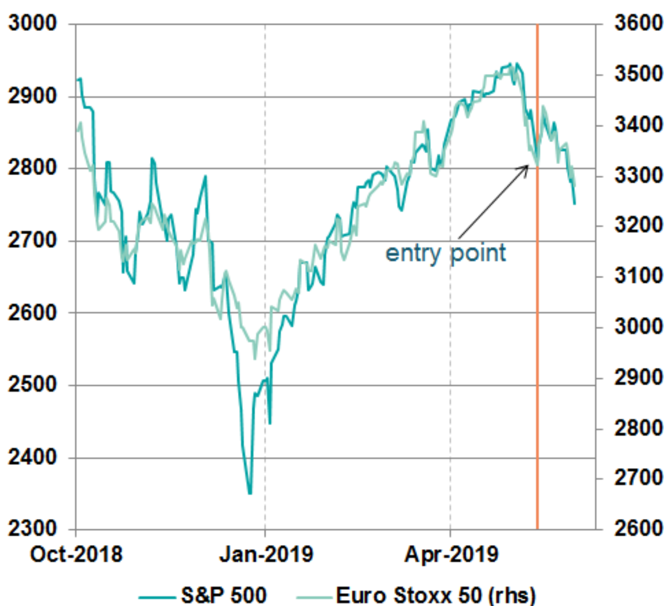
Buying the dip in equities: trade war as an entry point

Having been strategically neutral on equities for some time, we decided in early May to increase our market risk by going long DM equities after the correction in major indices triggered by the escalation of US-China trade tensions (Figure 11). Our base case of 'fragile goldilocks' is one that is conducive to buying dips in the equity market and, as discussed above, we have a cautiously constructive view on US-Sino trade tensions.

Separately, our market dynamic analysis is also supportive for the medium term (6-12m). Our market temperature indicators still flagged hot and pointed towards a consolidation to more normal conditions and our Technical Dynamic Analysis (TDA) pointed towards a small consolidation in the near term and a structurally bullish configuration in the medium term.

Taken together, having previously been unwilling to chase the market after a 15% rally in equities year-to-date, the recent correction gave us an attractive opportunity to increase market risk. We implemented this trade via US and EMU equity markets, not wanting to increase our EM exposure further given our long in EM hard currency debt (see below).

Figure 11: Buying the dip – long US & EMU equities

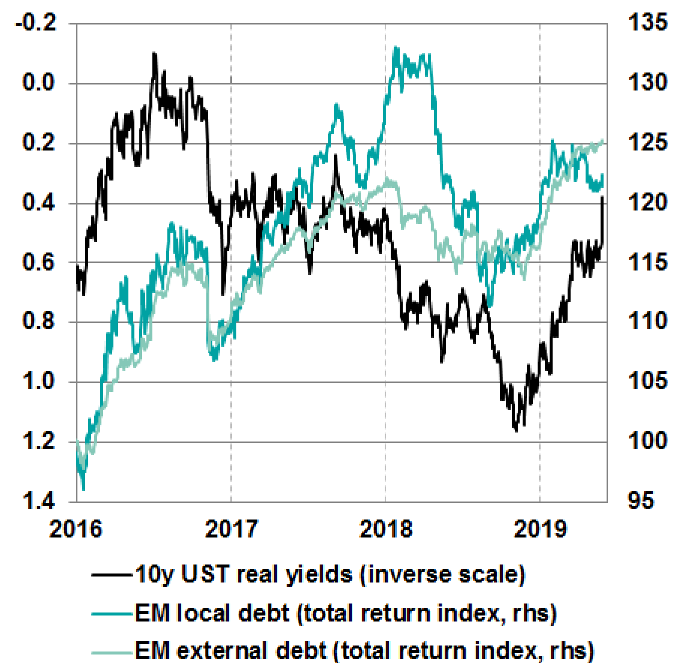


Source: Bloomberg and BNPP AM, as of 31/05/2019

Long carry assets

Elsewhere, we continue to believe that the dovish stance by the Fed and other major central banks should drive a search for yield dynamic. In our view, this environment favours being long carry assets. We continue to hold a long in EM hard currency debt, which is a USD exposure with high carry (roughly 6%). This has held up well compared to local currency debt given the recent EM FX weakness (Figure 12). This trade also helps us to somewhat neutralise the underweight in duration given our short in core EMU duration.

