FOR PROFESSIONAL INVESTORS – 4 November 2019

ASSET ALLOCATION MONTHLY

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

A TASTER OF REFLATION

SUMMARY

- **De-globalisation relief and reflation –** positive geopolitical news has caused markets to trade in a reflationary fashion. We feel this may last in the short term, but further out, things look trickier.
- **Fixed income most at risk –** we still see fixed income markets as being most at risk from a sustained move to a reflationary environment.
- **Weak data, but no imminent recession –** we acknowledge the slowdown in the macroeconomic data, but we think it is too early to call a recession just yet.
- **Key differences to Q4 2018 –** while the macro feels similarly weak, the central bank stance, valuations and positioning are clearly different.

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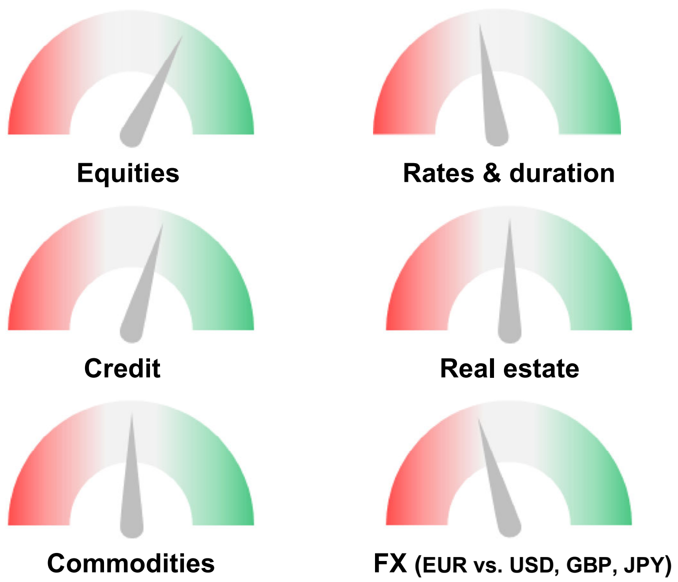
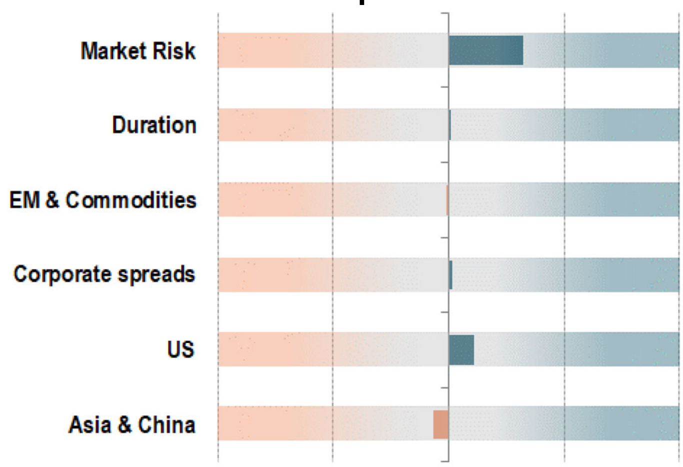
ASSET ALLOCATION: FACTOR EXPOSURE & ASSET VIEWS

- **MFA portfolio optimiser –** having introduced our new asset allocation portfolio optimiser which uses factor analysis to map core asset views to factor exposures, we will now also communicate views from a 'factor viewpoint'.
- **Factor exposure –** in the overall factor exposures from our current views, the standout is an overweight in *Market Risk*. Other factor exposures are light.
- **Overweight equities –** we remain nimble and in a recent dip we added equity overweights, the main contributor to the overweight in the *Market Risk* factor.
- **Underweight core EMU duration –** we aim to be nimble and have reduced short exposure given yield moves. But risks from reflation remain large for rates.
- **Search for yield –** we still believe in searching for yield. We remain in a high-carry EM external debt position and have added EMU REITs.
- **Robust portfolios –** we continue to hold trades with asymmetries to our risk scenarios, e.g. long US breakeven inflation and several de-globalisation trades.

Core asset class views*



Factor exposure*



* The factor exposure shown is for an unconstrained theoretical portfolio and derived from core asset class views. These factors will be projected onto individual portfolios taking constraints into consideration. Additional specific/tactical trades may be implemented and these will not be visible in the factor profile. They are listed at the end of this publication.

MARKET REVIEW: OCTOBER 2019

After equity markets did well in September, investors remained optimistic in October. Developed equity markets climbed by 1.9%, with the S&P 500 posting new all-time highs. Emerging markets gained 2.9%, outperforming their DM counterparts.

That said, global stocks were on a rollercoaster in the first half of October driven by concerns over global growth. Risk appetite surged in the second half of the month, triggering a robust rebound on the back of easing tensions between China and US over trade. Indeed, after the latest talks in Washington, the US announced a preliminary agreement on a 'mini trade deal'. The so-called *phase-one deal* includes a suspension of the scheduled 5% tariff increase on USD 250 billion of Chinese imports and USD 40-50 billion of annual purchases of US farm agricultural products by China. Although it does not roll back existing tariffs, the deal marks a truce, making it a positive geopolitical outcome for the markets.

Monetary policy remained supportive. At the conclusion of October's FOMC meeting, Fed Chairman Powell delivered a 25bp rate cut, lowering the target range for the federal funds rate to 1.50-1.75%, in line with market expectations. Whilst he indicated that the Fed is likely to pause for now, he made it clear that the hurdle for tightening is large. In Europe, at his last meeting as ECB president, Mario Draghi endorsed the latest package of measures: lower interest rates and a resumption of the quantitative easing programme at a pace of EUR 20 billion per month starting on 1 November.

Bond markets mirrored the shift in risk appetite as investors preferred riskier assets to government bonds. US Treasuries were unchanged in October, while German Bunds (-1.4%) dropped and 'peripheral' eurozone bonds (-0.7%) tumbled after a positive September. In credit market, both US investment-grade and high-yield rallied by 0.6% and 0.3% respectively.

