FOR PROFESSIONAL INVESTORS – 10 January 2019

ASSET ALLOCATION QUARTERLY

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

CENTRAL BANKS INDUCE REGIME SHIFTS

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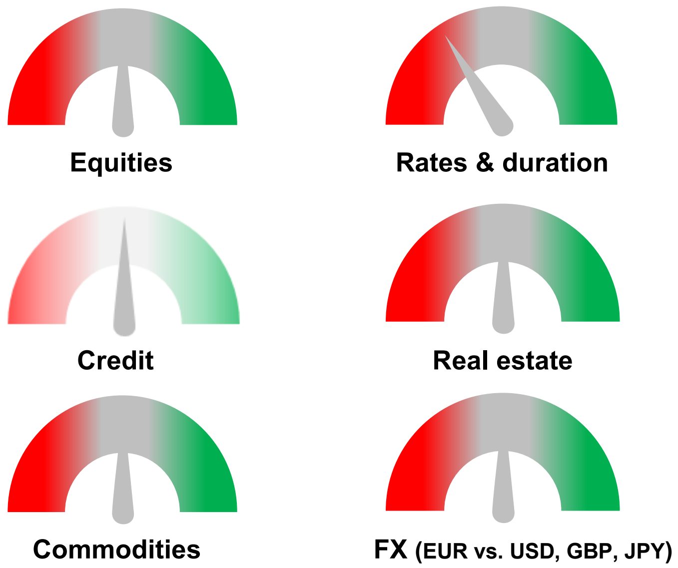
Asset allocation overview



SUMMARY

- **Central bank tightening fuels volatility –** As financial markets begin to slowly grasp that central banks are no longer underpinning asset prices, sharper and sudden market moves look set to become the new norm. In such a world more emphasis will have to be on fundamentals again, and price action will be determined more by incoming macroeconomic data and corporate fundamentals.
- **Bonds no longer good hedges –** As quantitative easing ends, we expect to see core bond yields moving structurally higher (especially as real yields and term premia reverse from their QE-depressed levels). This makes bonds less useful for portfolio hedging and we are diversifying using other assets.
- **What's in the price? –** We believe some bad news is already in equity prices. Previously elevated valuations have corrected sharply and our macroeconomic scenario framework shows that stocks have started pricing in the more bearish scenarios, but they could have further to run compared to our most bearish scenario.

ASSET ALLOCATION

- **Strategically neutral equities –** We still expect weaker (but robust) global growth with risks skewed to the downside. With more volatility becoming the new norm, we remain structurally neutral equities, having closed our tactical overweight recently.
- **Underweight fixed income –** We are underweight core bonds given our view of gradually rising inflation and monetary policy normalisation.
- **Aiming to be tactical –** With more volatility on the horizon, we seek to be ever more tactical and reactive around our main structural proposition, deploying our tactical market dynamics tools. After decent widening, we closed our underweight on HY credit in early January.
- **Exploiting asymmetries to hedge and diversify –** We continue to hold positions with asymmetries to our scenario analysis.

MARKET REVIEW: Q4 2018

Price action in October looked quite similar to the correction in February. Market concerns over an inflation overshoot resurfaced and hurt developed market (DM) equities as interest rates spiked up along with volatility in many markets. Subsequently, however, investors turned risk-off on concerns over slower global growth. Global equities, DM stocks in particular, continued to fall, taking Q4 returns in the US to almost -13%. European equities were down by more than 11% and Japanese stocks fell by more than 18% (Figure 1).

One of the main culprits behind these bearish trends is the uncertainty over recession risk and Chinese growth in particular. The Chinese manufacturing PMI fell to 49.4 in December, dropping to below 50, which points to a contraction.

The uncertainty also impacted commodity markets amid lower demand expectations. December's OPEC agreement to cut production by 1.2 million barrels per day did not do much to prevent crude oil prices from sliding further: WTI ended the year at USD 45 a barrel, down by almost 40% in Q4. Similarly, industrial metals suffered with copper down by 6.5% in the last quarter of the year.

