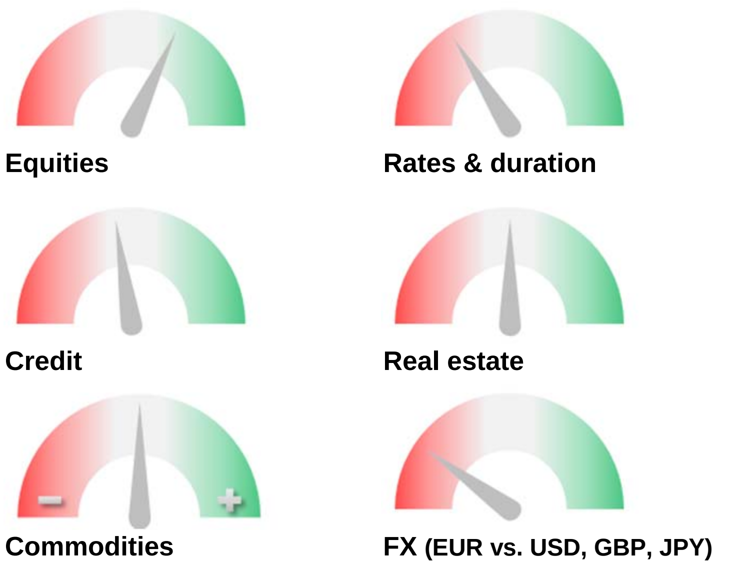
FOR PROFESSIONAL INVESTORS – 6 September 2018

ASSET ALLOCATION MONTHLY

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

REGIONAL DIFFERENCES, DIVERGENT RETURNS

Asset allocation overview:



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SUMMARY:

- US equities continued to outperform other markets such as EMU and EM equities. This partly reflects the divergence between the US economy -which is supported by fiscal expansion and a patient Federal Reserve- and relatively weaker growth in the eurozone and EM.
- But there is more to this divergence than faster US economic growth. The US equity rally has been led by the IT sector. This has accounted for 20%-50% of US equity returns since 2016. The rally is now looking stretched on various metrics.
- The other salient development in August was renewed stress in emerging markets (EM). A combination of economic stress in Turkey, weaker growth in China, Sino-US trade tensions and a stronger US dollar hurt EM assets.
- We believe there is value in EM assets, but the obvious circuit-breakers are still absent: a weaker USD, aggressive China stimulus and fresh Sino-US trade talks. EM assets prospects have soured and protectionism and tighter liquidity continue to cloud their longer-term prospects.

ASSET ALLOCATION:

Our long-held view – being long equities and underweight fixed income, notably in the eurozone – remains in place, but we reduced our risk exposure in the past few weeks. In particular, we have made the following adjustments to our asset allocation:

- We increased our underweight in EMU government bonds, taking advantage of low German yields.
- We went short US IT stocks versus long US equities, and we took profits on our long US banks position.
- We closed our long EM equities versus US equities position, and reduced our long EM local debt exposure.
- We went long a 50/50 basket of JPY and USD versus EUR as a hedge against negative global shocks.

