

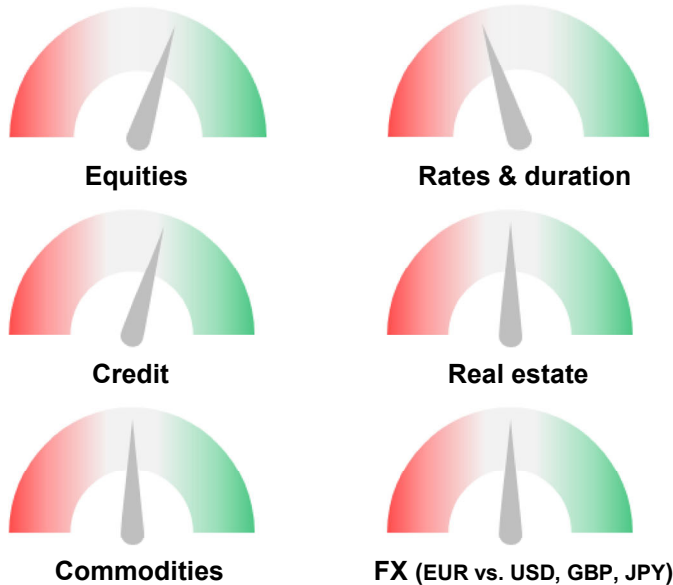


# ASSET ALLOCATION MONTHLY

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

## A MORE CHALLENGING BALANCE BETWEEN GROWTH AND POLICY

### Asset allocation overview



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## SUMMARY

- **A more challenging balance between growth and monetary policy** – Our ‘fragile goldilocks’ base case assumes that central banks can offset the ongoing growth slowdown. In our view, that assumption is now more tenuous in Europe, but still holds in the US.
- **Trade tensions and central bank policy resolve are key worries** – Trade tensions continue to be the main source of a negative shock to growth and most major economies, including the US, are feeling it. Falling inflation expectations are testing policymakers’ resolve.
- **Resilience and fiscal and monetary policy room in the US** – The US has a better chance of remaining in ‘goldilocks’ mode than Europe for two key reasons. First, it has more room for monetary and fiscal policy easing. Second, it is generally more resilient to external shocks.
- **Less room to manoeuvre in the eurozone** – Investors are losing confidence in the fire-power of eurozone policymakers. So far, hints of fiscal stimulus have not been enough to reverse the sharp fall in core EMU bond yields.

## ASSET ALLOCATION

- **Bought the dip in US equities** – We went long US equities tactically in line with our approach of buying dips so long as moderate growth and policy stimulus support a ‘fragile goldilocks’. This is still the case in the US where company earnings have been healthy, the economy has been robust, and there are ample policy levers. Our market temperature and technical indicators were also supportive.
- **Long carry assets** – The ‘search for yield’ environment is still in place given the global monetary easing moves; we remain long emerging market hard currency debt.
- **A focus on robust portfolios** – Aside from our core views, we continue to focus on building robust portfolios by holding trades that would benefit in more extreme scenarios such as a deeper slowdown or a revival of inflation.



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## MARKET REVIEW: AUGUST 2019

After positive performance in July, developed and emerging market equities fell in August, by 1.9% and 2.5%, respectively. Risk appetite soured after the Trump administration announced it would implement a 10% tariff on a further USD 300 billion of Chinese imports, triggering a global correction in equities. In response to the US decision, China let its currency tumble to 7 versus the USD and halted US crop imports. The conflict escalated further when the Chinese government announced a plan for levies to take effect in two stages (in September and December) on USD 75 billion of US goods, including soybeans, cars and oil. President Trump reacted to China's move by raising tariffs by a further 5%.

After the US Federal Reserve's decision to cut policy rates in late July, other central banks across developed and emerging markets followed suit. The ECB made it clear that it is preparing a package of measures. This was echoed by Finland's central bank governor and ECB official, Olli Rehn. He said the package would be such that it would beat analysts' expectations. Government bonds rallied in August in line with this material shift towards a more dovish stance by central banks.

