REGIME CHANGE

Please note that this document may contain technical language.
For this reason, it is not recommended to readers
without professional investment experience.

THE INVESTMENT OUTLOOK FOR 2019

BNP PARIBAS
ASSET MANAGEMENT

The asset manager
for a changing
world

CONTENTS

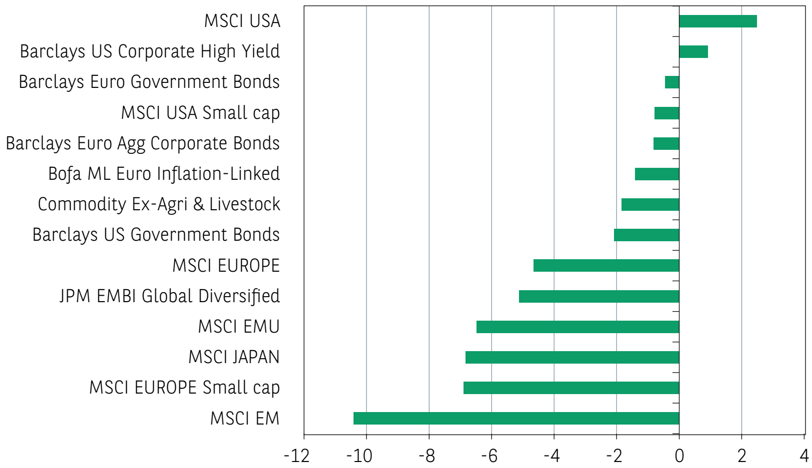
Note to readers: all assessments, data and forecasts in this document are made using data and information up to and including 31 October 2018, unless stated otherwise. Views expressed in this publication have a 6-12 month horizon, unless stated otherwise, and are those of the authors. Views are as of 31 October 2018, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares or other securities.

LETTER TO INVESTORS

A regime change is underway in financial markets. Non-conventional central bank policy in the wake of the Great Financial Crisis of 2007-2008 sent waves of liquidity flooding through global asset markets. In December 2015, the US Federal Reserve launched the first phase of its policy normalisation by raising the federal funds rate by 25bp at a time when other central banks were still cutting rates or expanding their balance sheets.

We are now entering the second phase of the unwinding of unconventional policy as the US policy rate increases are accompanied by rising rates elsewhere and shrinking aggregate central bank balance sheets (See Exhibit 1 below).

Performance of selected asset classes in 2018
(Total return in %, local currency year-to-date performance)



Source: Datastream, BNP Paribas Asset Management, 31 October 2018

Central bank policy has been the biggest single factor in determining financial market returns in recent years. As policymakers intended, their policy has driven investors out of 'riskless' assets into riskier sectors, compressing risk premia in the process. That liquidity is now being removed from the markets and asset valuations are adjusting to the new regime. This withdrawal of unprecedented levels of stimulus, however slow and however well sign-posted by central banks, is inherently uncertain, driving higher volatility and recent choppier, more unsettled market conditions.

Our 2019 Investment Outlook details our analysis of the way ahead in two sections. Firstly, we assess the global macroeconomic environment and the prospects for the principal asset classes. Further articles by our specialist teams discuss some of the issues that we believe investors should take into account in 2019.

The regime change underway offers greater opportunities to our investment teams. Amid the prospect of higher market volatility and another year of political, geopolitical and other uncertainties, an ability to look through the short-term market noise and focus on the investment themes that truly matter will be key.

At BNP Paribas Asset Management, we believe that there is one major constant to guide our investment decisions: as an asset manager and asset owner, we must act as a future maker and pursue efforts that lead to a sustainable world. That is a world in which we can earn long-term sustainable returns for our clients, while shaping the kind of future that we want for ourselves, our clients and the generations that follow.

Frédéric Janbon
Chief Executive Officer and Head of Investments
BNP Paribas Asset Management
frederic.janbon@bnpparibas.com

INVESTMENT OUTLOOK 2019

REGIME CHANGE

As pronounced bouts of market volatility – in January/February and again in October – reminded investors in 2018, swings in sentiment are never far away, especially in times when “stars” such as a growth recovery, muted inflation and a pro-growth monetary policy are no longer aligned, as they were in previous years. Does that mean regime change looms in 2019? It probably does. Does that spell poorer times for investors? It does not have to, as a range of experts from BNP Paribas Asset Management argue in this 2019 Investment Outlook.

THE ISSUES PERSIST, BUT THERE HAS BEEN TIME TO PREPARE

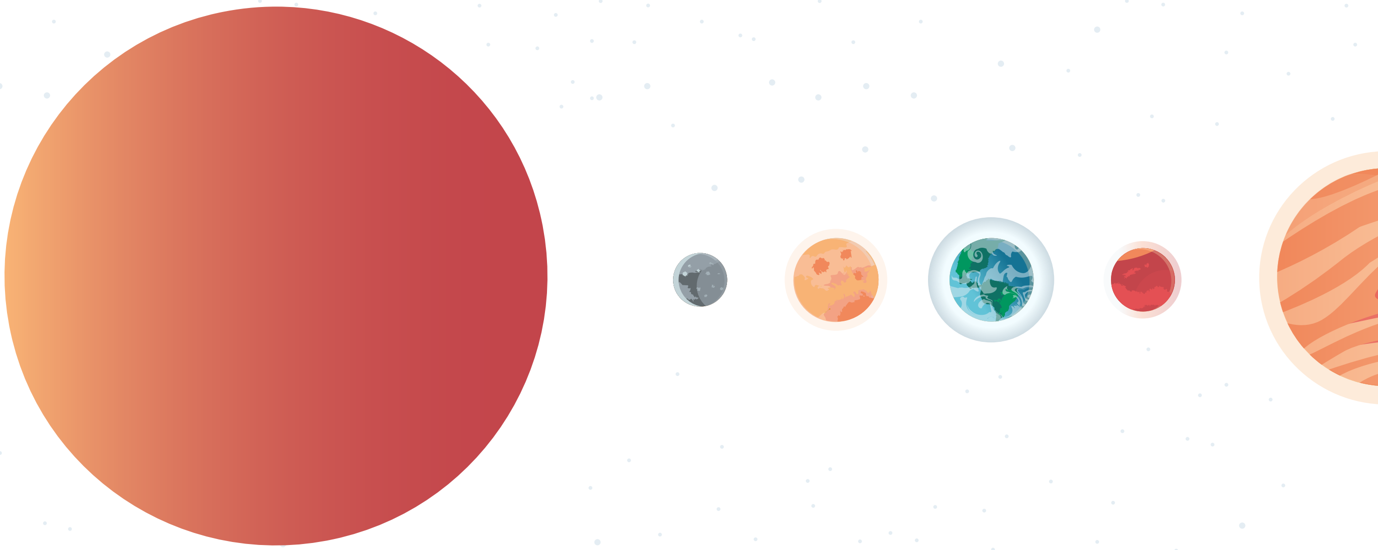
Broad-brush, some of the larger issues of 2018 will likely linger on in 2019. The US-initiated trade commotion should smoulder, keeping market concerns about its impact on growth and inflation alight. In the same corner, the wider US-China tussle for world hegemony and the accompanying tensions could well spark fresh geopolitical jitters in the markets, while Russia might seek to benefit from the rivalry, at a risk of fresh sanctions, possibly affecting its bond market and its banks.

Geopolitical clouds might also form out of the tension between Italy and the EU, spooking euro bond markets and the euro itself and fanning break-up concerns in a year that will be marked by the UK’s departure from the EU in one form or another. The deal/no deal uncertainty should end by March 2019, though at the time of writing it is by no means clear what the divorce arrangements will look like, so it remains too early to discard the prospect of a disorderly split and its high-impact consequences, not just for UK growth and inflation.

In fact, though, those ‘unknowns’ are generally known and markets have had time to draft scenarios, so while extreme outcomes could set off volatility and drive investors to safe havens, this is not what we on the whole expect. Our central scenario for 2019 focuses on generally robust, but weakening growth; gradually rising inflation; and continued monetary policy normalisation.

A SHIFT IN THE PARADIGM? YES, BUT STILL A BENIGN ENVIRONMENT

Does that represent a regime change? Well, it would in the sense that the decades-long bull market in bonds now looks to be definitely over and that on the side of equities, the US bull market – one of the longest in history – could increasingly be threatened. As the post-crisis recovery matures, the correlations between asset classes that investors have grown used to look set to unwind.



While this may sound gloomy, we believe the 2019 investment environment is in fact quite benign. Growth looks set to slow, but a recession is not in sight. In the US – the world's largest economy – government and consumer spending should sustain growth, while for the runner-up – China – a slowdown to a growth rate of less 6% looks unlikely amid government action to offset any impact of the US trade tariffs. The recovery in the eurozone can be expected to continue.

Inflation remains caught between, on the one hand, some upward pressure from the (years of) economic recovery, falling labour market capacity – first and foremost in the US and gradually also in the eurozone – as well as trade tariffs and, on the other, the mitigating effects of technological advances and improved productivity. On the whole, muted inflation should remove any pressure on the leading central banks to do more than gradually take away the extraordinary post-crisis measures and return to normal monetary policy regimes slowly but surely. Here too, a sudden step-up in the pace and the size of interest-rate rises could upset markets, but this looks unlikely at this point.

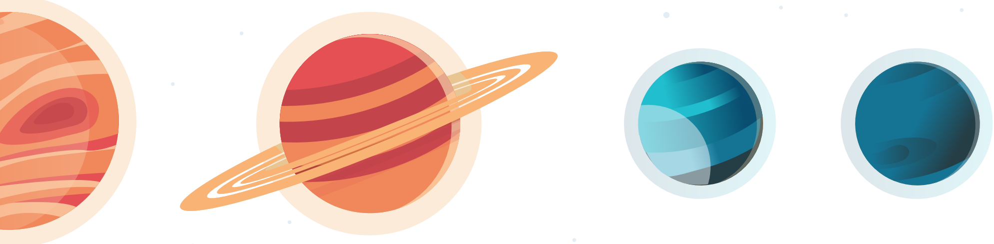
UNDENIABLE, BUT MANAGEABLE RISKS

What then could be the risks to this scenario for 2019? The US economy could overheat, taking inflation to boiling point, but given that the US Federal Reserve is proceeding on the rate-rising path, albeit cautiously, such an outcome now seems unlikely. On the US trade action, it appears the risk of a globalised conflict has become more remote. Now that the Trump administration has concluded agreements with various international partners, the fears of widespread protectionism have receded, leaving the focus on the US-China tug of war. That should mean that tariff implementations by the two sides will have only a limited impact on (global) growth and hence financial markets.

Apart from a disorderly Brexit, political risk in the eurozone could become a meaningful issue. Italy's populist government is persisting with budget plans that contravene EU rules and is shrugging off Brussels' rebuke, setting up a clash that could reawaken investor concerns over stability in the eurozone despite Italian efforts to defuse the stalemate as well as the country's assertions that it will not leave the euro. The spectre of Italian debt reaching unsustainable levels is likely to agitate markets and create bouts of volatility in 2019.

European parliamentary elections, changes at the top of the European Commission and perhaps most importantly, the arrival of a new ECB president should also help ensure that political developments in Europe will grab as much market attention as Donald Trump's policy agenda. ■

Our central scenario for 2019: robust, but weakening growth; gradually rising inflation; and monetary policy normalisation



SECTION I - MACROECONOMIC ANALYSIS

WAITING FOR INFLATION

Wage inflation has started to pick up. Is the revenge of the Phillips curve a theme for 2019?

Investors have been waiting for inflation to arrive for what feels like an eternity. Even in the eurozone, it feels as though the recovery is well-established and in the US, investors fret that the recovery is getting long in the tooth. Unemployment has fallen to low levels by historical standards and yet core inflation seemingly remains under lock and key. Labour costs have risen, but the inflationary impact has been suppressed somewhat by a cyclical recovery in productivity.

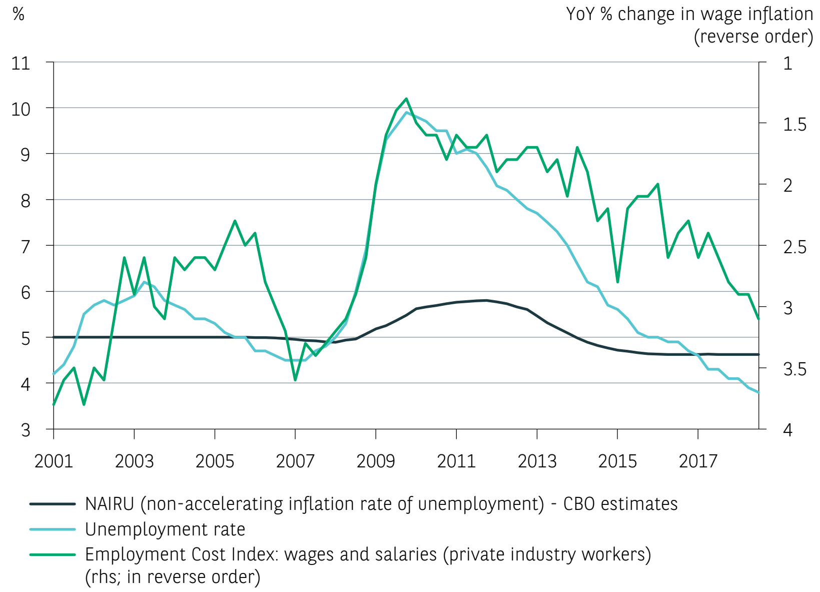
Reports of the death of the Phillips curve (see box and exhibit 1) have been exaggerated – although perhaps not greatly so. You can find evidence that capacity pressures do put upward pressure on prices in at least part of the consumption basket. So we do expect greater awareness of the Phillips curve in 2019 than has been the case of late. However, the inflationary headwinds of trade and technology are unlikely to abate, so it is too early to talk about revenge.