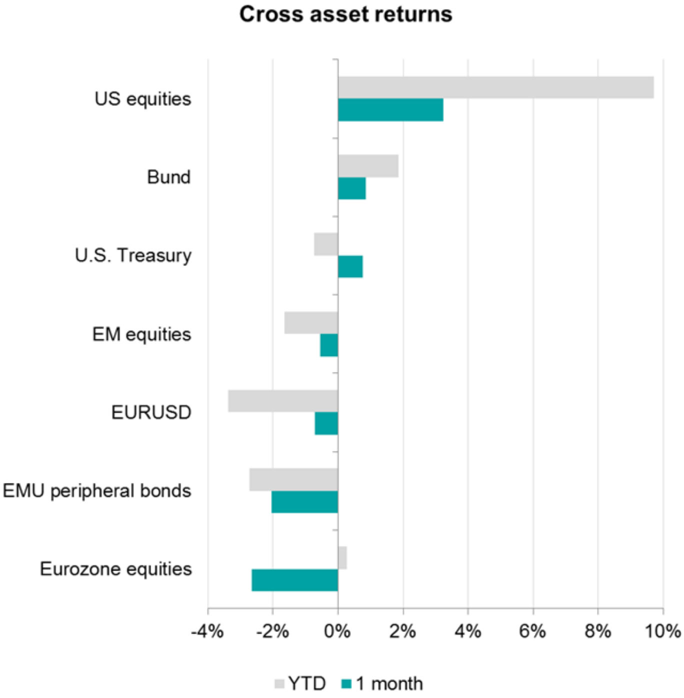
BNP PARIBAS ASSET MANAGEMENT

The asset manager for a changing world

MARKET REVIEW: AUGUST 2018

The main market moves in August have mirrored some of the key trends since the beginning of the year: the US equity market has continued to outperform major markets such as that of the eurozone and the emerging markets (Figure 1).

Figure 1: US equities continue to outperform EM and EMU equities



Source: Bloomberg

The good health of the US economy has been an important support for US equities. The unemployment rate is at historical lows and the Fed has remained patient in raising US interest rates and in signalling further increases. The S&P 500 equity index is back at an all-time high thanks to strong Q2 company earnings with earnings per share (EPS) growing by 25% YoY and 70% of companies beating analysts' sales estimates. But as we discuss later on, the rally is short on breadth, with the IT sector having delivered most of the gains.

By contrast, eurozone growth has slowed from albeit healthy rates. Two other factors have weighed on EMU assets in recent months. First, Italian politics, notably the uncertainty over the size of the fiscal deficit in the forthcoming budget, have put pressure on 'peripheral' debt (Figure 1). In addition, a row with the US has re-exposed the weak fundamentals of the Turkish economy and has led to questions on European bank exposure. This has put further pressure on eurozone banks. Both factors have caused German Bund yields to fall to close to 0.30% and Bunds to outperform in price terms (Figure 1).

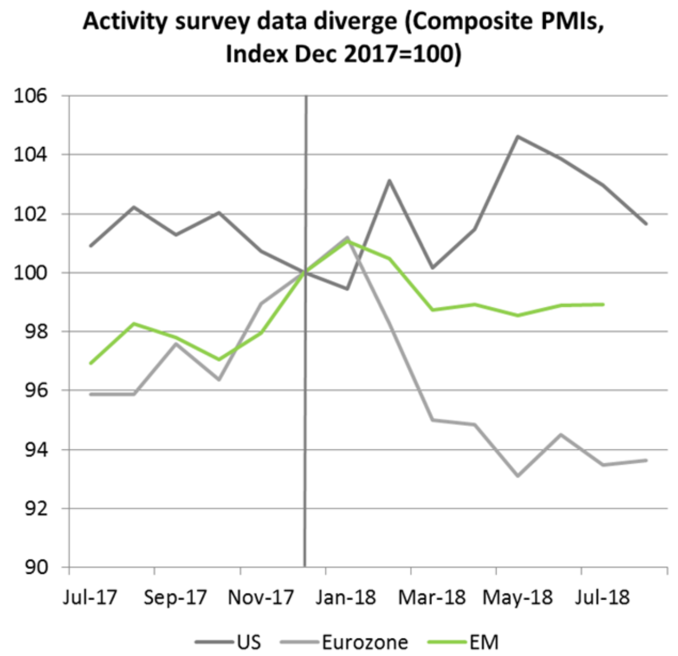
A further source of market stress has been the tension over trade between the US and various countries/regions, notably China. The US has made visible progress on trade with Mexico and the European Union, but talks with China have come to a standstill. The resulting uncertainty led to a rally in US Treasuries and a stronger USD vs. most major currencies and, notably, versus EM currencies.

EM assets struggled in this context, partly because growth in China has been slowing again. The authorities are easing policy in a targeted way, but to date, this has not been enough to reign in investor concerns over the downside risks to the economy. As a result, China-linked assets have significantly underperformed. In addition to Asian equities, copper lost 6.5% in August (down by almost 20% from its peak in June). The Australian dollar, which is also sensitive to market sentiment on China, fell by more than 3% in August versus the USD. Crude oil, however, rallied after the implementation of US sanctions on Iran. For now, these only cover financial transactions and some industries, but they are set to be extended to crude oil exports in November.