The rally supported credit markets despite the generally risk-off tone. US investment-grade credit, for instance, rose by more than 3.1%, while EMU 'peripheral' debt gained 2.7%, led by Italian BPTs (+3.9%). Italian bonds benefited from a sharp contraction of spreads over German Bunds despite the political turmoil that led to the resignation of Prime Minister Giuseppe Conte. For now, the risk of a general election has been avoided as the centre-left and the Five Star 'anti-establishment' party have agreed and formed a new parliamentary majority.

Commodities had a poor month (-0.3%), led by crude oil (-7%) and copper (-4%). By contrast, gold rallied by more than 6%, reflecting lower real yields and market concerns over currency depreciation. Supported by the fall in the Chinese yuan, the USD strengthened versus a basket of G10 currencies.

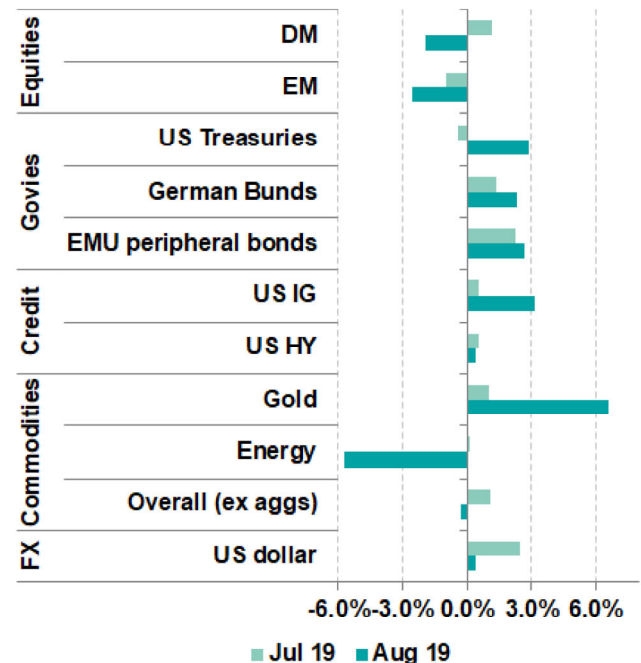
On the macroeconomic front, the US economy slowed in August. The latest PMI data showed a contraction in both manufacturing (49.9 from 50.4) and services (50.9 from 53.0). Industrial production fell by 0.2% month-on-month (vs. the 0.1% consensus expectation).

In Europe, the latest PMI data came in slightly above expectations and ahead of previous months in both manufacturing (47.0 vs. 46.2 consensus) and services (53.4 vs. 53.0 consensus). German manufacturing PMIs stabilised (43.6 from 43.2). However, final GDP growth for Q2 was negative (SA Q/Q -0.1%), with a material reversal in capital investment (Q/Q -0.1% from 1.1%).

In China, industrial production growth came in below the consensus expectation (4.8% vs. 6.0% forecast), while export growth surprised to the upside (Y/Y +3.3% vs. -1.0% forecast).

Markit manufacturing PMI rebounded to 50.4 (from 49.9), with output and employment readings picking up by 0.9pt and 1.2pt respectively, but weaker exports and new orders (-1.7pt and -0.1pt).

Figure 1: August 2019 returns – equities saw a correction



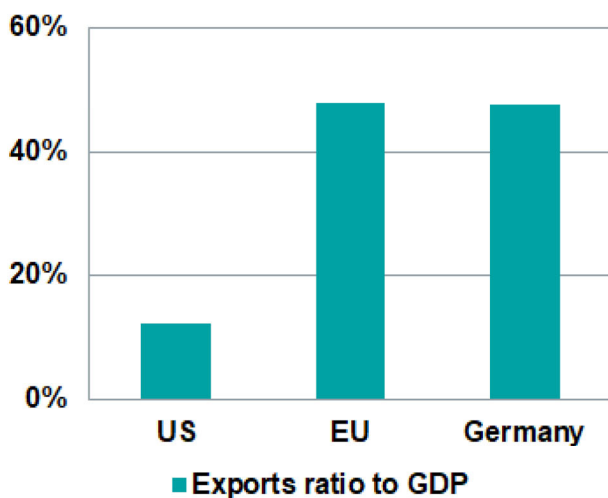
Source: Bloomberg and BNPP AM, as of 31/08/2019

