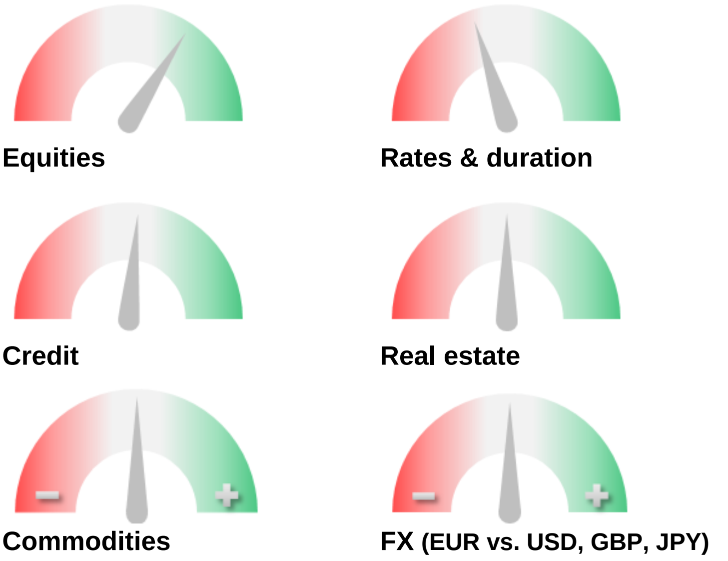
FOR PROFESSIONAL INVESTORS – 4 July 2018

ASSET ALLOCATION QUARTERLY

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

CAUTIOUSLY OPTIMISTIC

Asset allocation overview:



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SUMMARY:

- The second quarter of 2018 was tainted by trade tensions; investor concerns about Italy and European growth; and stress in emerging market (EM) and China-linked assets. However, not all news was bad for the markets: US equities and crude oil outperformed other risky assets and credit markets outside of the eurozone ‘periphery’ and EM have been generally stable.
- We foresee calmer markets over the next few months and have identified these reversal themes: (i) The crude oil market has likely seen a top already as it has priced in plenty of good news on demand, supply and geopolitics. (ii) Relative monetary policy divergence between the US Federal Reserve and the ECB is also largely priced in. We therefore expect the USD to stabilise against the EUR and the spread between US Treasury (UST) and German bond yields to tighten. (iii) More stable US rates markets and a stable USD should support EM currencies and therefore EM local debt.

ASSET ALLOCATION:

- Despite markets being more volatile than in 2017, our base case scenario remains one of robust global growth and contained inflation. This underpins our bullish view on equities, with a preference for eurozone equities where we see positive earnings growth prospects and room for margin expansion.
- We have recently taken a long position in US Treasuries versus German 5-year bonds and we will look for opportunities to add long EM currency exposure, for example, by adding to our existing long EM local debt position.
- Our market dynamics analysis (including technical, sentiment and liquidity conditions) had flagged a more challenging environment early in 2018. We maintain our positive view on risky asset in Q3, but we continue to monitor market movements closely.

BNP PARIBAS ASSET MANAGEMENT

The asset manager for a changing world

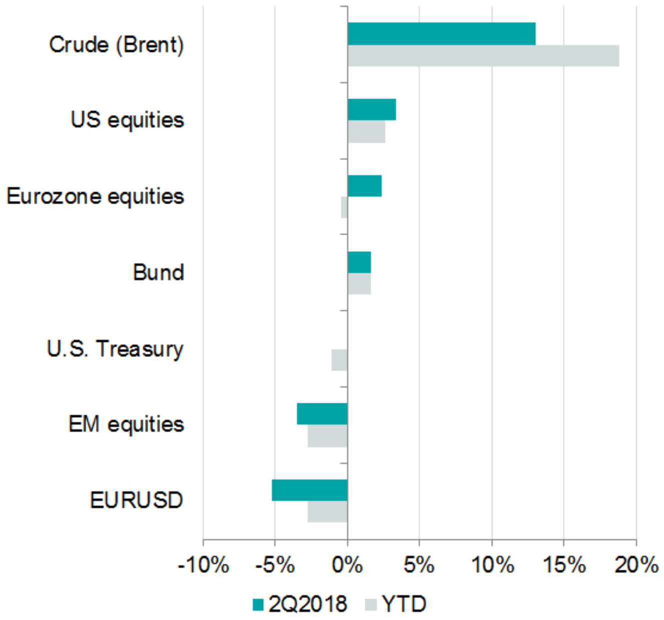
MARKET REVIEW: Q2 2018

The hallmark of Q2 has been the progressive economic divergence between the US and the rest of the world. This has been fuelled by several key elements. In the US, stimulus from the tax cut boosted economic activity and consumer confidence. This positive development could have benefited the global economy and financial markets. However, President Trump's protectionist agenda got on the way. The implementation of several import tariffs alongside aggressive rhetoric on trade unsettled investors and accentuated the divergence by hurting export-oriented economies such as emerging markets and developed countries such as Germany.