The significant fall in energy prices resulted in a sharp reassessment of inflation expectations and breakeven inflation which dragged down nominal rates. Yields on 10-year US Treasuries dropped by around 55bp in Q4, ending the year at around 2.68% (from a high of more than 3.2% just a few weeks earlier). In Europe, 10-year German Bunds fell by 23bp to close 2018 at their lowest for the year at around 0.24%. Central banks stuck to their guns with the ECB ending its asset purchase programme and the US Federal Reserve raising rates at its December meeting. Notwithstanding their steady stance, their tone remained quite dovish, adding to the downward pressure on government bond yields in developed markets.

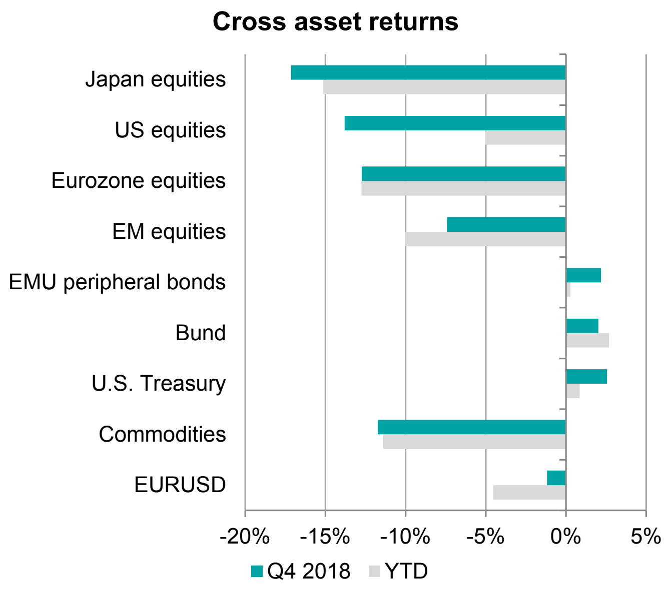
Moreover, political risk remained high, pushing up demand for safe-haven assets. In Europe, the Italian government clashed with the European Commission over its expansive budget. Even though it backtracked partly, this weighed on BTPs and 'peripheral' government bonds initially, European bank shares and, more broadly, on the euro. Elsewhere, the Brexit saga barely progressed. Prime Minister May postponed a parliamentary vote on a proposed deal, while talk resurfaced about a second referendum. In the US, the results of the mid-term elections did not have any significant implications for financial markets as they led to a status-quo situation with a divided Congress. In December, however, the standoff between Democrats and Republicans over President Trump's border wall project led to a government shutdown. Regarding Sino-US trade tensions, Trump postponed a tariff increase on Chinese goods by a couple of months to extend negotiations, but investor concerns did not fade much.

In credit markets, US high-yield (HY) spreads jumped by more than 200bp, taking them back to mid-2016 levels. This is indeed a significant widening, but it is still well below early 2016 levels when concerns over a hard landing by the Chinese economy and falling oil prices sparked a market rout. In Europe, high-yield credit spreads rose by almost 170bp in Q4 (pushing the yield to just above 5%, which is close to the 2016 highs). High-grade credit spreads also rose in the US and Europe, by about 50bp and 30bp respectively.

Emerging market equities, which suffered throughout 2018, were helped by the Fed's more dovish tone and outperformed DM equities by falling less (-7.9%) over Q4. The election in Brazil of a president in favour of market-friendly reforms triggered a 12.4% rally over the quarter, marking one of the best equity market performances across regions. EM dollar debt lost 1.3% and local debt gained 2.9%, helped by stabilising EM currencies.

The assets that did well in Q4 were mainly safe-haven ones: as mentioned above, core government bonds benefited from concerns over slower global growth and heightened political risk. Elsewhere, the Japanese yen gained 3.6% and gold rose by 7.7%.