## GOLDILOCKS HOLDS IN THE US, CHALLENGED ELSEWHERE

Since the beginning of the year, we have characterised the current market environment as a 'fragile goldilocks': a situation where growth and inflation are modest, but sufficiently weak to allow central banks to offer markets a credible policy put. We have also highlighted that the main risk is a more pronounced global slowdown. In that case, central banks may not be able to fully contain any negative shocks. As a result, investors would likely face a more damaging environment for risky assets.

Two developments in August have boosted the risk of a shift to a more marked slowdown: trade tensions and concerns over policy ammunition. Geopolitical risk and notably China-US trade tensions have continued to hurt the global outlook. A global manufacturing slump is already in the making, with trade and business investment weakening as part of it. The US has so far been resilient as it depends less on global trade (Figure 2).

**Figure 2: Eurozone more vulnerable to external shocks than the US as exports account for larger share of GDP**



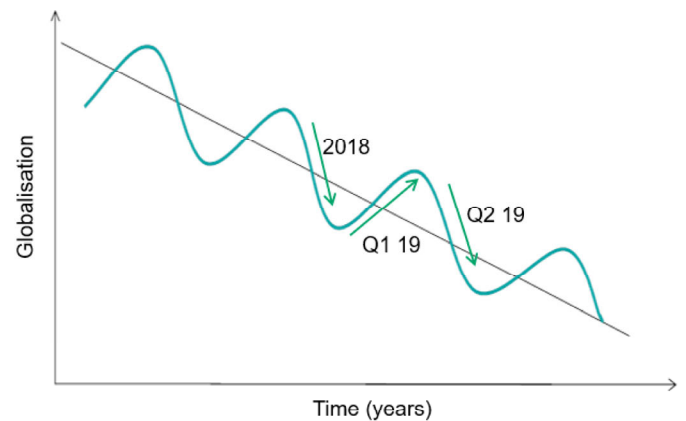
Source: Bloomberg and BNPP AM, as of 31/08/2019

On the policy front, markets have questioned the willingness and ability of central banks to ease policy effectively. This is evident in the rapid fall in inflation expectations, and also in the shift in stance by central banks such as the Fed and the ECB.

## TRADE WAR HURTS GROWTH

One of our main views has been that geopolitical risk and in particular US-China tensions are likely to last. In the case of these tensions, we have pointed out that they reflect a struggle for global power in areas such as the economy and IT and are not just a conflict over trade. We have also explained that this de-globalisation process will evolve in an erratic manner with escalations and de-escalations along the way (Figure 3).

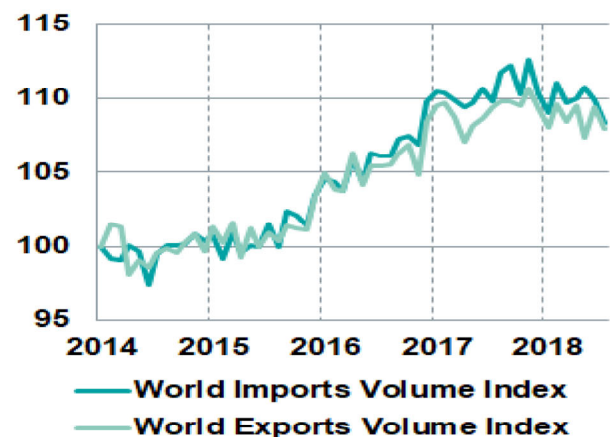
**Figure 3: Trade tensions oscillate along medium-term downtrend and should become more frequent**



Source: Bloomberg and BNPP AM, as of 31/08/2019

Furthermore, we see three damaging features of these swings. First, the escalations and de-escalations are becoming more frequent, clouding any hopes for a rapid resolution. Second, the longer these tensions persist, the more they will contribute to the uncertainty about the macroeconomic and market outlook. Third, this uncertainty is already hurting global growth. It is clearly visible in the manufacturing, business investment, and crucially, global trade data (Figure 4).