Do you expect a recession in the US in 2019? How will the US economy maintain momentum as the sugar rush of fiscal stimulus fades?

In our view, recession risks in 2019 are quite low. On the monetary side, assuming inflation remains near the Federal Reserve's 2% objective, the policy stance will likely remain broadly accommodative until around the middle of the year. Thereafter the move into restrictive territory should be quite gradual in speed and modest in degree.

The tailwinds from tax cuts should fade in 2019, but the bulk of the increases in discretionary spending approved by the US Congress in 2018 still lies ahead.

Exhibit 1: The Phillips curve: historically, the inverse relationship between rates of unemployment and corresponding rates of rises in wages; 2000-2018 (US unemployment and wages)



Source: Bloomberg, BNP Paribas Asset Management; November 2018

BROKEN, DEAD OR DORMANT?

The Phillips curve represents the traditional trade-off between unemployment and wages, stating that as unemployment falls, and the labour market tightens, the price of labour goes up, i.e. the pressure mounts for wages to rise. Thus, labour market data has been viewed as an important early warning signal of inflation building. However, globalisation has been seen as a factor weakening this relationship since it has increased access to large pools of workers able to meet demand for labour. With inflation falling short of many central banks' targets over the last couple of years, inflation expectations have been subdued, taking the sting out of wage negotiations and cementing wage levels at current levels. However, the more recent wave of protectionism and trade tariffs could boost the prices of foreign goods, resulting in imported inflation. This could reinstate the relationship and give central bankers fresh ammunition for measures to manage inflation.

Meanwhile, improved business investment has led to a more balanced profile for gross domestic product (GDP), which is an important development given that the housing sector will likely contribute little to growth in 2019. A tight labour market that is lifting real wages should also support consumer spending.

As for downside risks, further escalation in the trade dispute with China would weigh on growth, but if the impact is more severe than anticipated, the Federal Reserve will likely prove quite willing to pause the tightening cycle, while it considers the economic consequences of supply chain disruptions.

The more significant risk preoccupying us is the high level of non-financial corporate leverage. This represents a significant vulnerability should the US economy face any sort of exogenous demand shock.

Richard Barwell
Head of Macro Research

What influence do you see China having on the global economy in 2019?

China's GDP growth may slow towards a low 6% rate in 2019. With China having turned inward to boost growth to fight the fallout from the Sino-US trade war, it may still be a contributor to world growth, and especially growth in emerging Asia, amid policy normalisation by global central banks and geopolitical volatility.

Evidence of China's growth contribution can be seen in the year-to-date[1] growth in exports from emerging Asia (excluding China): the region's exports to both the eurozone (despite its recent recovery) and the US (despite its robust economy) have declined since early 2018. Only export growth to China has risen and quite strongly. Indeed, shipments to China contributed twice as much to export growth in emerging Asia in 2018 compared with exports destined for the US and the eurozone.

Crucially, China's imports of global manufactured goods have risen steadily since the trade war risk began. Data on the level of Chinese imports of goods to be assembled and re-exported shows imports have been growing at a steady, roughly 10% for a year now. So re-exporting assembled goods to beat US tariffs is not behind the rise in China's imports of global manufactured goods.

As long as China's growth holds up at an annual rate of more than 6%, the country will likely continue to contribute to world growth in 2019.

Chi Lo
Senior Economist Greater China

What do you see as the principal political risk in the eurozone for 2019?

Expectations that the election of French President Macron would usher in an era of relative tranquillity on the political front with tangible progress on reforms to complete the currency union have proven wide of the mark.

There have been discombobulating developments aplenty: from the independence movement in Catalonia, the election of a radical coalition government in Italy to an unstable grand coalition in Germany, to name but three.

However, the two key political risks in 2019 are likely both external in nature: a disorderly Brexit on the eurozone's doorstep and an escalation in protectionism on the other side of the Atlantic.

Steven Friedman
Senior Economist

1 To October 2018

EUROPEAN POLITICAL CALENDAR

Also see page 18 for more on the changes at European institutions in 2019

JANUARY 1	Romania assumes the presidency of the Council of the EU
JANUARY 21	UK: Deadline for the withdrawal agreement to be presented to UK parliament
FEBRUARY	**Alliance of Liberals and Democrats nomination of lead candidate and campaign start**
MARCH 3	Estonia: Parliamentary election
MARCH 9	Solovakia: Deadline for presidential election
MARCH 21-22	Leaders' summit
MARCH 29	UK leaves the EU; possible leaders' summit to take first decisions on future of Europe
APRIL 14	Finland: Parliamentary election
APRIL 21	Spain: Latest date for regional election in Andalusia
MAY 2	UK: Local elections
MAY 9	Informal leaders' summit
MAY 12	Lithuania: Presidential election
MAY 23-26	**European Parliament elections**
MAY 24	Ireland: Local elections
MAY 26	Belgium: Federal and regional elections
MAY 26	Spain: Local and regional elections
JUNE 17	Denmark: Deadline for general election
JUNE 20-21	Leaders' summit
JUNE 28-29	Leaders' summit (G20)
JULY	**New European Parliament president's term begins**
JULY 1	Finland assumes presidency of the Council of the EU
OCTOBER 13	Greece: Local elections
OCTOBER 13	Portugal: Deadline for parliamentary election
OCTOBER 20	Greece: Deadline for parliamentary election
NOVEMBER 1	**New European Commission president's term starts**
NOVEMBER 30	Poland: Deadline for parliamentary election
DECEMBER 1	**New European Council president's term starts**

SECTION I - MARKET ANALYSIS

POLICY NORMALISATION - A TRICKY BALANCING ACT

Guillermo Felices
Head of Research and Strategy, MAQS

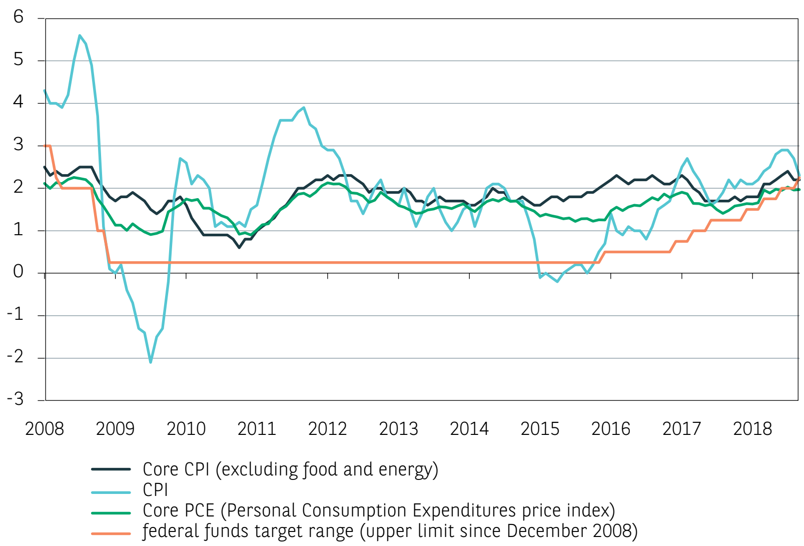
What are the key risks that investors face in 2019?

We see risks coming mainly from three distinct sources:

(i) the US economy could overheat
(ii) trade tensions between China and the US could escalate
(iii) Italian political turmoil could trigger systemic eurozone risks.

The US economy runs the risk of overheating because spare capacity is now low and inflation is near the Fed's 2% target (see exhibit 2). The Fed is in the middle of raising policy rates and reducing its balance sheet to prevent the economy from running too hot. But this is a tricky balancing act because policy normalisation (or quantitative tightening) should push 'risk-free rates' higher, potentially destabilising the valuations of riskier assets. Fiscal stimulus is also complicating matters as the Fed now has another source of demand pressure to contain.

Exhibit 2: US inflation has (finally) moved closer to the US Federal Reserve's target rate; 2008-2018
(in %; US inflation and federal funds target rate)



Source: Bloomberg, BNP Paribas Asset Management; November 2018

We believe that the China-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 likely to be with us for some time. Should they lead to further market stress and pressure on trade volumes, it is global growth and in particular emerging market growth that could suffer.

In Europe, the dispute between Italy and the European authorities is also likely to endure. The main risk here is that Italian sovereign debt suffers to the point where investor concerns about debt sustainability or about anti-euro political rhetoric revive eurozone break-up risk. This would be damaging for the region's growth prospects and the valuations of European risky assets.

One potential complication is that these three risks could easily compound if they escalate. For example, higher US interest rates could lead to contagion in Europe. Or trade tensions with China would have knock-on effects on other trading partners, including the eurozone. Finally, weaker eurozone growth could weigh on global economic sentiment, negatively impacting the outlook for the US and China.

What are your main asset allocation recommendations going into 2019?

Given our baseline macroeconomic scenario of robust, but weakening global growth, gradually rising inflation and continued monetary policy normalisation, we are neutral equities and underweight fixed income. But we also recognise that we have to be more tactical and reactive around this basic mantra because of the risks to our central case.

> Given our baseline scenario, we are neutral equities and underweight fixed income

For example, following the October correction, we went long developed market equities (MSCI World). We prefer to avoid a high concentration of risk in regions that are directly exposed to the risks around our central case.

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 will rise further. This is potentially a sea change for macro investors as under this scenario, US Treasury bonds are likely to be less effective in offering protection for risky portfolios.

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.

We would also underweight high-yield credit, especially in the US. Relative to historical levels, spreads (a measure of credit risk premia) are tight and as an asset class, credit is vulnerable to quantitative tightening.

As we explained above, we face three sets of risk that are unlikely to be resolved quickly: overheating of the US economy, US-China trade tensions and European political risk. That means that we will need to trade around those themes, especially when we consider that markets are not pricing them correctly. An example is our short EUR/USD exposure, which would work if Italian risks become more systemic or the US Fed tightens policy faster than anticipated to contain inflation.

What other factors do you think investors should consider beyond the fundamental/macroeconomic outlook?

The bull market in US equities has been one of the longest in recent history and it has been driven by extraordinarily accommodative monetary policy and a sustained economic recovery (see exhibit 3). As a result, distortions such as historically low asset price volatility have been building in financial markets over the years. These imbalances are at risk of unwinding as markets face the crosscurrents of a strong, but ageing US business cycle and policy normalisation.

