For professional investors - Marketing Communication - September 2021

ASSET ALLOCATION MONTHLY - SEPTEMBER 2021

The Delta dilemma

During August, investor edginess increased. Financial markets partly reflected this with a decline in equities and commodities, a fall in long-term bond yields, and a rise in the US dollar. Expectations about the US Federal Reserve's monetary policy partly explain these movements – and indeed their subsequent reversal – during the last week of the month, when US indices hit new all-time highs. Technical indicators also played a part in the rebound in major equity indices in late August. In addition, the Chinese authorities' decision to tighten regulations in sectors including technology, real estate, education, gaming and semiconductors unnerved investors and weighed on emerging Asian equities.

The primary source of concern, though, was the newest wave of the pandemic, which hit regions that had largely escaped previous waves, as well as countries that had thought themselves protected by vaccines. While research shows that vaccinations weaken the link between the number of new cases and hospitalisations in intensive care units, the greater contagiousness of the Delta variant means that achieving herd immunity will be harder.

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Head of multi-asset

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Chief market strategist

BNP PARIBAS
ASSET MANAGEMENT

The sustainable investor for a changing world

KEY MARKET DRIVERS

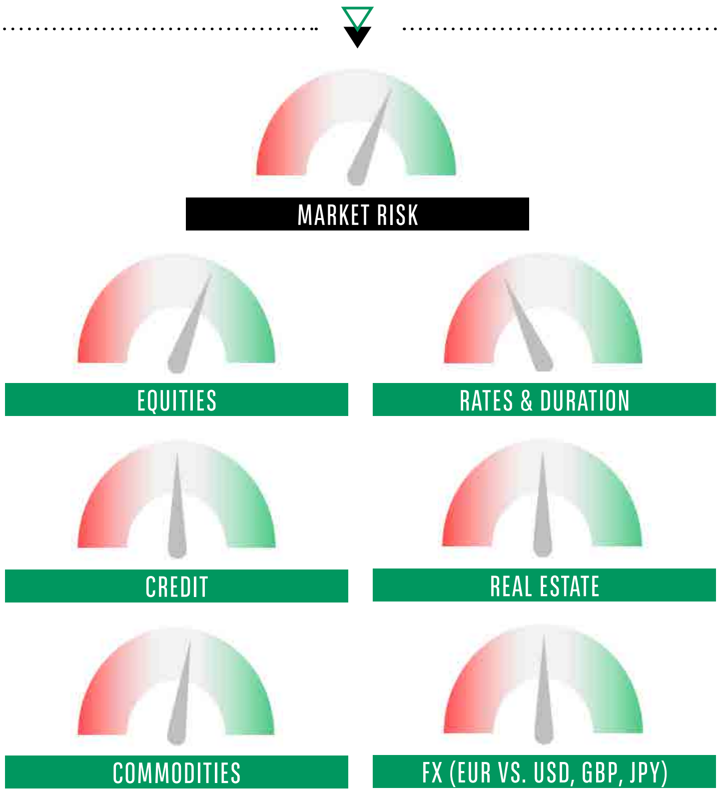
- The spike in the Covid infections over the summer has raised fears of a slowdown in growth.
- The global economy should nonetheless be able to overcome this obstacle. We anticipate the fall in demand will only be temporary.

VIEWS & ASSET ALLOCATION

- In the short term, geopolitical tensions and the transition to a less dovish US monetary policy could cause market jitters. Medium term, a number of fundamental factors should support equities.

