FOR PROFESSIONAL INVESTORS – 4 October 2018

ASSET ALLOCATION QUARTERLY

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

SO FAR SO GOOD BUT MARKETS UNDERESTIMATE RISKS

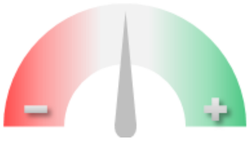
Asset allocation overview:

Equities

Rates & duration

Credit

Real estate



Commodities

FX (EUR vs. USD, GBP, JPY)

Christophe MOULIN
Head of Multi Asset, MAQS
christophe.p.moulin@bnpparibas.com
+33 1 58 97 23 61

Guillermo FELICES
Head of Research and Strategy, MAQS
guillermo.felices@bnpparibas.com
+44 20 7063 7196

Colin HARTE
Head of Research, MAQS
colin.harte@bnpparibas.com
+44 20 7063 7277

Maxime DAVID
Research Analyst, MAQS
maxime.h.david@bnpparibas.com
+44 20 7063 7270

SUMMARY:

- Asset returns were mixed in Q3 2018, with US equities in the lead, but other markets lagging, as investors digested the risks from emerging markets (EM), Italian politics and advancing trade protectionism.
- In September, however, equities and bond yields rose, suggesting that markets had become less preoccupied about these risks.
- We disagree with this assessment. We still see the risks associated with US-China trade tensions, Italian politics and US monetary policy normalisation as a force that will weigh on markets in Q4 and 2019.

ASSET ALLOCATION:

- We remain selectively long risky assets and underweight fixed income. But we have reduced overall risk and we are managing our positions more tactically. In particular, we have made these adjustments to our asset allocation over the past month:
- While we remain structurally underweight EMU bonds, we have taken advantage of yield volatility and first increased and then trimmed our underweight tactically, taking profits as German Bund yields rose.
- We closed our long Japanese equity exposure. This was an unhedged position, so the rally in equities was offset by losses from a weaker yen.
- Finally, since we have reduced risk, we have less of a need for hedges against negative global shocks, so we have closed our short EUR/JPY position.

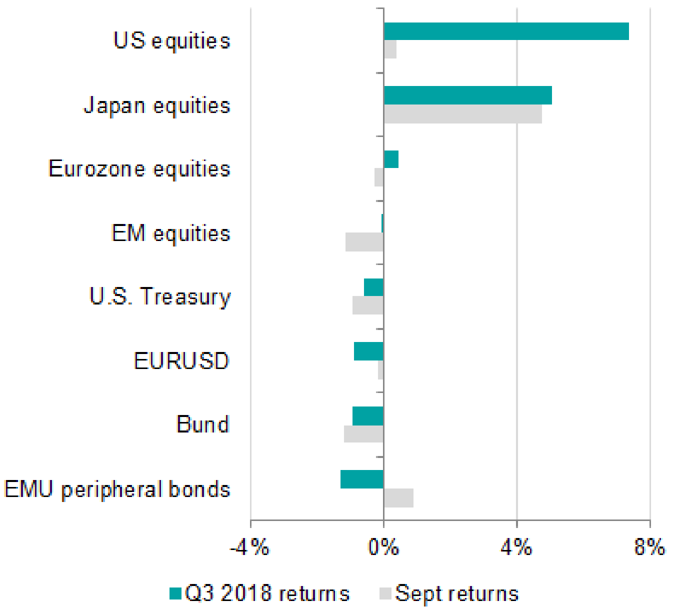
BNP PARIBAS
ASSET MANAGEMENT

The asset manager for a changing world

MARKET REVIEW: Q3 2018

As we usher in the last quarter of the year, it is time to review market moves in Q3 2018. The divergence between the US economy and the rest of the world continued with a strong US equity market and a more mixed performance in other regions. The S&P 500 index kept trending upwards and reached historical highs; it rose by more than 7% on the quarter. Other equity markets were more volatile and did not do as well. In Japan, equities started the quarter mixed before rallying in September, driven by a weaker Japanese yen (-2.7% vs. the US dollar), solid economic data and Shinzo Abe's re-election as leader of the Liberal Democratic Party, allowing him to pursue his expansionary economic policy as prime minister. Meanwhile, eurozone equity returns were flat.