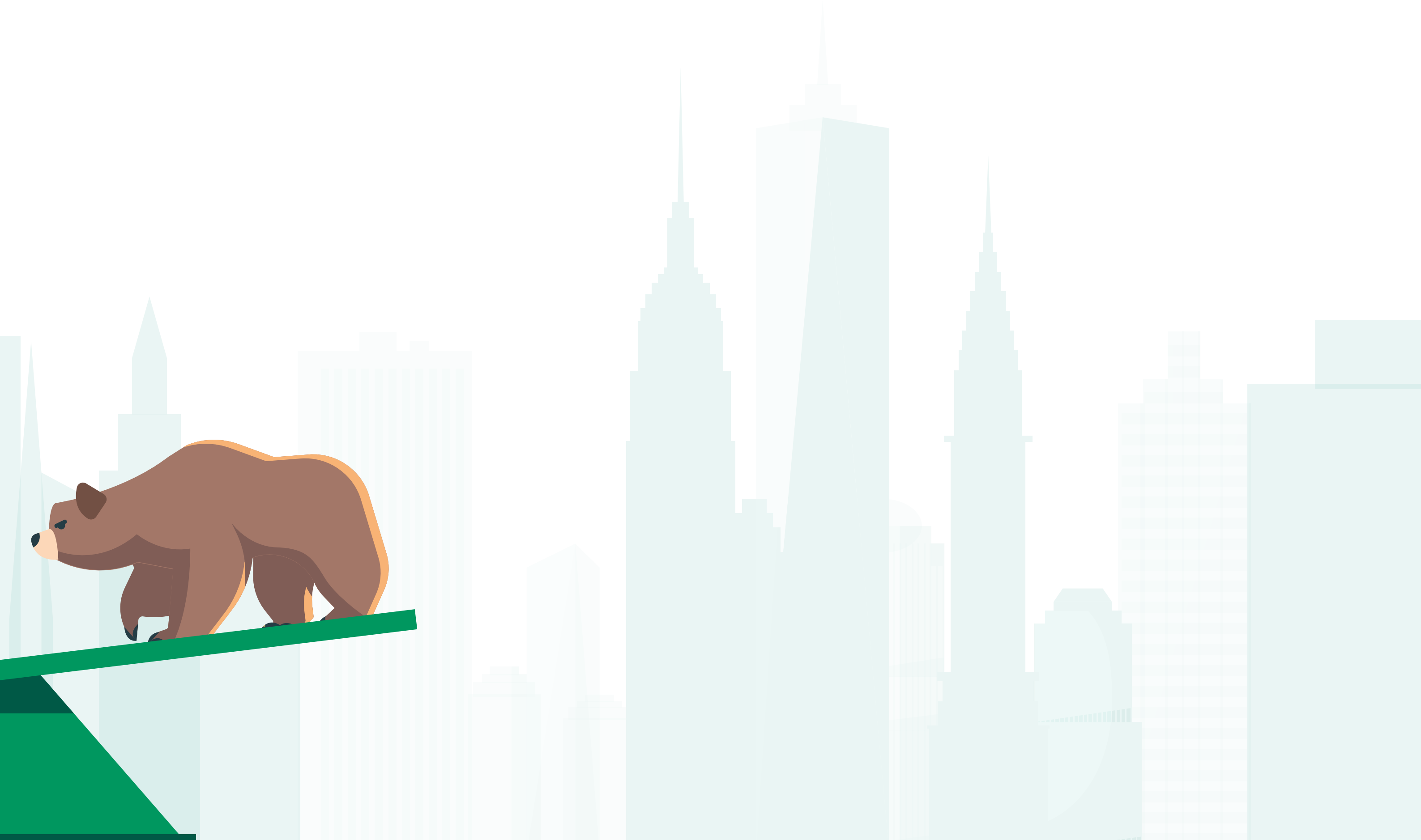
Exhibit 3: US bull market has kept on running and running; 1990-2018
(S&P 500 index; weekly data)

Source: Bloomberg, BNP Paribas Asset Management; November 2018

In this environment, markets are likely to be more sensitive to factors that affect market dynamics such as sentiment, volatility, liquidity and positioning. We use these indicators along with our in-house dynamic technical analysis to assess the prospects for market dislocations. Note that these dislocations may or may not reflect news or data on fundamentals.

It is these factors which, for example, signalled to us to reduce risk generally in September and to underweight US IT stocks relative to the overall US equity market. Sentiment indicators looked stretched at the time, volatility was historically low, and US companies were in a news blackout period that meant any share buybacks would be less supportive of prices.

Investors are likely to be more sensitive to factors that affect market dynamics such as volatility and liquidity



SECTION I - MARKET ANALYSIS

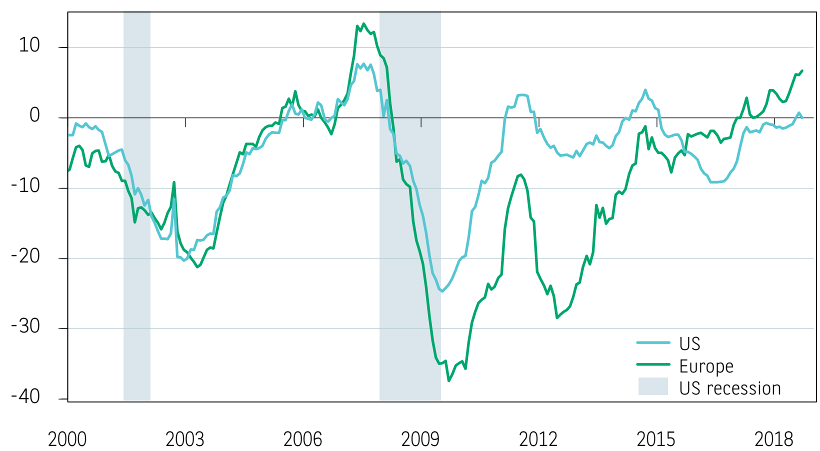
ADAPTING TO QUANTITATIVE TIGHTENING

Daniel Morris
Senior Investment Strategist

Whereabouts are we in the credit cycle?

Simply looking at measures of the credit cycle, for example, ratings upgrade-downgrade ratios or default rates, the environment still appears fairly benign. In the US, the ratio is improving, and not showing the signs of deterioration that are often seen ahead of a recession. In Europe, the balance is quite positive (see exhibit 4).

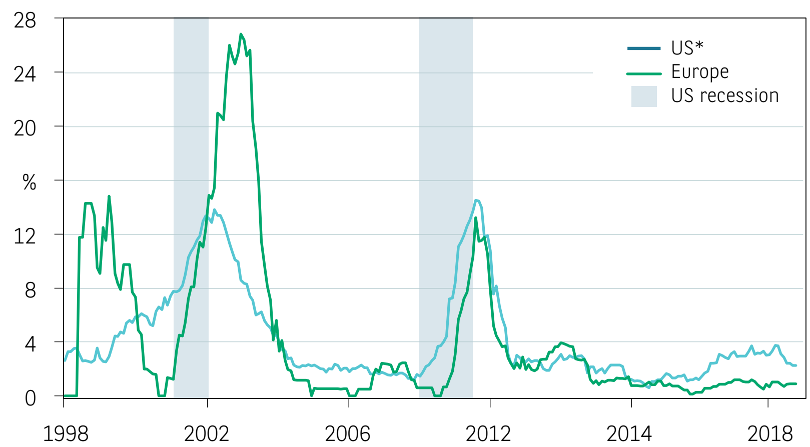
Exhibit 4: Investment-grade credit upgrade-downgrade ratio, 2000-2018 (six-month moving average)



Source: Data as at 31 October 2018. Source: Bank of America Merrill Lynch, BNP Paribas Asset Management

For high-yield credit in the US, excluding commodities, the rate of issuer defaults has been declining from the surge that began in 2016. In Europe, the rate remains low (see exhibit 5).

Exhibit 5: Changes in default rates of US and European high-yield debt, 1998-2018 (trailing 12-months)



Source: Data as at 31 October 2018. *Excludes commodities. Source: Bank of America Merrill Lynch, BNP Paribas Asset Management

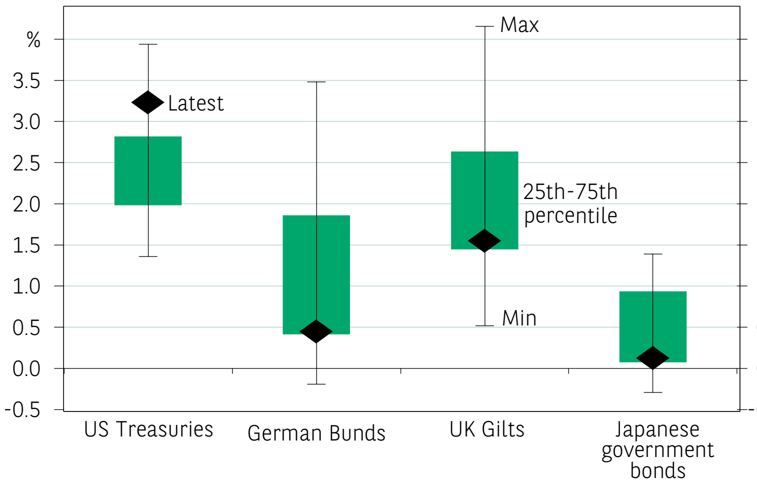
It should be just a matter of time before worries about growth drive investors to favour government bonds

We are nonetheless in the later stage of the US economic cycle and it should be just a matter of time before worries about growth drive investors to favour government bonds over corporate debt. We are worried about a lack of discipline among corporate debt issuers. The stimulus from the tax cuts should eventually fade, while the US Federal Reserve will still be raising rates to forestall an increase in inflation and will still be reducing the size of its balance sheet. It is then that the build-up in corporate leverage over the last few years will likely become a problem for company treasurers. The asset class has seen significantly lower fund inflows compared to 2017 as investors began to anticipate rising interest rates.

In contrast, the eurozone economy may not have shown the same vigour as that of the US, but as far as credit is concerned, it has the virtue of the tortoise versus the hare. The Bloomberg Barclays eurozone credit index outperformed the euro government bond index as at 31 October 2018. By contrast, in the US, only high-yield (slightly) bettered government bonds.

Europe, however, faces the prospect of a much steeper normalisation of monetary policy in 2019 as quantitative easing ends (including the ECB's Corporate Sector Purchase Programme (CSPP)) and the ECB may begin to raise interest rates. While this normalisation has already progressed reasonably far in the US (Treasury yields are well above the levels seen in the QE-era from 2010), yields of Bunds are still quite depressed (see exhibit 6).

Exhibit 6: Variations in the yields of selected benchmark 10-year government bonds, 2010-2018 (in %)



Source: Data as at 31 October 2018. Source: FactSet, BNP Paribas Asset Management

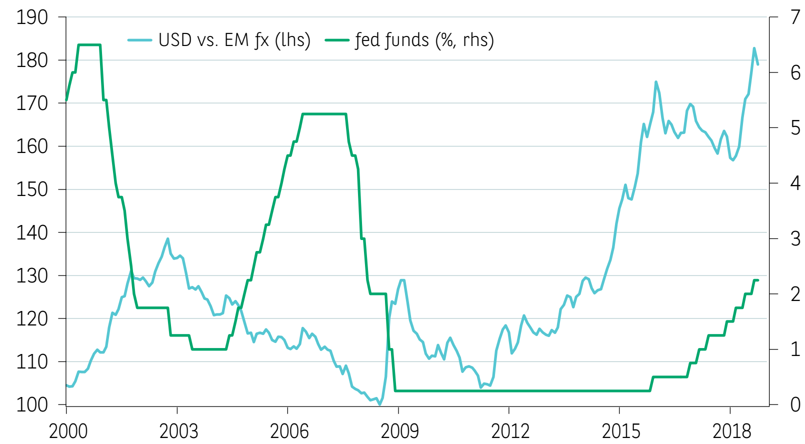
Emerging markets had a difficult 2018. How do you assess their prospects for 2019?

The key surprise in 2018 was the focus placed by President Donald Trump on trade. The fear of protectionism and trade wars contributed to a sharp rise in the US dollar and equally sharp falls in emerging market (particularly Chinese) equities.

Trade and the US dollar aside, however, the macroeconomic outlook for EM remains broadly positive. The prospects for 2019, then, depend on how the trade environment evolves.

Whenever President Trump 'tweeted' about trade, or announced higher tariffs on US imports, the US dollar generally strengthened. This explains much of why the dollar rose in 2018 after having declined from 2016 (see exhibit 7).

Exhibit 7: Changes in US dollar against emerging market currency index and US interest rates, 2000-2018



Source: Data as at 31 October 2018. Source: JPMorgan, FactSet, BNP Paribas Asset Management

We had expected the dollar to continue its depreciation in 2018, despite rising US rates, because we believed the currency was overvalued. It was the surprise increase in the dollar's value, combined with rising US rates, that put so much stress on emerging market assets in 2018.

We expect the Fed to continue raising interest rates through 2019, so pressures on emerging markets will only increase. Whether they will be able to withstand the pressure will depend on whether the dollar reverses course. If the trade tensions diminish (without entirely vanishing), we believe the prospects for a fall in the dollar are good, clearing the way for a rebound in emerging market equities and (local currency) fixed income markets.

There has nonetheless clearly been a negative impact on growth in emerging markets from the rising USD-interest rate combination. While purchasing manager indices (PMIs) for most markets have remained in positive territory (readings above 50 indicate expansion, those below 50 point to contraction), the trend over the last six months for many countries has been downwards (see exhibit 8).

