

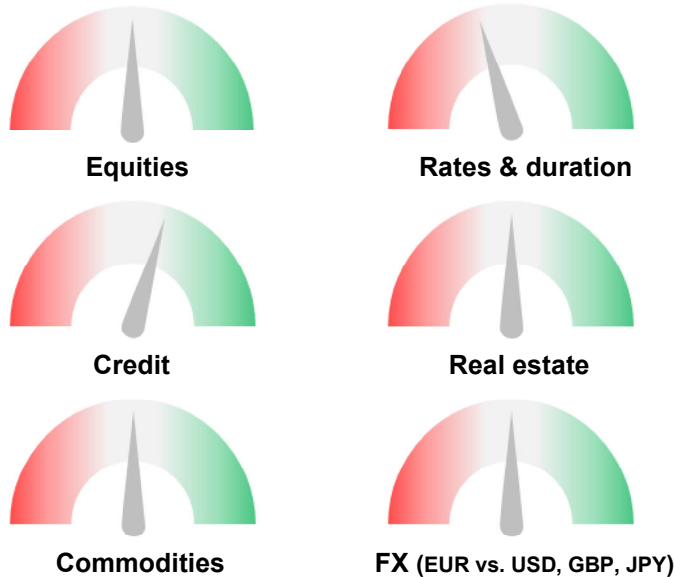
ASSET ALLOCATION MONTHLY

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



GOLDILOCKS HOLDS, BUT IS LARGELY PRICED IN

Asset allocation overview



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SUMMARY

- **'Fragile goldilocks' still in place** – The three key pillars behind goldilocks (macro data, central banks, and trade war dynamics) remain supportive, but we feel markets have already largely priced in this sweet spot. We are also continuing to monitor the risk scenarios around our base case closely as we still see this as a 'fragile goldilocks'.
- **Central bank easing & market impact** – At their respective July meetings, the ECB strongly hinted at upcoming stimulus – leaving the door open for rate cuts, rate tiering and quantitative easing (QE) – while the Fed cut rates by 25bps and announced the end to its balance sheet drawdown, which we see as an 'insurance cut'. In China, easing also continues. All else being equal, this should support risk assets, depress real rates and revive inflation breakeven rates, although tactical risk/reward seems unattractive.
- **Earnings season** – With goldilocks increasingly priced in, we are monitoring fundamental developments closely, too. The current earnings season is reasonably solid, especially against a bearish consensus heading into corporate reporting.
- **Chinese easing** – Elsewhere, we look at what China's easing could mean for its economy and its key trading partners. Given the upturn in measures like the credit impulse, we are hopeful for some stabilisation in the macroeconomic backdrop in H2.

ASSET ALLOCATION

- **Looking to buy equity dips after taking profits recently** – We still believe a tactical approach to risky assets is warranted, and are looking to buy dips in equities given the prevailing goldilocks support. We did so in developed market stocks in May and June, but took profits in late July on a tactical risk/reward view.
- **Long carry assets** – We still see the search for yield dynamic extending further given central banks actions and remain long emerging market hard currency debt.
- **A focus on robust portfolios** – Aside from our core views, we are also continuing to focus on building robust portfolios by holding trades with asymmetries, i.e. geared around a deeper slowdown or an overheating scenario.



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MARKET REVIEW: JULY 2019

Following their positive performance in June, equities continued climbing in July. Developed markets (+2.0%) outperformed their emerging market counterparts (-0.4%), with the S&P 500 posting new all-time closing highs.

Supportive central banks, the trade truce between the US and China at the G20 meeting, and the resumption of negotiations in late July, as well as a strong earnings season buoyed stocks.

There was a mixed performance in fixed income: US treasuries fell slightly in July (-0.4%), while Bunds gained (+1.0%). In Europe, peripheral bonds rallied (+1.8%) led by Italian BTPs (+3.8%). Indeed, despite the threat of new elections reiterated by Deputy Prime Minister Matteo Salvini, investors are seeing Italian yields as juicy enough to cover for messy politics. Investors were partly reassured by the Italian government's decision to cut its 2019 budget deficit to comply with European rules, thus avoiding sanctions and an Excess Deficit Procedure.