RISK UTILISATION*

CORE ASSET CLASS VIEWS**

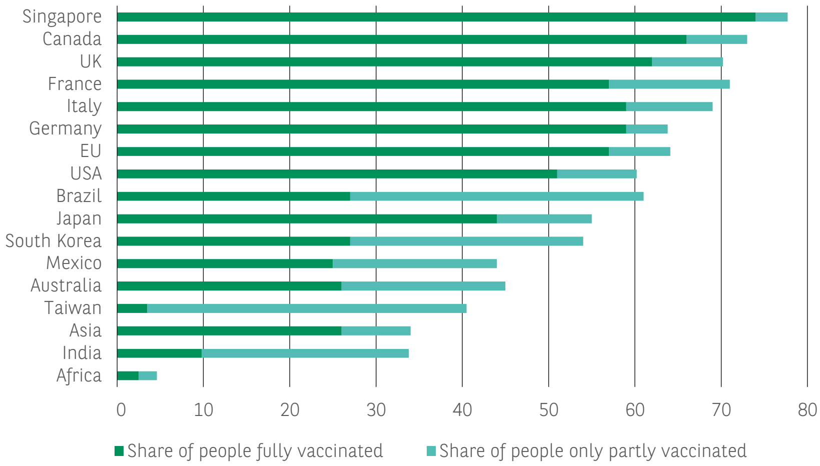


* Risk utilisation/active risk is a measure of the tracking error (as a percentage of maximum tracking error) of an unconstrained theoretical portfolio, derived from core asset class views and from additional specific/tactical trades. **The core asset class views dashboard reflects the key views of the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

Return to normal life delayed…

The race between the virus and the vaccine is not over and the Delta variant is delaying a return to normal. Governments' reactions are ranging from strict lockdowns in countries that have opted for a 'zero Covid' strategy or whose health care systems are swamped, to incentives to accelerate vaccination via more or less coercive solutions. In its latest update to the World Economic Outlook, the International Monetary Fund (IMF) identified access to vaccines as the 'principal fault line' between countries that can look forward to a further normalisation of activity and those that will still face resurgent infections and rising Covid death tolls.

Exhibit 1: Share of people vaccinated against Covid (in %) - Uneven

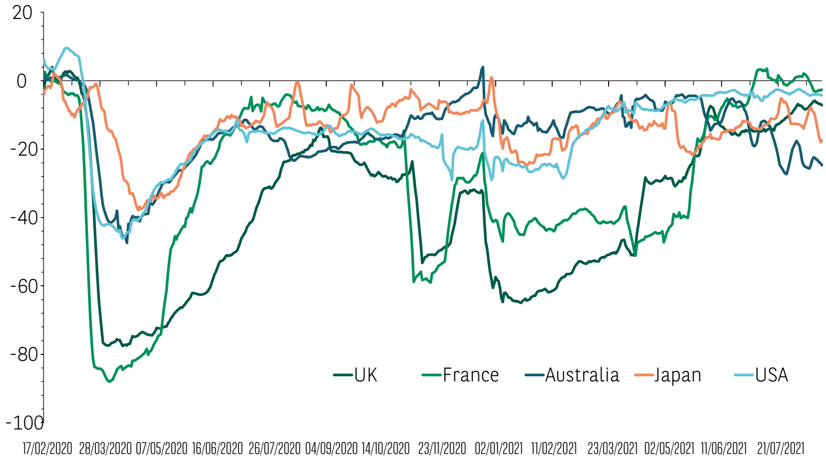


Data as at 20 August 2021. Sources: Our world in data, BNP Paribas Asset Management.

Delta is also likely to amplify the gap between these two groups of countries, not least because, with information showing that vaccines are less effective against contagion after a few months, some countries are advocating a third Covid vaccine dose for certain population categories. The World Health Organization (WHO) has opposed this approach at a time when access to vaccines remains very difficult in low income developing countries.

Investors are concerned about the risks to global growth posed by the newest outbreak, to say nothing of the risk of new vaccine-resistant Covid variants appearing. Pandemic risk justifies the continuation of restrictive measures, particularly on travel, in countries where the proportion of the population vaccinated is still low. Even in the absence of significant new restrictions, the health situation may ultimately weigh on business and household confidence and thus on activity. The longer the epidemic stays with us, the greater the negative effects on production (stress in supply chains, potential squeeze on margins, elevated prices), and the longer services consumption stays low.

Exhibit 2: Google mobility trends - Retail and recreation (% change relative to the period before the pandemic) - No global collapse during summer



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

… but not cancelled

GDP rebounded more vigourously than expected in the eurozone (+2.0% from the previous quarter, or 8.2% annualised) as economies reopened. Business surveys released at the end of July were very strong. The eurozone's composite Purchasing Manager Index (PMI), which reflects the views of the manufacturing and services sectors, fell from 60.2 in July (a 15-year high) to 59.5 in August (preliminary estimate published on 23 August), a modest decline that still leaves a very high two-month average.

First estimates of Q2 GDP confirmed that US growth is still solid (6.5% QoQ annualised), with domestic demand now back to its pre-pandemic trend, though still fell short of economists' expectations. After fearing economic overheating and accelerating inflation earlier this year, investors' expectations have pivoted to assuming that growth in the US economy will peak more quickly and then subsequently slow.