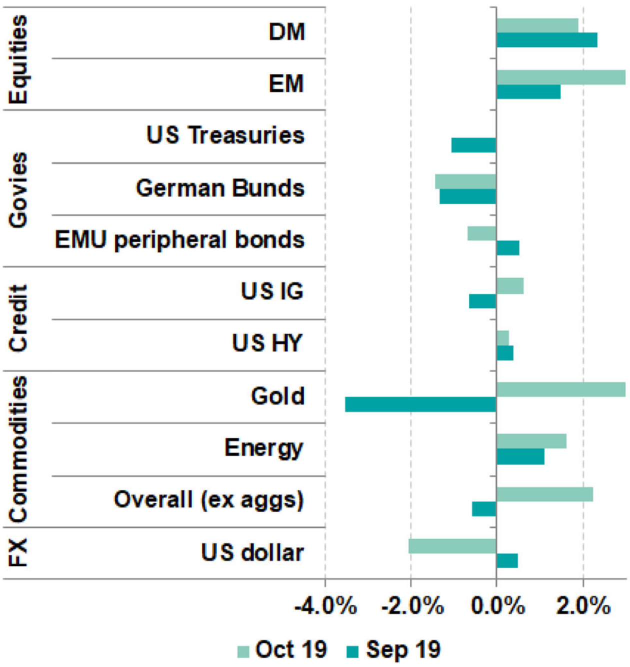
Elsewhere in commodities, the broad commodities index climbed by 2.2% in October, with the energy sector edging higher (1.6%) on the back of new hopes around a continuation of the global economic expansion. After poor performance in September, gold rebounded, climbing by 3.0%.

In currency markets, after a positive September, the US dollar fell against the euro (-2.7%), while sterling continued its rally, gaining 5.3% against the US dollar. The pound surged on the back of the agreement between the UK and the EU on a withdrawal agreement. However, the UK Parliament rejected the proposed timetable to leave the bloc by the end of October. As a result, EU authorities granted to UK a three-month extension as the UK headed for a general election in early December.

On the macroeconomic front, data was mixed. Chinese GDP growth slowed from 6.2% to 6.0% YoY, the lowest rate since 1990. However, domestic demand improved, with industrial production growth rising from 4.4% to 5.8% YoY and retail sales showing steady growth at 7.8% YoY from 7.5%. In the US, non-manufacturing and factory data slowed sharply, with the ISM non-manufacturing index dropping to 52.6 from 56.4, raising concerns over a services sector deceleration. However, the job market remained solid with the unemployment rate falling to 3.5% from 3.7%. And Q3 US GDP growth came in better than expected at 1.9% (vs 1.6% consensus).

In Germany, latest data was mixed: factory orders growth dropped to -0.6% MoM and consumer confidence tumbled with the ZEW index touching its lowest since 2011. Industrial production growth surprised to the upside (0.3% vs. 0% consensus). European Markit PMIs were stable in October, but the absolute level of these indicators is still low: the eurozone manufacturing index was unchanged at 45.7, services slightly higher at 51.8 vs. 51.6 in September and the composite index came in at 50.2 vs. 50.1 in the prior month.

Figure 1: October 2019 returns – reflation signals



Source: Bloomberg and BNPP AM, as of 31/10/2019

DE-GLOBALISATION RELIEF & REFLATION

In last month's publication, we discussed how reflation risks, and not just recession risks, could upset our 'fragile goldilocks' base case, one where risky assets are supported by central bank policy easing given the mix of moderate growth and subdued inflation.

Indeed, we explored three different routes to a more reflationary environment: a growth recovery; more expansionary fiscal policy; and more visible damage to aggregate supply.

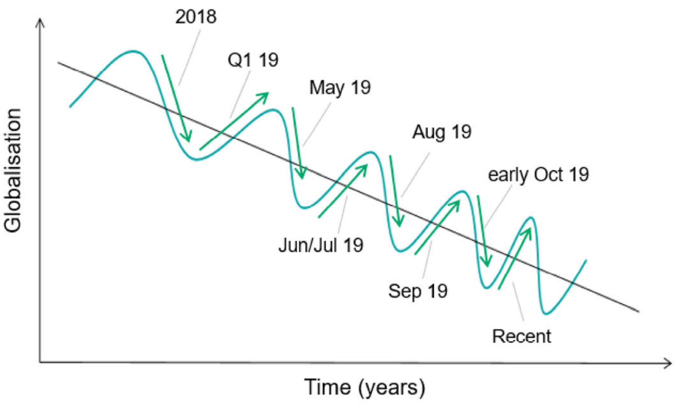
We explained how these could eventually fuel inflationary pressures. Perhaps sooner than envisaged, recent geopolitical developments have felt like the reflationary impulse we pictured.

Reflationary impulse taster

We have long argued that the Sino-US trade war has both a structural element to it (i.e. a sustained long-term move to a more de-globalised world) and a shorter-term cyclical aspect. We have used the schematic in Figure 2 to illustrate this.

For certain, de-globalisation uncertainty has put major pressure on the prospects for global growth since late last year. The slowdown in manufacturing is evident, with economies geared to manufacturing (e.g. Germany) feeling the pinch, and with investment a big drag on the macroeconomic outlook.

Figure 2: De-globalisation swings becoming more frequent

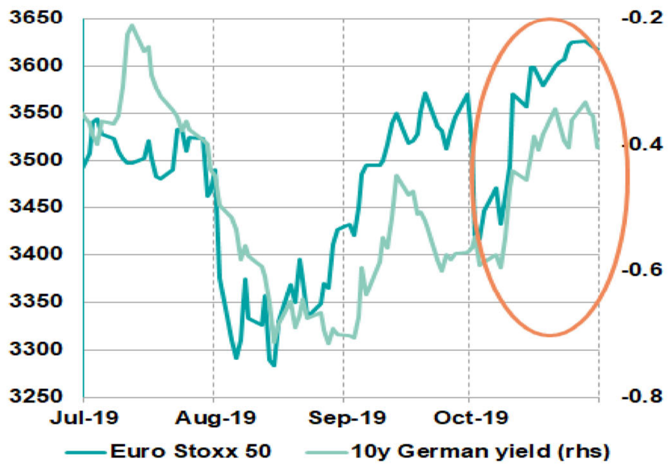


Source: BNPP AM, as of 31/10/2019

Cyclical gyrations in our de-globalisation framework have actually become more frequent in recent months (Figure 2). This has important ramifications for our asset allocation modus operandi (see below).