On the central bank side, at the FOMC meeting on 31 July, as expected, the Fed announced a 25bp rate cut and the end to its balance sheet drawdown. The statement and Fed Chairman, Jerome Powell, highlighted low inflation and the growing risk to growth related to tensions between the US and China.

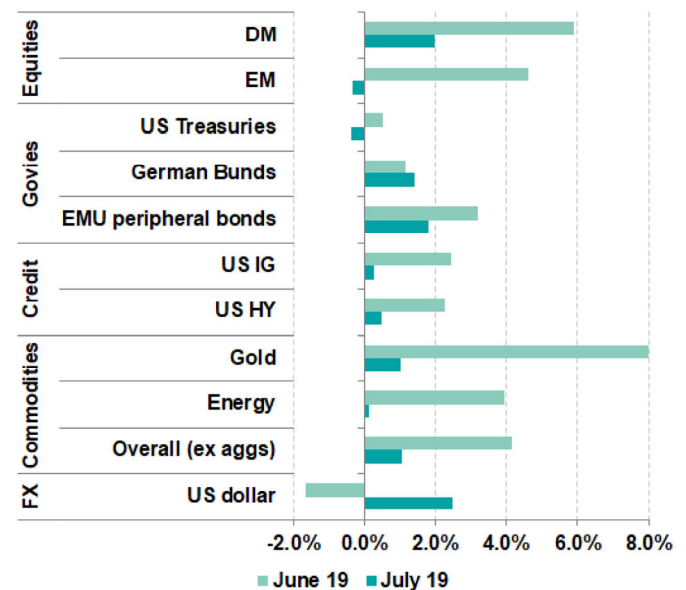
In Europe, Christine Lagarde, currently Chairman of the IMF, was announced as the next ECB President and will succeed Mario Draghi in November. At the July ECB meeting, Mr Draghi strongly hinted at upcoming stimulus, leaving the door open for rate cuts, rate tiering and QE.

In terms of currencies, the euro and sterling fell against the US dollar (-1.9% and -4.3%, respectively). After a rebound during the second half of June, the pound dropped again in July, driven by concerns around Brexit and a possible no-deal scenario. Indeed, the election of the new Conservative leader and UK Prime Minister, Boris Johnson, increases uncertainty over the UK's future. Johnson has said on several occasions that he is committed to delivering Brexit by 31 October, bringing the UK out of the bloc with or without a deal.

Commodities rallied slightly in aggregate in July (+0.4%): gold posted a positive performance (+1.1%), whereas Brent crude oil was flat over the month but with a rollercoaster ride intra month. Oil prices fell during the first half of the month amid concerns that a slowing global economy will weigh on oil demand, but recovered on the back of the tensions in the Strait of Hormuz, where the Iranian navy seized two UK-flagged oil tankers.

On data front, eurozone PMIs for July were disappointing: the composite PMI fell to 51.5 (from 52.2). The manufacturing PMI index fell by over a point to 46.4 (from 47.6), while the decline in services was less pronounced (53.3, from 53.6). In China, GDP data was in line with expectations, but confirmed the structural trend to lower growth rates (6.2, from 6.4).

Figure 1: July 2019 returns – mildly positive



Source: Bloomberg and BNPP AM, as of 31/07/2019

GOLDILOCKS: STILL THERE, BUT PRICED IN

Regular readers will be familiar with our ‘fragile goldilocks’ base case and the associated risk scenario matrix shown again in Figure 2. Indeed, we still see the current goldilocks backdrop as likely to persist. But with risks lurking around the corners, we continue to see this sweet spot potentially destabilising relatively easily. A move to a slower growth environment (top LHS to bottom LHS) or a move to an inflationary backdrop (top LHS to top RHS) needs to be monitored closely.

