For professional investors - Marketing Communication - October 2021

ASSET ALLOCATION MONTHLY - OCTOBER 2021

Removing the crutches

After a good start, September saw equity markets take a hit, particularly in emerging Asia. Alongside ongoing investor concerns about the pandemic and weakening global growth momentum, markets were rocked by news of debt payment problems at Chinese property developer Evergrande.

The lack of clarity on Evergrande's ability to overcome a serious liquidity crunch and repay its debts to bond investors led to worries the company might default. This possible Chinese 'Lehman' moment became a major focus of investor attention and largely explains the underperformance of emerging equities. Beyond this idiosyncratic development, questions remain about the economic outlook in China and Beijing's likely reaction (see 'Focus on China', below).

The main issue affecting long-term bond yields in the US and Europe was major central banks beginning to talk of a gradual end to the emergency monetary policy measures, put in place to protect economies from the consequences of the pandemic. These included massive asset purchases: EUR 1 337 billion from March 2020 to the end of August 2021 under the ECB's pandemic emergency purchase programme (PEPP); USD 120 billion per month since March 2020 for the US Federal Reserve. The message from both leading central banks is now clear: Tapering is coming.

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The sustainable investor for a changing world

KEY MARKET DRIVERS

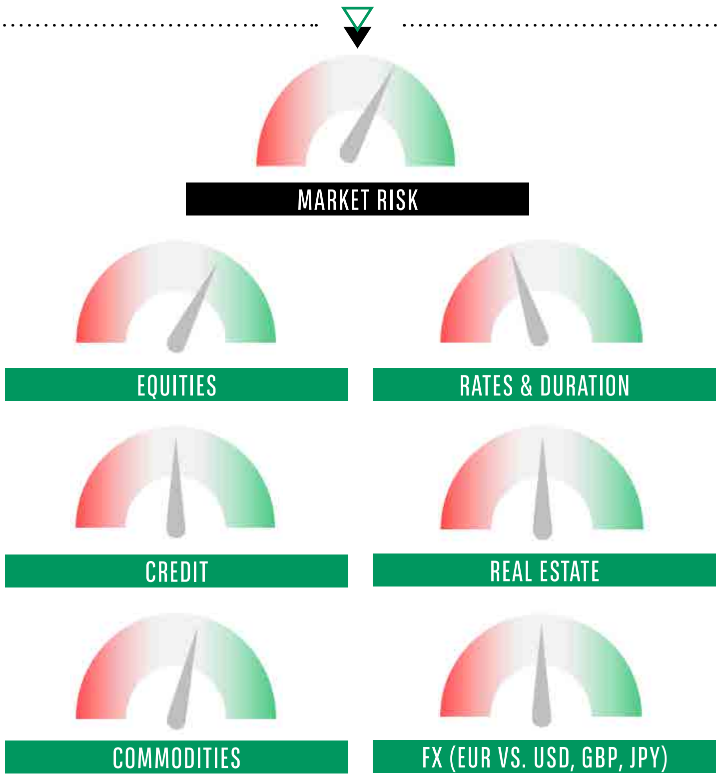
- Markets start Q4 on an edgy note thanks to hawkish central bank rhetoric, slowing global growth, and rising idiosyncratic risks.
- Investors may focus on persistent supply constraints and rising input price issues slowing a 'return to normal' rather than on the more upbeat medium-term economic prospects.

VIEWS & ASSET ALLOCATION

- Visibility on the outlook has deteriorated and selected risks have increased. We believe, however, the supportive base case continues to favour equities over government bonds. Growth should strengthen as Delta infections and inflationary pressures wane, while central bank support slowly recedes.