It has been an important driver for markets in the short term too. The increased likelihood of a Brexit deal and of a trade deal between the US and China have offered investors a breather. To the extent that this uncertainty has been partially reversed, growth assets could see some relief and bonds, and bond proxies, should sell off. This is exactly what happened in markets recently: assets that are sensitive to this news such as eurozone equity prices and German bond yields have risen in tandem in the short term (Figure 3).

Figure 3: Equities and bond yields rise in tandem



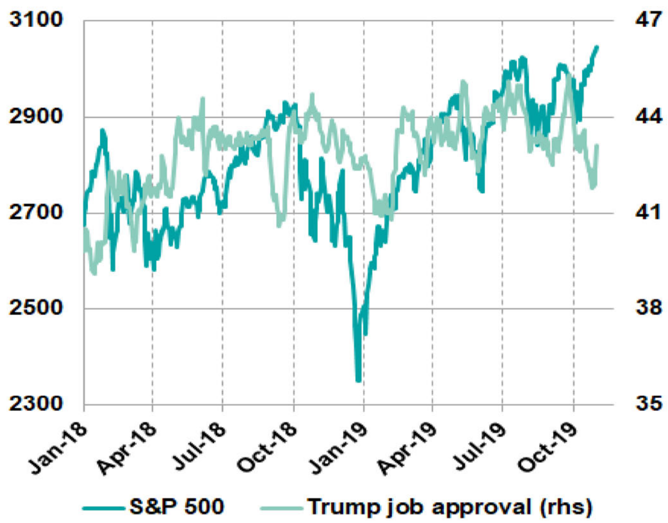
Source: Bloomberg and BNPP AM, as of 31/10/2019

Is reflation sustainable?

The key question is of course whether this de-globalisation relief can last, and as such, whether these market moves could persist and perhaps even be extended.

We feel that in the short term, say, in the next three to six months, de-globalisation dynamics could indeed remain supportive. With the US presidential election approaching next year, President Trump will surely eye his approval ratings closely. As a matter of fact, the uncertainty over the trade conflict with China has not been helping him. Trade tensions have hurt the equity market at times, and the fate of this market has been tightly linked to Trump's ratings in 2019 (Figure 4). In other words, he may become more less tough in negotiations with the Chinese heading into the presidential election.

Figure 4: Trump will likely pay attention to approval ratings

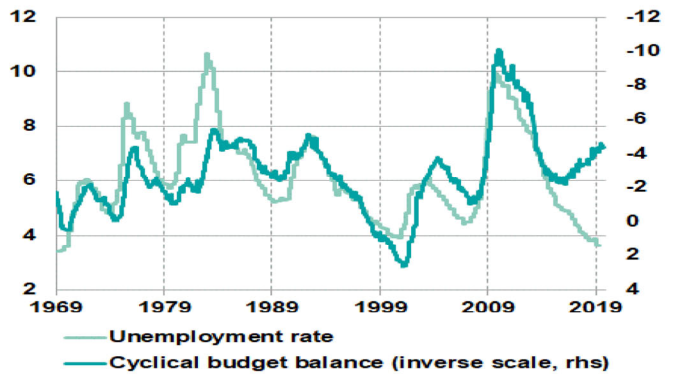


Source: Bloomberg and BNPP AM, as of 31/10/2019

Further out, things look trickier. As we have argued before, the Sino-US conflict is deeply rooted and has elements that extend far beyond trade. As such, de-globalisation risks likely prevail and could sour investment and the economic prospects.

Ultimately, for markets to see a reflationary environment as truly lasting, fiscal policy will need to come to the rise more broadly. In an historic aberration, we have already seen a move to counter-cyclical fiscal policy in the US (Figure 5). This has been a cornerstone of the Trump administration's policy. Moreover, China is expanding fiscal stimulus as highlighted previously. However, more broadly, especially in Europe, the political intention is there, but details are lacking in terms of timing, size and scope (domestic or eurozone-wide action).

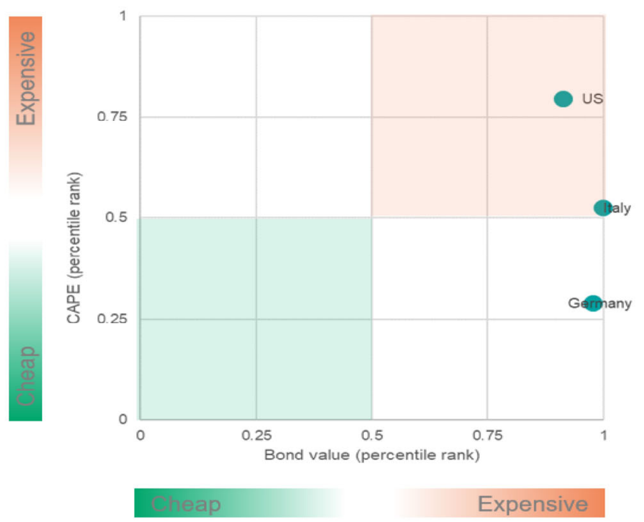
Figure 5: Counter-cyclical fiscal stimulus in the US?



Source: Bloomberg and BNPP AM, as of 31/10/2019

Last month, we showed how financial markets, and especially the fixed income market, were not priced for this at all. We are repeating the analysis in Figure 6 where we compare real yields and CAPE metrics to their long-term trends since 1990. Bond markets still stand out as rich across the main regions, and as such are at risk should we move to a sustained reflationary environment.

Figure 6: Equity vs. bond valuations: fixed income at risk



Source: Bloomberg and BNPP AM, as of 31/10/2019

WEAK DATA, BUT NO IMMINENT RECESSION

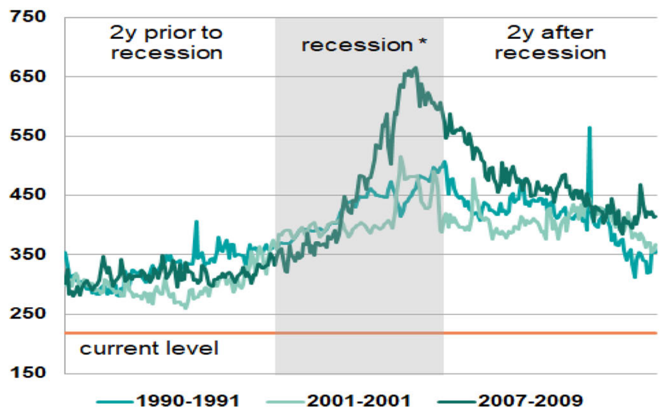
Since the market correction in Q4 2018, the slowdown has been a key concern for investors. This has accelerated and is now synchronised, albeit to varying extents, across major economies.