PERSISTENT OUTPERFORMANCE OF US MARKETS

The divergence between the US equity market and, for example, EMU and EM markets reflects, to a large extent, relative economic performance. The US economy has remained strong, supported by fiscal expansion and a patient Fed. This contrasts with the eurozone and EM where growth, while still robust, has weakened (Figure 2).

Figure 2: Economic divergence between the US and the eurozone and EM

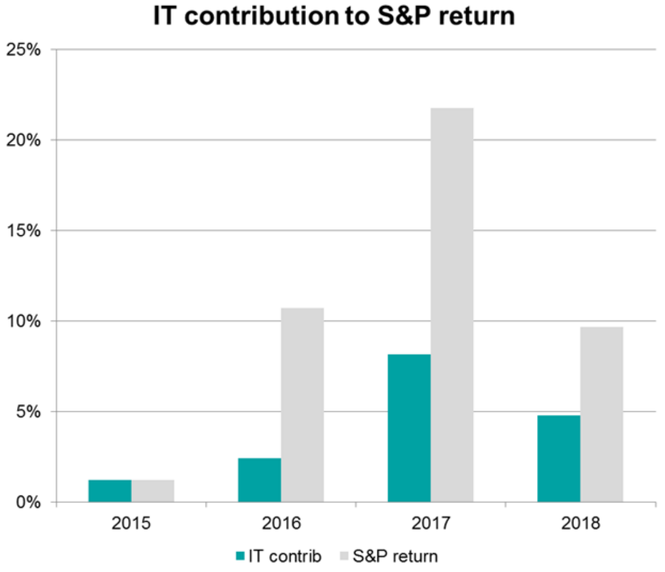


Source: Bloomberg

But there is more to this divergence than economic growth. The US equity market rally has been led by one prominent sector: information technology (IT). The US IT sector accounts for close to 25% of the S&P 500 index and close to 30% if we include Amazon which is usually regarded as part of the consumer discretionary sector. Not only is the US IT sector large, it so far has accounted for 20%-50% of

US equity returns since 2016. Indeed, of the roughly 10% rally so far this year, the IT sector has accounted for some 5% (Figure 3).

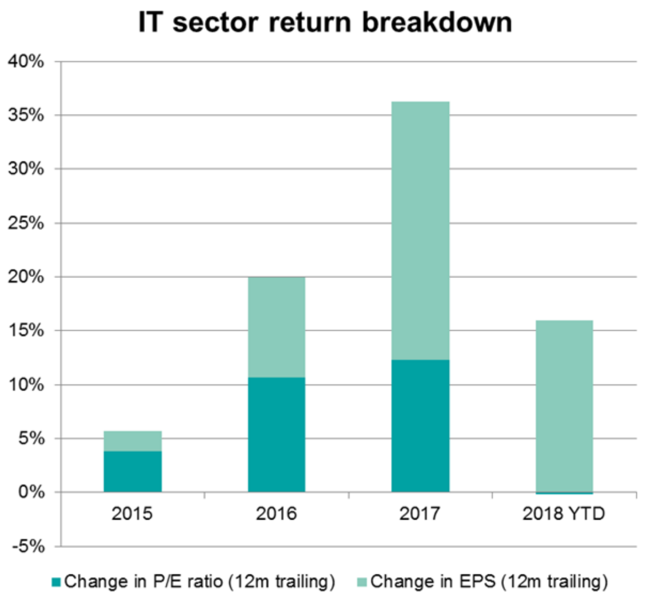
Figure 3: US IT leads: contributions to US equity returns are high



Source: Bloomberg

Many commentators worry that the rally has been driven mainly by an expansion of multiples, making the IT sector expensive in price/earnings (P/E) terms. In our view, quite the opposite is the case. Earnings in the sector have been strong since 2016. If anything, P/Es on a 12-month trailing basis have compressed so far this year, while earnings are up by 15% YoY (Figure 4). Relative to other sectors, IT is indeed one of the most expensive sectors with a 12-month trailing P/E of 24, but it is not materially higher than that of most other sectors or the index as a whole, which is at 22.