Figure 1: Investors turned risk-off in Q4



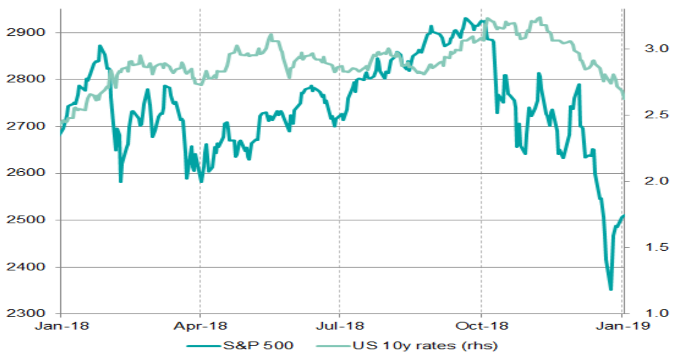
Source: Bloomberg and BNPP AM, as of 31/12/2018

REGIME SHIFTS ALL AROUND

Bonds no longer good hedges

2018 left investors with almost no place to hide as most major asset classes posted negative returns. Strikingly, given the equity market losses, bonds also fell, driving yields higher on the year, even when taking into account the sharp safe-haven led drop in yields in the last weeks of the year (Figure 2). In fact, a traditional 60:40 portfolio of US stocks and bonds lost slightly more than 1% in 2018, marking the first negative return since 2008 (when equities drove losses). And considering an annual average return for 60:40 portfolios of nearly 9% since the 1980s, the changing market dynamics are becoming apparent.

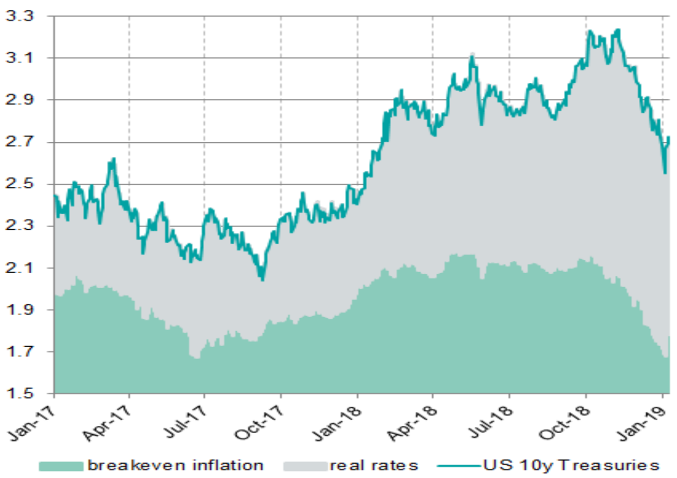
Figure 2: 2018 in the rear-view mirror: equities down, yields (marginally) up



Source: Bloomberg and BNPP AM, as of 31/12/2018

Dissecting fixed-income price action produces interesting results (Figure 3). Most of 2018 saw higher nominal yields driven by rising real yields and inflation break-evens moving sideways. And even the sharp rally in bonds in the closing weeks of the year was driven by a collapse in inflation break-evens, with real yields still near their highs.

Figure 3: US fixed income: real rates up, break-evens (recently) down



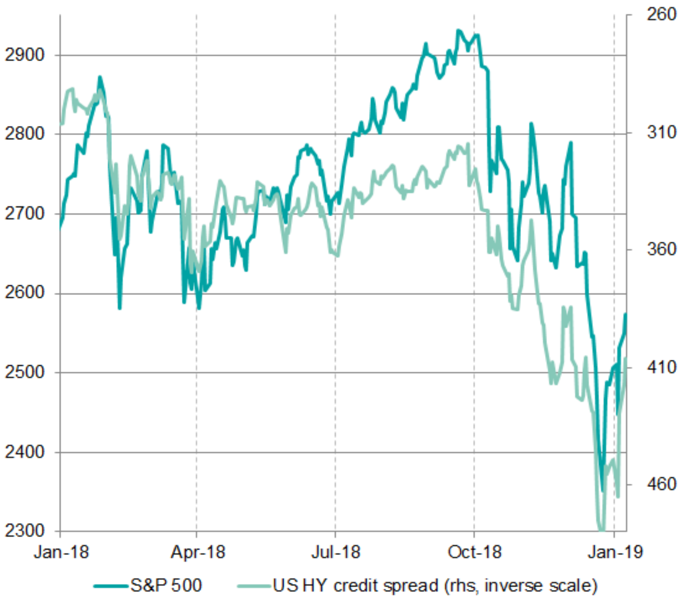
Source: Bloomberg and BNPP AM, as of 09/01/2019

After years of central bank influence, as we have argued before, fixed-income markets are now pricing in the unwinding of QE (see also the discussion below) and this should reverse depressed levels of term premia and real yields.