Figure 12: Stable/lower real yields to support carry assets



Source: Bloomberg and BNPP AM, as of 31/05/2019

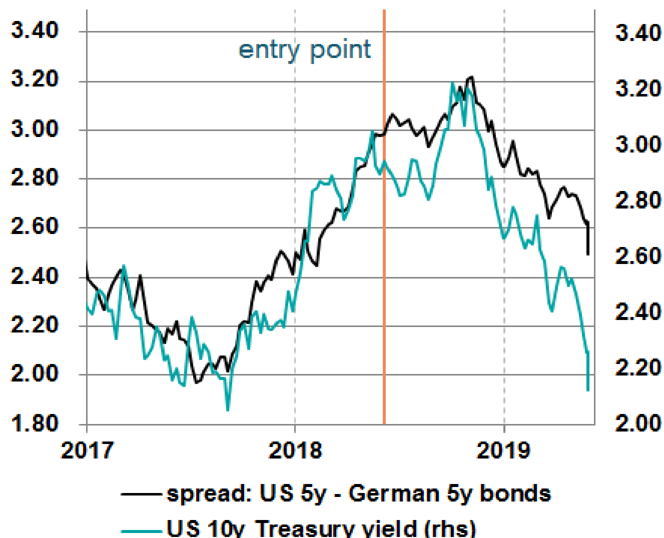
As we look for other sources of carry, European real estate (REITs) is on our radar, and we are waiting for better entry points. Attractive valuations relative to net asset value (NAV) and high carry versus government bonds should benefit REITS in a search-for-yield world.

Building robust portfolios

We believe that building robust portfolios and holding diversification trades is key at this juncture.

In government bond markets, we remain long five-year US bonds versus five-year Bunds. This is attractive because of stretched valuation differences and offers good defensive characteristics in risk-off environments (Figure 13). US yields have "more room to drop" in a slowdown. We believe this relative value trade is thus a good broad portfolio diversifier.

Figure 13: 5y UST vs. Bunds has defensive characteristics

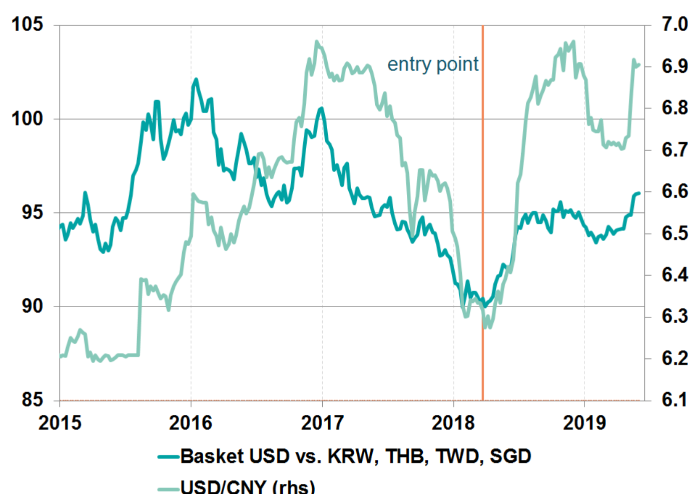


Source: Bloomberg and BNPP AM, as of 31/05/2019

Elsewhere, as discussed above, we continue to think 'old China' remains challenged and that protectionist forces are here to stay. We have explored several trades to protect us against this risk. We are long the French CAC 40 and short the German DAX. With Germany more exposed than France to de-globalisation, this relative value trade aims to limit our exposure to renewed trade tensions.

In FX, we are short a basket of Asian currencies vs. USD. This trade has done well recently as Sino-US tensions mounted. Indeed, note the correlation between our basket and USD/CNY (Figure 14). With almost no negative carry (compared to the high negative carry in other EM crosses), we can afford to hold this hedge for extended periods.

Figure 14: Short Asia FX vs. USD as a trade war hedge



Source: Bloomberg and BNPP AM, as of 31/05/2019

STRATEGIC OVERVIEW OF KEY POSITION CHANGES IN MAY 2019[1]

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

MAY

SHORT DM EQUITY CLOSED 02/05/19

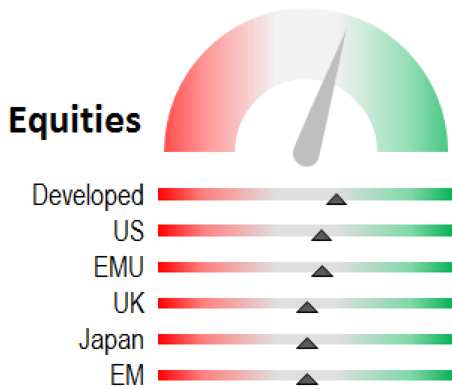
- We hit the hard stop loss levels of our tactical short in DM equity markets and closed this trade in early May.