Figure 2: ‘Fragile goldilocks’ & key risk scenarios

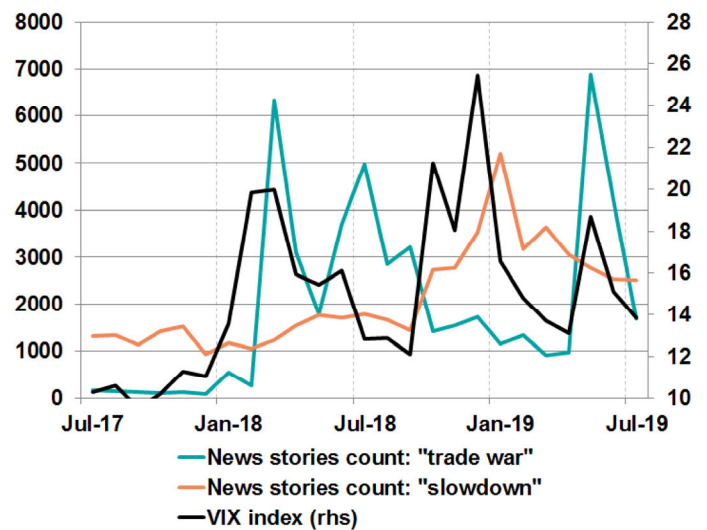
| | Fed pauses | Fed tightens |
|--------------|-------------------------|---------------------------|
| mature cycle | “fragile goldilocks” | “US economy overheats” |
| end-cycle | “synchronised slowdown” | “stagflation environment” |

Source: Bloomberg and BNPP AM, as of 31/07/2019

In the meantime, financial markets have continued performing in line with the notion of goldilocks in the past month, with risk assets hovering near (in some cases new) highs and risk-free rates near their lows. Put differently, markets are largely pricing in goldilocks. Indeed, the three pillars behind goldilocks we reviewed in detail in our *H2 outlook* last month remain firmly in place and supportive:

- **Macro data:** after stark weakness in Q4, broadly speaking the macroeconomic backdrop is still tentatively stabilising (but at lower levels), with weakness mostly limited to manufacturing activity. Contagion to other sectors needs to be monitored, but combined with low inflation, softer but reasonably stable growth should suffice for ‘goldilocks’ to persist.
- **Central banks:** major policymakers are still tending towards the dovish side. At its July meeting, the ECB strongly hinted at upcoming stimulus. At the July FOMC, the Fed cut rates by 25bps and announced the end to its balance sheet drawdown. In China, easing is also still ongoing. More on this below.
- **Trade-war:** the truce at the G20 between president Trump and Xi seemingly holds, albeit with little progress since. Interestingly, markets have adopted a “no news is good news” mentality, with our news story tracker on the subject declining further together with equity market volatility in recent weeks (Figure 3).

Figure 3: Markets see trade war risk as diminished



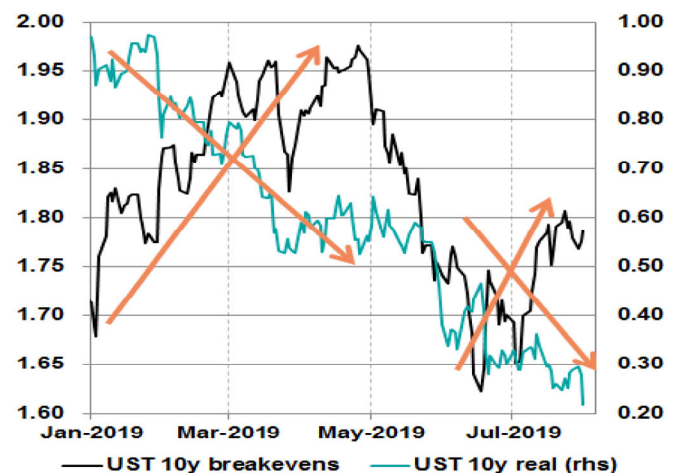
Source: Bloomberg and BNPP AM, as of 31/07/2019

All else being equal, we continue to see this status quo as being conducive for buying dips in market risk and carry assets, whereas duration markets are likely to be torn between higher breakeven inflation and lower real rates. Given the fragile nature of this base case, holding portfolio diversifiers is still key, too. More on this in the *asset allocation* section below.