Despite the recent positive news on de-globalisation dynamics, this slowdown has continued. It is clearly visible when looking at sectors/countries geared to trade/manufacturing.

Too early to call a recession

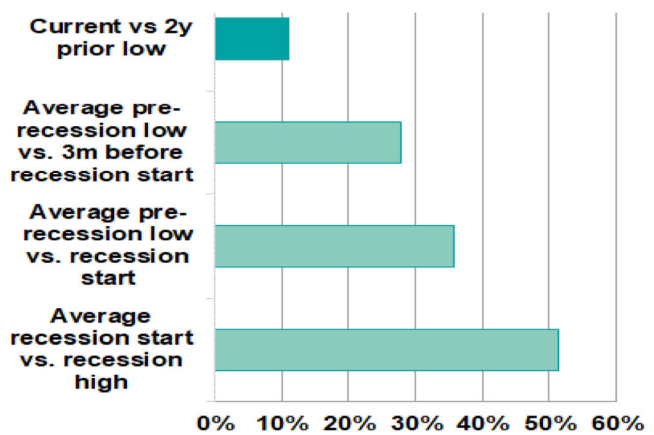
However, we think it is too early to call a recession. Especially in the US, where the consumer is key (consumption trends also drove the latest upside surprise to US Q3 GDP), domestic indicators have held up. Two key numbers we are monitoring concern the labour market and consumption. Both are on a solid footing. Consumer confidence, while off its highs, is nowhere near falling by as much as it usually does heading into recessions. In addition, initial jobless claims have remained near absolute lows (Figure 7) and, crucially, have not risen anywhere near the previous pre-recession dynamics (Figure 8).

Figure 7: Initial jobless claims around prior recessions



* Recession length varies across cycles; rebased recession start =100
Source: Bloomberg and BNPP AM, as of 31/10/2019

Figure 8: Initial jobless claims changes around recessions



Source: Bloomberg and BNPP AM, as of 31/10/2019

While it is also too early to say we are out of the woods, it is clearly too early to call a cyclical turn to a recession, and the combination of de-globalisation relief and central bank dovishness are giving investors a ray of recovery hope.

Key differences to Q4 2018 leave us optimistic

To put things into context, we find it instructive to compare the current backdrop to that of Q4 2018, especially given the large sell-off in risky asset then.

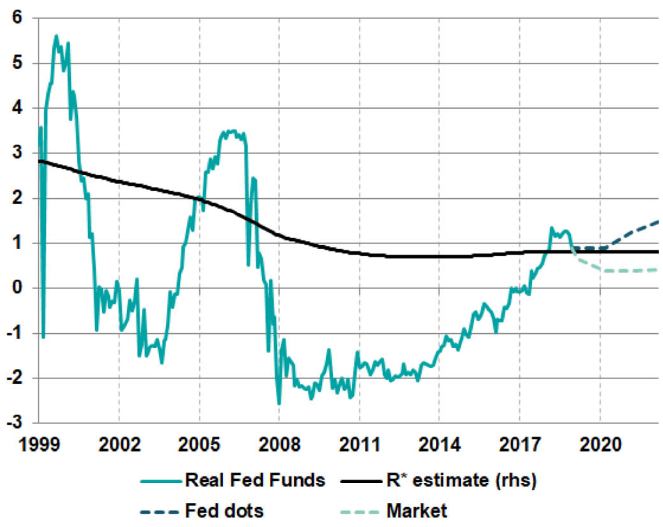
On the similarities, clearly we are seeing a slowdown in the macro data now, as was the case late last year. Political uncertainty is similarly high, and in some ways, trade tensions are more negative now (bar the recent improvement) as positions have become more entrenched and tariffs are already in place.

Nevertheless, there are key differences, which we feel make the current backdrop different to that of Q4 2018.

For one, and this is absolutely key for markets, major central banks are easing monetary policy, which contrasts with last year's tightening bias when the US Federal Reserve in particular was moving into restrictive territory at a time when the macro data was deteriorating. This was a toxic combination for markets that had been fuelled by a decade of QE. As shown in Figure 9, recent Fed rate cuts are reversing this overtightening. Whilst the Fed indicated at their October meeting that they are likely to pause after three recent rate cuts, Chairman Powell also made it clear that the hurdle to tighten policy is very high. There remains an asymmetry towards easier policy in other words.

Elsewhere, other central banks – notably the ECB and Chinese policymakers – have started easing policy again recently. If market expectations are correct, this easing could persist.

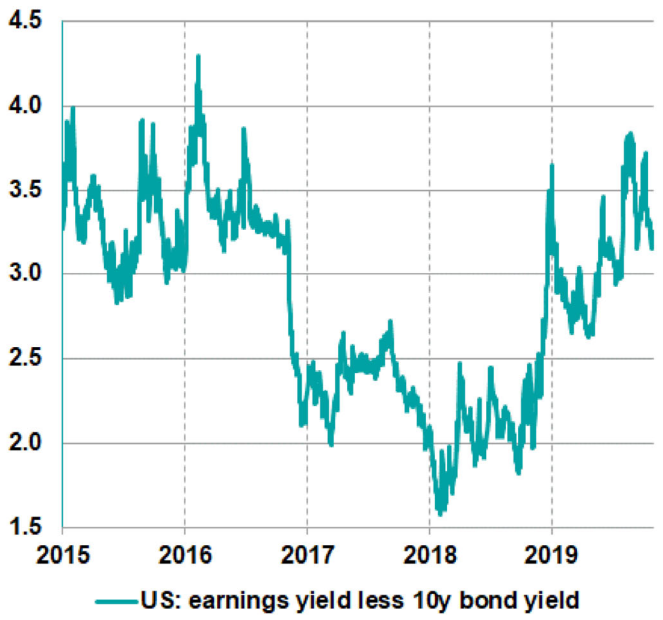
Figure 9: Fed stance: reversing overtightening



Source: Bloomberg and BNPP AM, as of 31/10/2019

Two other differences worth highlighting are investor positioning and valuations. Both are supportive compared to late last year. On the former, various indicators we monitor suggest investors are more defensively positioned, compared to their bullish stances late in 2018. And on valuations, with the fall in global bond yields, relative valuations of equities and bonds make equities less rich now than in 2018. In the US, for example, the gap between the S&P 500 earnings yield and bond yields is almost 200bp wider than before the 2018 sell-off (Figure 10).