RISK UTILISATION*

CORE ASSET CLASS VIEWS**

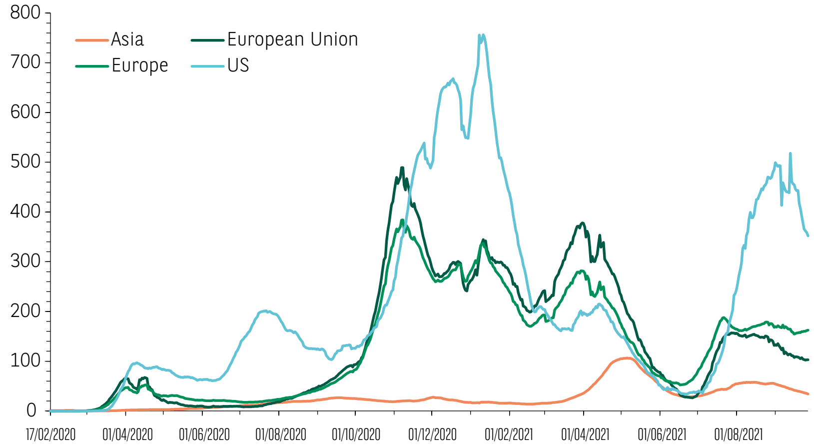


* Risk utilisation/active risk is a measure of the tracking error (as a percentage of maximum tracking error) of an unconstrained theoretical portfolio, derived from core asset class views and from additional specific/tactical trades. **The core asset class views dashboard reflects the key views of the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

Pandemic: The Delta wave continues to recede

For 18 months, we have seen the pandemic's ebb and flow, while keeping in mind the dramatic death toll (over 4.7 million worldwide as of 27 September, according to the World Health Organization). After a difficult summer, especially in the US and many Asian countries, health indicators have been improving since late August. New infections of the Delta variant are now falling, as is the virus's reproduction rate. Now that schools have restarted in many countries, however, further outbreaks could occur via transmission from unvaccinated children to their parents.

Exhibit 1: Daily new Covid-19 cases - The Delta wave is receding
(7-day average, per million)



Data as at 27 September 2021. Sources: Our world in data, BNP Paribas Asset Management..

The WHO has said the Delta variant is now predominant. It accounts for 90-100% of new infections in Europe, Asia, North America, Africa and Oceania, and for 80% in South America, where it continues to spread. Two 'variants of interest' (VOI), Lambda (which appeared in Peru) and Mu (identified in Colombia), are being closely followed by the WHO, which is concerned about possible vaccine escape.

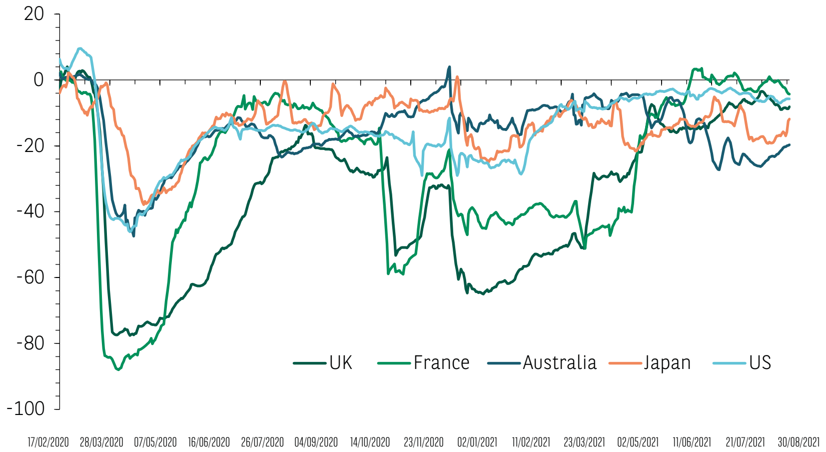
Financial markets have yet to price in this risk, perhaps because similar issues were raised each time a new variant emerged and yet vaccines remained effective against severe forms of the disease. Still, as the Mu strain begins to spread to the US, Anthony Fauci, the pandemic adviser to the White House, has called for caution.