CENTRAL BANK EASING & MARKET IMPACT

With little news on the macro data and trade-war front, financial markets have focused on the central bank driver a lot in recent sessions. This can be seen in intraday price action around key data releases/policymakers’ speeches, but more broadly is very evident from how fixed income is trading. As Figure 4 shows, real rates have continued falling to new multi-year lows, whereas breakeven inflation rates have risen lately – following the typical QE template from prior years but also seen earlier in 2019 when the Fed originally pivoted.

Figure 4: CBs ease...real rates down, breakevens up



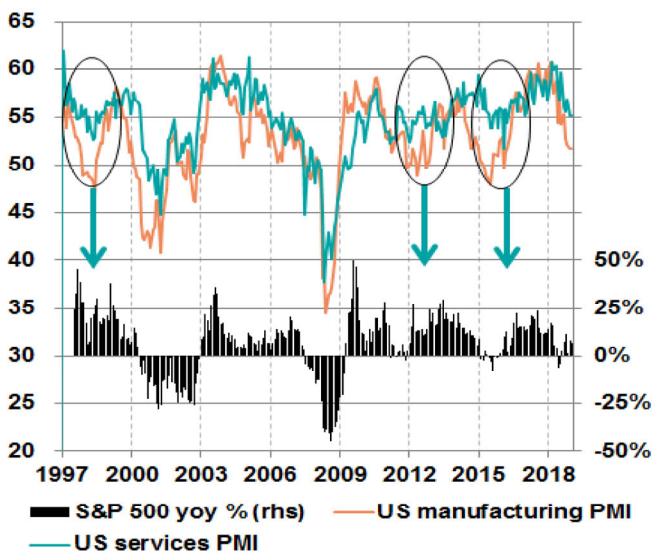
Source: Bloomberg and BNPP AM, as of 31/07/2019

On that front, at its July meeting, the ECB strongly hinted at upcoming stimulus. The wording of the statement clearly indicated the possibility of rate cuts in September, and the ECB said that it is looking into the size and composition of another QE programme, as well as a tiered system for reserve remuneration. The ECB also continued to emphasise low inflation and its commitment to its symmetric inflation aim.

Elsewhere, the FOMC met 30-31 July where it cut rates by 25bps and announced the end to its balance sheet drawdown. We continue to believe that the Fed is sending a clear message about its concern over stubbornly low inflation rather than immediate domestic growth concerns, albeit they did stress external growth risks. Distinguishing between these two drivers is absolutely key when it comes to central banks. As we showed last month, if growth concerns are the trigger for Fed easing (as was the case in many prior rate-cutting cycles), risk assets tend to do poorly and safe-haven assets rally. If, on the other hand, Fed dovishness is more of an 'insurance' move, the market outlook can be very different.

In Figure 5 we again highlight equity market returns in historic episodes when the Fed was dovish, but data weakness was contained to manufacturing, with the services sector robust. The historic take-away is clear, if – as we believe is currently the case – Fed easing is more of an "insurance cut" with the domestic backdrop still robust, equity markets (and the economy) can perform well over the medium term.

Figure 5: Equity market can perform when Fed turns dovish as 'insurance'



Source: Bloomberg and BNPP AM, as of 31/07/2019

That said, the tactical short-term risk-reward has started to look less attractive in equities, as markets have priced in goldilocks more and more. We have thus taken profits on our equity overweight, but remain buyers on renewed dips given the medium-term backdrop detailed above.

OTHER THINGS WE ARE WATCHING

With goldilocks firmly in place and arguably becoming more and more priced in, we are also looking at other areas which could "move the needle". Two interesting areas to highlight are the current earnings season, and developments around Chinese stimulus and what this could mean in the months to come.