Figure 10: Valuations: equities not rich compared to bonds



Source: Bloomberg and BNPP AM, as of 31/10/2019

ASSET ALLOCATION

****** We have introduced our new asset allocation portfolio optimiser – 'MFA' – which uses factor analysis to map core asset views to factor exposures across all our Multi-Asset portfolios, from the flexible to the very constrained. Please see a white paper here for details. From now, we will also communicate views from a 'factor viewpoint'. ******

Core views and factor exposures

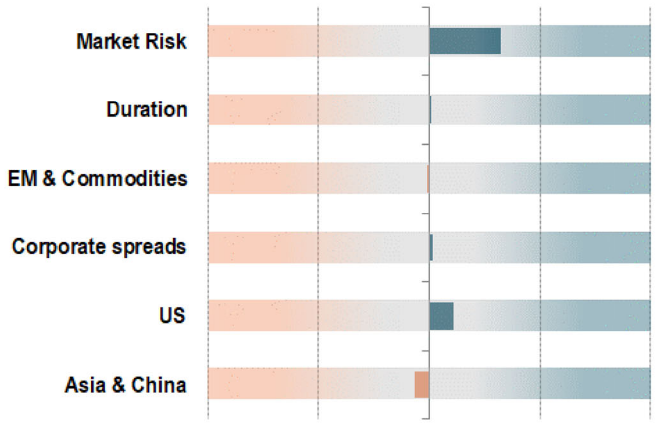
Our base case remains 'fragile goldilocks', but as we have argued, the probabilities of our alternative scenarios remain high. Broadly speaking, we thus continue to be nimble in our asset allocation views and think strategic risk/reward is still unattractive.

In the short term, the market is catching on to our reflation theme/risk: equity markets have rallied in tandem with bond yields increasing. This latest price action has boded well with our main factor exposures (Figure 11) – the biggest of which is an overweight in ***Market Risk***, and until recently a slight underweight in ***Duration*** (given the yield back up we reduced our short EMU duration view very recently).

The ***Market Risk*** exposure is mainly due to our renewed overweight in equities, but also due to other views such as the overweight in emerging market hard currency debt. Our ***Duration*** factor exposure is roughly neutral now, even though we are still slightly underweight EMU bonds, given the offsetting nature of search-for-yield trades such as the long in EM hard currency debt.

In terms of the other factors, with most of our other views in the relative value space or offsetting each other, factor loadings are currently small outside of ***Market Risk***.

Figure 11: Current factor exposures* from core asset views



* The factor exposure shown is for an unconstrained theoretical portfolio and derived from core asset class views. These factors will be projected onto individual portfolios taking constraints into consideration. Additional specific/tactical trades may be implemented and these will not be visible in the factor profile. They are listed at the end of this publication.

Source: BNPP AM, as of 31/10/2019

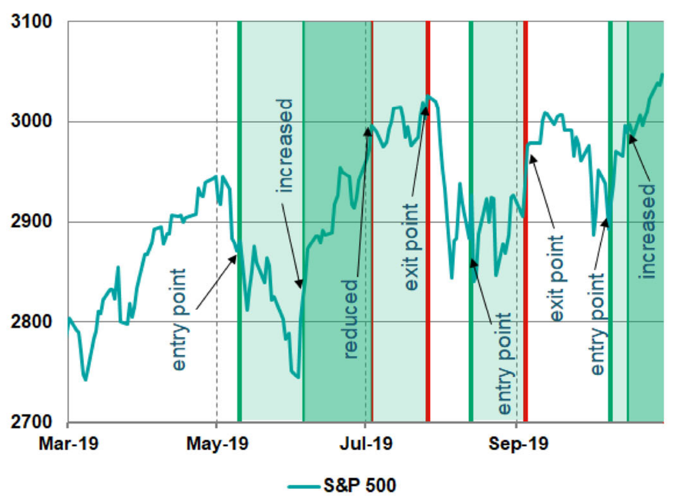
Nimble approach in equites: added market risk again

We have operated with a nimble 'buy the dip' modus operandi for most of this year, and have successfully navigated the zigzag range trading in equities. Having taken off our overweight last month, a renewed correction in global stock markets has allowed us to once again add to market risk via US and European equities (Figure 12).

As discussed above, with positive geopolitical developments, risk assets have been bid in recent weeks. Moreover, against the pessimistic consensus on earnings we discussed last month, the latest company reports have actually been decent. This means our renewed overweights in equities have done well, with the S&P 500 rising to new all-time highs at the time of writing. We will remain nimble and are operating with trailing stops given the moves of late.

In terms of factor exposures, these equity overweight tilts clearly add ***Market Risk*** exposure, making this the most prevalent factor exposure currently.

Figure 12: We bought the equity dip once again



Source: Bloomberg and BNPP AM, as of 31/10/2019

Reduced underweight in core EMU bonds

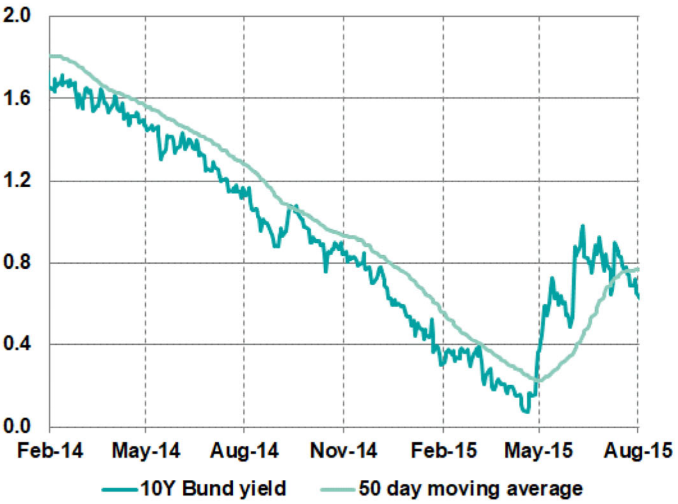
Last month, we argued that the risks for government bond yields were firmly to the upside absent a recessionary shock, and that the fixed income market was not priced for a reflationary environment whatsoever.