In major Western economies, the authorities affirmed their 'living with the virus' strategy of limiting social restrictions to maintain economic activity, while also encouraging people to get vaccinated. In the Asia Pacific region, the dominant strategy is still 'Zero Covid', as vaccination rates are lower because campaigns generally began later and hospitals are threatened with being overwhelmed. The only country in the region that stands out is Singapore: With a total vaccination rate of 77% (fully vaccinated as at 25 September), the nation is cautiously moving towards 'living with the virus', resulting in a rapid rise in the number of infections. Most patients have only mild or no symptoms, but the authorities are closely monitoring the situation.

“Tapering should be announced at the 2-3 November policy meeting.”

The stakes are high: A global ‘return to normal’ can only be achieved if restrictions are gradually lifted. The stringent measures imposed this summer weighed heavily on manufacturing activity in emerging Asia, impacting global production chains. Restaurant bookings have fallen off substantially in Australia, where a lockdown has been in place since late June in Sydney. In the services sector, restrictions have had less of an effect than expected in Europe, where mobility indices are now close to pre-pandemic levels.

Exhibit 2: Back to normality, but the strategy against the virus does matter
(Google mobility trends - retail and recreation; % change relative to the period before the pandemic)



Data as at 21 September 2021. Sources: Our world in data, BNP Paribas Asset Management.

In Japan, beyond the stringent restrictions that have imposed barriers to consumption, services activity levels remain closely linked to consumer confidence. Flash estimates show that the services purchasing managers’ index (PMI) in Japan picked up in September (though it was still below 50), while the equivalent indices fell in other major countries. Rapid vaccine progress has given hope back to households, even if the Japanese government’s management of the pandemic so far has been criticised.

Focus on China

China is one country where the Zero Covid strategy remains in place and it is having an impact on economic growth. Business surveys and hard data in July and August pointed to a slowdown in GDP growth momentum. In August, the Caixin PMI manufacturing index fell below the neutral 50 level for the first time since April 2020 amid supply chain bottlenecks. Retail sales growth slowed significantly in August to only +2.5% from a year earlier, marking the slowest pace since August 2020. The dramatic floods which hit Zhengzhou in particular in July also weighed on business activity.

There may be a rebound in September, but the recent tightening of regulations in many sectors and difficulties in the property sector will likely result in a further slowdown through the end of the year. The greater the challenges the economy faces, however, the greater the likelihood the government will respond with monetary and/or fiscal measures to support growth.

The People's Bank of China (PBoC) has already injected liquidity into the economy on a number of occasions since the threat of default by the country's second-largest property developer, Evergrande, raised fears for the sector as a whole. Any announcement of more comprehensive measures (key rate cuts, fiscal support) is nonetheless unlikely to be immediate and their effects on the economy would not be seen for some months. The political agenda must also be taken into account, with a Politburo meeting on the economy in late October, the Chinese Communist Party's Plenum in mid-November, a Politburo meeting in early December, and finally a work conference in mid-December. Barring a sudden contagion of Evergrande's difficulties to the rest of the sector (or to the financial markets), further large-scale support measures seem unlikely in the short term, but monetary policy could nonetheless be relaxed in the coming weeks to tackle the slowdown in activity.

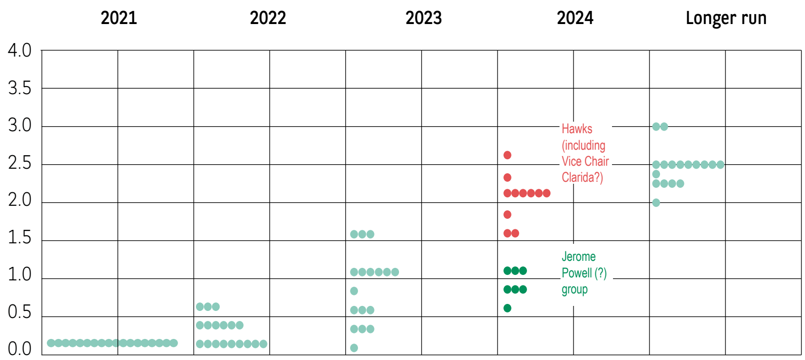
US Federal Reserve: More hawkish

The Fed's long awaited monetary policy meeting on 22 September generated no major surprises, but did raise some questions. As expected, chair Jerome Powell indicated that the criteria required to start reducing (tapering) the pace of asset purchases had been met, at least on inflation. The trend on employment is somewhat less clear, but the drop in the unemployment rate from 6.7% in December 2020 (when the criteria were first laid out) to 5.2% in August (the latest data point) brought it sufficiently close to the equilibrium unemployment rate, estimated at 4.0.