**Figure 4: Trade tensions are hurting global import and export volumes**

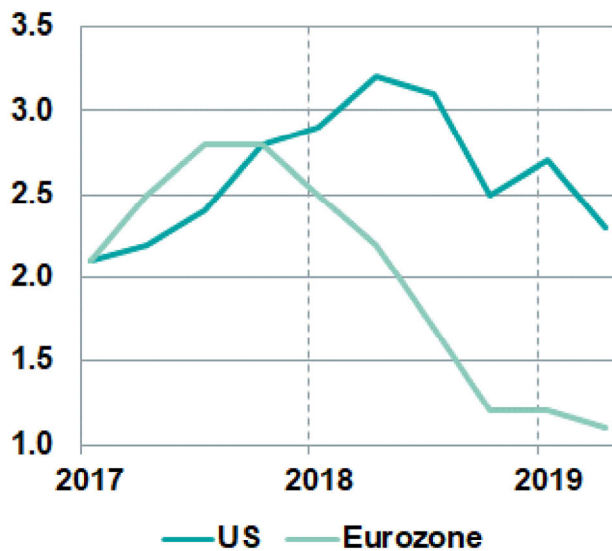


Source: Bloomberg and BNPP AM, as of 31/08/2019

## US economy more resilient so far

The slowdown was initially more visible in economies that depend largely on trade such as the eurozone and some Asian countries. Activity data is already showing signs of damage in the eurozone, and especially in manufacturing. Indeed, many observers now worry about recession in Germany after a slight contraction in GDP in Q2 (-0.1% vs. Q1).

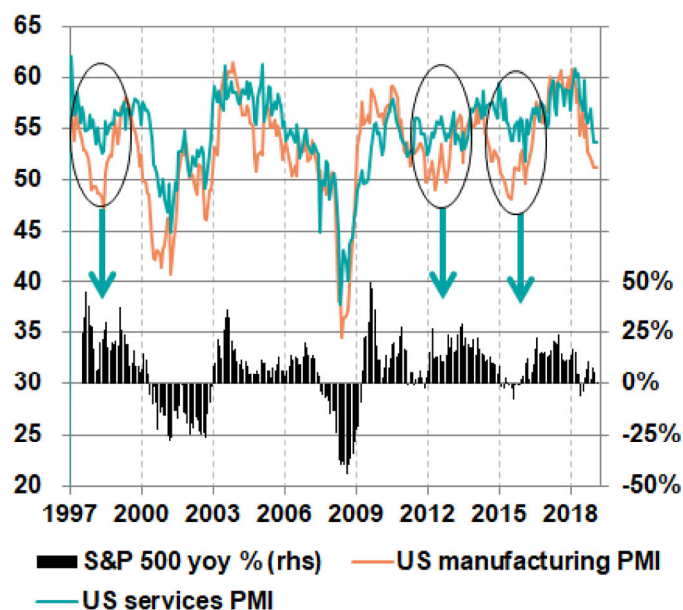
**Figure 5: US GDP growth slows, but is still more resilient than eurozone GDP growth**



Source: Bloomberg and BNPP AM, as of 31/08/2019

Until recently, the US economy had remained fairly insulated from these headwinds (Figure 5). However, recent soft data such as the PMIs has shown signs of weakness and this appears to be spilling over into the services sector. Figure 6 reminds us that these spill-overs are quite common and that as long as the slowdown is contained, the US equity market can still do well. However, the downside risks have increased and global equity markets are yet again hinging on the prospect of more aggressive policy easing.

