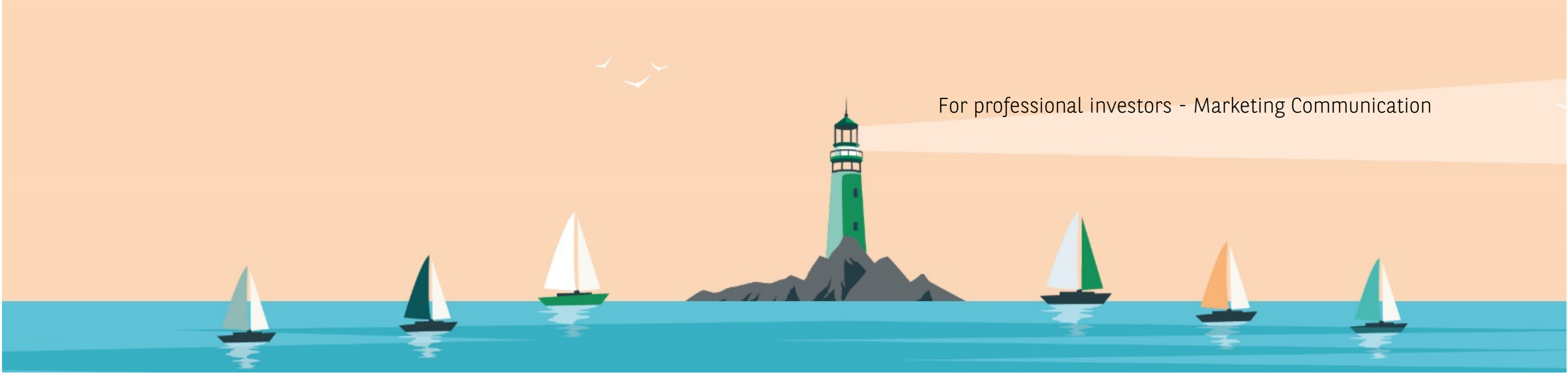

For professional investors - Marketing Communication

Asset Allocation Monthly March 2022

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Strong inflation currents

- Geopolitical tensions between Russia and Ukraine have continued to escalate meaningfully, prompting record falls in local assets, risk-off sentiment in global markets, heightened volatility and soaring commodity prices. European risk assets have been particularly hard hit. The situation remains highly unpredictable.
- We have taken two principal actions in our multi-asset portfolios over this period. First, on 23 February, we reduced risk-taking/tracking errors by halving our tactical risk positions in European and emerging market equities. We are 'keeping our powder dry' and could reduce equity exposures further should the situation deteriorate beyond what is currently priced in.
- We are not yet ready to buy broader equity risk, as further escalation of the conflict will impact earnings considerably, though any de-escalation would likely see a sharp rebound in prices. The longer the conflict continues, the greater the downside risk to growth and earnings.
- Second, on 2 March we increased our short duration position, seeking to capture attractive valuations given that our cautious fundamental view on core bonds is unaltered.
- Our main equity exposure is concentrated in Japan. We remain long commodities and long yen vs. the euro as a risk-off hedge.

BNP PARIBAS ASSET MANAGEMENT

The sustainable investor for a changing world

Portfolio perspectives

- We have taken two principal actions in BNPP AM multi-asset portfolios over recent weeks. First, on 23 February, we took advantage of the mini-rally in equities on the prospect of 'soft global sanctions' to protect portfolios from further geopolitical shocks. We halved our tactical risk positions towards European and emerging equities and moved into cash, lowering both regions to neutral on our risk-adjusted scorecard as a result. This move reduced risk-taking/tracking errors to the cusp of neutrality (or the middle quintile of respective tracking error ranges) and greater caution (or the second-lowest quintile of tracking error ranges). We are 'keeping our powder dry' in terms of reducing equity exposures further from a fortnight ago, should the situation deteriorate beyond what is currently priced in.

- Second, on 2 March, we deepened our short US Treasury duration position, seeking to capture attractive valuations given that our cautious fundamental perspective on core bonds is unaltered. The conflict is expected to add to already strong domestic inflation pressures. Longer-maturity bond yields appear much too low and the risk-reward is asymmetric. Offsetting the impact of higher inflation on nominal yields, geopolitical risks have pushed real rates lower. European forward real rates (GDP-weighted) are 350 basis points lower than in 2011 when oil prices were last at these levels. Forward real US rates are 125bp lower than levels associated with Secular Stagnation, which was already a fairly downbeat assessment of the global economy.

- Longer term, the role of government bonds as a source of diversification for multi-asset portfolios is also questionable. First, yields at or around 50-year lows lock in similarly low prospective returns and offer little by way of a protective buffer. Second, all the ingredients for higher bond yields are now present: Acute labour shortages, large scale stimulus rolling back faster than expected, globalisation in reverse and an oil shock overlaid upon a larger and longer-lasting inflation shock from Covid-19 than anticipated.