A fall in the US dollar would clear the way for a rebound in emerging equities and (local) fixed income

Exhibit 8: Changes in emerging market manufacturing PMIs, August 2017-Oct 2018

	11-2017	12-2017	01-2018	02-2018	03-2018	04-2018	05-2018	06-2018	07-2018	08-2018	09-2018	10-2018	1-mo change
Emerging markets	52	53	54	53	52	52	52	52	52	52	52	52	0.1
Czech	59	60	60	59	57	57	56	57	55	55	53	52	-1.0
Egypt	51	48	50	50	49	50	49	49	50	51	49	49	-0.2
Ghana	55	54	53	55	55	54	56	53	52	52	49	50	1.0
Hungary	59	60	61	57	57	53	55	53	53	56	54		
Israel	50	53	54	54	55	54	50	53	58	50	50		
Kenya	43	53	53	55	56	56	55	55	54	55	53	54	1.3
Lebanon	46	46	47	47	46	46	46	46	45	46	46	46	0.4
Nigeria	55	57	57	56	59	58	59	58	56	56	56	54	-1.9
Poland	54	55	55	54	54	54	53	54	53	51	50	50	-0.1
Russia	56	56	55	55	53	55	53	52	52	52	53	56	2.4
Saudi Arabia	57	57	53	53	53	51	53	55	55	55	53	54	0.4
South Africa	49	48	49	51	51	50	50	51	49	47	48	47	-1.1
Turkey	53	55	56	56	52	49	46	47	49	46	43	44	1.6
UAE	57	59	57	55	55	55	57	57	55	55	55	54	-0.9
Brazil	49	49	51	53	52	51	50	47	50	48	47	51	3.2
Mexico	52	52	53	52	52	52	51	52	52	51	52	51	-1.0
China	53	53	53	53	53	53	53	53	53	52	53	52	-1.1
India	50	53	52	50	51	52	50	53	54	52	52	53	1.4
Indonesia	50	49	50	51	51	52	52	50	50	52	51	51	-0.1
Malaysia	52	50	50	50	49	49	48	49	50	51	51	49	-2.2
South Korea	51	50	51	50	49	48	49	50	48	50	51	51	-0.3
Taiwan	56	57	57	56	55	55	53	54	53	53	51	49	-2.1
Vietnam	51	53	53	53	52	53	54	56	55	54	52	54	2.4

Source: Data as at 31 October 2018. Source: Markit, FactSet, BNP Paribas Asset Management

This deceleration stems from emerging market central banks needing to either increase domestic interest rates or refrain from lowering them to defend their currencies. Inevitably, higher interest rates slow growth. If the US dollar pressure recedes, interest rates in emerging markets should stabilise or decline, as inflation remains contained in most countries.

How likely is it that trade tensions will lessen? It is worth separating the Trump administration's concerns into three areas: divergent tariff levels, national security, and intellectual property. The first issue applies to most of the US trading partners, while the latter two are specific to China.

As for tariffs, there has already been progress with South Korea, Europe, Canada, Mexico and Japan to adjust or reduce levies. While the changes in the actual levels have in the end often not been large, the important thing for the markets is that the prospect of a global trade war resulting from the imposition of retaliatory tariffs by the US trading partners has fallen significantly.

We are cautiously optimistic that a similar arrangement will be made with China (eventually) as it is so clearly in the interest of both countries to keep trade flowing.

National security considerations, leading to restrictions on Chinese mergers and acquisitions in the US, and the concerns of both the US and the European Union about the forced transfer of intellectual property to the Chinese partners of foreign companies operating in China will remain.

However, marginally less M&A activity is not going to materially damage equity markets in either country, and any reduction in intellectual property transfers will be to the benefit of those companies retaining that asset.

While the US now has a more assertive stance vis-à-vis China than was the case under the Obama administration, this does not preclude continued economic growth in both countries and further equity market appreciation.

A recession is still a reasonably distant prospect

Do you think we have seen the high for global equities in this cycle?

We do not see a near-term trigger for a sustained, negative trend in global equities, though the "leader board" will likely be different in 2019. The most likely catalyst for a broad downturn would be a US recession. With consensus forecasts for GDP growth of 2.5% in 2019 and 2.0% in 2020, recession is clearly not what economists expect. A recession will occur, but with US tax cuts and fiscal stimulus still stoking economic growth in 2019, and US inflation contained (allowing for only modest additional rate rises from the Fed), a recession is still a reasonably distant prospect.

In developed economies outside the US, a recession seems even less likely. The recovery of the eurozone has been gradual compared to that of the US. Inflation remains well below the ECB's target and there is still spare capacity in the economy.

Equity valuations are nonetheless high in some markets, but high valuations in and of themselves are rarely the cause for a market downturn. It is only when the justification for the high valuations fails that multiples decline. And in any event, it is only in certain markets that valuations appear particularly stretched (see exhibit 9).

Exhibit 9: Relative equity market valuation metrics (z-scores)

Region / country	P/E	P/B	P/S	P/CE	PEG	DY	ROIC
US tech+	0.2	0.9	1.2	0.1	-0.8	-1.3	0.4
US	0.1	0.8	1.3	1.1	-1.9	0.7	-0.7
US ex-tech+	0.1	0.5	0.5	1.1	-2.3	0.6	-0.5
Developed markets	-0.6	0.3	1.1	0.9	-1.8	0.4	-0.7
Europe	-0.5	-0.1	0.1	0.6	-0.5	0.1	0.0
Emerging markets	-0.9	-0.7	-0.3	-0.5	-0.2	-1.1	0.0
Japan	-1.1	-0.8	0.8	-0.5	-0.5	-0.8	-1.1

> 1
> 0.5
< -0.5
< -1

Below average Average Above average

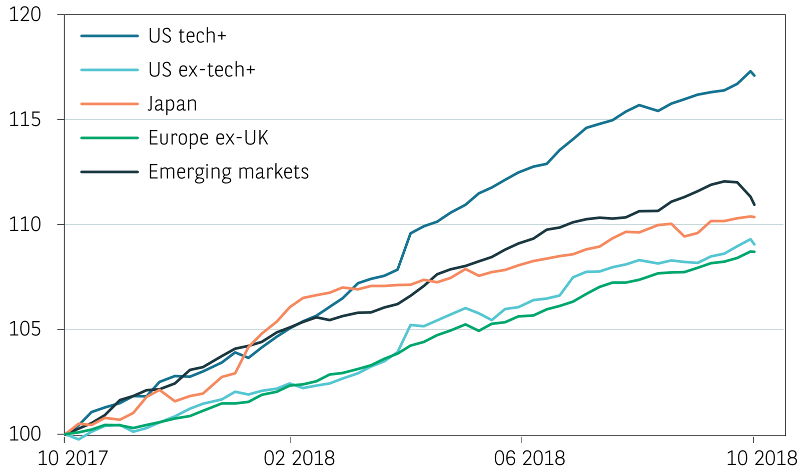
Source: Data as at 31 October 2018. Note: P/E based on current price to next-twelve-month earnings relative to long-run average. For price-to-book, multiple based on IMI indices from 1974. Japan value calculated only since 2001, otherwise from 1987. Tech+ z-score based on average, not mean. Price-to-book ratio is relative to average since 1974 except EM which is from 1995. Colours indicate z-score, with threshold at +/- 1 and +/- 0.5. Tech+ = IT sector plus internet & direct marketing retail. Source: IBES, MSCI, FactSet, BNP Paribas Asset Management

Valuations for several markets by many measures are near their long-term averages (a z-score of 0 in the above table). Japanese multiples are still well below average.

The clear outlier for valuations is the US, but this more notably concerns the technology sector (including internet retail). Price-to-forward-earnings multiples are only 0.2 standard deviations above the long-run average but 0.9x and 1.2x above on price-to-book and price-to-sales. The PEG (price-earnings-to-growth) multiple, however, shows that there may still be opportunities in the sector (and hence the US market). The PEG is below zero, that is, below the long-run average, suggesting that the price investors are paying for the index is not excessive relative to the earnings growth outlook. Unfortunately these growth estimates come from equity analysts and hence are likely to be unduly optimistic, but we still believe the medium to long-term outlook for the sector is very promising.

Importantly, earnings revisions are still good across the major markets. US tech not surprisingly has the best profile, followed by emerging markets (see exhibit 10).

Exhibit 10: Forward earnings estimates, Oct 2017-Oct 2018 (Oct 2017 = 100)



Source: Data as at 31 October 2018. Note: Indices in local currency, EBITDA for US indices. Source: Bloomberg, BNP Paribas Asset Management

The projections for the rest of the US market are more modest, and in line with those for Europe ex-UK, but still show the potential for further equity market appreciation.

Apart from a recession in the US and the eruption of a full-scale trade war between the US and China, the biggest risk to additional equity market gains would be a steep rise in US interest rates, that is, another taper tantrum as major developed market central banks continue to unwind their extraordinary policy measures. It was exactly this scenario that (partly) explains the drop in markets in October. The Fed is nonetheless progressing cautiously with its rate increases and it is continually evaluating the impact on US economic growth and inflation from the trade tariffs.

While real yields of US bonds are normalising, we do not expect them to reach the long-run average of around 2% anytime soon. This means markets will have time to adjust to the increase in interest rates and the additional cost of debt (and higher discount rates) should be offset by the positive growth outlook. ■

The projections still show the potential for further equity market appreciation

SECTION I

CHANGES AT EUROPEAN INSTITUTIONS IN 2019

As well as the European Parliament elections, Europe will see the filling of a number of key positions in 2019. In all cases, the process is subject to negotiation at the highest political level. Most appointments require European Parliament approval. Typically, this involves compromise between the centre-right European People's Party (EPP) and the centre-left Socialists & Democrats (S&D).

JEAN-CLAUDE JUNCKER
President of the European Commission

Jean-Claude Juncker (Luxembourg) has said he will not stand again.

Term length: 5 years
Term expiry: October 2019

The "Spitzenkandidat" system allows the largest political group in parliament to name the candidate for president. The candidate still needs to be approved by an absolute majority of MEPs and be endorsed by the European Council.

DONALD TUSK
President of the European Council

Donald Tusk (Poland) cannot renew his term for a second time.

Term length: 2.5 years, renewable once
Term expiry: November 2019

The president is elected by a qualified majority of members of the European Council (heads of state or government, the president of the European Council and the president of the European Commission).

ANTONIO TAJANI
President of the European Parliament

Antonio Tajani (Italy) could be reappointed, but the role usually rotates between EPP and S&D.

Term length: 2.5 years, renewable once
Term expiry: July 2019

The president is elected by an absolute majority of MEPs. Since the 1980s, the terms have alternated between the EPP and the S&D.

AUSTRIA
Rotating presidency of the Council of the EU

Term length: 6 months
Term expiry: December 2018

The presidency is held by a national government. Austria will be followed by Romania (January-June 2019) and Finland (July-December 2019).

MÁRIO CENTENO
Eurogroup president

Mário Centeno (Portugal).

Term length: 2.5 years
Term expiry: July 2020

The president is elected by a simple majority of group members.

MARIO DRAGHI
ECB president

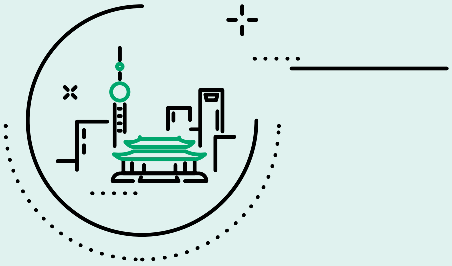
Mario Draghi (Italy).

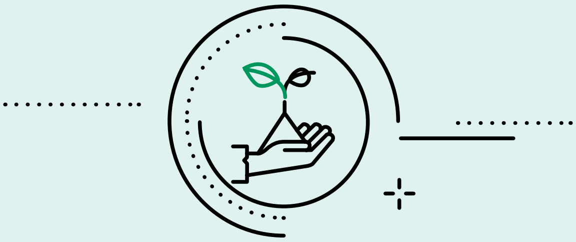
Term length: 8 years, non-renewable
Term expiry: October 2019

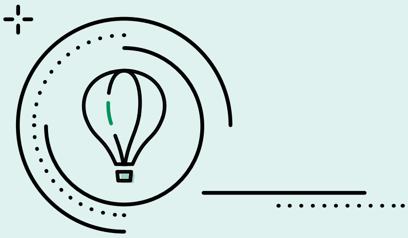
Appointed by a qualified majority in the European Council (all heads of eurozone states and governments), after consulting the European Parliament and the ECB's governing council.

SECTION II

INVESTMENT SOLUTIONS FOR 2019







SECTION II - INVESTMENT SOLUTIONS FOR 2019 - EMERGING MARKETS I

OPPORTUNITIES AMID THE FUROR

L. Bryan Carter
Head of Emerging Market Fixed Income

We have long argued that there is a real reason to worry about the fundamentals of many emerging markets (EM): too many countries have recklessly racked up debt in the low-interest rate environment of the past few years with economic policies that have not warranted such accelerated borrowing. Equally, the proceeds have not always been invested productively. However, we must stress that this does not relate to all EMs. A duality has emerged, with a small, but growing number of EMs now at real risk of imminent debt distress. We have already witnessed a pickup in default rates and we expect that increase to gain pace as US interest rates continue to rise.

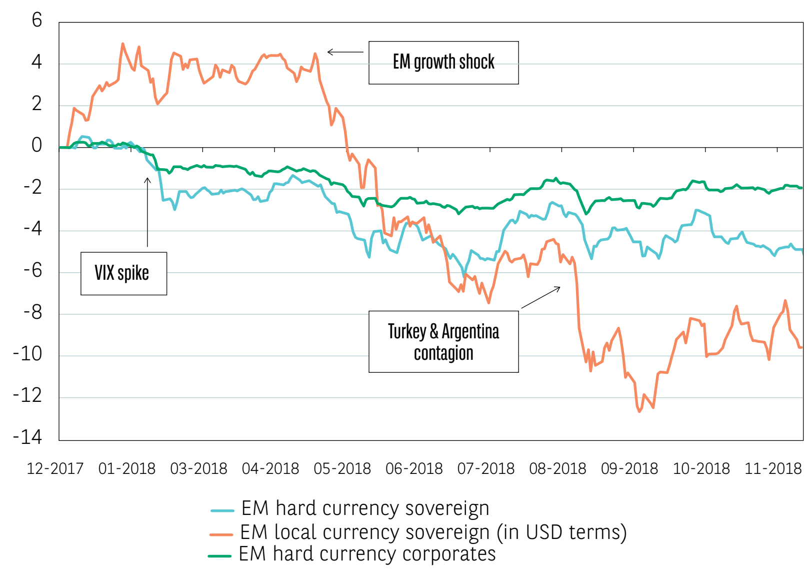
On the other side of the duality, however, a great number of EMs appear increasingly robust. Inflation is structurally low in most big EMs and current account balances are better across the board. Growth has improved in Brazil, Russia and India. Governance has improved in South Africa, Malaysia and Chile. Indeed, the adherence to economic orthodoxy and the liberal global economic order is currently stronger in China and eastern Europe than it is in the US and UK.