Figure 1: US equities continued to outperform other markets thanks to robust economic growth



Source: Bloomberg (MSCI total return in local currencies), as of 01/10/2018

The US outperformance was fuelled by a strong company earnings season and robust economic growth, while data released in other markets was more mixed. Looking at inflation, US core inflation is now firmly above 2% year-on-year. Employment figures are at historically high levels and average hourly earnings growth is rising steadily, at +2.9% in August (the latest available number) and exceeding consensus estimates. This backdrop reassured the US Federal Reserve as it continued to raise the fed funds rate. It did so with a more hawkish tone, removing the word 'accommodative' from its policy statement. This stance underscores its intention to stabilise the US economy to avoid potentially undesirable inflationary pressures.

Emerging markets (EM) had a more difficult quarter. First, idiosyncratic issues put serious pressure on countries such as Turkey, Argentina and Venezuela. Although these pressures did not spill over significantly, they pushed investors to reassess their EM views, resulting in less risk appetite. The MSCI emerging market index continued on the downward trend that started at the end of January, although now with increased volatility.

Second, stronger US growth and a more hawkish Fed supported the US dollar, which usually hurts EM markets, notably when they hold significant debt denominated in USD. This also affected EM currencies and EM denominated assets such as local currency debt. Looking at the JPMorgan GBI EM local debt index, the currency component returned -6.5% in August. This improved in September with several EM central banks raising interest rates to defend their currencies, so that the index ended Q3 at -1.6%. Looking ahead, higher EM rates may be a drag on economic growth. In the last few days of September, it was notable that EM currencies held their ground even as the US dollar rallied against G10 currencies.

Another factor putting emerging markets under strain has been trade protectionism. Indeed, EM economies rely significantly on exports and any reversal in globalisation may herald lower profits from trade and a tougher economic backdrop. During the quarter, US President Trump imposed trade tariffs on a further USD 200 billion worth of Chinese goods and threatened to expand this to hit all exports from China. Such developments on international trade do not bode well for global growth, including the US, but so far, market participants appear to have spared the US market from any fallout from this threat.

European markets were also less flamboyant than that of the US, with the EuroSTOXX 600 index moving sideways over the quarter. Company earnings were not as strong and activity data continued to soften. Manufacturing PMIs have been falling since the beginning of the year, even though they are still in expansionary territory. By contrast, the US ISM manufacturing PMI reached 61.3 in August, its highest level since the 1980s. More importantly, political risk remained front and centre in Europe, with the Brexit negotiations still in gridlock after the Salzburg meeting and Italy proposing a budget that will worsen its deficit and is likely to exacerbate tensions with the European commission. As a result, spread volatility increased between 'periphery' and core EMU countries, especially between Italian BTPs and German Bunds.

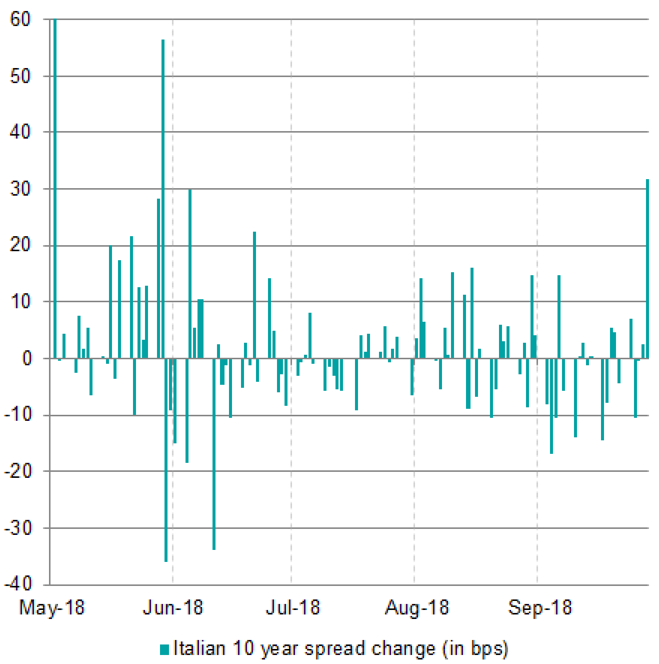
Looking at the commodity market, the picture is mixed. On the one hand, energy rebounded significantly, with the price of Brent crude oil breaking above USD 80 per barrel. This came as supply was tightened by the sanctions on Iran imposed by the US as well as continued difficulties in Venezuela. On the other hand, industrial metals dropped sharply as a result of softer Chinese growth and the trade tariffs. Copper lost about 5% over the quarter (and -15% since its peak in June). Silver and gold also underperformed in Q3.