The divergence is evident in monetary policy: the US Federal Reserve continues steadily on its normalisation path, while the ECB has remained cautious to avoid a financial taper tantrum with investors still digesting slowing economic activity in Europe and rising political risk. The Bank of Japan is still committed to its unconventional loose policy and the Bank of England is striving to keep the UK economy stable amid uneasy Brexit negotiations.

In Europe, the resurgence of political risk (notably in Italy) dragged down equity markets and 'peripheral' bonds. The main stress factor was the nomination of the new ruling Italian coalition of far-right and far-left parties, both giving a cold shoulder to European institutions when it comes to immigration or fiscal policies. Hardest-hit were European banks as well as Italian sovereign bonds (BTPs), down 6.9% and 8.5% respectively. Elsewhere, in Germany, cracks started to appear in the grand coalition over immigration policy, endangering the CDU/CSU alliance.

Figure 1: US equities and crude oil outperformed in Q2 2018



Source: Bloomberg, BNPP AM; data as of 03.07.18

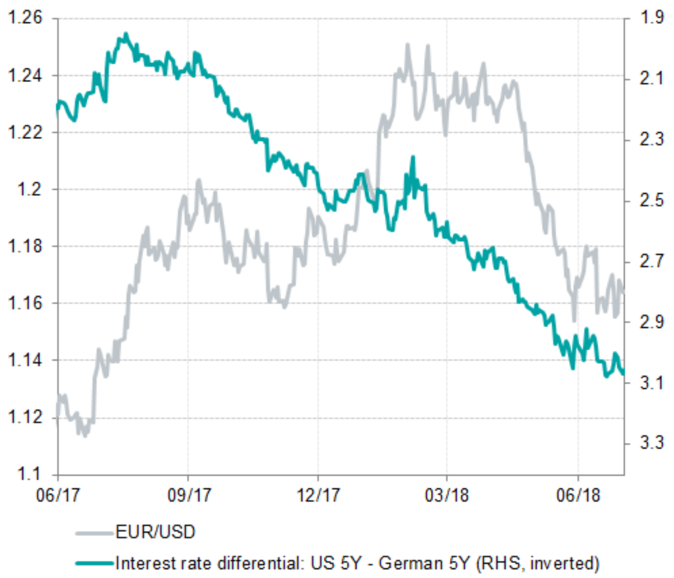
A stronger US dollar and higher US yields were a strong headwind for emerging markets. EM fundamentals are still solid, but the speed of losses in some EM currencies as well as protectionist worries led to outflows from EM assets. More recently, concerns over Chinese growth, protectionism and the risk of capital outflows led to CNY depreciation and further worries about EM outflows.

In this choppy environment, worries over softer global growth weighed on industrial metals, with copper down by more than 3% from early April. Crude oil was one of the best-performing assets, partly due to OPEC's decision to increase production by less than market participants expected. Gold's 6% underperformance over the quarter reflects higher US real yields and the stronger dollar.

SUMMER REVERSALS

In a recent Asset Allocation Flash – entitled Mid-year reversals – we said that we expected a pause and potentially a reversal in some of the trends that have been prominent in recent months. In particular, we expect UST yields and the USD to stabilise in the near term.