**Figure 6: US services expansion losing momentum, but still consistent with YoY equity gains**



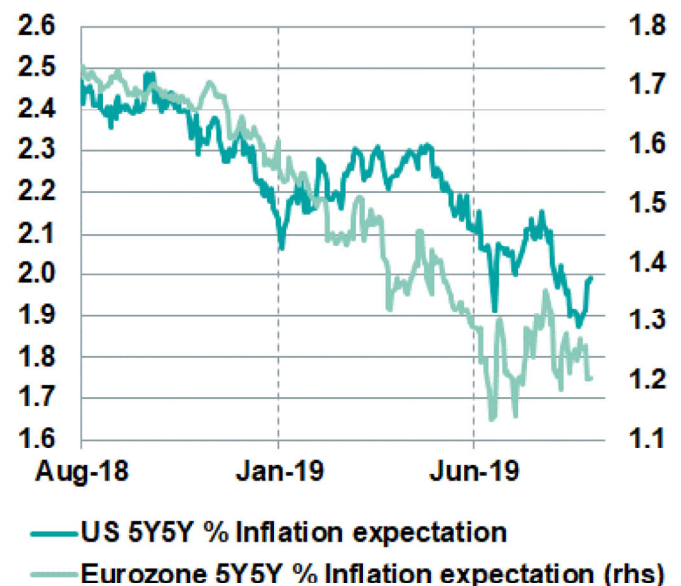
Source: Bloomberg and BNPP AM, as of 31/08/2019

## MARKETS QUESTION POLICYMAKERS' RESOLVE

Another important development in recent months has been the rapid fall in market-based inflation expectations. This is partly linked to weaker growth prospects. But judging by the decoupling versus actual inflation, this also reflects market concerns over the ability and willingness of policymakers to boost inflation (expectations), especially in the eurozone. Furthermore, investors know that looser fiscal policy is the right medicine, notably for the eurozone, but they are not fully convinced that it will be deployed effectively.

Figure 7 shows that the fall in long-term inflation expectations started earlier and has been more pronounced in the eurozone. More recently, however, US expectations have also fallen rapidly. This is a sign that markets are becoming more anxious about a more pronounced spill-over from the manufacturing slump to the wider US economy.

**Figure 7: Long-term inflation expectations have fallen by more, and more rapidly, in the eurozone than in the US**



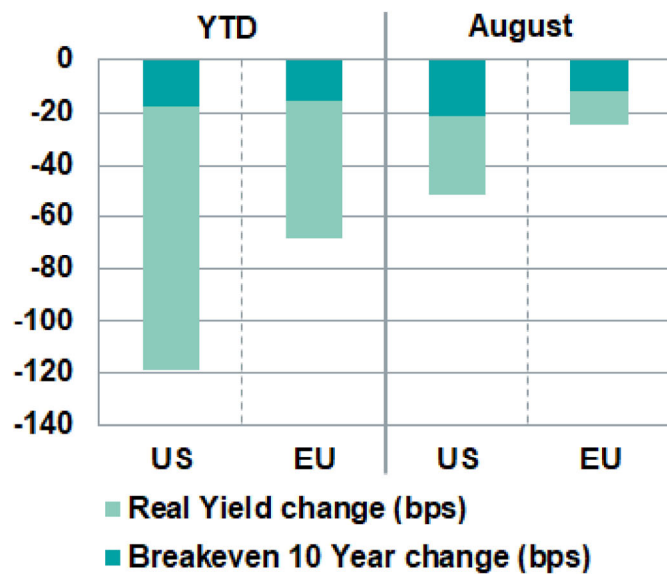
Source: Bloomberg and BNPP AM, as of 31/08/2019

## Global monetary policy easing underway

Slower global growth and falling inflation expectations have set off a fresh round of monetary policy easing in various economies: the Fed cut rates by 25bp in July and the ECB has strongly hinted at an imminent package of measures. Fixed income markets had anticipated the growth worries since the start of the year, with both real yields and inflation expectations falling. The moves gained traction in August (Figure 8).



**Figure 8: Fall in nominal yields driven by real yields, but also by lower inflation expectations**



Source: Bloomberg and BNPP AM, as of 31/08/2019

A key question on investors' minds is whether central banks are willing and able to support inflation expectations and tackle recession fears. We believe that the Fed can loosen policy further. Policy rates are at 2.0-2.25% and it could re-start quantitative easing (QE) if it wanted to. A willingness to act aggressively is less evident for now, but that is understandable given the resilience of the labour market and the wider economy so far.