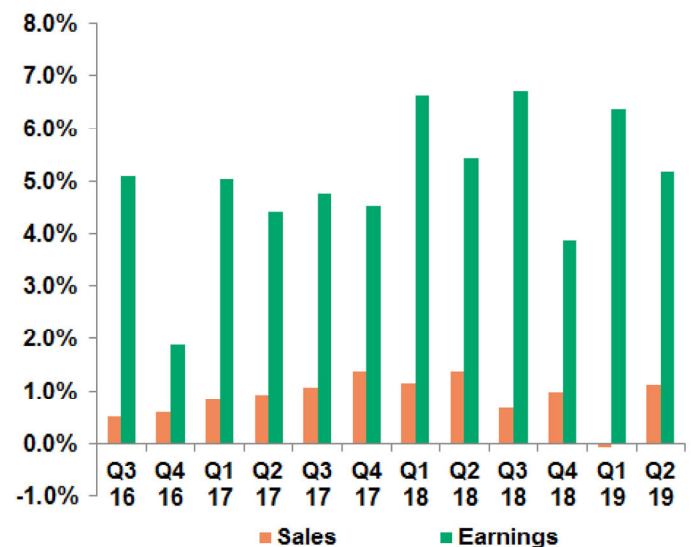
Earnings season

We have argued for some time that fundamentals will grow in importance again and with goldilocks increasingly priced in, we are taking particularly close interest in the current earnings season.

We note that consensus expectations were bearish going into reporting, with US EPS growth expectations looking for a contraction of around 2% YoY. Against this cautious consensus, actual earnings releases have been rather solid. In the US, more than 60% of corporates have so far reported, with earnings surprising on the upside by 5.2% (Figure 6), earnings growth reported at 3.6% so far, and generally guidance also constructive. In Europe, almost 60% of corporates have reported, and we note a similar rate of exceeding consensus expectations, although guidance and actual earnings growth is less encouraging.

To us, these solid reports underscore the hypothesis inherent in Figure 5, namely that the US economy is on a strong domestic footing, and that the recent insurance cuts by the Fed will help extend this expansion for a while longer.

Figure 6: US earnings seasons: solid surprises



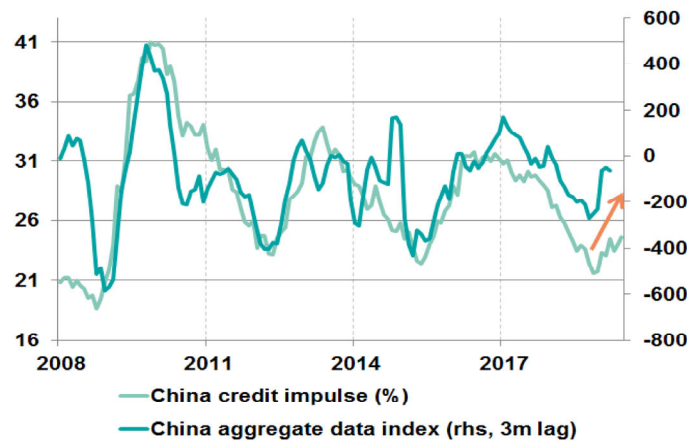
Source: Bloomberg and BNPP AM, as of 31/07/2019

Chinese easing efforts

We have previously highlighted that Chinese policymakers have been easing on numerous fronts, recently confirmed by China's Politburo mid-year meeting. This is in stark contrast to only dovish rhetoric from their DM counterparts. True, the magnitude and nature of the recent easing measures in China (mainly targeted) are not comparable to the strong easing waves in prior years, but nonetheless could be a crucial component in stabilising the macroeconomic backdrop in coming months.

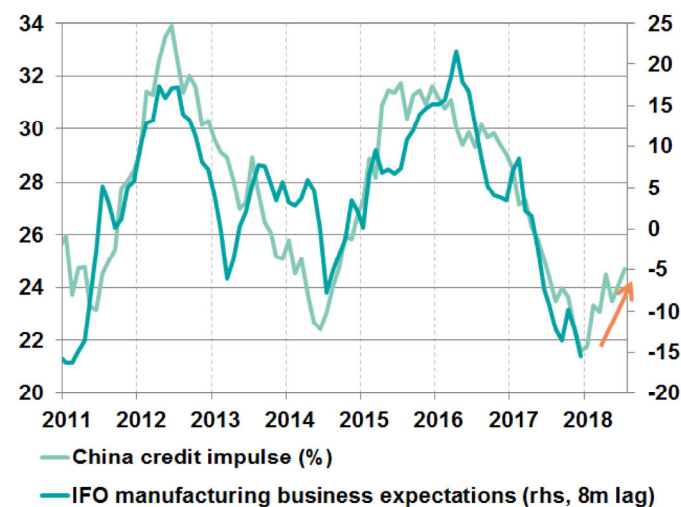
Here we note the tight, slightly leading, relationship between the Chinese credit impulse and Chinese aggregate macroeconomic data (Figure 7), as well as the relationship between Chinese easing and the macroeconomic backdrop of key trading partners (Figure 8). In both these relationships, we see the upturn in the Chinese credit impulse possibly helping to stabilise the Chinese economy and its key trading partners in the second half of 2019.