We believe the 2018 correction in EM asset prices exposed the value on offer in this asset class, particularly among the strong performers. Globally, central banks are still likely to remove monetary policy accommodation cautiously, with China embarking on fiscal easing measures to ensure a soft landing. Furthermore, the long-running trade disputes appear to be near resolution, in our view.

CONTAGION RISK

The impact of rising US interest rates on large borrowing programmes in US dollars was felt most directly in Argentina and Turkey. The knock-on effect shook investor confidence in the broader asset class over the summer of 2018 and led to modest outflows from EM debt funds, triggering limited contagion in countries with similar fundamentals or close trade relationships (see exhibit 1).

Exhibit 1: Returns of selected emerging market fixed income debt sectors



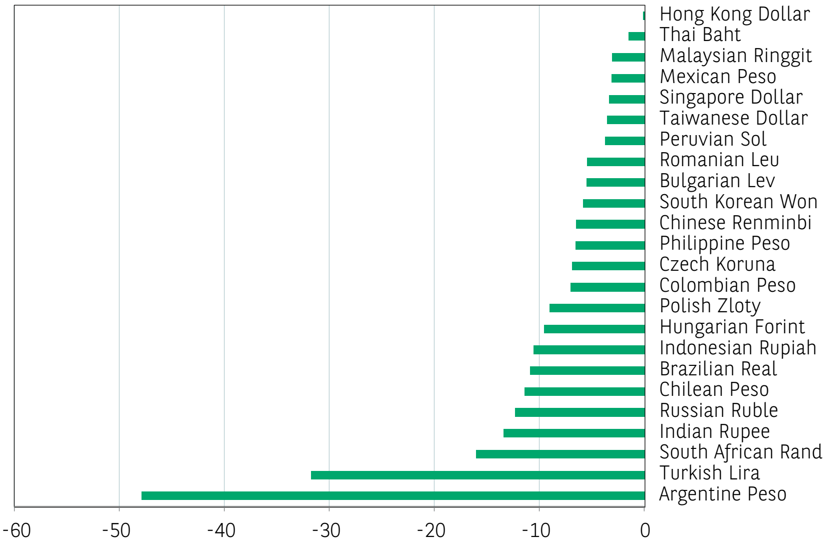
Source: BNP Paribas Asset Management, JPMorgan; mid-November 2018

Turkey's vulnerability was not entirely a surprise given the poor fundamentals: high external debt balances with major reliance on foreign funds to fuel economic growth; significant inflationary pressure worsened by a depreciating currency; a poor central bank reaction function and issues around government involvement.

This was compounded by the US imposing sanctions over Turkey's detention of a US pastor. Turkey's currency, bonds and shares experienced a sharp sell-off. That eventually forced the central bank to raise interest rates. For the moment, this has staved off a further exodus of investment.

Other EM countries with debt vulnerabilities, poor current account metrics, inflationary concerns and heightened political risks came under pressure, particularly their currencies. Exhibit 2 highlights the returns of selected EM currencies relative to the US dollar in 2018 (through October).

Exhibit 2: Performance of EM currencies relative to the US dollar through October 2018 (year-to-date, in %)



Source: Bloomberg, BNP Paribas Asset Management, 31 October 2018

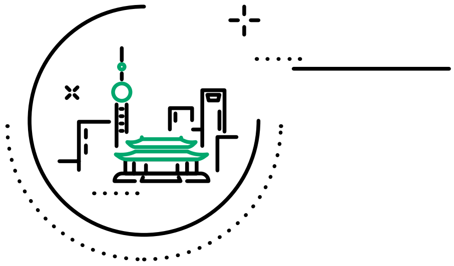
Asian bonds were relatively resilient. The hard currency fixed income market, as measured by the JPM JACI index, lost only 2.43% in the year to date (30 October). Asian local rates and currency markets were also relatively more stable than their global peers. This can at least partly be explained by China's policy easing measures as well as better sovereign credit fundamentals across Asian markets.

Among the crisis countries, we are perhaps most positive on Argentina. The peso gained more than 10% since a monetary policy programme backed by the IMF was put in place when Guido Sandleris took over as governor of the central bank in September. Argentina's liabilities in pesos, which were as high as 11%-12% of GDP when the currency crisis began in April and which were one of the main investor concerns, have now more than halved (to 5%-6% of GDP), helped by the devaluation of the peso.

Argentina is also arguably in a stronger position now thanks to its plan to freeze money supply growth for the next nine months as it attempts to lower a monthly inflation rate that was running at 6.5% in September.

The risk is, however, that the high interest rates the central bank is employing in this liquidity squeeze strangles economic growth just as Mauricio Macri campaigns to be re-elected as president in 2019.

The correction in emerging market asset prices has exposed the value on offer in this asset class, particularly among the strong performers



Given our view that more EM counties will experience Argentina and Turkey type crises over the next few years, how can we be so sanguine on the asset class? In summary, we do not expect a generalised contagion of emerging markets for the following principal reasons:

- Valuations across the EM fixed income asset class are extremely compelling and asset values already reflect a higher incidence of default and volatility. This was not true six months ago.
- Technicals in EMFI are much cleaner now after the recent outflows. Survey and listed derivatives data shows that the market swung from a short USD position in the first quarter of 2018 to a clear and large long USD position, especially against EM currencies. Dedicated managers are underweight EM currency and are under-leveraged in their investments.
- Global growth and company earnings have remained relatively resilient in the face of the global trade frictions. Our real-time monitoring of emerging markets gives us confidence that growth has stabilised and the cycle for EM is still the best in almost a decade.
- China's policy shift towards easing is a significant change of direction and should help provide market liquidity.
- Our concerns about rising US yields as a threat to EMs have peaked and we now see the US economic cycle slowing with still-benign inflation and potential for a pause in the Federal Reserve's (Fed) cycle of rate rises.

> 66
> We encourage investors to enter this under-owned asset class now

KEY CHALLENGES REMAIN

To be certain, the two key challenges that remain for the EMFI asset class are global trade frictions and further rises in US interest rates. Yet we see these as largely priced in by the market now, with scope for resolution on both fronts.

On the trade frictions, we would note that the rhetoric around them has appeared to soften, particularly on China's side. In the US, a full-blown trade war is unlikely to win over the electorate, many of whom would be hurt by export tariffs and rising import prices. We have seen positive talks on trade between the US and Europe, as well as on NAFTA.

With regards to US interest rates, US wage inflation data has remained muted. Equity market volatility suggests the tariffs imposed by the US on China are weighing on business sentiment. In our view, this increases the probability of a pause in the Fed's drive to push official rates higher.

It is pleasing to note that various emerging market central banks have acted on actual and expected Fed rate increases to protect their currencies or stem inflation and capital outflow concerns. As such, many EM economies are in a much better position to tackle rising rates than they were, for example, during the taper tantrum period in 2013.

The green light for further gains may eventually come from the Fed, but we encourage investors to enter this under-owned asset class now because if and when the Fed signal does arrive, it may be too late to catch the market rebound.

We believe that, encouragingly, the good EM stories comprise the majority of the main benchmark's market capitalisation.

SEPARATING WHEAT FROM CHAFF

We believe that sustainability lies at the heart of responsible long-term investing. As such, we have developed a proprietary ESG implementation for our EM investments that reflects the duality in EM policies and eventual outcomes. Our methodology tilts in favour of high-scoring countries, while limiting the exposure to the worst performers in terms of long-term climate, social policy and institutional factors.

We believe this approach, in addition to our alpha-generation skills and smart-beta benchmark replication, comprises the essential steps in protecting investors and ensuring favourable returns. ■

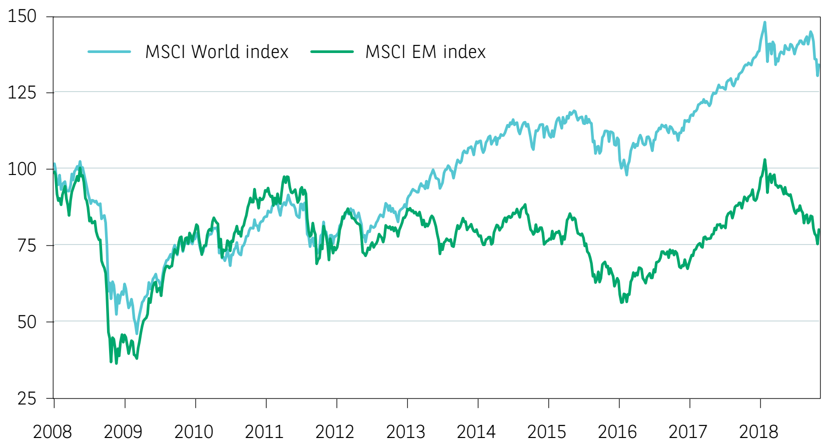
SECTION II - INVESTMENT SOLUTIONS FOR 2019 - EMERGING MARKETS II

BUY THE DIP IN EMERGING EQUITIES?

Vincent Nichols
Investment specialist, global emerging market equities

As investors moved into 2018, global equity markets, as measured by the MSCI World index, had not seen a bear market (i.e., a market correction of 20% or more) since 2011. This helped to solidify and reinforce the 'buy the dip' mantra of recent years that could be heard with every instance of market weakness. The jury is still out on whether 2018 turns out to be any different, with global markets remaining resilient, but volatile, after the steep sell-offs in January/February and October.

Exhibit 1: Performance of MSCI World index and MSCI EM index
(January 2008 = 100, weekly data)



Source: Datastream, BNP Paribas Asset Management, November 2018

However, emerging market (EM) equities are the exception: entering and remaining in bear market territory. The question now is whether in 2019, EM equities will resume their prolonged underperformance, which began in 2011 with the Arab Spring, or whether the asset class can rebound and continue its rapid appreciation which began in early 2016.

RATS – LIKE PIIGS, BUT UNINSULATED BY A COMMON CURRENCY

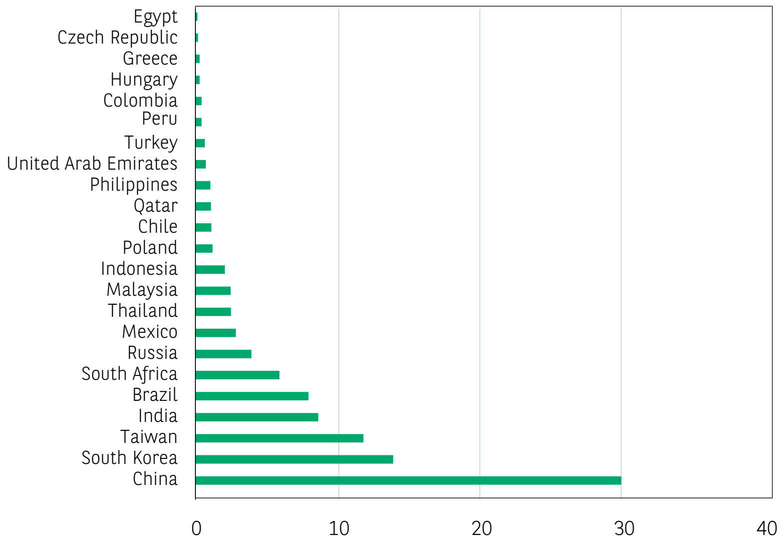
To begin to answer this question, we must first determine what the principal influences have been in the latest EM downturn. One possible explanation is the 'RATs' (Russia, Argentina and Turkey) of EM resembling the 'PIIGS' (Portugal, Italy, Ireland, Greece and Spain) during the European crisis, or worse. Unlike the eurozone's PIIGS, the RATs are not insulated by a common currency. The pain of this reality has been felt most acutely in Turkey and Argentina, whose currencies are down by 32% and 48%, respectively, in the year to end-October as investor flows have rapidly retreated.

However, in Argentina, the International Monetary Fund has increased its credit line to the country to USD 57 billion and the central bank abandoned its inflation targeting regime and shifted to a goal of zero money growth until June 2019 to defend the currency. The additional funds from the IMF come with stiff austerity requirements though, so although the environment has cooled considerably, President Macri is not out of the woods yet.