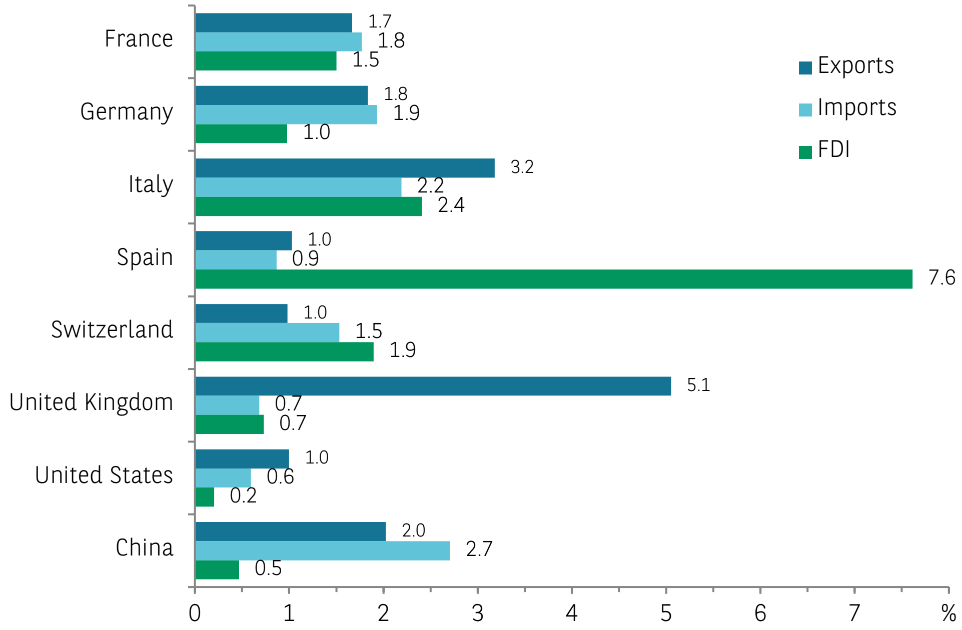
- It is not clear that it is time to buy broader equity risk, as any further escalation of the conflict will impact earnings considerably, with Europe hardest hit. Alternatively, any de-escalation would likely see sharp price recoveries given current positioning. The longer the conflict continues, the greater the downside growth and earnings risk.

- BNPP AM multi-asset portfolios remain long commodities (in funds where this is permitted), with a trailing stop of 3% from the latest high, and long yen vs. the euro as a risk-off hedge.

Transmission channels

The evolving situation in the Ukraine poses a risk to demand via souring consumer and investor sentiment, and to corporate profits via higher costs for key Russian exports (oil, natural gas, metals, agricultural crops, fertilizers). The threat to corporate revenues is rather less as sales to Russia for the companies making up the MSCI All Country World Index (ACWI) are small. In aggregate, Russia accounts for just 1.2% of ACWI sales, and the largest share for any single country index is just 3.1% (Austria). These low figures are mirrored in the trade and foreign direct investment (FDI) exposures of major countries to Russia (see Exhibit 1).

Exhibit 1: Russia share of exports, imports and foreign direct investment (FDI)



Data as at 8 March 2022. Sources: Haver, BNP Paribas Asset Management.

One of the lessons of the eurozone financial crisis was that even if a country's GDP was comparatively small, the impact on financial markets of a crisis could be substantial through the exposure of the banking sector. In this case, we do not see a significant risk of contagion as bank exposure to Russian assets is also low, at less than than 1% of banking assets for any country in Europe bar Austria (3.3%).