Figure 2: EUR/USD should stabilise as the interest-rate differential narrows

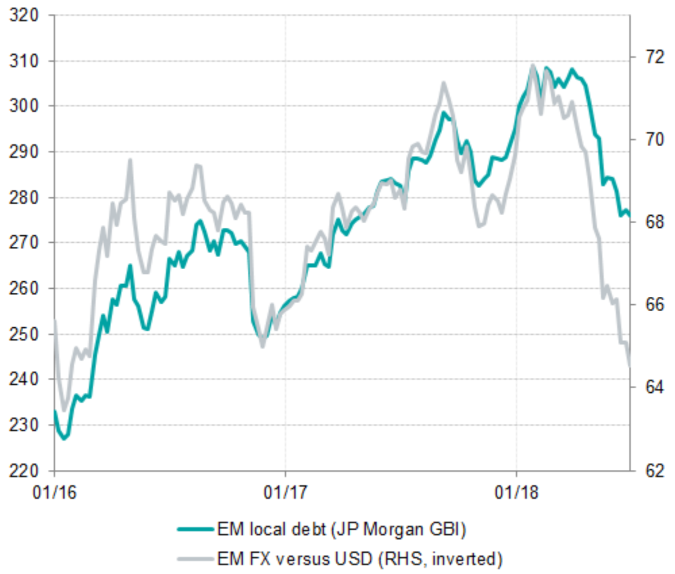


Source: Bloomberg, BNPP AM; data as of 03.07.18

Admittedly, both UST yields and the USD already started stabilising in June. UST yields have priced in good news on growth, inflation and Fed tightening. By contrast, the eurozone economy has slowed and Italian political risk rose, pushing yields on core eurozone bonds down. While the ECB has signalled its intention to end its asset purchase programme by the end of 2018, it does not expect to raise interest rates until well into 2019. We therefore expect the spread between UST versus German yields to fall and the USD to weaken versus the EUR (see figure 2).

A weaker USD should help stabilise EM currencies and EM local debt (see figure 3). Two additional factors should support EM currencies: (i) the restoration of EM rate differentials as EM central banks raise interest rates or sound more hawkish, and (ii) the fact that growth and external fundamentals are stronger than five years ago when growth in China was slowing rapidly, commodity prices were in a bear market and countries such as Brazil and Russia were in recessions.

Figure 3: A USD stabilisation should help EM debt in local currency



Source: Bloomberg, BNPP AM; data as of 03.07.18

The recent trend in crude oil can also reverse. Crude was one of the few risky assets that has rallied since the beginning of the year, by close to 15%. In our view, in late May, too much good news on demand, supply and geopolitics was priced in. After a brief fall, oil prices have rallied again recently to close to highs for the year due to (i) concerns that supply increases by OPEC as a whole will not be enough to offset falling supplies of some members, and (ii) much bigger-than-expected falls in US inventories.

There are two drivers that could help crude oil weaken: (i) a reassessment of global demand. Most risky assets have already incorporated some bad news in terms of the growth prospects, but not crude. (ii) Most of the focus is on OPEC supply, but US supply remains strong, registering a record high in Q2. Lower or more stable oil prices should help stabilise US breakeven inflation and therefore UST yields.

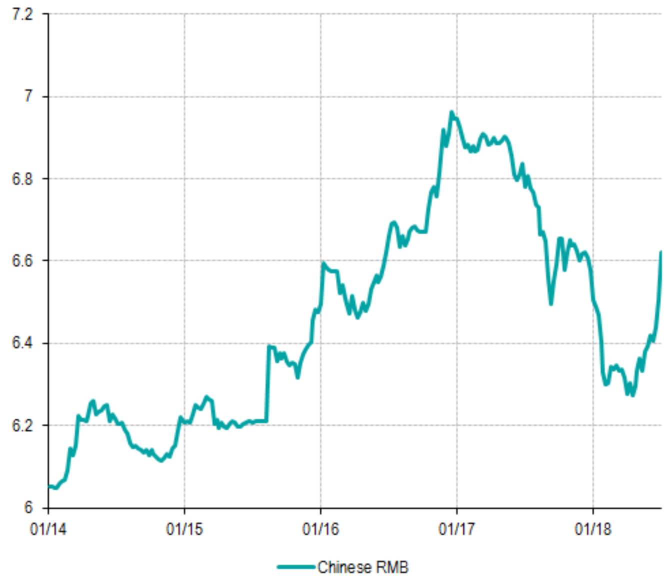
CHINA AND EM UNDER PRESSURE

Emerging market assets have been under pressure for several months. Initially, this was triggered by higher US interest rates and a stronger USD. This was exacerbated by concerns about external fragility, notably in Argentina and Turkey, and the resulting outflows from the asset class.

More recently, concerns have risen further, but this time due to worries over Chinese growth and the risk of capital outflows. The latest activity data on China came in softer-than-anticipated. For example, industrial production growth retreated to 6.8% from 7.0%, while retail sales growth slowed to 8.5% year-on-year.

The Chinese authorities have opted to allow their currency to weaken as a way of easing monetary conditions and support the economy. CNY weakness could also reflect posturing by the authorities over US trade tariffs. The CNY lost 5.5% during Q2 2018 relative to the USD. This rekindled investor memories of the damage that a material devaluation did to markets in 2015 (see figure 4). As a result, Chinese and other EM equity markets have remained under pressure.