In recent trading, this has come to fruition: major bond markets started selling off after this year's steep rally. The wave of geopolitical optimism caught the market by surprise, in other words.

Even after recent moves, we still think that a lasting reflationary shock represents a major risk. As such, the risk/reward for underweights in core government bond markets remains attractive for the medium to long term. We are underweight core EMU bonds, but here too are applying a nimble approach. So after a near 40bp backup in yields, we have reduced our short exposure, looking to possibly add at better levels.

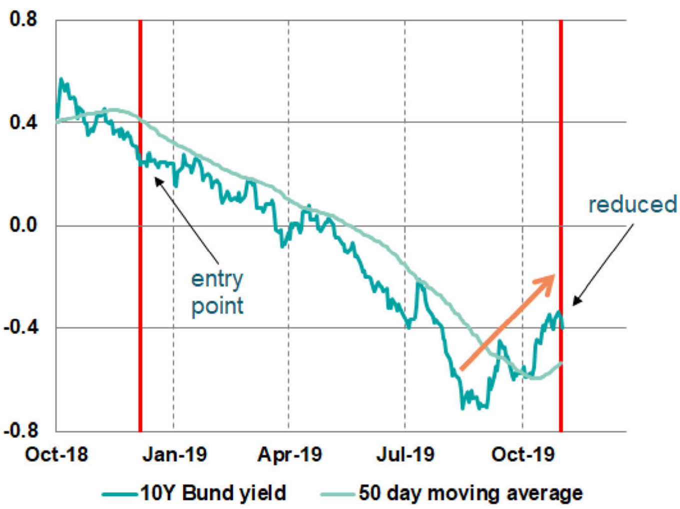
Otherwise, we also highlighted that from a technical perspective, our proprietary market dynamic and timing signals were pointing to a possible inflection point and that the trading set-up on the Bund reminded us of 2014-2015. Then, the 50-day moving average bound the rally associated with market expectations of QE, only to unwind swiftly once this key resistance was breached (Figure 13). Today, price action looks similar, and the unwind we warned of last month on the markets breach of the 50d moving average has continued in recent weeks (Figure 14). Nonetheless, we see it prudent to reduce exposures after swift moves and upcoming risk events.

Figure 13: German Bund yields in 2014-2015



Source: Bloomberg and BNPP AM, as of 31/10/2019

Figure 14: Still underweight core EMU duration



Source: Bloomberg and BNPP AM, as of 31/10/2019

From a factor exposure viewpoint, this trade adds negative ***Duration*** to portfolios (albeit this is counteracted by other views such as our long in EM debt; see below).

Search for yield: overweight EM hard currency debt and EMU REITs

Elsewhere, we still believe that the drivers of our 'fragile goldilocks' base case, especially continued central bank easing, will prolong the search for yield. We continue to focus on finding attractive entry points in high-carry assets.

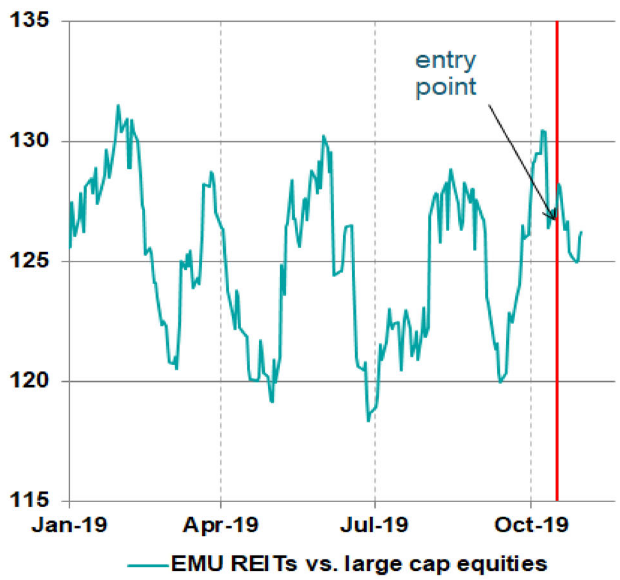
In this light, we have held an overweight in EM hard currency debt. This worked well in previous episodes of central bank easing and falling real yields. Chinese policy easing efforts have been a further positive, helping to compress EM spreads.

In factor terms, this position adds ***Duration*** exposure (countering the effects of the underweight in core EMU bonds) and introduces exposure to the ***EM & Commodities*** factor.

Otherwise, regular readers will recall that REITs markets have been on our radar for several months, also from a search-for-yield viewpoint. Recently, taking advantage of a small dip, we added an overweight in EMU REITS (Figure 15).

We have implemented this view RV against large-cap equities and core bond markets to ensure the factor exposures of this trade do not significantly counteract our convictions in core asset classes. The factor exposures of this RV trade are minimal: the main one is a slight tilt towards ***Market Risk***.