As a result, if the economy progresses as expected, tapering should be announced at the 2-3 November policy meeting. Powell said that tapering should end sometime around mid-2022.

The Fed's inflation forecast for 2021 has risen sharply from 3.0% to 3.7% for the core PCE. The Fed now expects its preferred measure of core inflation (personal consumption expenditures excl. food and energy) to remain slightly above 2% from 2022 to 2024. Powell has defined this as a 'very modest overshoot' of the Fed's 2% target. However, the dot plot, which shows the level of the policy rate deemed 'appropriate' by Federal Open Market Committee members, indicated a split committee: Six members expect a rate rise next year, while the other nine are pencilling in a later 'lift off' in rates.

Exhibit 3: FOMC participants' assessments of appropriate US monetary policy reflect a split committee



Data as at 22 September 2021. Sources: Summary of Economic Projections, Federal Reserve, BNP Paribas Asset ManagementManagement.

The initial reactions of financial markets after the 22 September meeting suggested that the Fed chair had communicated his intentions clearly. In the days that followed, it appeared that the FOMC was divided not only over the date of the first rate increase, but also, more fundamentally, over the interpretation of the flexible average inflation targeting framework. Some members believe that key rates can remain low (at around 1% in 2024) with inflation slightly above 2.0%, while others, such as Fed Vice-President Richard Clarida, believe that much of the path towards the longer-run rate will have to be travelled by 2024.

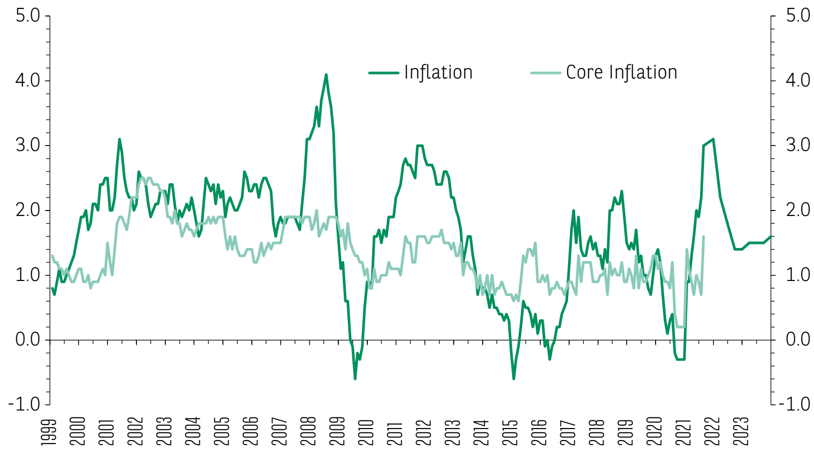
These divergent views could partly explain the upward pressure on US long-term bond yields since the FOMC meeting and the renewed expectation that key interest rates may begin rising next year. Furthermore, even if the pre-announcement of tapering went well, there is a difference between the notions of the Fed reducing its purchases and having to accept that it will happen soon.

"The time has come for central banks to consider removing the punch bowl."

European Central Bank: Beyond September adjustments

Following the Governing Council meeting on 9 September, ECB President Christine Lagarde said that "favourable financing conditions can be maintained with a moderately lower pace of net asset purchases under the pandemic emergency purchase programme than in the previous two quarters". The PEPP envelope remains at EUR 1 850 billion and the programme is due to end in March 2022. The ECB has not communicated yet on the future of the PEPP nor on changes to its asset purchase programme (APP). Investors will have to wait for the December policy meeting.