With core rates markets undergoing a structural change, their role as portfolio hedging instruments is being questioned. Indeed, we have been underweight fixed income as part of our core positioning for some time and are expressing our portfolio hedges via different assets instead.

One such hedge is a short in HY credit, which sold off together with – and arguably even ahead of – equities in Q4 (Figure 4). On a longer term view, we continue to think that HY credit is vulnerable at this stage of the cycle. Historically, spreads are tight and as an asset class, credit is vulnerable to quantitative tightening and slower growth. In the short term, with equity markets bouncing recently we decided to cut this trade tactically for now.

Figure 4: HY credit a good risk hedge



Source: Bloomberg and BNPP AM, as of 09/01/2019

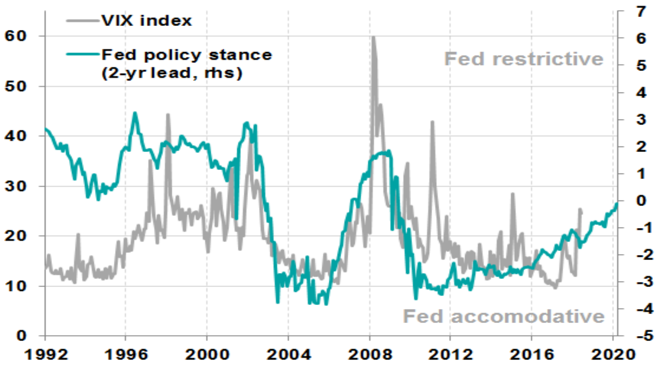
Central bank tightening fuelling volatility

One of the key themes from our 2019 multi-asset outlook is summarised well by Figure 5 – we expect more volatility.

Since the great financial crisis, the aggressive and unconventional monetary policies of the main central banks have been a major support for equities and other risky assets. These policies led to unusual market distortions such as persistently low asset price volatility, high risk-adjusted returns and historically tight risk premia in both equity and fixed-income markets.

It is these imbalances which look set to unwind as central banks trim their balance sheets and raise interest rates, in other words, as 'quantitative tightening' gathers momentum.

Figure 5: Expect more volatility as the Fed tightens



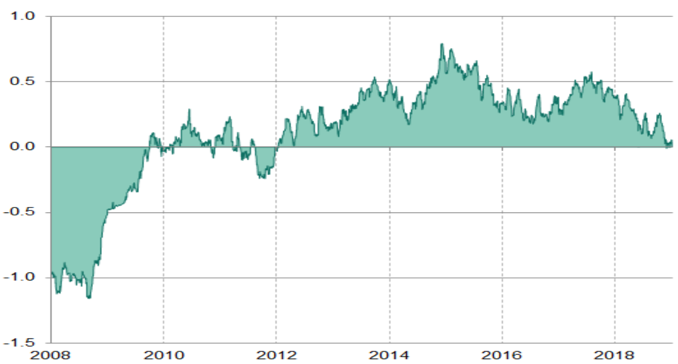
Fed policy stance: spread between the real fed funds rates and R* estimates. Source: Bloomberg and BNPP AM. Data as of 09/01/2019

The market's response to December's FOMC US rate policy-setting meeting is a case in point. In light of the equity market falls, market participants were hoping for a "dovish rate rise". Some even counted the Fed pausing its rate rising cycle. While the Fed did revise lower its 'dots' (signalling fewer future rate rises), comments by Chair Powell accompanying the increase in the fed funds rate were not dovish, driving market volatility even higher. Subsequently, Fed speakers turned more dovish, allowing markets to start rebounding slightly.

As markets slowly grasp that central banks are no longer underpinning assets with their magic QE wand, sharper and sudden moves will likely become the new norm. The low volatility QE world many participants were used to is ending.

In some ways, this is actually a return to 'normal' (i.e., the QE world was an historical aberration). In the new normal, the emphasis will likely shift towards fundamentals again, and price action will be determined more by incoming macroeconomic data and corporate fundamentals. In this light, we note the deterioration in our aggregate US macro data quant signal: after being positive since 2012, it now stands at neutral (Figure 6). Clearly, markets have already priced in this decline, so whether the signal deteriorates further or improves from here will be key. We also expect all eyes to be on the Q4 corporate earnings season just starting.