In our view, financial markets have shown complacency towards mounting risks, especially in September when various equity indices rallied and bond yields rose. In other words, investors appeared to finally price in robust growth and policy normalisation. However, the salient risks have not gone away: the Sino-US tariff row remains; the Fed and other central banks appear determined to normalise policy further; and Italian political turmoil looked unlikely to abate.

RENEWED POLITICAL RISK IN EUROPE OVER ITALIAN SITUATION

The Italian government has agreed on a budget that involves a budget deficit of 2.4% of GDP, which fails the EU's deficit sustainability objective. This could result in Brussels opening an excessive deficit procedure against Italy if the Commission deems the budget unreasonable. Markets had believed that Finance Minister Giovanni Tria would target a deficit at 1.6%-1.7% of GDP, which would reduce the size of Italian debt relative to GDP by 0.1% (the debt currently stands at 130% of GDP). However, following pressure from Luigi Di Maio (Five Star) and Matteo Salvini (League), Tria agreed to a 2.4% deficit for 2019 and indicated the deficits would be similar for 2020 and 2021. This will allow for increased expenditure and further tax adjustments. Spreads on Italian debt, which had been narrowing, widened significantly in anticipation of the EU Commission rejecting the proposal. Italian budgetary concerns also negatively impacted European equities, notably the banking sector.

Figure 3: Italian budget plan surprised markets negatively



Source: Bloomberg, BNPP AM, as of 27/09/2018

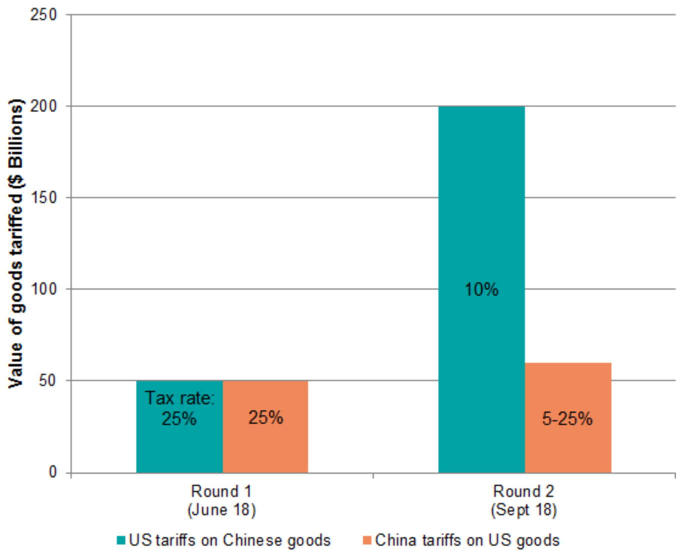
Whilst the reaction of Italian credit default swaps (CDS) has been more muted, the reaction of Italian bank stocks was more pronounced given the banks' above-average exposure to government debt versus the eurozone average. In aggregate, Italian banks are estimated to hold 12% of their assets in Italian sovereign debt compared to the 4% eurozone average. Any serious concerns over Italian sovereign debt could have major contagion effects in the Italian banking system. The interdependence of sovereign solvency and the eurozone banking system is still significant.

Another looming risk concerning Italy stems from potential credit rating downgrades. Italian debt is rated by S&P and by Moody's as BBB and Baa2, respectively. Both agencies are due to review this rating at the end of October. If either or both downgrade Italy by one notch, there would be further pressure on Italian yields, but this should be manageable. However, a downgrade by more than one notch could trigger a negative feedback loop, which would lead to Italy's debt dynamics becoming unsustainable. This could occur if the downgrade forced a significant portion of holders of Italian debt to divest as it drops to below their credit threshold. This would create a sudden halt in the supply of capital to Italy (similarly to Greece's and Portugal's experience), and Italy would require financial support. In the past, that support came from the ECB. Now this is less clear as quantitative easing (QE) comes to an end and as President Draghi has suggested that the capital key will not be changed as maturing debt held by the ECB is reinvested.