By contrast, in Turkey, President Recep Erdogan has stated that "interest rates are the mother and father of all evil" and his consolidation of power has rendered the independence of the central bank questionable, at best. Despite Erdogan's disdain for interest rates, rampant inflation has inevitably forced the central bank to sharply raise the policy rate to 24%. It appears that the market believes this is the necessary first step to rein in inflation as the lira is now appreciating. However, even if the market is wrong in its assessment, it should be noted that the country accounts for only 0.5% of the MSCI EM index and has minimal financial linkages to the global economy. Regardless of the outcome, for EM as an asset class, developments in Turkey carry relatively little weight.

Emerging markets are now generally better equipped to tackle the challenges

Exhibit 2: Breakdown of MSCI EM index by country



Source: MSCI, FactSet, BNP Paribas Asset Management, 31 October 2018

IN RUSSIA, SANCTIONS COULD POSE THE GREATER RISK

The situation in Russia is much different, but still one of concern. The economy has held up rather well relative to that of Turkey and Argentina due to the strength in the oil price. The Central Bank of Russia only had to raise the policy rate by 25bp in September, which was a conservative decision given that it maintains one of the highest real interest rates in the world, even after considerable policy easing over the last few years.

We believe the larger risk facing Russia is a seemingly endless wave of sanctions imposed by the West. Investors worry about proposed bans on trading new Russian government debt and limits on the operations of state banks, which make up roughly two-thirds of the financial sector. Concurrently, foreign direct investment fell by more than 50% in the first half of 2018.

EM INVESTOR JITTERS FROM CHINA WEAKNESS AND USD STRENGTH

The broad weakness in EM during 2018 is likely not explained by the – mostly isolated – risks posed by these countries, though. More plausibly, economic weakness in China from escalating trade tensions against a backdrop of already slowing growth is having a larger impact. Most recently, the US imposed 10% tariffs on USD 200 billion of Chinese goods, which are set to rise to 25% at the start of 2019, and China has since retaliated. At the time of writing, President Trump had asked his cabinet to draw up a potential deal, but this might just be posturing before the midterm elections.

In the US, there is yet to be any meaningful impact on the economy, although there likely will be if there is no agreement. Meanwhile, in China, yuan depreciation has offset much of the impact so far. President Xi Jinping might delay decisive action until the ultimate goal of US policy becomes clearer. In US dollar terms, the MSCI China index was down 30% by end-October from its peak in January. As the second largest economy in the world, China is easily the largest component of the MSCI EM index, so it is logical to assume that China has been a significant driver of EM underperformance.

Lastly, the impact of a strong US dollar has likely also added to investor jitters over EM. With the US Federal Reserve's continued rate-rising cycle, a relatively stronger US economy and shrinking US dollar liquidity, the dollar has appreciated sharply, driving net speculative long positions to their highest point in more than a year, increasing faster than at any point since the Trump election. However, the US's relative growth outperformance is partly due to the temporary boost from tax cuts and one would expect the widening budget deficit, especially during a peaking business cycle, to limit the potential for further dollar gains.

EM RISK/REWARD POTENTIAL LOOKS INCREASINGLY ATTRACTIVE

Going into 2019, there are a number of risks facing EM equities, but EM countries are now generally better equipped to tackle these challenges than they were a few years ago. Current account deficits have improved considerably since the taper tantrum of 2013. EM equity valuations are now at a considerable discount to those of developed markets and well below their long-term average.

This is despite the evolving EM index composition. The benchmark now includes considerably more exposure to the growth-oriented consumer and information technology sectors at the expense of the more value-oriented energy and raw material sectors than it has had historically. We believe that alone justifies a higher valuation than the long-term average.

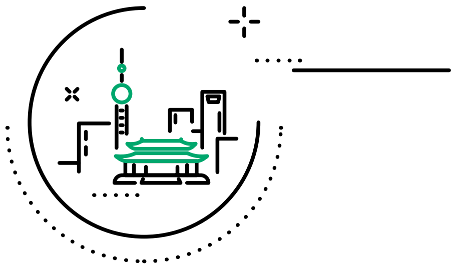
Forecasting short-term market moves is not our expertise, but we can say with confidence that the risk/reward potential for the asset class looks increasingly attractive.

RECENT EM WEAKNESS PRESENTS AN OPPORTUNITY

In the long term, we believe the asset class still offers favourable growth dynamics and is under-represented in global indices in terms of market capitalisation in proportion to EM's share of the global population and global economic output. The opportunity is also under-appreciated as many global equity funds maintain an underweight allocation to the asset class.

There is a strong argument for diversified investors to allocate to EM equities and we believe the recent weakness presents an opportunity for those who recognise the long-term potential of the emerging market growth story.

The benchmark now includes considerably more exposure to the growth-oriented consumer and IT sectors, which justifies a higher valuation



SECTION II - INVESTMENT SOLUTIONS FOR 2019 - SUSTAINABLE INVESTING

INVESTING FOR A SUSTAINABLE FUTURE

Jane Ambachtsheer
Global Head of Sustainability

AN EVENTFUL RIDE

Competing forces shape capital markets, and it serves investors well to pay attention. Jobs, trade, the environment, migration, diversity, human rights, lobbying... all play a role in shaping the narrative.

Among the positives, we have seen unparalleled progress on global efforts to address the world's biggest sustainability challenges, showcased by the launch of the Sustainable Development Goals (SDGs) and the Paris Climate Agreement in 2015. The Agreement marks the beginning of a transition towards a low-carbon energy model for the global economy. The 2030 agenda of the SDGs lays the foundation for a regenerative and circular economy, and the inextricably linked nature of social and environmental challenges. The goals stress the need to address extreme poverty, while highlighting the urgency to make this new economic model resource-efficient. Both initiatives enjoy wide-ranging support from the world's largest investors, companies, civil society and numerous levels of government, including regions, states and cities.

Less encouraging is the fact that this progress has been tempered by the rise of political instability and populism in a number of countries. This is a phenomenon that may be with us for some time as long-term trends, including globalisation, technological change and inequality of opportunity generate social and cultural insecurity.

One consequence has been that some countries have pulled away from climate (and other) commitments at a national level. While this does not mean progress will come to a stop, it certainly is not helpful.

SO, WHAT CAN WE DO?

Having personally watched all this unfold from my perch in the financial industry over the past 20 years, one of the things that has become apparent to me is that long-term institutional investors:

a) have a lot at stake in what happens in the world from a sustainability perspective, not least because of the potentially negative economic impact of unmitigated climate change and environmental degradation, and
b) are punching below their weight in terms of using their influence accordingly.

Enlightened asset managers and asset owners have the potential to embrace their role as future makers by using their assets and influence to push for a sustainable world – one that facilitates their ability to generate long-term returns for their clients, with the added benefit that we end up with a world into which people actually want to retire. BNP Paribas Asset Management is committed to being just this kind of investor – a future maker. This is why I decided to join BNPP AM as Global Head of Sustainable Investment in August 2018.

SUSTAINABLE INVESTING: GROWING UP, AND GOING FURTHER

The field of sustainable investing is currently on two tracks: growing up, and going further.

Growing up is a process of refining and further embedding the various concepts and tools that leading investment professionals have been using for years. For example, BNP Paribas Asset Management has been addressing sustainable investment since 2002, and in 2012, we committed to integrating environmental, social and governance (ESG) criteria across all of our open-ended mutual funds.

This has been progressively implemented. Today, we have reinforced those processes. Clear governance now ensures we meet our aims as effectively as possible. As an example, our sustainable investment philosophy is set out in exhibit 1.

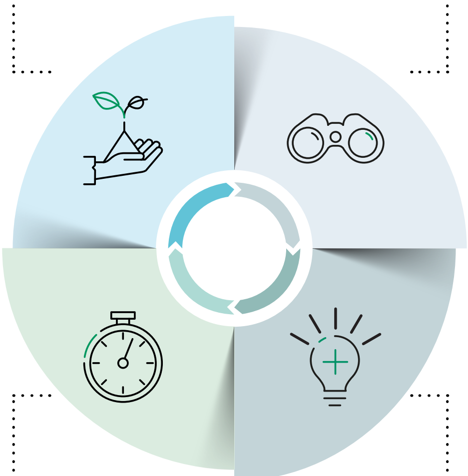
Exhibit 1: BNP Paribas Asset Management – sustainable investment philosophy

SUSTAINABILITY IS A LONG-TERM DRIVER OF RISKS AND RETURNS

Sustainability is a long-term driver of investment risks, and returns. We believe that, by integrating ESG factors in our investment process, we will gain a deeper and richer understanding of the risks that we face, and will, over the longer term, make better-informed investment decisions for our clients. The energy transition, environmental constraints and social inequality amplify the importance of this perspective.

BELIEF ABOUT MISPRICING

Sustainability is imperfectly understood, under-researched and mispriced. An absence of common standards, combined with the lack of reliable, audited data and investor heterogeneity in terms of values, objectives, approaches, levels of understanding, and access and ability to process information creates multiple market inefficiencies.



TIMEFRAME AND ENGAGEMENT

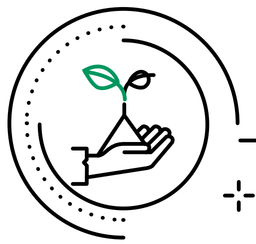
Our investment horizon is long term and we promote long-term thinking by the entities in which we invest. Active engagement with companies and regulators allows us to positively influence ESG practices in individual entities and across the markets we invest in, helping to mitigate risk and promote sustainable economic growth and longer-term returns.

COMPETITIVE ADVANTAGE TO EXPLOIT MISPRICING

We are an early mover, with a deep understanding of sustainability issues and a strong commitment of resources. We have a focused, differentiated approach to systematically integrate material ESG factors into all investment processes.

This philosophy is accompanied by five over-arching sustainable investment beliefs, each of which have a number of sub-beliefs. Together, these guide our thinking and practice, and drive consistency across investment teams. We will be sharing these with our clients shortly.

Enlightened asset managers and asset owners should embrace their role as future makers and push for a world that facilitates their ability to generate long-term returns for clients as well as a world into which people actually want to retire



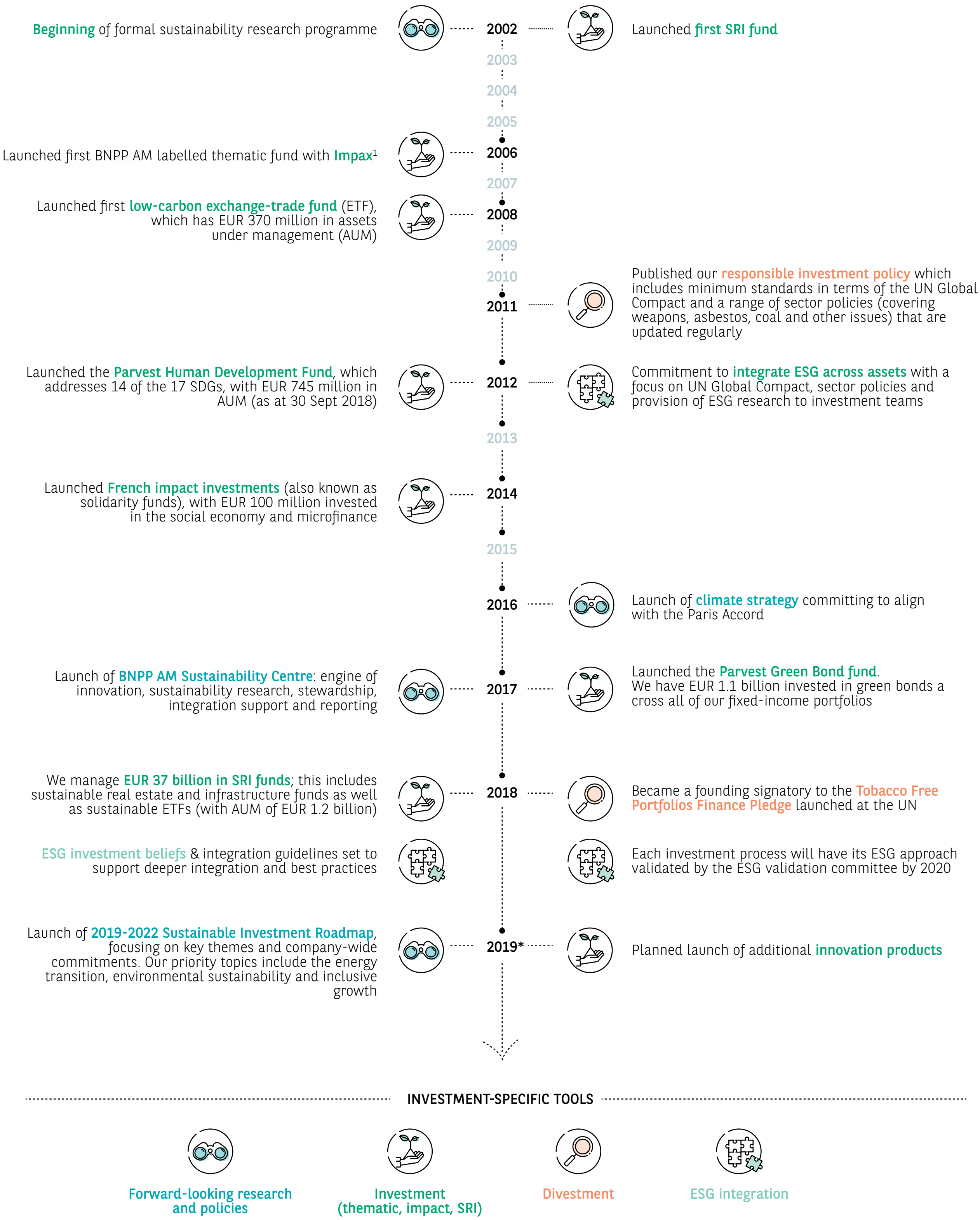
TOOLS OF THE TRADE

We use a range of tools to implement our sustainable investment approach. They fall into these two categories:

a) Investment-specific tools – forward-looking research and policies; ESG integration; divestment and thematic investment
b) Portfolio-wide tools – company voting & engagement; policy advocacy; and measurement and reporting.