Figure 4: Chinese CNY depreciation is comparable to 2015 move



Source: Bloomberg, BNPP AM; data as of 03.07.18

Admittedly, allowing the currency to weaken can mitigate the pressure from capital outflows and restore competitiveness relative to other Asian currencies that have already slipped. However, the Chinese authorities likely want to strike a balance between supporting the economy via some monetary easing, including currency weakness, and investor concern over a rapidly weakening CNY.

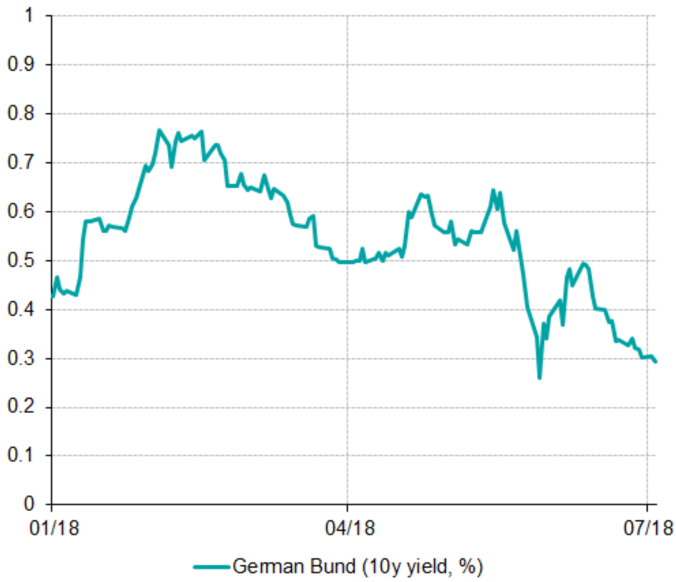
So far, the authorities have struck the right balance and markets have been calmer than in the last few weeks.

ASSET ALLOCATION

Despite uneasy markets in Q2 2018, we have confidence in our medium-term view of continued growth and muted inflation, which should benefit equities, especially in the eurozone and Japan where we forecast positive surprises on earnings growth. Notwithstanding our optimistic roadmap, we have had to deal with the resurgence of political risk, trade protectionism and softer global growth. This required swifter portfolio adjustments and more tactical positions.

In Europe, we addressed the resurgence of political risk by reducing our underweight duration position temporarily at the end of May. Indeed, political risk in Italy triggered a rotation from 'peripheral' countries towards safe-haven core countries such as Germany. After the rally in German Bunds, we chose to return to our longer-term view of rising yields and reopened our underweight position. We also implemented a relative value trade: long US Treasuries versus short German bonds (in 5 year maturities) after the spread widened significantly. We expect it to progressively tighten as the ECB heads towards policy normalisation (see figure 5).

Figure 5: German Bund rallied due to political stress in Europe



Source: Bloomberg, BNPP AM; data as of 03.07.18

We took advantage of the rising yield environment by investing in US banks. This also allowed us to diversify our equity position geographically.

In EM, we continue to look for opportunities to add long EM FX exposure, for example, by adding to our existing long EM local currency debt position. Our view on EM remains constructive. We believe that market participants have now discounted most of the bad news and that there are now more elements for positive rebound.

Our market dynamics analysis (including technical, sentiment and liquidity conditions) had already flagged a more challenging environment early in 2018. We are maintaining our positive view on risky asset in Q3, but we continue to monitor market movements closely.

STRATEGIC OVERVIEW OF KEY POSITION CHANGES IN Q2 2018

The BNPP AM MAQS team made the following strategic calls:

JUNE:

LONG US BANKS — OPEN — 06/06/2018

- US bank equities should benefit from a robust US economy and higher interest income as interest rates rise.

LONG US TREASURIES VERSUS GERMAN BONDS — OPEN — 06/06/2018

- We believe that German yields have more room to rise compared to UST that have already sold off significantly.

SHORT EMU DURATION — OPEN — 13/06/2018

- This reflects asymmetric risks in EMU duration given the low yields and the move by the ECB to end its QE programme.

MAY:

LONG EMU EQUITIES — REDUCED — 23/05/2018

- We reduced our risk exposure in the face of Italian political risk and weaker growth.

SHORT GERMAN BUND — CLOSED — 23/05/2018

- Similar to our EMU equities move, Italian risks and weaker growth led us to trim our underweight in Bunds.

LONG EUR/GBP — CLOSED — 23/05/2018

- We closed this position as political risk put pressure on the euro and the likelihood of a softer Brexit increased.