The main components of domestic demand, business investment and consumption, however, are not inherently weak. After the direct aid they received in the Spring, households still have high savings and their incomes should benefit from stronger employment. Even though private spending is already above the pre-pandemic level (+3.1% from end 2019), consumption in services has not rebounded by as much; it currently accounts for about 60% of the total compared to 65% in normal times. Services hard hit by Covid (airlines, package tours, leisure) have yet to fully recover. A reconfiguration of consumption is expected in the coming quarters.

The outlook for business investment is encouraging: Companies face strong demand and report hiring difficulties; investment intentions remain high. Consequently, US growth should navigate the recovery speed bump rather than experience a sudden halt.

The other leading driver of the global recovery, China, has seen economic indicators disappoint recently. Bottlenecks delaying the production of manufactured goods (such as automobiles) were beginning to show signs of normalisation, but new Covid restrictions could prolong supply shortages and drag on the recovery in consumption. With GDP growth momentum easing, Beijing believed the country's persistent lopsided recovery justified a cut in key rates in July. At a time when authorities have tightened regulation in many sectors, further monetary easing remains possible if the slowdown turns out to be deeper. The government continues to try and balance its desire to reduce debt levels in the economy and pursue structural reforms with the need to maintain strong growth rates.

FIXED INCOME: CHANGING TONE AT THE FED

Since the June meeting of the Federal Open Market Committee (FOMC), several comments from members have confirmed investors' intuition that flexible average inflation targeting was not going to result in the Fed tolerating, or even seeking, a long period of well-above-target inflation. Nearly one million jobs were created in June and July and the Fed is not far from considering that the 'substantial progress' needed to begin tapering its quantitative easing (QE) has been made. The impending tapering announcement was the notable feature of the minutes of the late July FOMC meeting.

In addition, Vice Chairman Richard Clarida indicated in early August that recent economic developments and the inflation outlook suggest that conditions for a rate hike could be in place by the end of 2022. These various comments suggest that asset purchases (currently USD 120 billion a month) would begin to be reduced in late 2021 to stop in the autumn of 2022, paving the way for a first rate hike in early 2023. The length and the magnitude of the next rate hike cycle could be the next source of uncertainty for investors.

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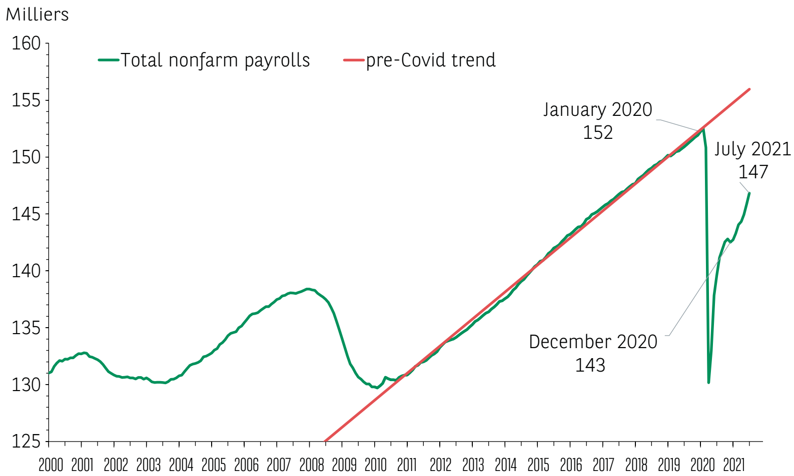
Exhibit 3: US Total nonfarm payrolls (in millions)

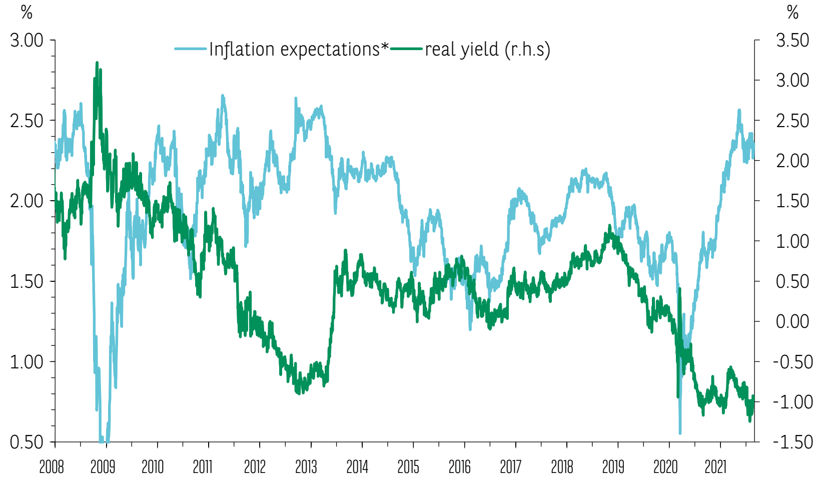


Data as at 6 August 2021. Sources: Bureau of Labor Statistics, BNP Paribas Asset Management.