Exhibit 4: Inflation in the eurozone towards 2% after 2023? Who knows?
(actual data; ECB forecast on dotted line; YoY % change)

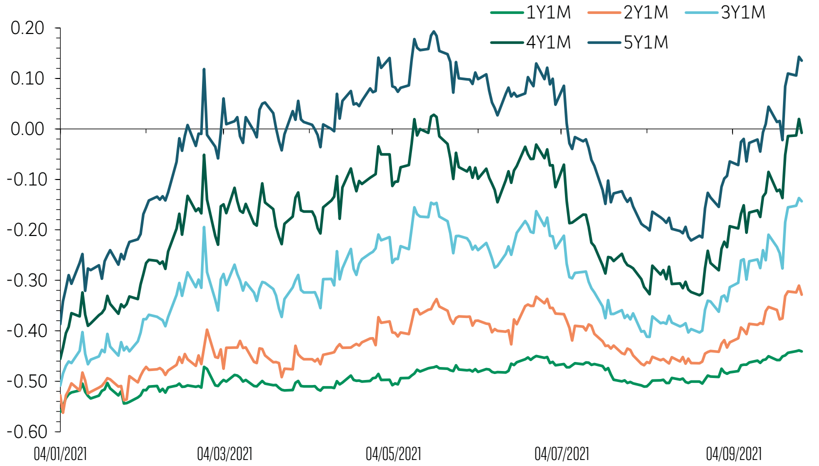


*HICP: Harmonised Index of Consumer Prices
Data as at 28 September 2021. Sources: Bloomberg, ECB Macroeconomic projections as of September, BNP Paribas Asset Management

In the meantime, the ECB, like the Fed, risks being faced with upward pressure on long-term bond yields. In Q4, the monthly rate of PEPP purchases will be reduced to between EUR 60 billion and EUR 70 billion from EUR 80 billion in Q2 and Q3. However, uncertainty over the amounts that will be bought after March 2022, while government bond issuance remains significant, are beginning to worry investors.

Recent weeks have been marked by statements from several ECB members who want to distance themselves from the inflation forecasts released in September, which they consider to be too low. In particular, one press article referred to a private meeting between 'German economists' and ECB chief economist Philip Lane, in which he mentioned an internal scenario showing the return of inflation to 2% after 2023. Although partially denied, this story fuelled the idea that the mood may soon become a little more hawkish within the ECB.

Exhibit 5: ECB rate expectations based on OIS* forwards (in %)



*OIS: Overnight indexed swap

Data as at 29 September 2021. Sources: Bloomberg, BNP Paribas Asset Management.

While bond markets appear to have finally accepted that the recent acceleration in inflation is 'transitory', discussions at the central banks on this theme now seem to be giving rise to further upward pressure on long-term yields. Furthermore, although the Fed and the ECB are cautious in their official communications, other institutions have spoken out more clearly. For example, the Central Bank of Norway, which recently raised its key rate from 0% to 0.25%, indicated that a further increase was likely in December and that the rate could rise to 1.25% by the end of 2022 as home prices have risen sharply in recent months. The Bank of England, for its part, has indicated that recent developments reinforce the need for a 'medium-term' rate rise and multiple hikes rate next year are now priced in. Meanwhile, several emerging market central banks have already had to raise policy rates in the face of accelerating inflation.

As William McChesney Martin, Fed chair in the 1950s and 1960s, put it, the time has come for the chaperone to consider removing the punch bowl; bond investors seem upset about having to leave the party.

Is the reflation trade back?

Perhaps one way to look at recent events is to consider that central banks are removing the crutches that carried economies through their gradual recovery from the Covid crisis. The Organisation for Economic Co-operation and Development (OECD), the International Monetary Fund (IMF) and others have already pointed out that the exceptional recession of 2020 will leave deep scars, notably on employment, and that emergency treatment does not heal those scars.

For that to happen, it is up to governments to implement structural fiscal policy measures. Such decisions depend on the legislative timetable and will take longer to show their effects – longer than financial markets have patience for. Moreover, while parliaments had no hesitation in voting for one-off support for households and companies in 2020, further action could be trickier, which in turn could worry investors. Discussions in the US Congress on the ambitious infrastructure investment and major social reform plans proposed by President Joe Biden are taking longer and are more difficult than expected, even among Democrats.