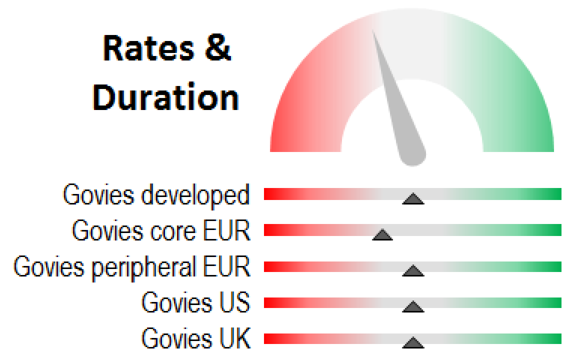
LONG DM EQUITY OPENED 10/05/19

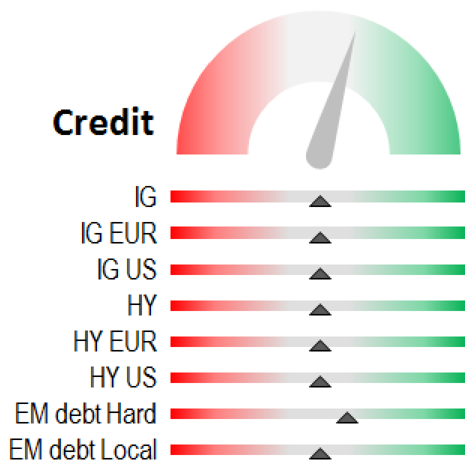
- As our 'fragile goldilocks' base case suggests buying dips and we ultimately expect a resolution of the US-China trade conflict, we used the recent market dip to open a long position, split 50:50 between US and European equity markets.

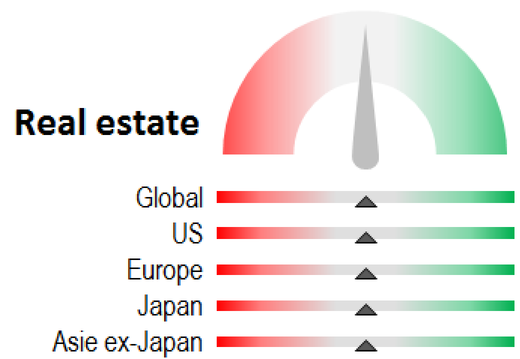
[1] Please note that our underweight in broad EMU government bonds will no longer be monitored as part of the MAQS investment committee views.

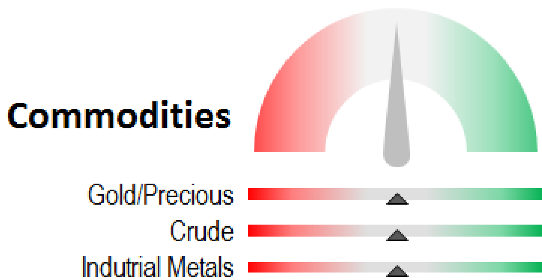
ASSET ALLOCATION DASHBOARD[2]

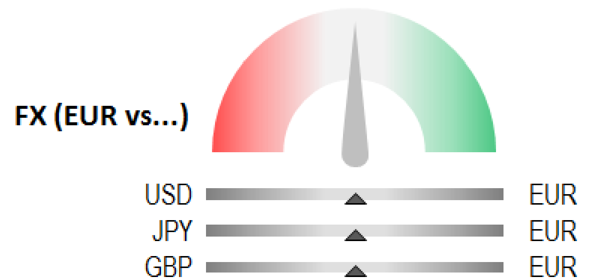


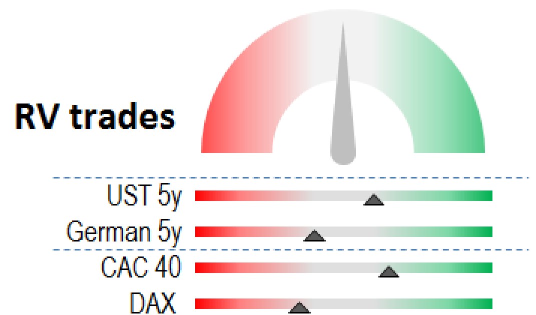












[2] The dashboard shows the asset allocation in our portfolios and reflects the decisions of the Investment Committee of the Multi-Asset team at MAQS. Views expressed are those of the Investment Committee of MAQS, as of June 2019. Individual portfolio management teams outside of MAQS may hold different views and may make different investment decisions for different clients.

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