Even if this timing is delayed by the latest outbreak of Covid-19, particularly in southern states where vaccination rates are still low, the shift towards less accommodative US monetary policy seems inevitable.

A rise in nominal long-term yields could therefore occur earlier than the market expects. Critical to the impact this has on the market will be the relative changes in inflation expectations and real yields. Should the Fed surprise by adopting a more hawkish-than-expected stance, it could result in a sharp rise in real yields.

Exhibit 4: US 10-year inflation expectations and real yields



*10-year Treasury Breakeven inflation rate
Data as at 26 August 2021. Sources: Bloomberg, BNP Paribas Asset Management.

As for inflation, changes in consumer price indices were in line with expectations in July, but remained high. The prices of the components that have contributed most to the acceleration in inflation since the beginning of the year (leisure, transport, hospitality and restaurants) are normalising. But inflation rates for other components (shelter costs) are starting to trend upwards. We remain convinced that the environment argues for moderate inflation over the medium term, but in the coming months, bond investors will remain sensitive to potentially erratic changes in producer and consumer price indices.

The reflation scenario, which arose in November 2020 but then waned from April, may take time to return to the fore. Indeed, the rise of the 10-year T-note yield from around 0.90% at the end of 2020 to 1.75% at the end of March reflected several factors, including the prospects of massive fiscal stimulus and the assumption that the Fed would keep monetary policy very loose despite accelerating growth and inflation. The anticipation of such a supportive policy mix explains the steepening of the yield curve during that phase.

While we believe the gradual reduction of risk in our portfolios over the past few weeks is warranted, we do not believe it is appropriate to remove all the fixed income and equity positions we initiated to trade the reflation theme. We maintain our short duration position in government bonds (US and eurozone) and, as part of our overweight of developed equities, we favour US value stocks. However, we do not think it would be appropriate to sell duration further as this positioning (about -2.5 years of duration) is already the main contributor to the risk utilisation deviation in our active asset allocation.

WHAT'S THE SCENARIO FOR EQUITIES?

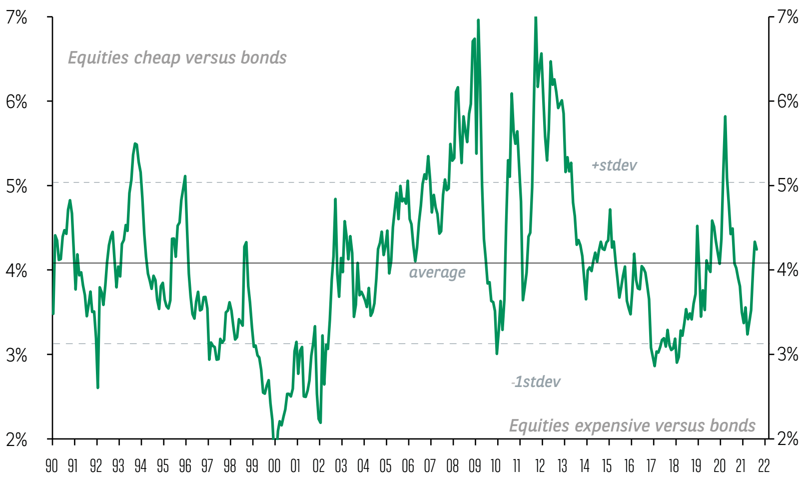
While global economic growth may have peaked in the Spring, the subsequent slowdown, which could be aggravated in Q3 by the Delta surge, should not threaten the overall recovery. Demand for goods remains strong and services consumption is set to accelerate as economies re-open.

Changes in GDP since Q2 2020 reflect the path of the pandemic: Collapse during the great lockdown, technical recovery (facilitated by supportive policies) due to pent-up demand, rebalancing activity towards services with the re-opening of economies allowed by vaccination.