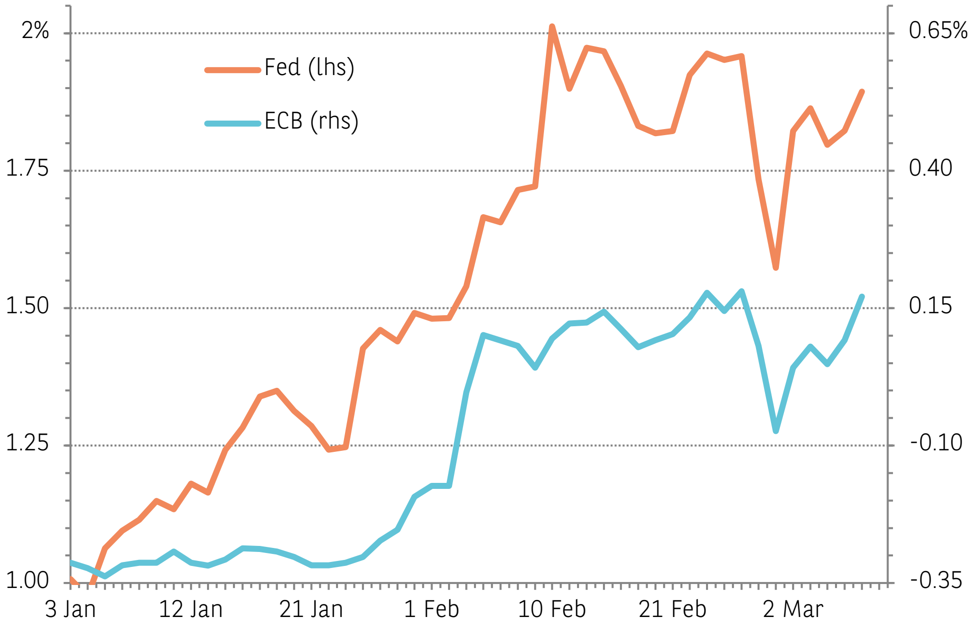
History tells us that most geopolitical crises have only a transitory affect on sentiment. Consumer and investor behaviour is driven more by macroeconomic factors than political ones, unless the political event is significant enough to affect macroeconomic variables. That is potentially the case here, however; a sustained increase in energy prices will drive inflation higher and lead to a slowdown in economic growth. An ECB study from 2010 concluded that a 10% sustained increase in oil prices would lower real eurozone GDP by 0.24% after three years. Oil prices have so far increased by 50% from end-2021 levels; this jump is unlikely to be sustained even if prices do settle at a higher level than before. There was a similar increase in oil prices in 2011, which slowed growth but did not result in a recession. The risk of stagflation has certainly increased, but fortunately most of the world's large economies were forecast to see above-trend growth this year and next, so there is a cushion to absorb the drag.

The short-term implications for financial markets are rather more pessimistic. Markets have thus far declined further than an objective estimate of the economic impacts would suggest is warranted. This reflects worries about further sanctions and/or restrictions on Russian oil and natural gas exports. Until markets assess that this risk has fallen, we can expect ongoing volatility and possibly further declines in risk assets.

Sustained trends

While Covid headlines have been replaced by the Ukraine, the deeper, more persistent factor affecting asset prices remains the anticipated tightening in monetary policy either through higher policy rates or quantitative tightening (QT, the reversal of previous quantitative easing purchases). Although the Ukraine crisis has made central bankers more cautious, they appear unlikely to meaningfully change course. While the threat to growth would suggest that pausing rate hikes or quantitative tightening is warranted, rising inflation expectations call for the opposite. Consequently, markets have changed very little their forecast for the level of policy rates in one year (see Exhibit 2).

Exhibit 2: One-year overnight index swap (OIS) forward rates



Data as at 25 February 2022. Sources: Bloomberg, BNP Paribas Asset Management.

Before the Ukraine shock stalled the sell-off, the US 10-year Treasury note yield had reached 2.04%, its highest since summer 2019. The increase had been driven primarily by rising real yields as the prospect of a higher fed funds rate has kept inflation expectations in check. We anticipate that the pre-Ukraine pattern for real yields will eventually re-assert itself, with yields rising again. While five year-five year real yields had at one point this year increased almost 100bp above the lows of 2020, even then they were still 50bp below the Secular Stagnation 'New Normal' of the decade prior to the pandemic. We believe the medium-term growth and inflation outlook today is superior to that period and hence real yields should be higher. As an unwinding Fed balance sheet removes the pressure on real yields, they should rise towards pre-pandemic levels. Consequently, we remain underweight US duration.

Equity risk

The fourth-quarter earnings season was comforting for equity investors. Earnings growth was very strong for companies in both the US and European indices (38% and 45% year-on-year, respectively). These results fed through to rising earnings estimates, particularly for Europe, where the 2022 earnings per share forecast rose more than for any other major region.

This momentum has already started to reverse and will likely accelerate as analysts incorporate the new, more downbeat growth outlook into the forecasts. So far at least, the impact has not been large, partly because downgrades for consumer discretionary stocks, where one anticipates higher inflation crimping demand, are being offset by higher forecasts for commodity sectors (see Exhibit 3).