### Fiscal or monetary push?

It is a different story in the eurozone where the ECB has little monetary ammunition to support the economy as policy rates are already negative and legal constraints limit the scope for government bond purchases. Even if the will is there, the bond market is already questioning its ability to act.

Most economists, investors and market observers know that an effective way to revive inflation expectations and support the economy is to expand fiscal policy. This boosts aggregate demand more directly and it helps to push interest rates higher. This is what the eurozone desperately needs. Unfortunately, the scope for such a policy is only ample in northern Europe and in Germany in particular. Indeed, the German finance minister recently suggested that it could deploy EUR 50 billion if the slowdown morphed into a recession. Markets are not fully convinced that even such stimulus would be a game changer for the economy or the German bond market which is already in scarce supply. However, these would be steps in the right direction. The freefall in yields stopped after these comments, but a material reversal is yet to be seen.

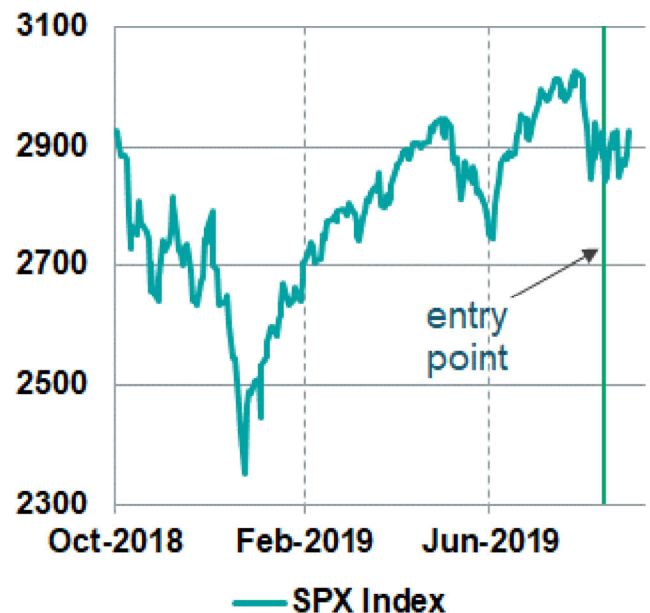
## ASSET ALLOCATION

### Tactically long US equities

We have added to market risk on dips over the last few months mainly via DM equities. In late June, we took profits on our long exposure as we felt that 'fragile goldilocks' had largely been priced in and our market temperature and technical signals flashed red. In July, after a renewed dip, we added to market risk again tactically, but this time focusing on the US market (Figure 9).

We prefer the US since we believe the economy is more resilient, earnings are healthier and there is more scope for further policy action. Fed easing has been supportive and there is plenty of room to cut rates further if the slowdown deepens. In other words, the US has a better chance of staying in 'goldilocks'. Finally, our market temperature and technical analysis signals were supportive when we entered the trade.

**Figure 9: Bought the dip – tactically long US equities**



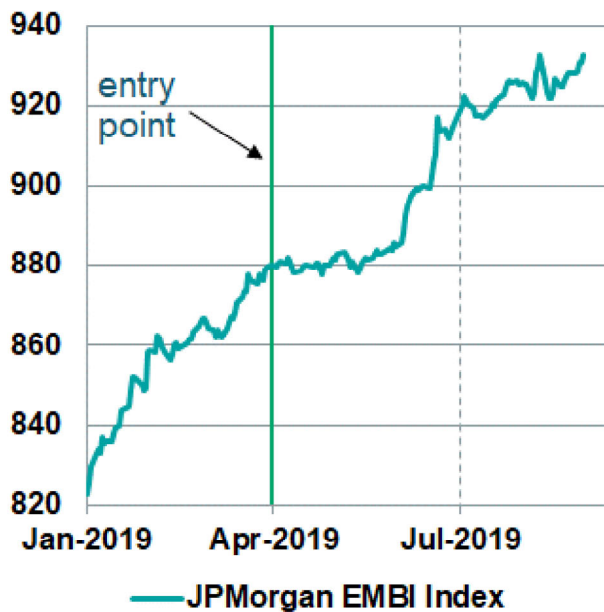
Source: Bloomberg and BNPP AM, as of 31/08/2019

### Long carry assets

We believe dovish major central banks should anchor core yields at low levels and lead investors to search for attractive yields elsewhere. This should support high-carry assets.