Since the end of the first lockdown, company earnings have consistently (and by a wide margin) exceeded expectations, contributing to a surge in equities. Given the economic environment expected for the coming months, the earnings outlook remains favourable in the medium term even if expectations for the upcoming quarter may be overly optimistic. The earnings support is crucial and should allow equity markets to continue to rise despite high valuations for some indices. The impressive stock market performances since the trough in March 2020 and the new records being set by the indices are not in themselves destabilising factors.

Furthermore, the S&P 500 risk premium shows that US equities remain attractive relative to US government bonds: the yield on the 10-year T-note came in at about 1.30% while the 'combined yield' (dividend and share buybacks) for equities came out at 2.50% (at the end of August).

Exhibit 5: S&P500 equity risk premium



Data as at 23 August 2021. Sources: Macro Research Team, BNP Paribas Asset Management.

A continued rise in equities implicitly assumes that the gain in long-term yields will remain limited and orderely, as central banks are keen to avoid a repeat of the 'taper tantrum' of the spring of 2013, when the US 10-year T-note yield rose from 1.80% to 2.80% in four months. Indeed, the key driver of equity multiples is the discount rate, i.e. the real yield. The current real yield level is low (see exhibit 4) and any sharp rise could lead to a swift de-rating of equities.

"The impressive stock market performances since the trough in March 2020 and the new all-time highs are not in themselves destabilising factors."

MARKET DYNAMICS INPUTS

Our proprietary market temperature indicator calls for caution in the short term. It turned red in mid-August and remains there. Short-term investor optimism remains high, while vulnerabilities in terms of positioning remain, with weak participation, low volumes and a lack of buying strength. Besides, the rebounds in equities that took place in July and in August did so after modest declines.

Over the last four months, global equities experienced four 'mini' sell-offs that were followed by market rallies. The lack of market capitulation prevents the index from building solid momentum. Besides, the VIX index (implied volatility) and the VVIX (VIX volatility) are far from reaching new lows despite the new all-time high posted by the S&P 500 on 25 August. Such a divergence is generally seen as a warning signal.

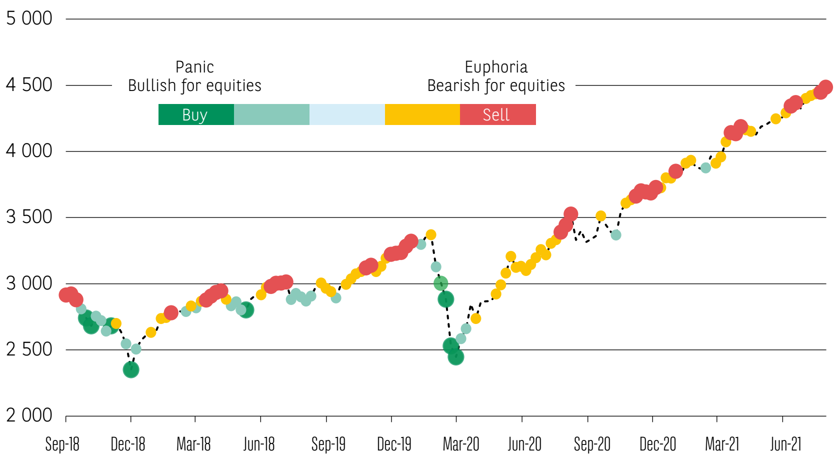
"Our proprietary market temperature indicator calls for caution in the short term."

From our Technical Dynamic Analysis (TDA) viewpoint, the picture is gradually changing. Even if short-term developments (poor momentum, dispersion across indices and sectors) still warrant short-term cautiousness, notably for the S&P 500 index, turning points may soon materialise on other indices. The correction of the Nikkei 225 and the MSCI Emerging Markets index, among others, could be coming to an end.

The bullish trend could resume on commodities (energy and metals) as monthly support levels have recently been reached.

Last but not least, the corrective setback on the US 10-year T-note yield could be over: 1.05% is a strong support and any weekly close above 1.30 would validate the upward trend. Besides, it is worth reminding that the movement seen between end-March and early August (10-year yield falling from 1.75% to below 1.20%) is not atypical and should not be over-interpreted in relation to the economic scenario. Position adjustments were sometimes brutal, as investors were heavily underweight government bonds and several reports show that this situation took time to normalise, which exacerbated the downtrend in long-term yields.