Figure 7: China stimulus to stabilise Chinese macro data?



Source: Bloomberg and BNPP AM, as of 31/07/2019

Figure 8: China stimulus to help DMs?



Source: Bloomberg and BNPP AM, as of 31/07/2019

ASSET ALLOCATION

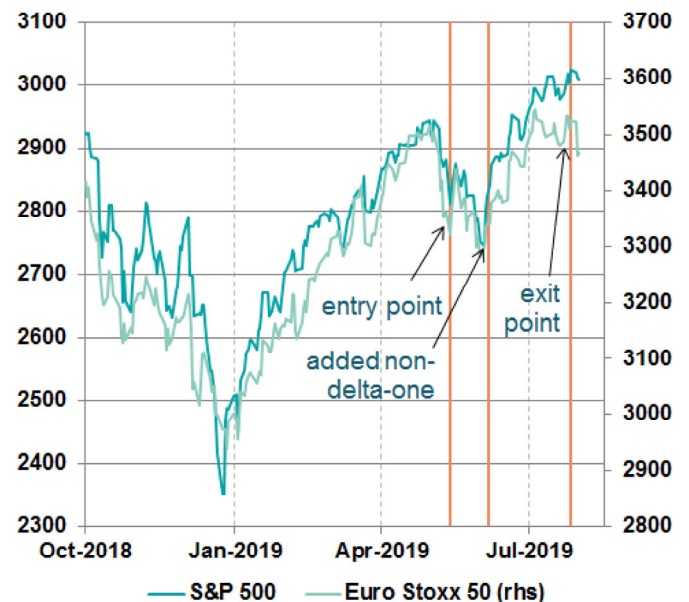
Took profits on equities, but still in buying dips mode

In May we increased our market risk by buying DM stocks into a trade-war related sell-off, and further increased exposure for flexible portfolios via options when markets initially sold off further in June (Figure 9).

As detailed above, we see the medium-term backdrop as mainly supportive, but we also believe a tactical approach to risky assets is warranted. So, given market pricing on goldilocks got extended in recent sessions, and some of our proprietary market temperature/market technical timing indicators flashing red, we decided to take profits on our long in DM stocks in late July after a good run.

That said, we are still looking to buy dips in equities given the prevailing support from goldilocks.

Figure 9: Took profits on long US & EMU equities, but still looking to buy dips



Source: Bloomberg and BNPP AM, as of 31/07/2019

Long carry assets

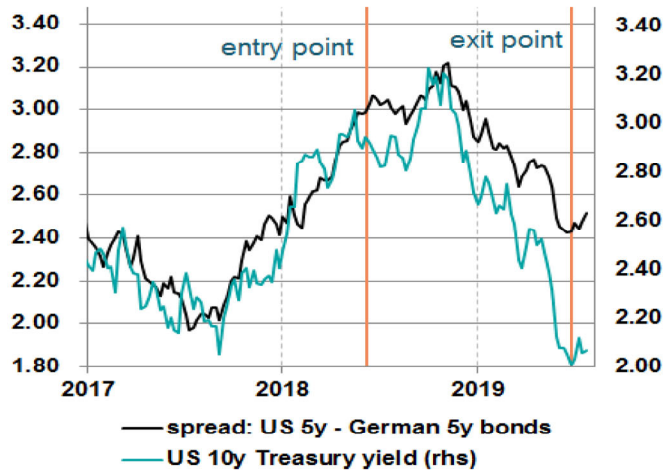
Elsewhere, we still see the search for yield dynamic extending further given central banks' actions. As explored above, the compression of real yields should entice investors to extend on the risk spectrum and higher carry assets should benefit. In this light, we continue to hold a long in EM hard currency debt, a USD exposure with an approximate carry of 6%.