While US and eurozone yields have fallen, emerging market debt still offers interesting carry opportunities. We are holding long EM hard currency (USD) debt (Figure 10).

Figure 10: Searching for yield – long EM hard currency debt



Source: Bloomberg and BNPP AM, as of 31/08/2019

### Focus on robust portfolios

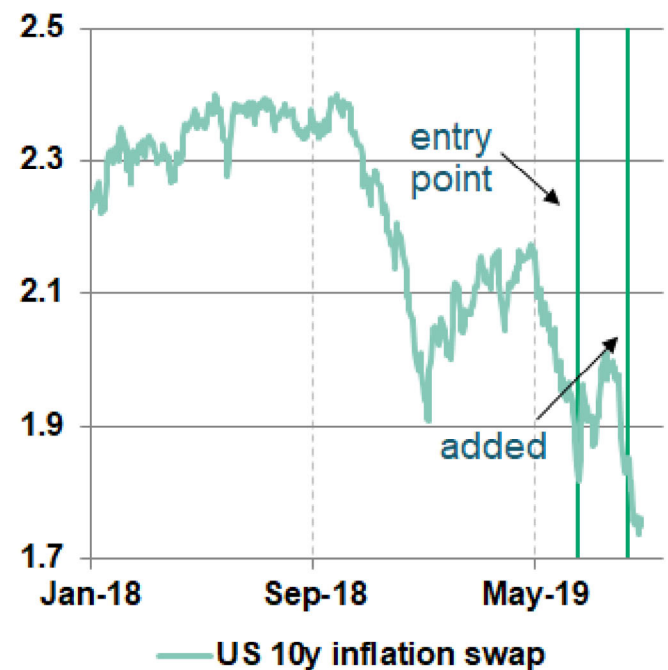
We seek to build robust portfolios by holding positions that we expect to do well in environments with risks to our base case such as a more marked slowdown or higher US inflation.

We are tactically underweight EMU duration. Originally, the trade was not a hedge/diversifier, but we now see an interesting asymmetry in being short duration. Given how deeply negative EUR yields are, it should not be difficult for this position to do better if the cycle recovers, central banks succeed in boosting inflation expectations, or if fiscal expansion materialises.

As we discussed last month, we are long US breakeven inflation. This position has gone against us, but we see plenty of scope for the Fed to revive inflation expectations if needed. Indeed, we increased our exposure after a material dip in July (Figure 11).

Elsewhere, to diversify and hedge against trade war escalation, we are long French CAC 40 and short German DAX. France is less exposed to de-globalisation than Germany. Likewise, we are short a basket of Asian currencies vs. USD as a hedge.