Figure 4: US IT sector performance has been driven by strong earnings, not just multiple expansion



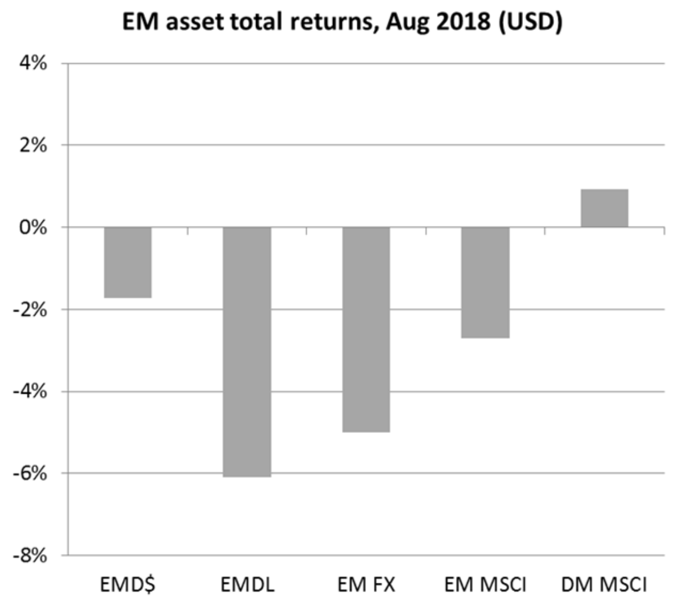
Source: Bloomberg

The strong earnings tell us that the IT sector is benefiting from the cyclical upswing in the US. But the rally is now looking extended at a time when regulatory risks are rising, both domestically and abroad. We therefore would not be surprised if there is a correction relative to other sectors in the near term.

RENEWED STRESS IN EMERGING MARKETS

Another salient development over the past month or so has been renewed stress in emerging markets. In early August, a combination of economic stress in Turkey, weaker growth in China and a stronger USD caused EM assets to fall (Figure 5).

Figure 5: EM assets suffered again in August



Source: Bloomberg

EM assets were hit by four developments over the past few months. First, the Chinese economy has slowed by more than markets had expected and China's policy response has not been overwhelming. Second, Sino-US trade tensions escalated and there was no progress in the latest round of discussions. Third, the USD appreciated across the board, boosted by Fed policy tightening and the US fiscal expansion. Fourth, an escalation of tensions between the US and Turkey along with weak external fundamentals put renewed pressure on Turkish assets. This spilled over into various emerging markets, especially those with external vulnerabilities such as Argentina, South Africa and India.

A lot of bad news has already been discounted in the prices of EM local currency debt, largely reflecting EM currency losses. However, it is difficult to time a bounce because the potential circuit-breakers are not in place yet. They include a weaker USD, aggressive policy stimulus in China and constructive trade discussions between the US and China. These factors may emerge in the next few months and EM assets could then recover. After all, the growth prospects remain solid in many emerging markets and valuations are now generally attractive. However, the longer-term prospects are less clear-cut as uncertainty lingers over the evolution of Sino-US relations.

Furthermore, unless US growth slows, tighter monetary policy will likely reduce the global search for yield and hurt EM assets.

ASSET ALLOCATION

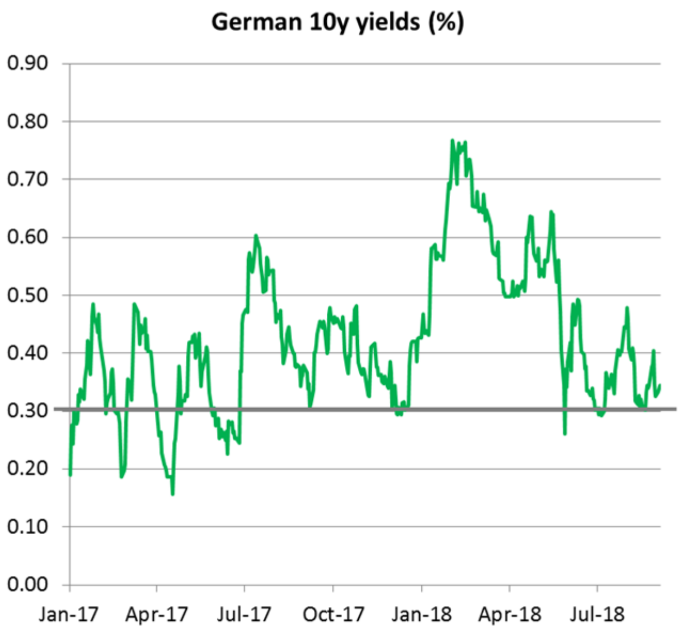
Our long-held view – being long equities and underweight fixed income – remains in place. However, we have reduced our risk exposure over the last month or so.