A focus on robust portfolios

Aside from our core views, we also continue to focus on building robust portfolios by holding trades with asymmetries to some of the risk scenarios discussed above.

One such trade was a long in 5-year US bonds versus 5-year German bonds, which had valuation on side but also exhibited clear risk-off characteristics/correlations to risk-free rates. Given a decent move, we recently decided to take profits on this trade (Figure 10) but will be looking to possibly re-enter on a backup.

Figure 10: Took profits on long 5-year US vs. German bonds

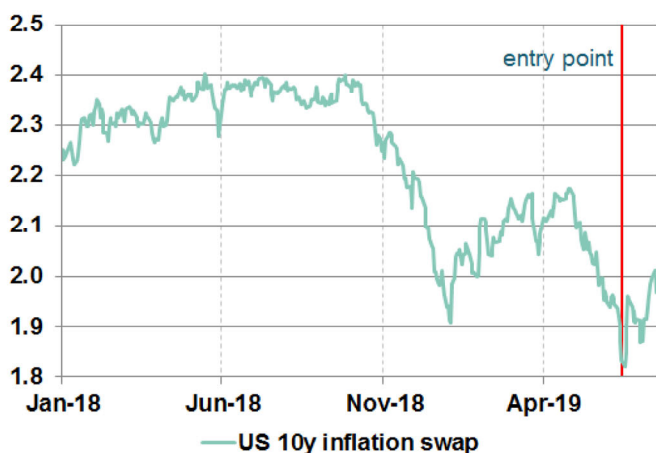


Source: Bloomberg and BNPP AM, as of 31/07/2019

Elsewhere, we continue to be tactically underweight core EMU duration, primarily because of stretched valuations in bond markets. While not originally seen as a hedge/diversifier, given recent market gyrations we are now also seeing this as a potential trade which would work if central banks disappoint market expectations on easing.

And in a similar vein, as explored last month, we are also long breakeven inflation as of mid-June (positioning for higher market inflation expectations). Again, the main rationale was valuations (Figure 11), but here too we see some elements of portfolio diversification benefits should an inflationary overheating scenario pan out.

Figure 11: Long US breakeven inflation



Source: Bloomberg and BNPP AM, as of 31/07/2019

Elsewhere, to diversify a possible renewed flare up in China-US trade tensions, we remain long the French CAC 40 and short the German DAX (given Germany is more exposed than France to de-globalisation) and also remain short a basket of Asian currencies vs. USD as a hedge.

STRATEGIC OVERVIEW OF KEY POSITION CHANGES IN JULY 2019¹

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

JULY:

LONG 5Y US VS GERMANY BONDS CLOSED 01/07/19

- Having rallied over the first half of the year, US Treasuries might be affected by upcoming Fed decisions and the trade truce between US and China. Therefore, we decided to take profits and close the position.

LONG EUR BREAKEVEN INFLATION OPEN 03/07/19

- For funds which have not been able to implement the long USD breakeven trade, we decided to open a long position in EUR breakeven inflation via swaps.

LONG DM EQUITIES VIA OPTIONS REDUCED 03/07/19

- For flexible funds we decided to reduce the position and shift from calls to call spreads.