Figure 11: Long US breakeven inflation



Source: Bloomberg and BNPP AM, as of 31/08/2019

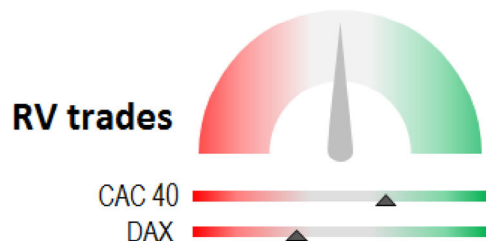
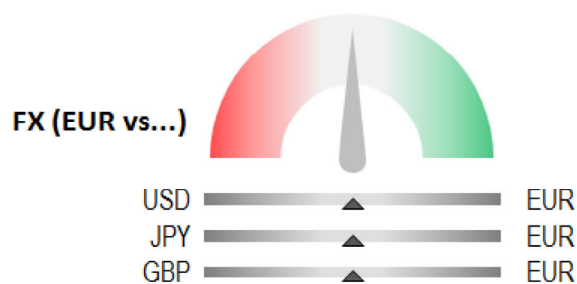
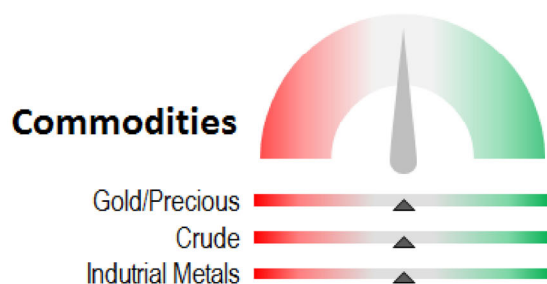
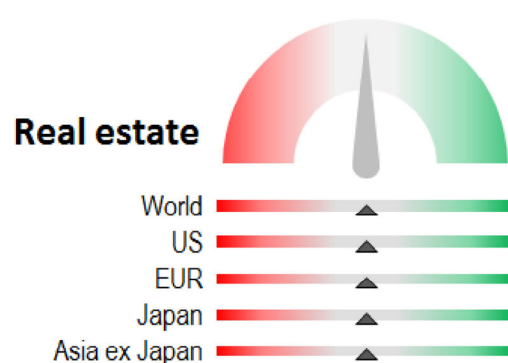
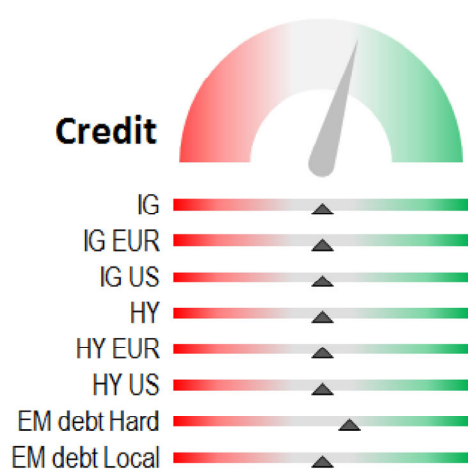
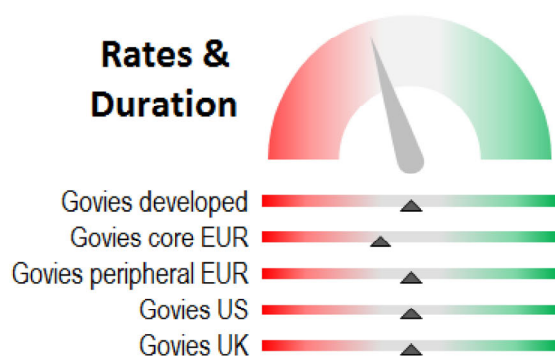
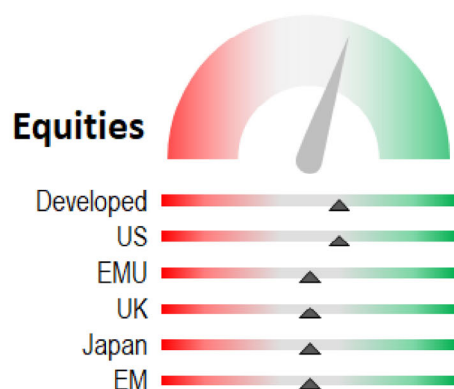
## STRATEGIC OVERVIEW OF KEY POSITION CHANGES IN AUGUST 2019

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

<b>SHORT CAD VS NOK</b>	<b>CLOSED</b>	<b>01/08/19</b>
<ul style="list-style-type: none"><li>Our trade being short CAD/NOK hit its stop loss and we closed the position as a result.</li></ul>		
<b>LONG US BREAKEVEN</b>	<b>INCREASED</b>	<b>07/08/19</b>
<ul style="list-style-type: none"><li>The July FOMC meeting confirmed the Fed's dovish stance and this is likely to push inflation expectations higher. Therefore, we decided to add to our long breakeven trade.</li></ul>		
<b>LONG US EQUITY</b>	<b>OPENED</b>	<b>13/08/19</b>
<ul style="list-style-type: none"><li>As our 'fragile goldilocks' base case suggests buying market dips, we used the recent correction to open a long position in US equities.</li></ul>		



## CORE ASSET ALLOCATION DASHBOARD<sup>1</sup>



<sup>1</sup> 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 September 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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As at September 2019

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