TRADE WAR PROGRESSIVELY ESCALATING, IN PARTICULAR US-CHINA TENSIONS

With President Trump in the White House, protectionism has returned in political discussions and resurfaced on investors' radar screens. Until the beginning of 2018, it had been more talk and threats rather than action. Since then, the US president has started to ramp up trade tariffs on many goods, imposing these on several countries. Trump wants to renegotiate trade deals with more favourable terms for the US and address the country's structural trade deficit. Tension has been escalating with China. The US wants better access to the growing Chinese consumer market and seeks to curb technology transfers. After imposing tariffs on USD 50 billion of Chinese goods, President Trump has implemented a second round, taxing an extra USD 200 billion of goods at 10% and threatening to raise this to 25% by next January. Moreover, Trump has signalled this could be expanded to all Chinese goods if no deal is struck. For each of these rounds of tariffs, China has retaliated by imposing a levy on US imports (Figure 2).

Figure 2: US tariffs and China retaliations have not stopped



Source: BNPP AM, as of 27/09/2018

However, China cannot match tariff rounds forever for the simple reason that fewer US goods are imported into China than the other way around. After the second US round, China withdrew from the negotiations. It will now have to resort to other tactics to counter these protectionist measures.

This has put China in a difficult position as it is already busy deleveraging its economy and trying to maintain steady growth. In the absence of an agreement with the US, China will have several options to address the situation. First, it can reinforce trade with other partners. To some extent, this is already the case under its Belt and Road Initiative which aims to build infrastructure so that Eurasian countries can be reached more easily. Second, the Chinese authorities have implemented new fiscal stimulus that is devised to sustain economic growth and as a consequence could also be used as a tool to dampen the adverse effects of greater protectionism.

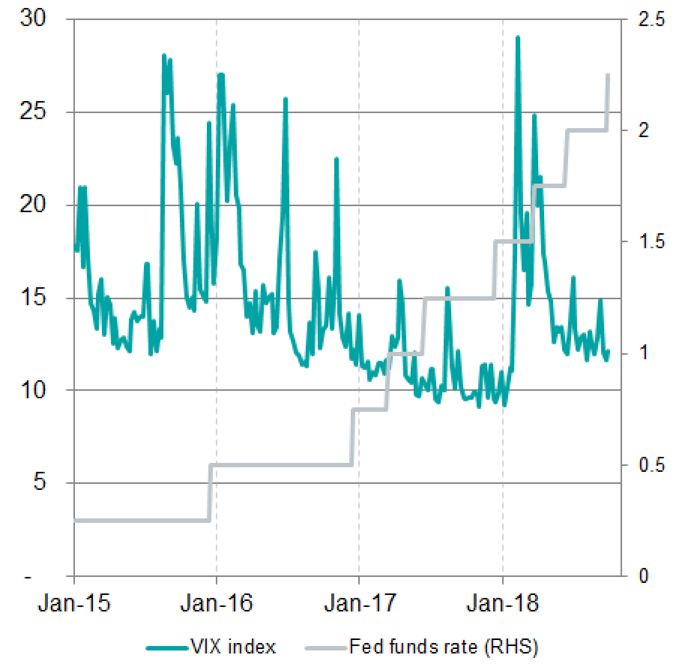
Looking at financial markets, Asian equities have been affected by the EM rout and protectionism has put extra pressure on Chinese equities. The Shanghai Shenzhen CSI 300 index has been falling throughout the year. It is now more than 20% below its January peak. Taking a step back, the US aggressive protectionist decisions may be more than just temporary coercive measures aimed at notching up concessions on trade deals. They could bring more structural changes in international trade relations as US-China tensions fail to ease, hurting global trade and growth. However, for the time being, market participants have been looking through these potential headwinds for the US (and global) economy.

GRADUAL MONETARY POLICY NORMALISATION SHOULD WEIGH ON RISK-ADJUSTED RETURNS

Last month, the Fed increased the fed fund rates for the third time this year, which makes it the seventh hike since 2016. The central bank remains positive on the economy, and removed the word "accommodative" from its September meeting statement. However, it is not slamming the brakes on the US economy yet: it is following a gradual cycle to normalise monetary policy. According to several Fed members, the central bank still favours prolonging the US economic expansion even if this means inflation rising to moderately above 2%. Indeed, the US economy is already buoyant with robust GDP growth, optimistic 'soft' data such as a high manufacturing ISM index suggesting strong business confidence. Unemployment is historically low. However, with a tight job market, wages could start creeping up as seen in the latest data on average hourly earnings growth. This could in turn lead to inflationary pressures.