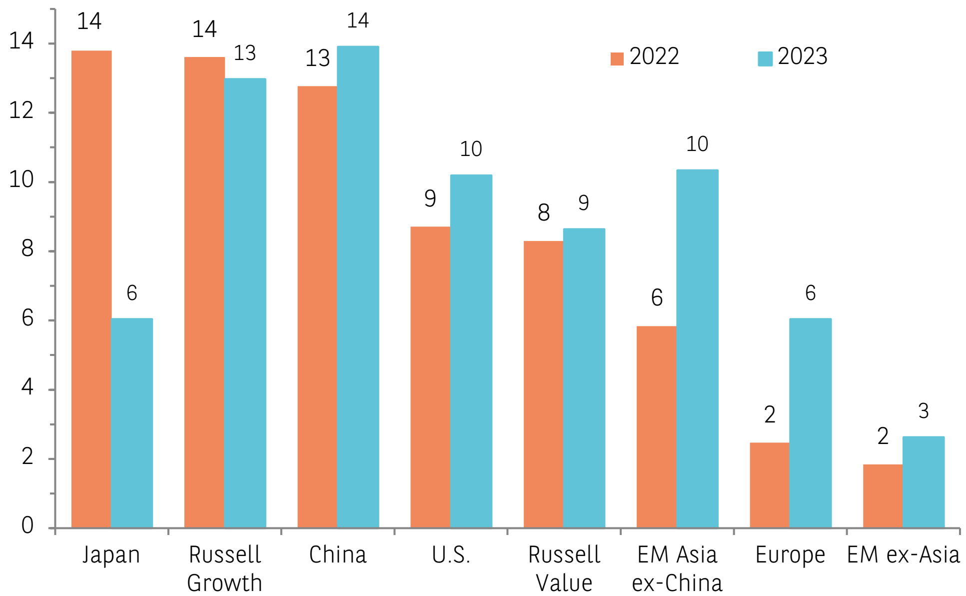
Exhibit 3: Change in consensus EPS estimate for 2022 since 18 February 2022
Local currency terms

	ACWI	US	Europe	Japan	EM Asia	LatAm	EMEA
Sector	**0.3**	**0.3**	**0.3**	**1.1**	**0.4**	**2.1**	**0.3**
Energy	**4.3**	6.8	2.4	6.8	2.1	5.4	4.0
Materials	**1.2**	1.9	0.9	1.3	0.4	3.5	0.6
Industrials	**0.7**	-0.1	-0.4	4.6	1.4	0.8	3.7
Consumer Discretionary	**-0.5**	-0.8	1.1	-0.5	-2.6	0.5	3.3
Consumer Staples	**0.0**	0.2	-0.3	-0.9	-0.1	0.4	-0.0
Health Care	**-0.3**	-0.3	-0.2	0.3	-0.6	-1.6	-0.6
Financials	**-0.1**	-0.1	-0.2	0.0	-0.0	0.8	-0.0
Information Technology	**0.2**	0.2	-0.2	0.7	0.3	0.2	0.0
Communication Services	**-0.6**	-0.4	-0.6	-1.0	0.3	0.2	-0.1
Utilities	**-0.2**	0.0	0.0	0.0	-0.3	-2.3	-2.2
Real Estate	**-1.1**	-0.4	-0.8	-0.3	-2.6		1.9

Data as at 8 March 2022. Sources: FactSet, BNP Paribas Asset Management.

Similar to the situation with the economic growth forecasts, there is room for earnings to fall while still generating positive growth for this year and next. Average earnings growth forecasts remain good, with 14% year-on-year expected for Japan, 9% for the US, 7% for emerging markets; Europe looks better next year (see Exhibit 4). Japanese corporates are also notable for their high cash levels (valuable in a rising interest-rate environment), attractive valuations (even for Japan), local policy support (both top-down and bottom-up), and benefit from their distance from the Ukraine conflict. Emerging market returns may diverge between commodity-exporting EMEA and Latin America relative to commodity-importing Asia. Ongoing regulatory changes in China also remain a concern.

Exhibit 4: Consensus year-on-year EPS growth forecasts



Data as at 4 March 2022. Sources: FactSet, BNP Paribas Asset Management.

The declines in equities so far this year have primarily been driven by normalising valuations, first driven by higher discount rates and then by geopolitics. Yet, with the exception of Japan and the UK, equities are not particularly cheap. On a forward price/earnings ratio basis, current multiples are arguably only temporarily low as earnings expectations have not yet fallen enough. We will need to have both a stabilisation of the geopolitical situation and a clearer assessment of the earnings outlook before we can determine where valuations are truly attractive.

Asset class views

	Strongly Dislike	Dislike	Neutral	Favour	Strongly Favour
Risk appetite*			X		
Asset allocation		Government bonds	Credit Real Estate Cash	Equities Commodities	
Equity regions			US Europe GEM	Japan	
Equity style/size			EU large cap EU small cap US large cap US small cap		
Sovereign bonds		US Europe	Japan EM local Australia UK Linkers		
Credit			EU IG EU HY US IG US HY EMD		
Commodities			Precious metals	Energy Base metals	
FX			USD, AUD, GBP, EUR EM FX	JPY	

* Risk appetite/return to risk - Data as at 2 March 2022. The views reflect those of the Investment Committee of the Multi-Asset team at MAQS. Other specific/tactical trades may be implemented in addition.

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