Figure 15: Long EMU REITs



Source: Bloomberg and BNPP AM, as of 31/10/2019

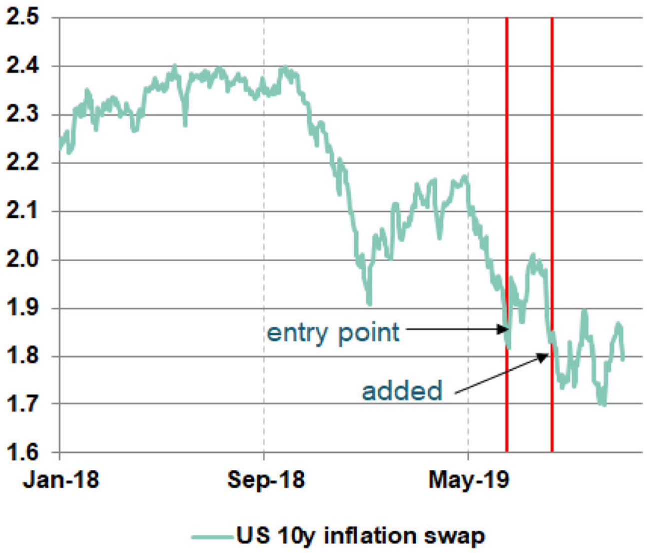
Robust portfolios: long US breakeven inflation

Regular readers will be familiar with our mantra of building robust portfolios, and we have implemented various views along these lines in recent months.

We remain long US breakeven inflation, a trade originating from a valuation perspective, but as discussed last month, also a viable hedge to a reflationary impulse. Indeed, in recent weeks, this trade has done well, recuperating some of the prior losses (Figure 16).

Note that we also have specific tactical trades that are implemented outside of our new factorisation model. The long in US breakevens is one example of such a trade, and it thus does not affect the factor exposures of the broad book of business discussed elsewhere. Accordingly, as it is thus not factorised, it will also not be implemented in every portfolio.

Figure 16: Long US breakeven inflation



Source: Bloomberg and BNPP AM, as of 31/10/2019

Robust portfolios: de-globalisation trades

We have also held two trades specifically geared to de-globalisation for some time.

Firstly, a long in CAC/DAX. We see German equities more geared to the manufacturing slowdown/trade war than French stocks. Since inception, this trade has done well, although recently, idiosyncratic factors related to earnings have caused volatility.

In factor exposure terms, note that the two RV legs have almost identical exposures and thus the factor profile of the RV trade is almost negligible.

Elsewhere, in currency markets, we are still long the US dollar versus low-yielding Asian FX crosses. Our basket is correlated to USD/CNY and hence did well in periods of trade war stress.

We continue to see this low carry-cost trade as a good portfolio diversifier.

Note that this is another example of a specific trade implemented outside of the new optimiser.

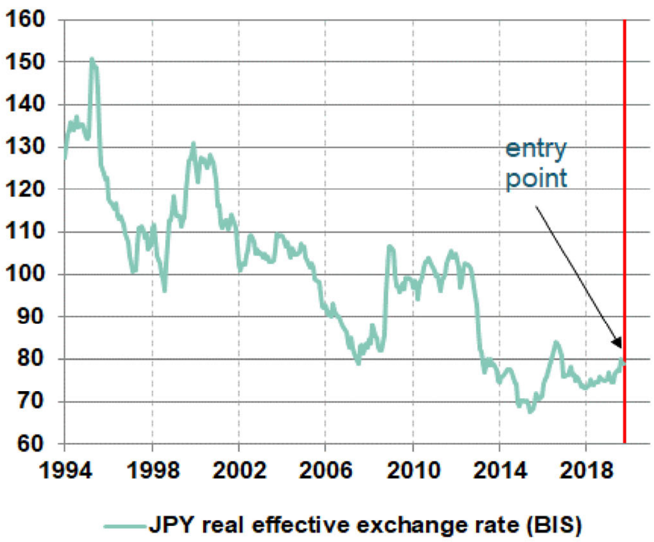
Robust portfolios: other diversifiers

Finally, we added two additional portfolio diversifiers in this past month, again to build robust portfolios.

The first is a long in JPY versus EUR. We see scope for the yen to rally in a risk-off market shock, especially given the currency's cheapness (Figure 17). Put differently, with the Bank of Japan already near the absolute lower policy bound, the yen would not just do well from its usual safe-haven characteristics, but in a recessionary environment where other central banks would ease, rate differentials would also support the yen. We implemented this against the euro, also offering a hedge to EMU break-up scenarios.

From a factor viewpoint, the main factor loading on short EUR/JPY is a negative exposure to ***Market Risk***.

Figure 17: JPY is a cheap risk-off currency



Source: Bloomberg and BNPP AM, as of 31/10/2019

Finally, we added a long in gold this month. We feel it is a good portfolio diversifier for several reasons. Firstly, given its limited supply and zero yield, it should be supported in the status quo where central banks are debasing their fiat currencies and operating in negative yield space (on the latter point, gold's zero yield effectively has become a positive yield).

Nevertheless, in risk scenarios, gold could also be an attractive asset and we feel that both in a risk-off/recession scenario and in an inflationary shock, gold will be supported.

This is also a specific trade implemented outside of our new optimiser, hence does not affect the factor loadings of the broad book of business discussed above.

OVERVIEW OF KEY VIEW CHANGES IN OCTOBER 2019

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

OCTOBER:

CORE ASSET CLASS VIEWS:

LONG EMU REITS VS. EMU EQUITIES AND BONDS OPEN 02/10/19

- QE and the low rate environment pushes investors to search for alternative investments, and we believe real estate will benefit. We entered a long in EMU real estate, using duration and equities as a funding leg.

LONG US EQUITIES OPEN 09/10/19

- As our ‘fragile goldilocks’ base case suggests buying dips, we used the early October correction to buy US equities again.

SHORT EUR/JPY OPEN 09/10/19

- To build robust portfolios, we hedged our long US equities view, among other positions, with a short in EUR/JPY.

LONG EMU EQUITIES OPEN 16/10/19

- As our technical indicators and market dynamics analysis suggest that we should be positioned for an upside breakout, we opened a long position in EMU equities.