Nevertheless, it is important to note that the Fed's message is becoming more nuanced as it progressively moves away from clear forward guidance. Moreover, the latest quarterly Summary of Economic Projections, where 2021 rate projections have now been added, shows policymakers have more diverging views. The mode of their rate forecasts slightly decreases (from 3.625% to 3.375%) between 2020 and 2021. This suggests that the Fed is starting to consider an economic slowdown or at least a stabilisation. When it comes to the potential impact of the trade tariffs on the US economy, the Fed does not appear to be concerned. Trade tariffs could add a temporary jump in inflation to the equation as the levies could cause import prices to increase.

Figure 3: US implied equity volatility is low despite higher interest rates



Source: Bloomberg, BNPP AM, as of 27/09/2018

The US financial market has so far turned a blind eye on all these potential risks and reasons for caution. Indeed, the S&P500 has been grinding higher and higher, reaching historical highs, while volatility has remained fairly low (Figure 3). It is difficult to see this can continue uninterrupted as major central banks gradually normalise their monetary policies. Indeed, with less monetary support, markets will likely refocus on the fundamental drivers. As a result, asset returns should be less correlated and Sharpe ratios should decrease as volatility rises progressively and absolute returns fall.

The market correction at the beginning of the year was caused in part by inflation fears. Investors are more complacent this time as they appear to have forgotten this risk. If inflation starts to surprise strongly to the upside, US assets could be exposed to a new correction. There is also a fair amount of complacency regarding the trade tariffs. Should the levy increase to 25% in January 2019 on the USD 200 billion of Chinese goods, or the tariffs be extended to all Chinese imports, market participants could rapidly reassess the impact on the US economy. As a result, we view US equities as vulnerable and prefer to remain cautious.

ASSET ALLOCATION

Our long-held view – being selectively long equities and underweight fixed income – remains in place. However, we have reduced our risk exposure over Q3 2018, taking a more tactical approach.

Reducing risk as we are less complacent on various political and macroeconomic threats

We reduced our EM debt exposure and cut our long EM versus US equities position. EM assets have been hit by three key developments. First, growth in China has slowed down by more than markets expected and China's policy response has not been overwhelming. Second, China-US trade tensions have been escalating with a fresh round of tariffs. Third, the US dollar appreciated across the board, boosted by Fed tightening and US fiscal expansion. A lot of the bad news has already been priced into EM local debt including EM currency losses. We think there is long-term value in the EM debt position as the growth prospects remain solid in many emerging markets But there is still uncertainty about the near-term evolution of US-China relations and the US dollar, both of which could deteriorate further. Therefore, we have chosen to reduce our position partially. Similarly for EM equities, we do not see near-term circuit breakers to kick-start EM optimism such as an aggressive policy response in China, a pause in Fed tightening, a weaker US dollar or a progress in China-US relations.

When it comes to equities, we closed our long position in Japanese equities: We have been long Japanese equities (FX unhedged) since the beginning of the year based on our view that company earnings growth is likely to be stronger than the consensus estimates, helped by companies' exposure to the global cycle. Japanese equities rallied at the end of Q3, partly helped by a weaker yen, but global growth is now slower and less synchronised. We exited the position after reassessing our risk exposure in equities.

We closed our long US bank stocks. US bank shares have risen slightly since we entered this trade in early June. The rationale was that US banks would benefit from the maturing US cycle and gradually higher interest rates which should boost their interest income. We are worried that US equities as a whole could see a leg-down after a long rally driven by the information technology (IT) sector. A possible trigger could be upside inflation surprises in the US. Even if banks are likely to outperform the broader index, they are likely to suffer as markets price in higher US rates.