Exhibit 6: Evolution of market temperature since July 2018 (S&P 500)
All temperatures shown except neutral



Data as at 24 August 2021. Sources: MAQS, BNP Paribas Asset Management.

ASSET ALLOCATION

Vaccines are proving to be effective against the Delta Covid variant Vaccines are proving to be effective against the Delta Covid variant by limiting the severe effects of the disease. In the face of this highly contagious variant, governments around the world have chosen to accelerate vaccination campaigns to protect as much of the population as possible, while recognising that herd immunity will be difficult to achieve. Even though some governments (particularly in Asia Pacific) are maintaining their 'zero Covid' strategy, more and more countries are opting for a 'living with the virus' approach. This strategy may be more favourable (or at least less unfavourable) for global growth.

In addition, the number of new contaminations appears to be peaking, which should allow investors to refocus on economic factors. Growth and inflation indicators will be closely watched by investors because they will likely elicit responses by the central banks, not least the Fed. The less dovish direction of US monetary policy is quite clear, but the timing of any move by the Fed will be highly data dependant.

We could see a transitional 'Bad news is good news' period: Equity investors would be reassured by weaker economic indicators as they are likely to delay the move to a less accommodative US monetary policy. These market phases generally do not last and can cause erratic movements without setting a new trend.

We remain convinced that, beyond short-term hiccups, the medium-term economic environment is favourable for equities to continue to rise, although probably at a slower pace than earlier in the year. Investor perceptions of Fed actions will play a fundamental role. As such, US Treasury Secretary Janet Yellen's support for Jerome Powell's re-appointment as Fed chair is important. A change of Fed chair next February, when tapering would have barely begun, could damage – or at least complicate – the message.

The broad lines of our allocation reflect our convictions: Long developed equities, short duration. Market conditions in recent weeks have led us to make some adjustments, which are detailed below. At the beginning of July, as the probability of a short-term correction increased in the context of a classical risk-off environment (risky assets down and bond markets up), we decided to adjust our main positioning while staying long risk in the medium term. As we enter the last phase of 2021, the number of active positions is quite low and we will monitor market conditions in order to diversify. We are comfortable with the level of our short duration and are not willing to go shorter.

At the end of August, the multi-asset investment committee began to add risk by increasing the overweight in commodities relative to our benchmark and re-establishing an overweight position in emerging market equities after having gone to neutral during the summer.

EQUITIES Overweight

We are long equities: Equities still look attractive versus bonds, despite the all-time highs reached in recent weeks, even if absolute valuations (e.g. P/E ratios) appear high. We are bullish on the US via US value stocks, which are cheaper than the mega-cap-heavy S&P 500 and still have room to catch up. We kept our long on Japanese equities as they look attractive relative to other markets.

"We remain convinced that beyond short-term hiccups, the medium-term economic environment is favourable for equities."

We are **neutral on EMU equities** with a relative trade (long EMU small caps versus large caps). Small caps are likely to continue to outperform in an economic recovery. They should benefit from being high beta and from their more attractive valuations relative to large caps.

We recently re-entered a **long position on emerging market equities** as a tactical trade based on positioning and technical factors. The regulatory tightening in China could be seen as short-term pain for long-term gain but negative news on this topic could remain for several more months. We foresee more volatility in Chinese equities even if Beijing's monetary policy becomes more accommodative. We are in no hurry to rebuild a strategic long position in Chinese equities (which we cut in early August) given the recent earnings downgrades.

GOVERNMENT BONDS Underweight
We added to our **short position in US government bonds** in July and have kept our **short on EMU bonds**. This short duration position is now the largest contributor to the deviation of our active asset allocation from the target risk level and, from now on, the short duration should be seen as a funding leg for our equity exposure.

In April, we added to our underweight position in EMU bonds given our view that EMU yields should continue to rise, supported by the eurozone reopening, rising inflation expectations, and a dovish ECB. EMU yields are historically low, notably real rates in core eurozone countries such as Germany.