While the White House announcements on the large-scale plans at the start of the year fuelled the reflation trade, the reality of the protracted debates in Congress has now taken some of the shine off this theme. At the same time, economic indicators have shown that the peak in the global growth recovery has passed. Although supply chain bottlenecks have limited industrial production, and services are suffering as the pandemic persists, demand remains high. The resolution of both these issues should lead to a strong recovery in both the services and the manufacturing sectors and the expansion should resume at a robust pace. However, investors do not seem to be focusing on this positive prospect, but rather on the short-term risks.

The current edginess could be heightened by the upcoming debt ceiling debate in the US, but once it has passed, the reflation trade could return. Our analysis of market dynamics indicators shows that technical configurations on many assets already reflect this.

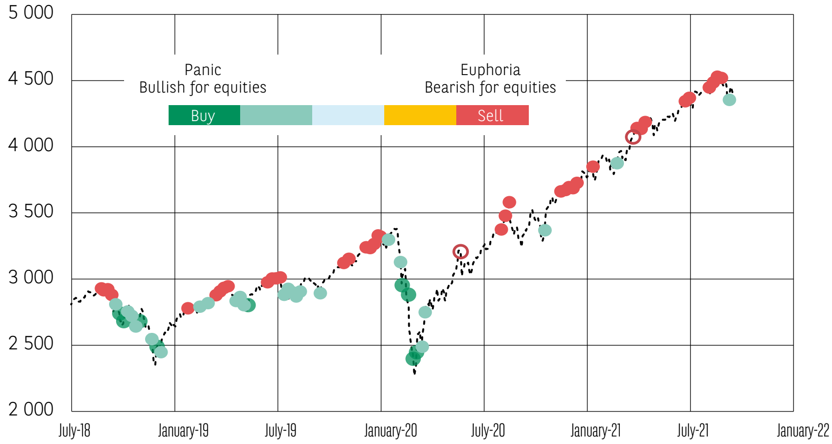
MARKET DYNAMICS INPUTS

From a chart technicals point of view, the move in US bond yields provides the clearest illustration of the re-emergence of the reflation trade: In September, both 10-year nominal and real yields broke out of the established trading range. The nominal US 10-year T-note yield broke the 1.15%-1.40% range that had been in place since August and, despite the fall in equities, rose to above 1.53%. This was its highest level since mid-June and only 20bp below its 2021 high, posted at the end of March. The next resistance level is at around 1.64%, but we believe that should not be a big hurdle given the strength of the recent move. In addition, our in-house indicator on the T-note future continues to point to a rise in US long-term yields in the coming weeks. The volumes on T-note futures remain limited and volatility has not reached extreme levels. Separately, the German 10-year Bund yield hit -0.20% on 28 September – the day when the T-note broke out of its band – and is also in a bull trend, with the next resistance level seen at -0.08%.

The reflation trade can be seen in the technical patterns of cyclical commodities (oil and natural gas) as well. The signals are strong and we do not expect them to be reversed easily. In addition, assets that could be considered as 'anti-reflation', such as gold and silver, have come under pressure and are not benefiting from any kind of flight-to-safety or hedging strategy amid the recent equities turmoil. For the time being, currencies have not joined the global reflation trade.

After four consecutive weeks in the red zone from mid-August, our blended 'market temperature' indicator calculated on the S&P 500 has turned more neutral. The recent sell-off contributed to the normalisation of exceptional patterns on the VIX volatility index, the term structure, and in other areas of the market. This normalisation could result in a more favourable market temperature in the coming weeks. Moreover, seasonal bearishness should end as we enter the fourth quarter.

Exhibit 6: Evolution of Market Temperature since July 18- S&P500 Daily
(All scores except neutral and yellow)



Data as at 27 September 2021. Sources: MAQS, BNP Paribas Asset Management.

"The autumn of 2021 is likely to remain a transitional phase."