Let me illustrate what is involved in each of these areas, reflecting our framework for sustainable investment.

BNP Paribas Asset Management framework for sustainable investment: investment-specific tools



1 Impax is a specialist asset manager, experienced at investing in the opportunities arising from the transition to a more sustainable global economy and part-owned by BNPP AM.

Please note that funds referred to in the documents are not available for investors in Australia.

BNP Paribas Asset Management framework for sustainable investment: portfolio-wide tools

We regularly engage with policymakers on issues such as sustainable financial markets, listing requirements and carbon pricing. BNPP AM is represented on key initiatives such as the FSB Task Force on Climate-related Financial Disclosures (TCFD) and the European Technical Expert Group on Sustainable Finance (TEG)

- **2002** — Established our **proxy voting policy**
- 2003
- 2004
- 2005
- **2006** — As a founding PRI signatory, we began to report annually on our sustainable investment progress; BNPP AM has an **A+ rating**
- 2007
- **2008**
- 2009
- 2010
- **2011** — Published the **responsible investment policy** which includes **voting and engagement approaches**
- **2012** — Began to publish an **annual Responsible Investment report** for clients
- 2013
- 2014
- **2015** — Committed to the Montreal Pledge; BNPP AM has provided the **carbon footprint** on its open-ended funds since then
- **2016**–**2017** — Integrated climate change and the sustainable dividend concept into our **proxy voting policy**. Ongoing increase in engagement activity (e.g., with the energy sector on carbon asset risk, methane risk and Arctic exploration; Access to Medicine and Nutrition indices; energy efficiency in the real estate & building sectors)
- **2018** — **Joined the following initiatives**: Climate Action 100+, where we engage with the 100 largest greenhouse gas emitters worldwide; PRI-Ceres Investor Working Group on sustainable cattle; Technical Advisory Group of Zoological Society of London SPOTT on timber, pulp and paper; PRI Plastic Investor Working Group; the New Plastics Economy Global Commitment led by the Ellen MacArthur Foundation
- **2019*** — Planned launch of **BNPP AM's Engagement Report** & updated Engagement Policy
  - Additional reporting to be made on a range of company-wide and fund-specific **ESG key performance indicators**

PORTFOLIO-WIDE TOOLS

Voting & engagement

Reporting

Please note that funds referred to in the documents are not available for investors in Australia.

Part of BNP Paribas Asset Management's 'growing-up' process has been to provide more governance, structure and support to the sustainable investment practices that we have been undertaking for years. We are also strengthening our acclaimed sustainable investment team, which was set up more than 15 years ago, and will make a number of key appointments over the coming months, reflecting our commitment and ambition.

We effectively have 12 years left at the current run rate for annual CO2 emissions

GOING FURTHER: THE CLOCK IS TICKING

In addition to growing up, the field – out of necessity – must go further. A few months after taking on my new role, the Intergovernmental Panel on Climate Change (IPCC), which is the international body for assessing the science relating to climate change, issued a Special Report on Global Warming of 1.5 °C[2]. In it, the IPCC concludes that limiting the rise in average global temperatures to 1.5°C is still possible, but time is extremely short. A revolutionary change to the way we produce and deliver energy will have to occur if we are to meet it.

We effectively have 12 years left at the current run rate for annual CO2 emissions for a 66% chance of achieving a 1.5°C outcome. Human-caused warming is adding around 0.2°C to global average temperatures every decade as a result of both "past and ongoing emissions", around 100% of which is the result of human activity, the IPCC says. If this rate continues, the report projects that global average warming "is likely to reach 1.5°C between 2030 and 2052."

The UN has been holding annual, international climate change talks for more than 20 years, yet success has been limited. One of the principal reasons is that the institutional investment community – including long-term asset owners and managers, such as BNP Paribas Asset Management – had historically not been engaged in the discussion and debate. While governments are charged with managing our long-term social and environmental outcomes and hold the ultimate responsibility for doing so, they themselves are subject to short-term pressures, not least driven by electoral and budget cycles.

For this reason, we – and others investors – have become an intentional part of the climate solution. In 2016, BNP Paribas Asset Management launched its climate change strategy[3] and committed to gradually align its investments with the Paris Accord. This included a three-pillar strategy.

Exhibit 2: A three-pillar strategy

ALLOCATION OF CAPITAL

- Identifying and measuring the carbon risks in our investments
- Integrating and reducing carbon risks
- Developing our low-carbon offering and financing the energy transition

RESPONSIBLE STEWARDSHIP

- Addressing climate change through our voting at annual general meetings
- Engaging in dialogue with security issuers on their climate strategy

TRANSPARENCY & COMMITMENT

- Reporting on progress made
- Oversight of our climate change strategy
- Raising awareness and client support

More recently, we and 400 other investors representing USD 32 trillion of assets under management launched The Investor Agenda, which commits us to accelerate and scale up actions that are critical to achieving the Paris Accord target in four areas: investment, corporate engagement, investor disclosure and policy advocacy.[4]

2 Available at http://ipcc.ch/report/sr15/
3 Available at https://docfinder.is.bnpparibas-ip.com/api/files/C002961F-77B9-4AAD-8E02-72EE61F5BE22
4 For further information, see www.theinvestoragenda.org

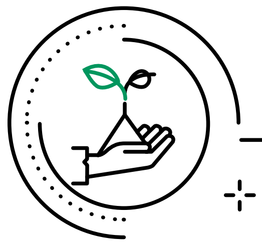
These examples focus on climate, which is clearly a massive economic, environmental and social threat that requires drastic, short-term attention. However, we are also turning our focus more clearly towards critical issues such as pollution, land-use and inclusivity, which are affecting our investments, our economy and our clients' quality of life. Here, we have the opportunity to be part of the solution.

RISING TO THE CHALLENGE

A sustainable world requires sustainable financing and investment. To get there, the investment community must rise to the challenge. We need to look more closely at what we do – and do not – invest in. And we need to allocate sufficient resources to engaging with the companies in our portfolios and with the policymakers who create the rules of engagement. We cannot be passive 'takers' of the future world – we must build the world we want, and need, for our investments and our clients, and for the generations that follow.

While we have already been active in this field in the past, we are scaling up our work to match the level of today's challenges. We have recently appointed a Head of Stewardship - Americas and are recruiting for a Head of Stewardship - Asia since we believe it is important to have a strong voice in the markets in which we invest. And while we have been involved from the beginning in crucial industry initiatives such as the European Institutional Investors Group on Climate Change and the PRI, we are also scaling up our presence elsewhere. For example, in 2018, we joined the Asian and US Investor Networks on Climate Risk and we are represented on the EU Technical Expert Group and the FSB Task Force on Climate Related Financial Disclosure (TCFD).

A sustainable world requires sustainable financing and investment



FOR OUR CLIENTS, AND BEYOND

We put clients at the heart of what we do and our goal is to meet – and exceed – their expectations. We are the investment manager for a changing world and sustainable investing allows us to better manage the risks – and pursue the opportunities – associated with the energy transition, environmental sustainability and inclusive growth.

Beyond a heightened risk management approach in the short term, we are using our voice and our leverage to push for the appropriate management of sustainability issues such as climate change over the long term. We aim to take our clients on a sustainability journey with us and will engage more closely with them to share our views and gather theirs, while keeping them informed on our progress.

In particular, as we document more fully how we integrate ESG within each investment strategy, we will communicate these updates to clients accordingly, while adopting enhanced ESG portfolio-level reporting. Across portfolios, we will begin to provide annual engagement reports – letting our clients know how we have voted and engaged on behalf of them, including our ambitious policy advocacy agenda.

Looking ahead, asset owners should expect all of their investment service providers to have a well-developed perspective on sustainability and to be acting on it as asset owners themselves will be impacted by the rapidly changing world. We at BNP Paribas Asset Management look forward to partnering with our clients and our peers on this journey. ■

SECTION II - INVESTMENT SOLUTIONS FOR 2019 - FIXED INCOME

A REGIME CHANGE IN FIXED INCOME

Maximilian Moldaschl
Senior Multi-Asset Strategist,
MAQS

Guillermo Felices
Head of Research and Strategy,
MAQS

As markets face central bank quantitative tightening (QT), there are signs that we are on the brink of a regime change across major asset classes. We believe US bond yields are moving structurally higher, driven by: strong US GDP growth, expansionary fiscal policy and future bond supply, less foreign investor demand for US Treasuries, the US Federal Reserve (Fed) moving into restrictive territory and depressed real rates and term premia reversing.

Perhaps the most important implication for cross-asset investors and asset allocators is a possible shift in the equity/bond correlation as inflation and term premia pick up in the move away from quantitative easing (QE). Furthermore, more broadly, the reversal of the currently high QE-induced correlations between asset classes suggests a return to an environment favouring 'asset-pickers' where portfolio managers can add more alpha again.

We believe the future likely comprises lower returns than during the height of QE, and importantly, more market volatility. For us as asset allocators, this means being ever more tactical in managing portfolios.

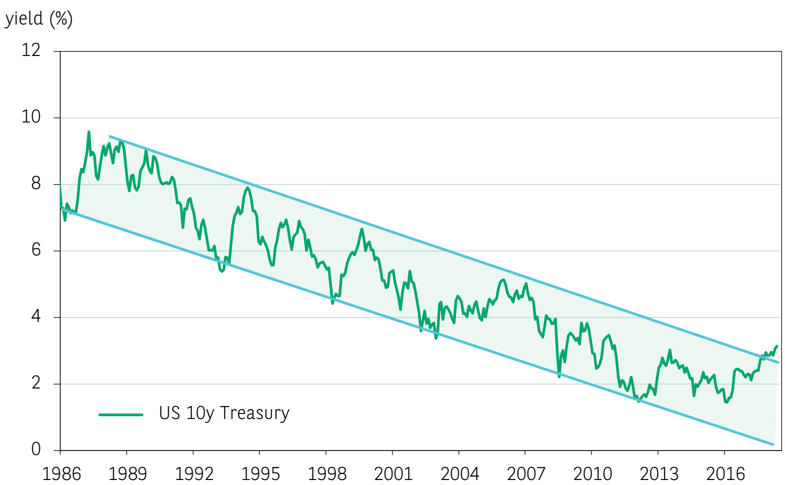
In this article, we explore some of the shifting sands in the macro/market backdrop and the implications for cross-asset investors and asset allocators.

FIXED INCOME MARKETS: BRACE FOR IMPACT?

US interest rates

Changes in the yields of US Treasuries (USTs), the ultimate risk-free instrument, potentially have major implications for the valuations of many asset classes. In 2018, 10-year UST yields broke out of their multi-decade downward sloping yield channel established since the mid-1980s.

Exhibit 1: 10-yr UST yields breaking out of 30-yr fixed income bull-trend & above taper tantrum highs



Source: Bloomberg and BNP Paribas Asset Management, as of end-October 2018

Interestingly, we find that the push higher in nominal yields in 2018 has been almost exclusively driven by higher real rates, while breakeven inflation rates moved sideways. Even during the equity market correction in October 2018, yields did not reverse much, with real yields in particular remaining near their highs.

The break higher in nominal yields driven by higher real rates could hint at a structural shift in the macro/market backdrop. It is occurring at an interesting juncture:

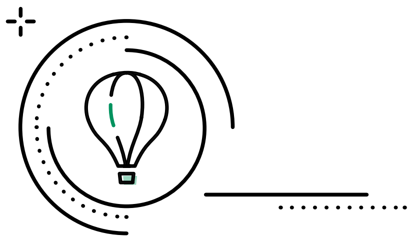
- Higher yields are consistent with still-strong US GDP growth
- Expansionary fiscal policy means a higher deficit and increased issuance of USTs to finance the deficit. Faced with increased supply investors will require bigger premia
- At this critical juncture of increased supply foreign buyers of USTs may be harder to find. Currency hedging costs have risen vastly and are eating into otherwise attractive-looking yield pick-ups: a 10-year UST currency-hedged into JPY yields only around 10bp; currency-hedged 30-year USTs yield only 28bp. This leaves Japanese investors better off sticking with their domestic market
- Higher Federal Reserve policy rates may eventually start to weigh on economic activity
- The anchoring of yields via the extraordinary monetary policy actions of recent years should reverse and abnormally depressed term premia could finally revert back to normal.