Hedging accordingly

On currencies, we were short EUR versus the JPY and USD. The short euro side reflects our cautious stance on resurfacing political risks in Europe, especially over the Italian budget and Brexit. The long leg was split between JPY and USD, two currencies that typically do well when market sentiment shifts to risk-off. As we reduced our risk over the quarter, we closed the JPY part. We are now short EUR versus USD. Given our view that markets are complacent about US inflation surprises, the USD may benefit if there is a shock to risky assets from higher US rates. September's rate rise did indeed benefit the USD.

Capturing market asymmetries

We opened a relative value trade: short US IT sector versus US equities. This reflects our bearish view on the sector after it rallied disproportionately compared to the broader US equity market. Earnings have been strong, but there are doubts about whether the current pace of earnings growth can be sustained. The most visible correction triggers are: (i) regulatory risks (domestically and abroad) faced by US IT giants, (ii) earnings misses, and (iii) tighter-than-expected monetary policy by the Fed. Our dynamic technical analysis also suggests that the outperformance of the IT sector relative to the overall index is vulnerable to a correction in the near term.

Regarding other market asymmetries, we are maintaining our underweight in high-yield credit as we believe the historically expensive valuations reflect investor complacency toward riskier assets. This could expose the asset class to a sudden correction, should market participants reassess the risk. More structurally, high-yield credit has benefited from loose monetary policies over the last few years as central banks loaded up their balance sheets with bonds and credit, artificially compressing spreads. As this exogenous support falters, high-yield credit spreads should progressively widen in line with their level of risk. Moreover, if inflation pressures materialise, the stance of central banks could rapidly turn more restrictive with higher rates hurting leveraged companies to the point where defaults would rise and trigger a high-yield sell-off.

Tactical approach on renewed European uncertainties

In EMU, we have been managing our structural underweight in government bonds tactically. We are maintaining the position, but are adding a tactical overlay to it to benefit from more volatile rates. German Bunds are sensitive to European political risk and act as a safe asset when investors worry about tensions. When Italian risk reappears, Italian credit spreads widen as BTPs sell off and German Bunds rally. After August's rally took spreads to 0.30%, we increased our underweight. We believe that most of the bad news was priced in at this level. About a month later, we took partial profits as German 10-year yields rose to the 0.50% area. We also believed that Italian risk would put renewed pressure on Bunds. We continue to monitor European bonds for new tactical opportunities.

STRATEGIC OVERVIEW OF KEY POSITION CHANGES IN Q3 2018

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

SEPTEMBER:

LONG JAPANESE EQUITIES — CLOSED — 26/09/18

- After equities rallied in September, partly on the back of a weaker JPY, we exited the position after we reassessed our risk exposure to equities amid slower and less synchronised global growth.

SHORT EUR VERSUS JPY — CLOSED — 19/09/18

- This position was implemented as a hedge against a risk-off environment. We closed it after our equity exposure was reduced. Moreover, our technical dynamic analysis is flagging the risk of a higher EUR/JPY.

SHORT EMU DURATION — REDUCED — 19/09/18

- We took profits on August's tactical increase as Bund yields rallied. We remain structurally underweight.

LONG EM EQUITIES VERSUS US EQUITIES — CLOSED — 05/09/18

- EM equities are vulnerable in the absence of near-term circuit breakers (e.g., an aggressive policy response in China, a pause in Fed tightening, a weaker USD or progress in China-US trade relations). Our dynamic technical analysis is also signalling that the correction in EM equities could accelerate and that this relative value trade may not stabilise in the near term.

SHORT US IT SECTOR VERSUS US EQUITIES — OPENED — 05/09/18

- The US IT sector has decoupled from other US equity sectors and its rally is now starting to look overdone. Our dynamic technical analysis is flagging the risk of a correction relative to the US index in the near term.

AUGUST:

LONG US BANK EQUITY — CLOSED — 29/08/18

- We took profits after a roughly 2% rally in the index. We see risks to US equities generally from an overextended rally in the IT sector and from potentially higher inflation and a more hawkish Fed.

LONG EM LOCAL DEBT — REDUCED — 29/08/18

- EM local currency debt offers carry and portfolio diversification, but still faces uncertainty over the evolution of Sino-US relations and the risk of a stronger USD, both of which would be negative for EM assets. We therefore reduced our long exposure.