ASSET ALLOCATION

The autumn of 2021 is likely to remain a transitional phase, making predictions more difficult. It was easy to foresee the recession that followed the first great Covid lockdown and governments' subsequent measures to help economic activity recover. The large-scale roll-out of effective vaccines should allow many economies to return to pre-pandemic levels of activity. The lockdowns of spring 2020 triggered a supply and demand crisis. Demand has recovered strongly, sparking persistent supply difficulties that are putting upward pressure on commodity and other input prices.

In response, major central banks are cautiously considering 'normalising' their monetary policy, reflecting reasonably optimistic economic growth scenarios. The recent announcements by the Fed would seem to largely explain the upward pressure on bond yields, which in turn led to erratic equity market movements in September.

Investors, too, need to accept that policy rates and bond yields will return to levels more in line with the fundamentals, while acknowledging that the medium-term economic environment remains supportive of equities. The elimination of supply bottlenecks should enable companies to meet strong demand.

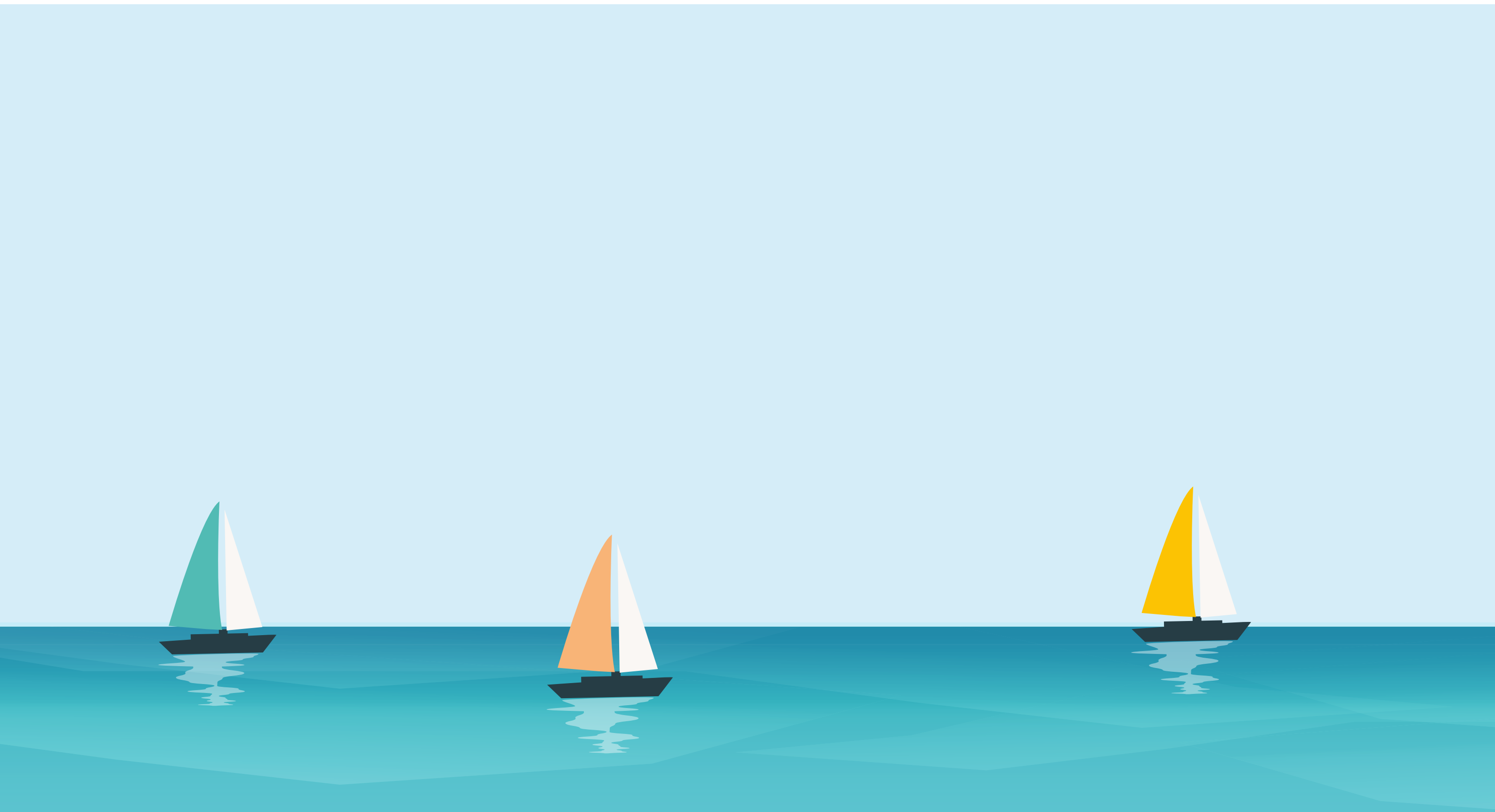
Our asset allocation reflects these convictions: we are long equities, short bond duration, but in this transition phase, we reduced our risk exposure on these two major asset classes in September. These adjustments to our core positioning, and other changes, reflect our constructive view on risk assets, as detailed below.