Figure 6: Aggregate US macro data – fell to neutral



Source: BNPP AM, as of 09/01/2019

WHAT'S IN THE PRICE?

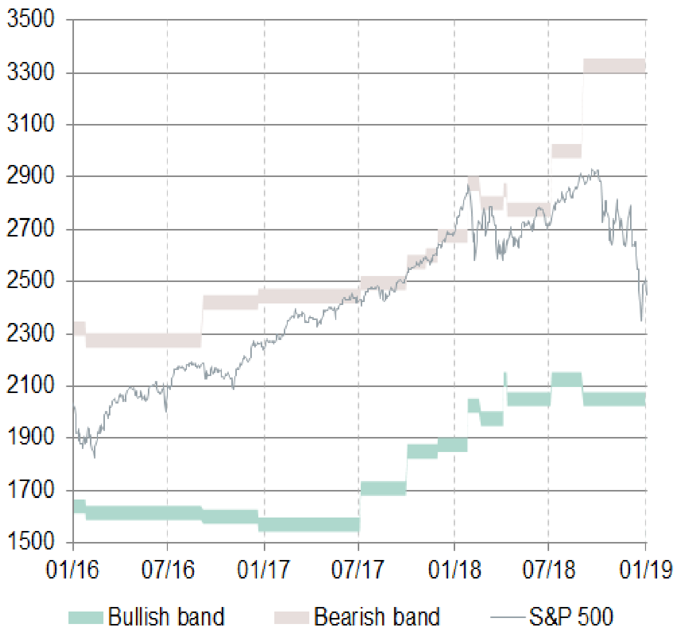
What the market already prices is of course a key consideration. As discussed above, with macroeconomic data already deteriorated and equity markets around 20% off their year-ago highs, a lot of bad news is already in the price.

Put differently, previously elevated valuations have corrected sharply – e.g., the S&P 500 forward P/E ratio went from 20 points to around 14.5 currently, which is a level last seen in 2013.

Here our macroeconomic scenario framework, which models plausible states of the world given available information and the potential evolution of various factors, comes in helpful. As shown in Figure 7 for the S&P 500, for example, US stocks have started pricing in the more bearish scenarios in our framework, but clearly, they could have further to run compared to our most bearish scenario.

In a way we are at a crossroad, both in terms of the deterioration in the macroeconomic data and in terms of market pricing. In light of this uncertainty, we closed our tactical equity longs in December. We remain structurally neutral on the asset class (also see the below discussion).

Figure 7: S&P 500 scenario analysis

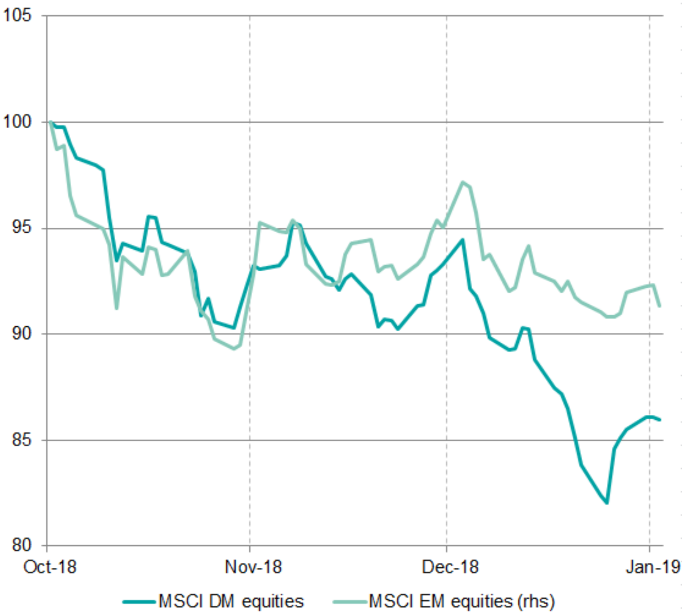


Source: Bloomberg and BNPP AM, as of 09/01/2019

Looking at valuations and what is priced in, we note that EM equities have fared much better in recent weeks, not participating in the meltdown seen by G10 equities (Figure 8). Better valuations (read previous underperformance) have surely helped. Now that the market is also pricing out further Fed rate rises, there is further support for the asset class.