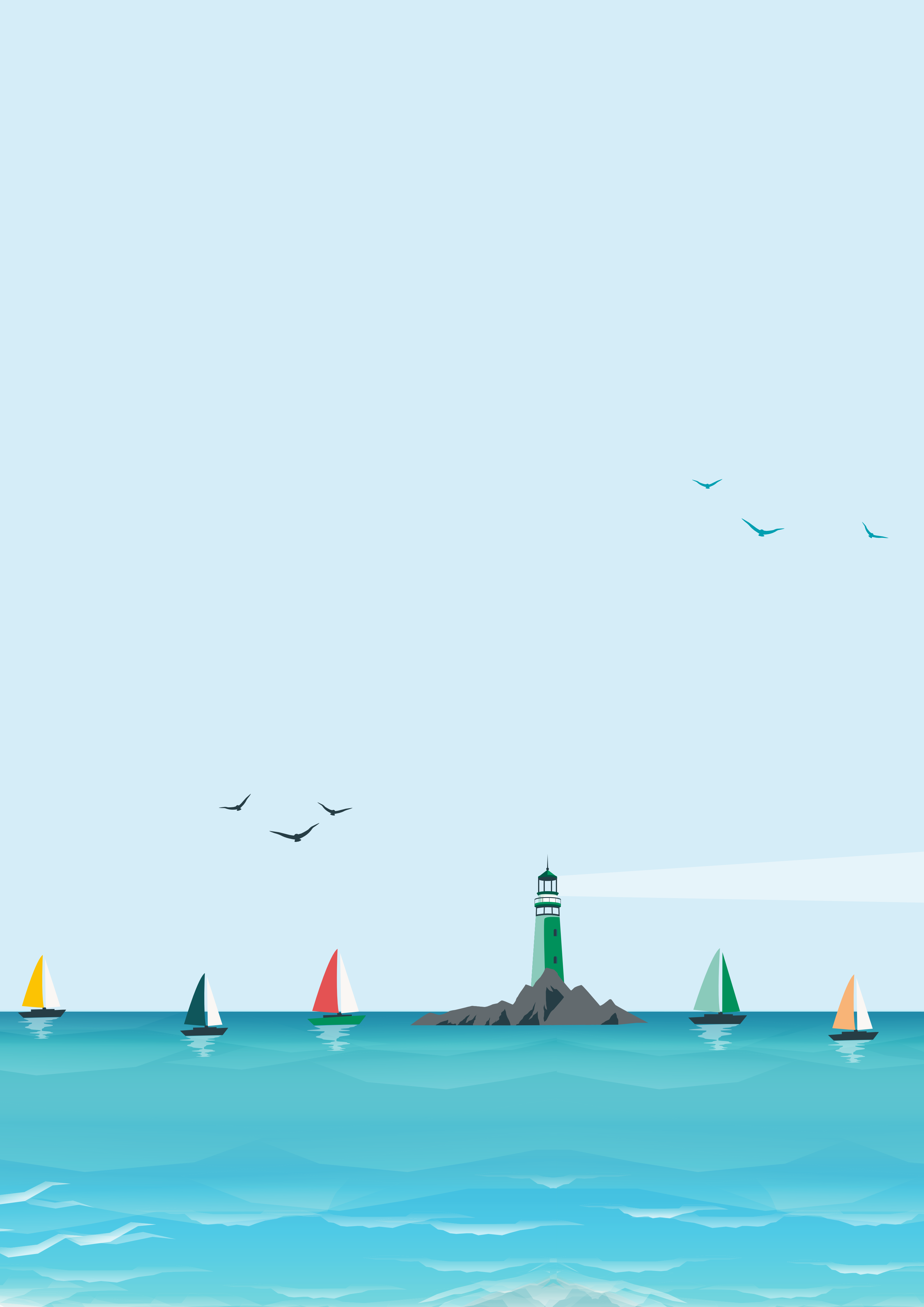
We closed our long emerging market local currency debt as both the fundamentals and technicals have become less supportive of this trade.

CREDIT Neutral

CURRENCIES € Neutral
In July, we cut our short EUR/AUD and short EUR/NOK as both positions reached stop-loss levels. In August, we exited the short EUR/JPY position as this trade was introduced in early July as a satellite position to hedge our long equities views. In the meantime, the long position on equities has been gradually reduced.

COMMODITIES Overweight
At end-August, we increased our long on commodities after the correction posted during the summer and are looking for entry points to increase it further as we are bullish on commodities over the medium term. We are long gold as it can be seen as a currency that cannot be debased by central banks and one that is a good hedge against the risk of inflation.

THEMATICS Overweight
We are building positions in various investment themes: Global environment, energy transition, artificial intelligence, US infrastructure. The latter was introduced in June to benefit from President Biden's infrastructure spending plans. Recent developments in Washington bode reasonably well, with the Senate passing the USD 1 trillion bipartisan infrastructure bill in August.



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