EQUITIES **Overweight**

We are long equities: In the short run, investors might focus on the downside risks (global growth, China, US monetary policy), but we believe the medium-term outlook for equities is good thanks to a solid economy and strong earnings growth. What is more, equities still look attractive versus bonds despite their rich multiples.

We are **long on US equities**. We kept our long on **Japanese equities**: After an excellent earnings season, earnings revisions have started to pick up relative to the rest of the world. Market sentiment, the chart-technical configuration and investor positioning are favourable in the medium term, even after the sharp market rise that sent the Nikkei 225 to its highest since August 1990. We are **neutral on EMU equities** overall, with a long on small caps and on banks. Small caps should benefit from being high beta and from their more attractive valuations relative to large caps. Moreover, European fiscal expansion (in the form of the Recovery Fund) and ECB support should benefit small caps. European banks are highly sensitive to the yield environment and should benefit from the expected rise in long-term yields. Earnings revisions and their relative valuations are supportive.

At the end of August, we re-established an **overweight position in emerging market equities** after having gone to neutral during the summer. This was a tactical move, triggered by oversold markets, since the fundamentals are not conclusive, in our view. However, the cyclical recovery we anticipate should benefit the emerging markets, that are a play on IT and no longer on commodity prices. Besides, the short-term economic outlook for Asia should improve after the Covid infection rate peaks. Finally, we cannot totally rule out a strong commitment of Chinese authorities to support growth if the news flow become too negative.



GOVERNMENT BONDS Underweight

Being underweight duration is a strategic position given the favourable economic outlook, the current low level of yields and the prospects of a normalisation of monetary policies (even if only gradually and cautiously). Nevertheless, we decided to reduce our short on US long-term yields in mid-September as inflation indicators peaked and signs of less buoyant growth momentum emerged.

We closed our long position in emerging market local currency debt during the summer as both the fundamentals and technicals became less supportive.

CREDIT Neutral

CURRENCIES € Neutral

COMMODITIES Overweight

At the end of August, we increased the overweight in commodities to add risk to the portfolio in line with our positive macroeconomic outlook. We will look for further entry opportunities. The energy and metals sectors are back in a bull trend in the wake of the sharp rise in natural gas prices. An uptrend in oil prices still has to be confirmed. We are long gold, but we trimmed our exposure early in September in a short-term risk consolidation. In the medium term, gold, which is a currency that cannot be debased by central banks, can be seen as a good hedge against inflation risk.

THEMATICS Overweight

We are building positions in various investment themes: Global environmental protection, the energy transition, artificial intelligence and US infrastructure. We introduced this last theme in June to benefit from President Biden's infrastructure spending plans. The news flow from Washington on the infrastructure bill became noisy in September given internal divisions among House Democrats.

This report was finalised on 30 September 2021

October 2021 - Design: Creative Services BNPP AM - P2110001

INVESTORS' corner

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