But as we have said before, to expect significant (outright) upside for EM assets, three conditions must be satisfied: i) a dovish Fed, ii) more policy easing in China, and iii) an easing of trade tensions between the US and China. On all three fronts, after seeing little progress in Q4 last year, we are noting some improvement recently. On our radar screen for the weeks and months to come.

Figure 8: EM equities outperforming recently



Source: Bloomberg and BNPP AM, as of 09/01/2019

ASSET ALLOCATION

Tactical tilts around structural views

Our structural asset allocation views are unchanged since our last publication. We continue to expect weaker but still robust global growth and believe the balance of risks is skewed to the downside. All else being equal, we continue to be structurally neutral on equities and see greater volatility as the new norm. In fixed income, we remain underweight given our view of gradually rising inflation and monetary policy normalisation.

We continue to deploy our tactical views and tools around our main mantra however – with more volatility on the horizon, we aim to be ever more tactical and reactive around our main structural proposition. In this light, we cut our tactical overweight to equities in late December and are now back at neutral. Price action in the asset class has been bearish, exacerbated by the usual low liquidity during the festive period. We are on the sidelines for now, while we monitor incoming macroeconomic data and the latest earnings reports.

Exploiting asymmetries to hedge and diversify

Elsewhere, we continue to hold hedges/positions with asymmetries to our scenario analysis. We are still long 5-year US bonds versus German bonds, reflecting valuation differences. We believe European fixed income is more vulnerable as the ECB begins to withdraw policy accommodation, but this is also a good defensive position in risk-off markets.

In fixed income, we were short HY credit which performed well in the recent period of risk off. In light of the recent bounce in risk assets however, and given our tactical aims, we recently cut this trade for now.

To reduce our exposure to renewed trade tensions between China and US, we are still long USD versus a basket of Asian currencies and we are also long the French CAC 40 versus the DAX since we believe Germany is more exposed than France to de-globalisation.

Finally, we recently entered a tactical short in CAD/NOK in FX markets where we believe valuations and the relative central bank policy outlook looks supportive.

STRATEGIC OVERVIEW OF POSITION CHANGES IN Q4 2018 & EARLY 2019

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

OCTOBER:

LONG DEVELOPED MARKET EQUITIES OPENED 17/10/18

- We took advantage of October's market correction to add equity exposure tactically by going long DM equities.

LONG EMU EQUITIES CLOSED 17/10/18

- We closed the EMU equity strategy as we rotated to the above developed market equity position.

LONG CAC VERSUS DAX OPENED 17/10/18

- We went long CAC 40 versus DAX since the French index is less exposed to trade tensions, in our view.

NOVEMBER:

LONG USD VERSUS ASIAN CURRENCIES OPENED 02/11/18

- We went long USD vs. a basket of Asian FX as a hedge against de-globalisation and greater trade protectionism.

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

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

LONG DEVELOPED MARKET EQUITIES INCREASED 21/11/18

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

DECEMBER:

SHORT BUNDS AND OATS OPENED 05/12/18

- Given the declines in yields, there was a good entry point with an asymmetric outlook for yields.

LONG LEMD CLOSED 05/12/18

- We had less fundamental conviction.

LONG DEVELOPED MARKET EQUITIES REDUCED 10/12/18

- The reduction in conviction mainly reflects less supportive technical indicators.

LONG DEVELOPED MARKET EQUITIES REDUCED 19/12/18

- The reduction in conviction mainly reflects less supportive technical indicators.

SHORT EUR VERSUS USD CLOSED 19/12/18

- Both fundamentals and technical indicators suggest that the risk/reward of the trade is now less attractive.

LONG DEVELOPED MARKET EQUITIES CLOSED 21/12/18

- The position reached stop-loss levels as market volatility increased recently.