In particular, we have made the following adjustments to our asset allocation:

Increased our underweight position in EMU duration

One of our high-conviction views is that government bond yields in major economies such as the US and the eurozone will rise, so we have been underweight EMU duration for several months. Yields have remained historically low and we believe that it would not take much news on faster growth and higher inflation for markets to start anticipating a more hawkish ECB. Ten-year German yields fell to 0.30% after a combination of negative shocks including stress in Turkey, Sino-US trade tensions and Italian political issues. But yields have bounced off this level at least four times in the last year (Figure 6). We took this opportunity to increase our underweight exposure in EMU duration.

Figure 6: German yields should bounce off the 0.30% level again



Source: Bloomberg

Took profits on our long US banks position

US bank equities have rallied by close to 2% since we entered this trade in early June. Our rationale was that banks should benefit from the maturing US cycle, while gradually higher interests rates should boost their interest income. However, we are now worried that US equities as a whole could see a correction after a long rally driven by the IT sector. A possible trigger could be concerns over the sustainability of the IT rally as well as a more hawkish Fed, especially if inflation surprises to the upside in the US. While banks should outperform the broad index as interest rates rise, they would still suffer in a broad US market correction.

Introduced a tactical short US IT vs. long US equities position

The IT sector has decoupled from the other US equity sectors and its rally is now starting to look overdone. Earnings have been strong, but there are questions over whether that pace can be sustained, especially when some of the IT giants are facing regulatory risks domestically and abroad. Our dynamic technical analysis suggests that the sector's outperformance relative to the overall index is vulnerable to a correction in the near term.

Reduced our long EM local debt exposure

As said, a combination of factors has hurt EM assets over the past few months, but a lot of bad news has been discounted in the prices of EM local currency debt. We think there is long-term value in our long position as the growth prospects are generally solid in emerging markets. In addition, EM offers high interest rates and diversification in global portfolios. However, uncertainty remains over the evolution of Sino-US relations and the risk of a stronger USD. Both factors could be negative for EM assets.

Closed our long EM equities versus US equities position

The outlook for EM equities has worsened for the reasons mentioned earlier. Value has opened up in EM after a prolonged correction, but we do not see any near term circuit breakers (e.g. an aggressive policy response in China, a pause in the Fed's tightening cycle, a weaker USD, or progress on US-Sino 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. We therefore decided to exit the position.

Switched from our long JPY as a hedge against negative global shocks to a basket of long JPY and USD

In mid-July, we entered a long JPY versus a 50/50 basket of EUR and USD. The idea was to protect portfolios that could not use options to hedge against the risks of a sharp, negative shock, for example, one associated with concerns over global growth. The resulting shift in market sentiment to risk-off would favour the JPY. We believe many markets are complacent about US inflation surprises, especially after the fairly dovish comments at the Jackson Hole conference of leading central bankers. We expect the USD to benefit if there is a shock to risky assets from higher US rates. Accordingly, we have rotated the trade to a short EUR versus a long 50/50 basket of JPY and USD.

STRATEGIC OVERVIEW OF KEY POSITION CHANGES SINCE AUGUST 2018

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

AUGUST:

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

- German 10-year yields have 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).

LONG US BANKS 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 have 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.