SHORT GBP/USD — CLOSED — 16/05/2018

- We closed this position as the likelihood of a softer Brexit grew and relative central bank policies shifted in favour of the GBP.

LONG EMERGING MARKET DEBT LOCAL CCY — INCREASED — 14/05/2018

- We took advantage of the EM FX downturn to add to our position. EM yields are higher and more stable UST yields and USD should support EM local debt.

APRIL:

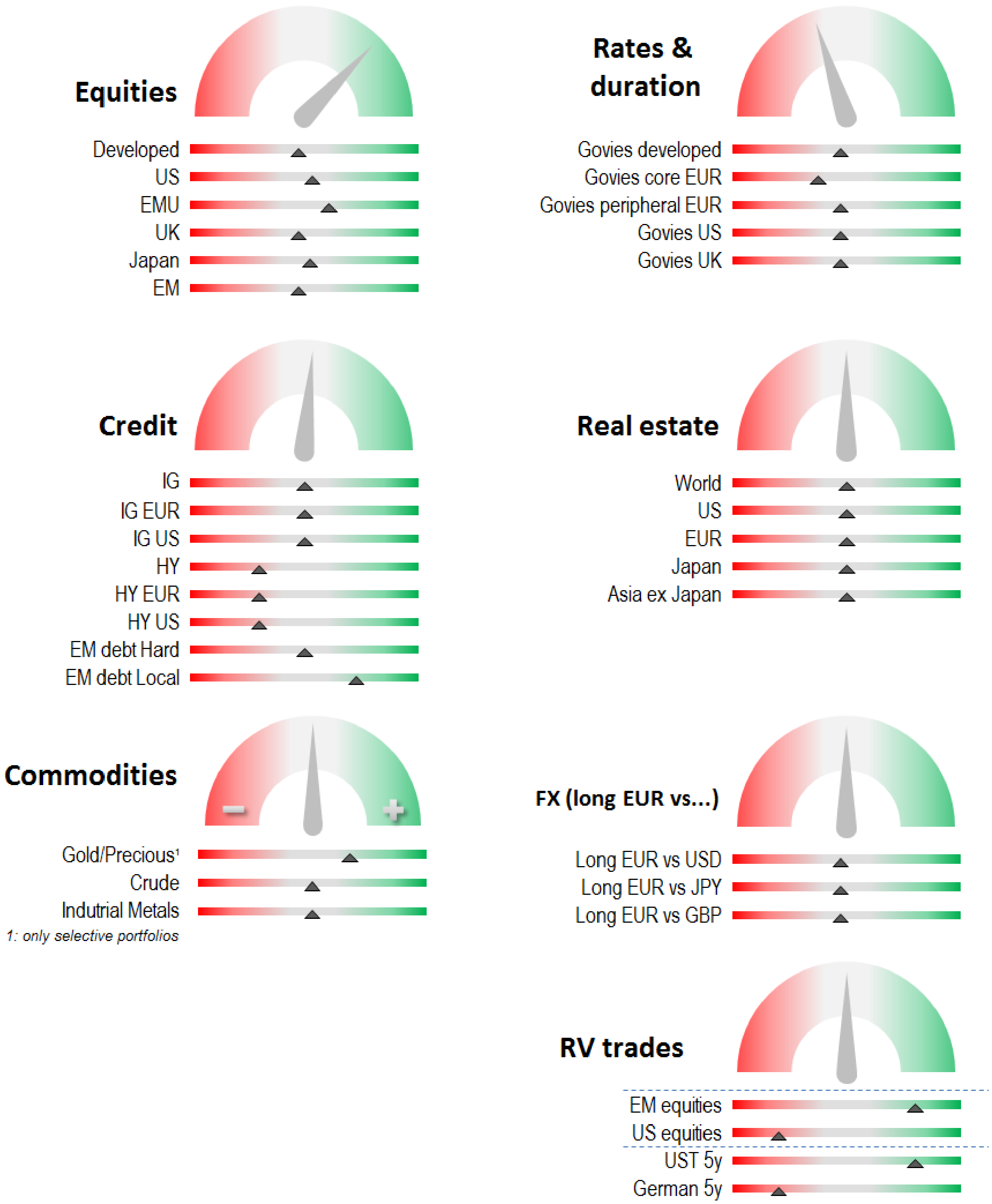
LONG US BANKS VERSUS US EQUITIES — OPEN — 18/04/2018

- US banks should outperform the broader market as yields rise.

LONG US REITS VERSUS US TREASURIES — CLOSED — 11/04/2018

- We closed the position due to our fading conviction; rising US yields could hurt US REITs further.

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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