All of this leads us to expect structurally higher rates for the medium term, even though for short-term trading, we note that short positioning is starting to look stretched and positioning squeezes should not be ruled out.

Other interest-rate markets

While UST yields are at new highs above their 2013 taper tantrum levels, German Bunds are still below those levels, but that said, the correlation between USTs and other fixed income markets has remained high. So, with UST yields likely pushing higher, the other markets should follow, especially given their high valuations.

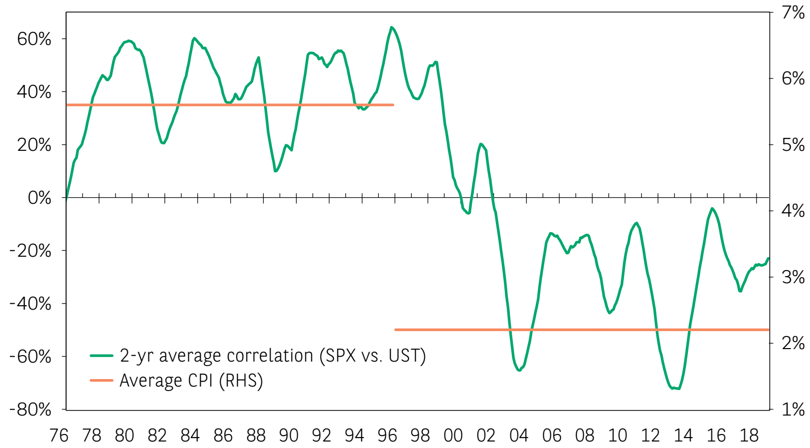
> The future will comprise lower returns, more market volatility and a more tactical approach to managing portfolios



HIGHER YIELDS AND EQUITIES: SHIFTING CORRELATIONS?

Many market participants will likely recall a negative correlation between stocks and bond returns in the last two decades. But this has not always been the case. Before the mid-1990s, correlations were positive (Exhibit 2).

Exhibit 2: Equity/bond correlation mostly negative since mid-1990s
(S&P 500 vs. UST weekly return correlation)



Source: Bloomberg and BNP Paribas Asset Management, as of end-October 2018

We find that low and anchored inflation may be one of the causes for this negative correlation (see the average level of inflation before and after the mid-1990s in Exhibit 2). But the question of what ultimately drives yields higher in the first place, and how sharply the fixed income sell-off is, matters too. If yields rise in response to a better economy, and this comes with better company earnings, yields can rise and equities can rally in tandem. When yields rise aggressively, say in response to a shock (e.g. higher inflation or fiscal expansion), the sudden increase in the discount rate frightens the equity market and stocks sell off, while yields push higher.

That said, the short-term correlation between equities and bonds can flip around quite quickly, especially in risk-off periods. What is perhaps striking is that in October's correction (preceded by higher yields), UST yields receded only briefly and rebounded quickly thereafter. This begs the question whether bonds are still a good equity/portfolio hedge (see Exhibit 3).

Unfortunately, our analysis suggests the answer is 'no'. In the current cycle, and especially in 2018 price action, bonds have not offset equity market losses. In fact, in 2018, yields tended to rise as equities have suffered. This is a sign that the equity/bond correlation may be shifting into positive territory.

This is worrisome, especially in the face of likely larger equity corrections when we eventually hit end-cycle. If bonds cannot hedge smaller setbacks in the bull run, how can they be portfolio hedges when stocks enter a bear market? While in such a scenario, a safe-haven bid may propel bonds, the low starting point of yields (and thus lowered return expectations) means that bonds will be worse hedges. To illustrate this, 10-year yields would need to fall to around 1% from the current 3.1% to give a return of 20% that would match the average historical equity market sell-off. In fact, equity sell-offs have been clearly bigger in some recessionary periods.

Exhibit 3: Are bonds already becoming a worse equity hedge? Returns and yield changes during S&P 500 corrections

		SPX			US 10-year yield			
Start	End	Start	End	Return	Start	End	Yield change	Return
10-1997	10-1997	983.1	877.0	-11%	5.92	5.80	-0.12	0%
07-1998	08-1998	1184.1	957.3	-19%	5.47	4.98	-0.49	3%
07-1999	10-1999	1418.8	1247.4	-12%	5.67	6.07	0.40	-1%
03-2000	10-2002	1527.4	800.6	-48%	6.08	3.66	-2.41	30%
11-2002	03-2003	938.9	800.7	-15%	4.26	3.58	-0.68	5%
10-2007	03-2009	1552.6	683.4	-56%	4.06	2.87	-1.19	16%
04-2010	07-2010	1217.3	1022.6	-16%	3.81	2.98	-0.83	4%
04-2011	10-2011	1363.6	1099.2	-19%	3.29	1.76	-1.53	9%
04-2012	06-2012	1419.0	1278.1	-10%	2.18	1.45	-0.73	4%
07-2015	08-2015	2128.3	1867.6	-12%	2.37	2.07	-0.30	1%
12-2015	02-2016	2102.6	1829.1	-13%	2.14	1.66	-0.48	3%
01-2018	02-2018	2872.9	2581.0	-10%	2.66	2.82	0.16	-1%
10-2018	10-2018	2925.5	2728.4	-7%	3.18	3.16	-0.02	0%
			Average	**-19%**	**3.93**	**3.30**	**-0.63**	**6%**
			Median	**-13%**	**3.81**	**2.98**	**-0.49**	**3%**

Source: Bloomberg and BNP Paribas Asset Management, as end-October 2018

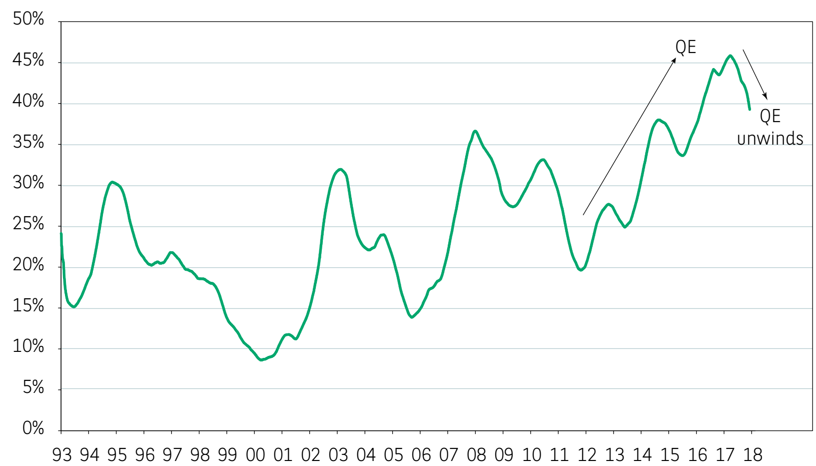
OTHER IMPLICATIONS FOR ASSET ALLOCATORS

The shifting macro/market backdrop will, in our view, also set other challenges for asset allocators.

- Volatility should generally rise, particularly given that QE has been a big contributor in depressing market volatility in recent years.
- With valuations looking more stretched and no central bank put underpinning markets, return expectations should also be much lower for the foreseeable future.

One of the effects of post-crisis monetary policy action was a rise in correlations across asset classes (see Exhibit 5). This should also reverse, with individual assets likely to revert to being driven by their own fundamentals/news and not purely by QE flows. This unwinding may already be under way.

Exhibit 4: Cross-asset correlations were very high during the QE era; this may now be unwinding (correlation for selected pairs, S&P 500, USTs, gold, JPY)



Source: Bloomberg and BNP Paribas Asset Management, as of end-October 2018

CONCLUSIONS

As major central banks proceed with the unwinding of extraordinary policy measures financial markets face a prolonged period of quantitative tightening in the months and years ahead. There are already signs that we are on the brink of a change in regime for major asset classes. Indeed, on two occasions in 2018, we saw a sell-off in bond markets triggering a correction in the valuations of equities.

We believe that US bond yields are moving structurally higher – with 10-year UST yields already above their 2013 taper tantrum highs and crucially breaking out of a multi-decade bull market for bonds. To us, this break higher in bond yields is no coincidence given the macro/market drivers with which interest rate markets are confronted:

- Strong US economic growth
- Expansionary fiscal policy and increased supply of bonds on the horizon
- A potential decline in demand among foreign investors for USTs
- Federal Reserve monetary policy moving into restrictive territory
- A structural increase in the level of real interest rates and term premia as QE is unwound

These factors should keep US rates in the 'driving seat', potentially affecting valuations in many asset classes. Perhaps the most important risk is that of a shift in the equity/bond correlation. We find that broadly speaking, the mainly negative correlation between the two asset classes since the 1990s is a function of (low) inflation and compressed term premia, both of which could pick up as we move away from QE. In 2018, we saw bond markets rallying little during equity corrections. Put differently, bonds have been the source of equity sell-offs and as such, they now offer less protection to cross-asset portfolios.

Furthermore, as a function of the shifting macroeconomic sands, we are aware that the future is likely to be made of lower returns than those during the height of the QE era, and importantly, also more volatility. Sharpe ratios for buy-and-hold investors are thus likely to be much lower than those many market participants have become used to in recent years. For us, this means being ever more tactical in managing portfolios.

The unwinding of QE should also help reverse high correlations between asset classes. This suggests a return to an environment favouring 'asset pickers', where portfolio managers can again add more alpha. ■

ASSET CLASS OVERVIEW

PERFORMANCE: TOTAL RETURN IN EUR

(AS OF 31 OCTOBER 2018)

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
9.9%	57.7%	28.8%	6.2%	26.7%	21.2%	32%	11.5%	15.6%	8.4%	3.4%
-5.3%	34%	19.5%	6.2%	19.2%	6.5%	19.5%	10.4%	10.7%	7.5%	2.0%
-25.2%	25.9%	15.1%	3.6%	14%	0%	8.4%	1%	10.1%	3.7	-1.1%
-37.6%	17.5%	14.5%	-2.4%	10.7%	-0.1%	7.5%	-0.5%	8.1%	0.3%	-1.8%
-37.6%	16.6%	7.2%	-2.7%	4.4%	-0.1%	2.6%	-0.7%	4.6%	-0.2%	-3.9%
-45%	1.1%	3.5%	-14.7%	-2.1%	-9.8%	-17.8%	-25.9%	2.3%	-2.1%	-5.8%

Performance +

Performance -

- Global government bonds (H)
- Global corporate bonds (H)
- Global corporate high-yield (H)
- Commodities (H)
- Developed equities (UH)
- Global real estate (UH)

H: hedged; UH: unhedged
Source : Bloomberg, Quant Research Group, BNP Paribas Asset Management (as of 31 October 2018)
Indices used: global real estate (RNGL), developed equities (MSDEWIN), global government bonds (SBWGEC), global corporate bonds (LGCPTREH), global corporate high-yield (LG30TRUH), commodities (BCOMHET). Bloomberg ticker in brackets

Past performance or achievement is not indicative of current or future performance.

THE THOUGHTFUL ASSET MANAGEMENT BLOG FOR A CHANGING WORLD

OUR BLOG – INVESTORS' CORNER

INVESTORS' CORNER BY BNP PARIBAS ASSET MANAGEMENT OFFERS YOU INSIGHTS AND COMMENT BY OUR INVESTMENT PROFESSIONALS ON THE THEMES AND ISSUES THAT MATTER TO INVESTORS
INVESTORS-CORNER.BNPPARIBAS-AM.COM

IN ENGLISH, FRENCH AND GERMAN

MORE ON THE TOPICS THAT MATTER TO YOU

MORE ABOUT OUR EXPERTS

SUBSCRIBE TO THE NEWSLETTER

SHARE OUR POSTS

INVESTORS' corner

DOWNLOAD THE **INVESTORS' CORNER** APP.
NOW AVAILABLE FOR IOS AND ANDROID

GET IT ON Google play
Download on the App Store

PRODUCTION
Editor in chief: Andrew Craig
Editors: Nieck Ammerlaan and Steve Leddy
Project coordination: Christine Bosso
Graphic design: Graphic design studio BNPP AM
This publication is produced by the Publication Centre at BNP Paribas Asset Management.
For comments, questions and suggestions, e-mail AMAU.ClientService@bnpparibas.com

December 2018 - Design : AM STUDIO- P1811009

IN A CHANGING WORLD,
YOU NEED TO KEEP AN EYE ON THE RIGHT PATH.

At BNP Paribas Asset Management, we manage assets with the world in mind, looking beyond financial metrics to ensure we manage all risks and invest in responsible businesses that perform over the long term. This is why we say: investing means the world to us.

www.bnpparibas-am.com.au

BNP PARIBAS
ASSET MANAGEMENT

The asset manager
for a changing
world