SEPTEMBER:

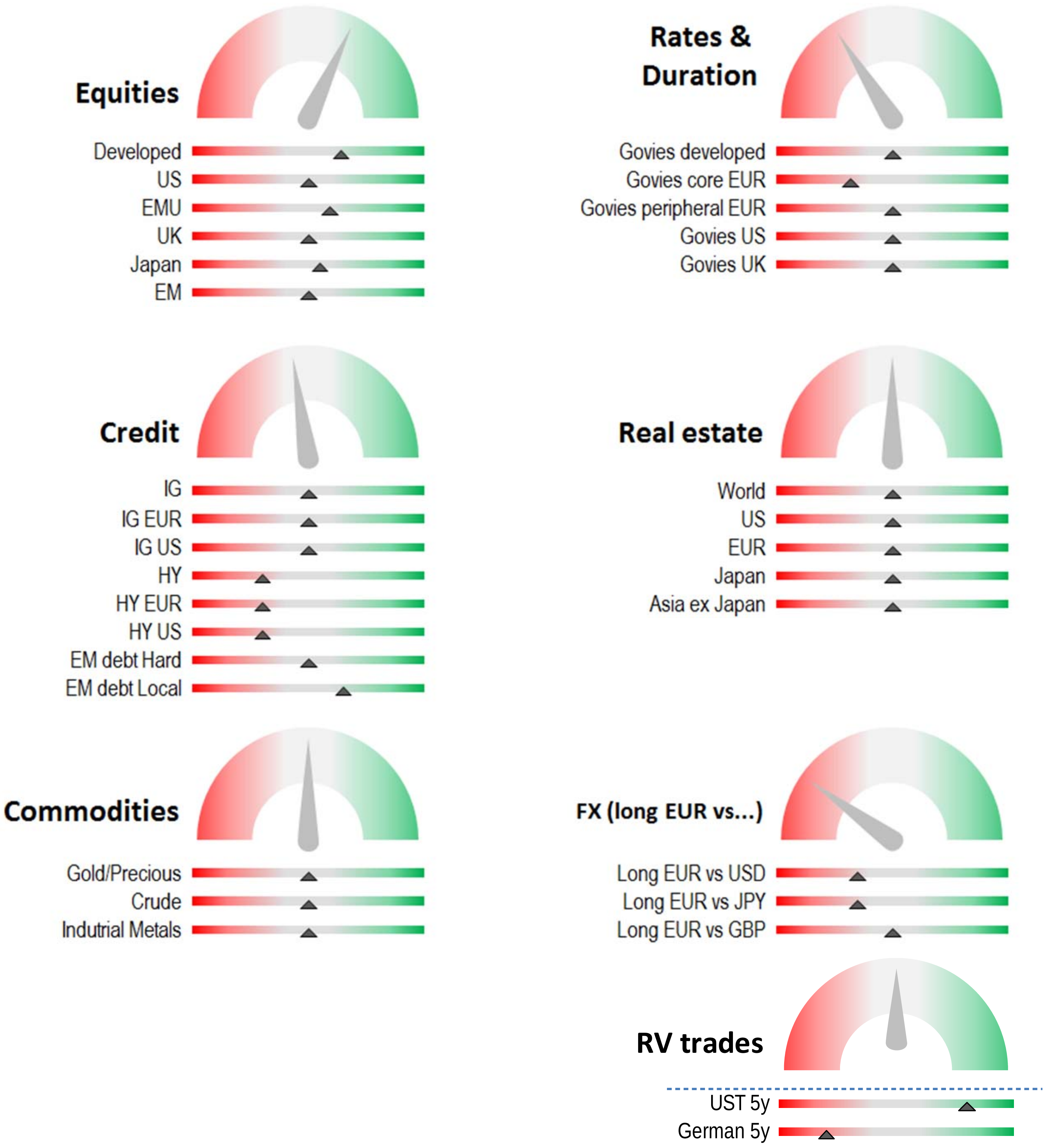
LONG EM EQUITIES VS. US EQUITIES — CLOSED — 05/09/18

- EM equities are vulnerable in the absence of near term circuit breakers (e.g. aggressive policy response in China, a Fed pause, a weaker USD, or progress in China-US relations). Our dynamic technical analysis also signals 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 the 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.

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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