JANUARY:

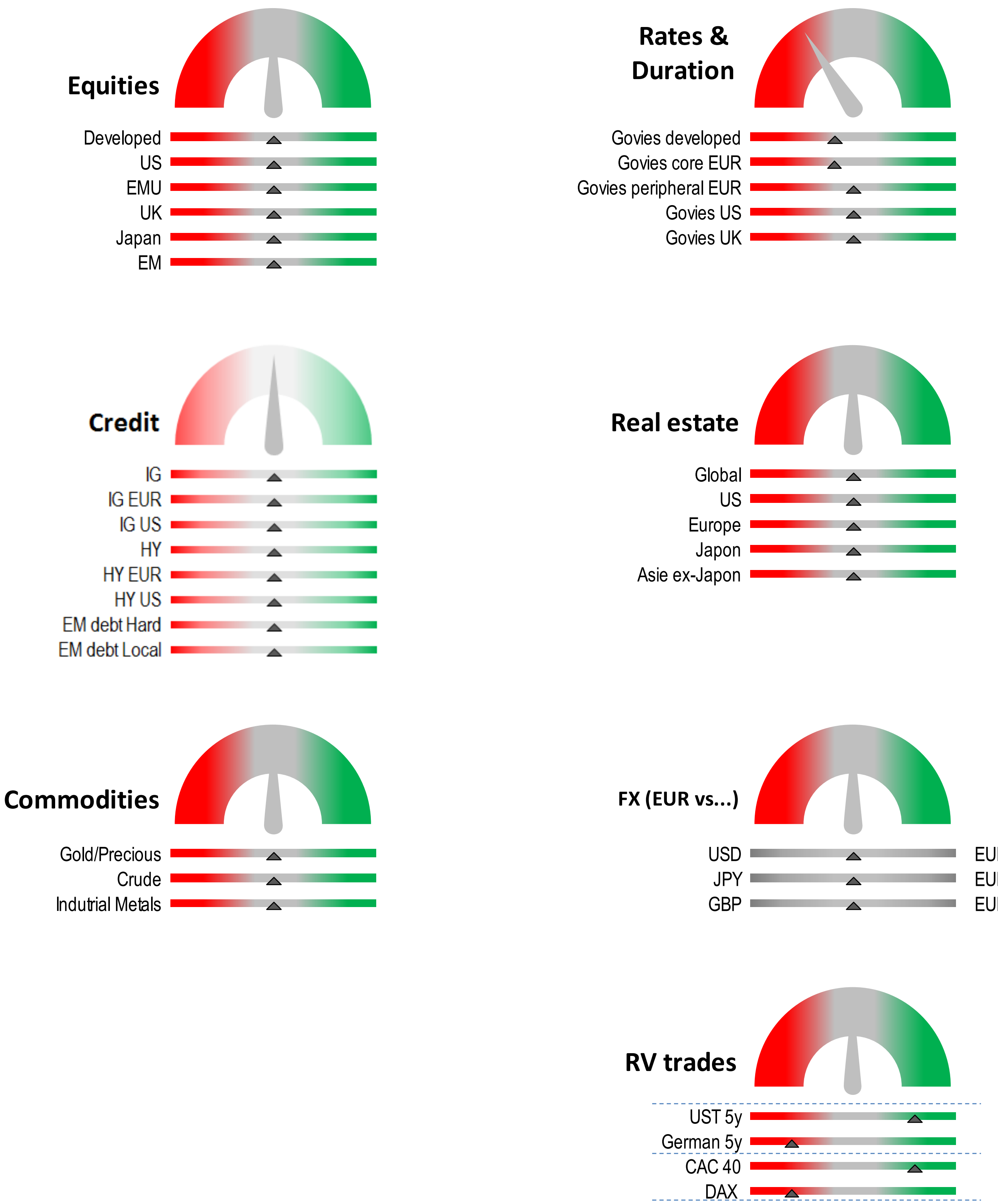
SHORT HY CREDIT CLOSED 09/01/19

- This trade performed well in Q4 but with equity markets bouncing is at risk in the short term.

SHORT CAD/NOK OPENED 09/01/19

- We believe valuations and the relative central bank policy outlook looks supportive for CAD/NOK lower.

ASSET ALLOCATION DASHBOARD[1]



[1] 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 January 2019. Individual portfolio management teams outside of MAQS may hold different views and may make different investment decisions for different clients.

DISCLAIMER