LONG DM EQUITIES CLOSED 26/07/19

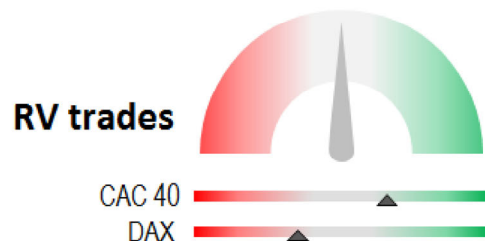
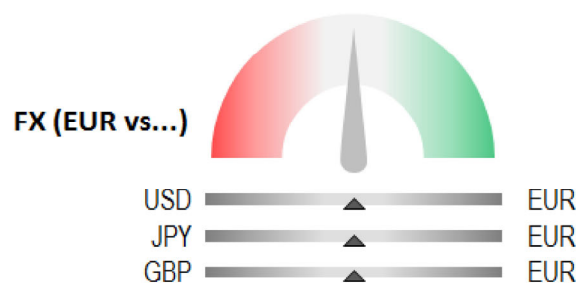
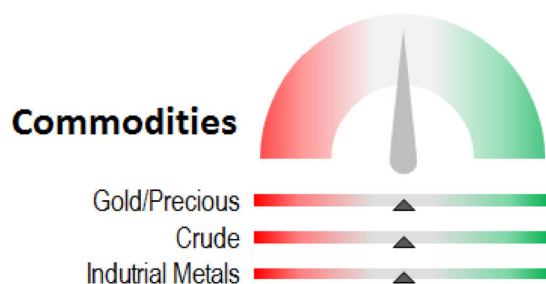
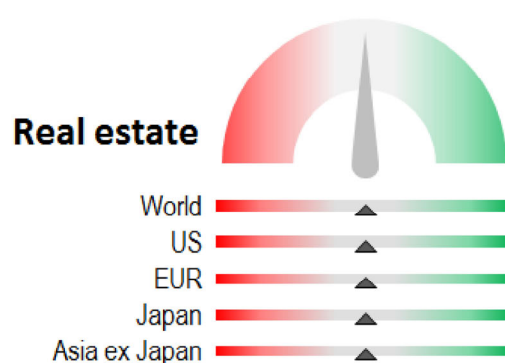
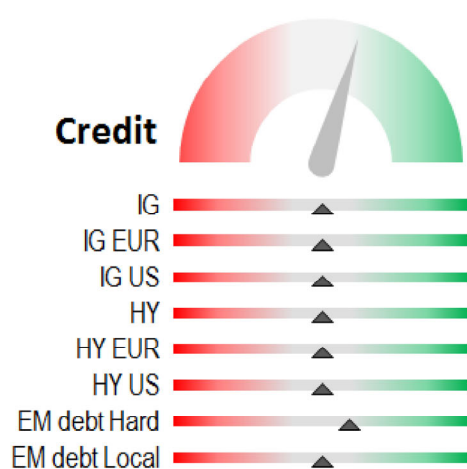
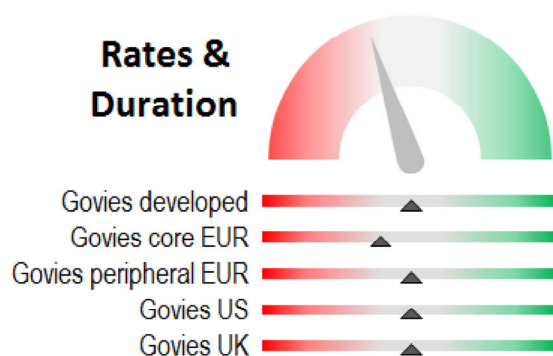
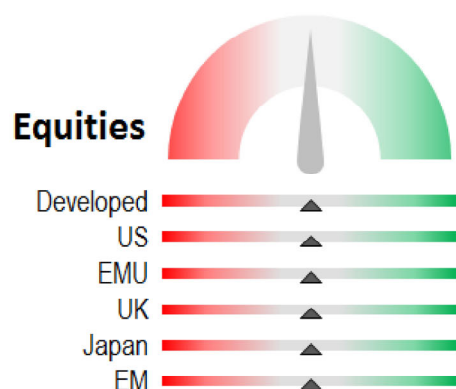
- With goldilocks priced in more and more, the short-term tactical risk/reward seemed unattractive heading into the July FOMC meeting. After a good run, we tactically took profits.

LONG EUR BREAKEVEN INFLATION CLOSED 26/07/19

- Following ECB dovishness, after a sharp repricing higher in EUR inflation breakeven rates, we decided to take profits on this trade.

¹ Please note that our underweight in broad EMU government bonds will no longer be monitored as part of the MAQS investment committee views.

CORE ASSET ALLOCATION DASHBOARD²



² The dashboard shows the asset allocation in our portfolios and reflects the decisions of the Investment Committee of the Multi-Asset team at MAQS. Views expressed are those of the Investment Committee of MAQS, as of July 2019. Individual portfolio management teams outside of MAQS may hold different views and may make different investment decisions for different clients.

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