SHORT CORE EMU DURATION REDUCED 30/10/19

- Given fundamental and market dynamic inputs, after a ~40bp move higher in yields, we decided to manage this position nimbly and reduce our exposure ahead of the FOMC meeting

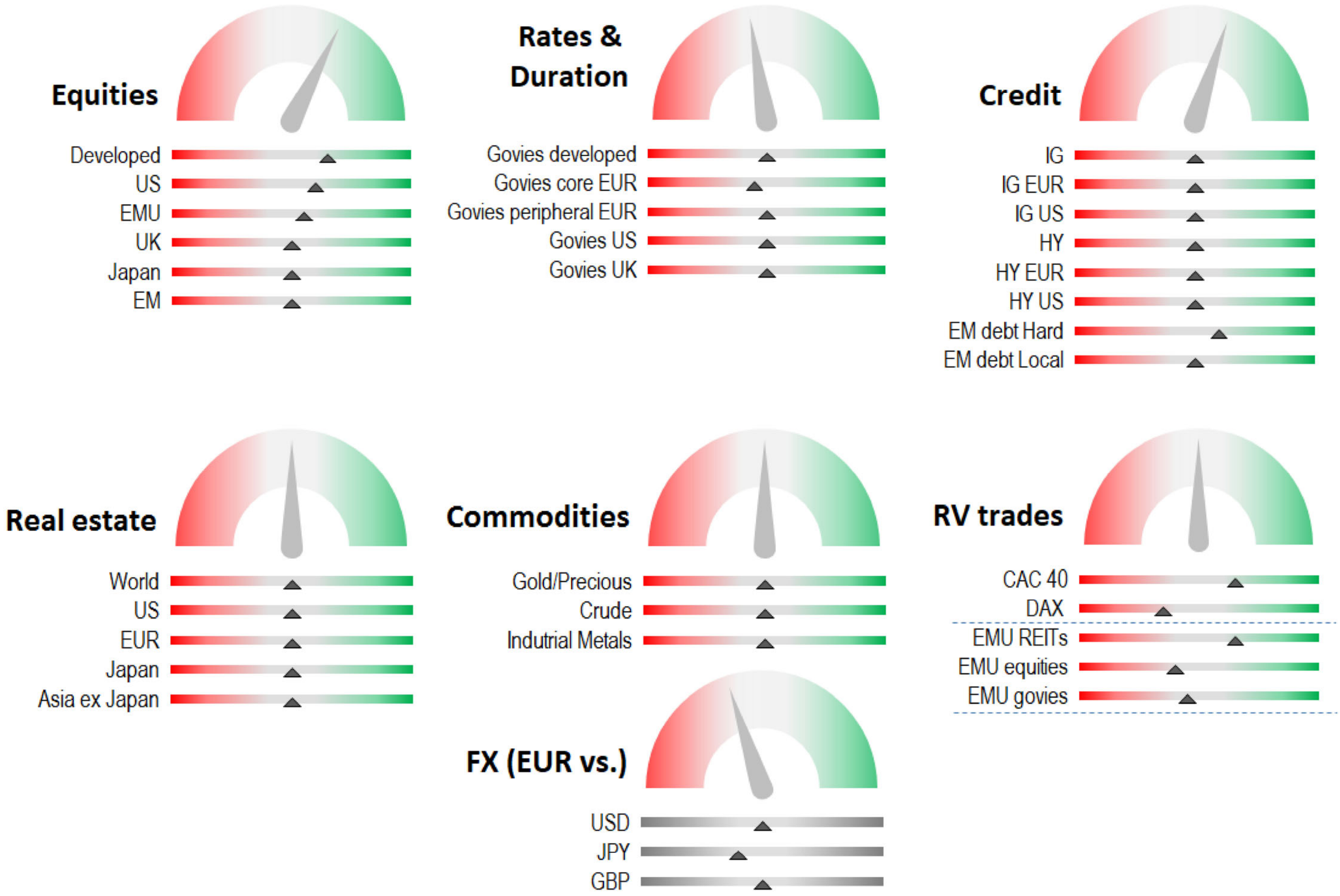
SPECIFIC/TACTICAL VIEWS:

LONG GOLD OPEN 09/10/19

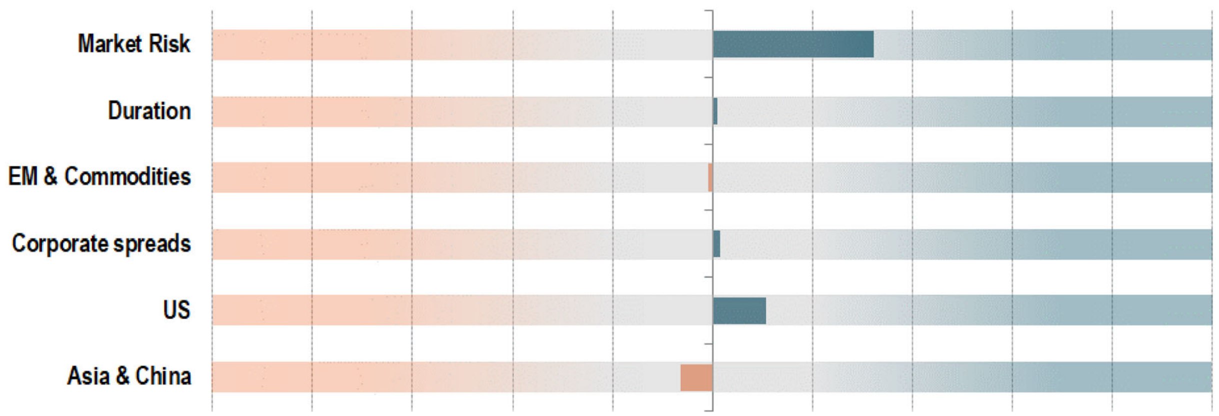
- As gold is a good hedge against inflation and risk-off scenarios, we opened a long position.

CORE ASSET CLASS VIEWS & FACTOR EXPOSURE

Core asset class views[1]



Factor exposure[2]



[1] The core asset class views dashboard reflects the key views and decisions of the Investment Committee of the Multi-Asset team at MAQS.
[2] The factor exposure shown is for an unconstrained theoretical portfolio, derived from core asset class views. These factors will be projected onto individual portfolios considering constraints. Some specific/tactical trades may be implemented in addition and will not be visible in the factor profile. Such trades are listed at the back of this publication.

SPECIFIC/TACTICAL TRADES[3]

Trade	Asset class	Specific/Tactical
Long USD vs. Asian FX	FX	Specific
Long US Breakeven inflation	Rates & duration	Tactical & specific
Long gold	Commodities	Specific

[3] Specific/tactical trades are implemented in addition to the core asset class views and will not be visible in the factor profiles shown elsewhere in the document.

Views expressed are those of the Investment Committee of MAQS, as of November 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 November 2019.