SHORT EUR VERSUS JPY (50%) AND USD (50%) — OPENED — 29/08/18

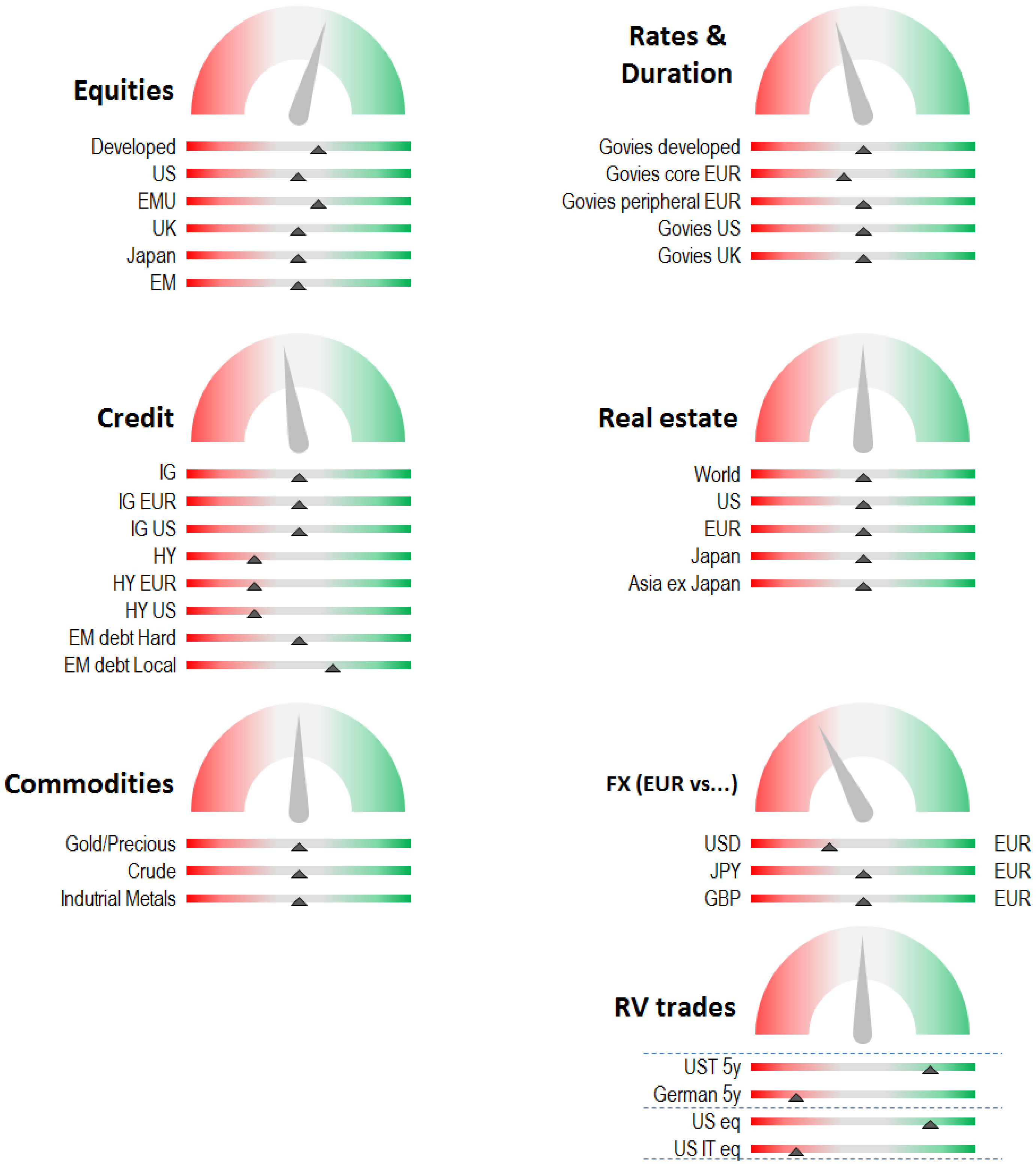
- This position is a hedge against the risks of a sharply negative shock, for example, one associated with concerns over global growth. Both the USD and JPY should act as safe havens in such an environment.

SHORT EMU GOVERNMENT BONDS — INCREASED — 20/08/18

- German 10-year yields bounced off the 0.30% level at least four times in the last year. At that level, yields are historically low and they price in a lot of negative news (including weaker growth and concerns over Italian politics).

JULY: *(NO CHANGE)*

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.

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