

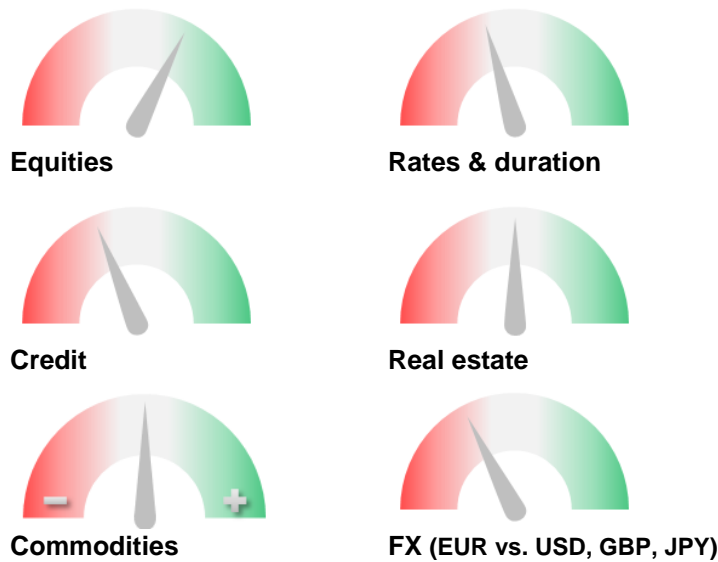


# ASSET ALLOCATION MONTHLY

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

## MORE VOLATILITY AHEAD: BE TACTICAL

### Asset allocation overview:



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## SUMMARY:

- October's price action felt very much like a repeat of the February correction. Equity prices dropped sharply, equity volatility spiked higher and other asset classes, including EM currencies and credit, remained contained.
- One of the main reasons for the equity correction was higher US Treasury yields. In our view, this move is structural. Firstly, UST yields appear to be breaking out of a multi-year downtrend. Secondly, the move-up was driven by real yields reflecting the forces of both quantitative tightening and strong growth.
- While the higher yields can be explained by fundamentals, the timing of the equity selloff was more difficult to predict. In such a context, we rely on our market dynamic indicators. These were signalling equity market vulnerability to a correction in September.

## ASSET ALLOCATION:

- We have adopted a more tactical approach relying more on our dynamic market analysis and not just on fundamentals.
- We took advantage of the correction to add equity exposure tactically by going long developed market equities.
- We have also taken a long position in French equities relative to German equities as the CAC/DAX ratio looks historically low and as we see the French CAC index as more insulated from trade protectionism than the DAX.
- We remain underweight EMU duration since we see yields as too low historically and given the shape of the eurozone economy. We remain short EUR/USD as a hedge against an escalation of Italian political risk as well as the risk of higher inflation in the US.
- We went long USD against a basket of Asian currencies as a hedge against the risk of de-globalisation and greater trade protectionism.



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## MARKET REVIEW: OCTOBER 2018

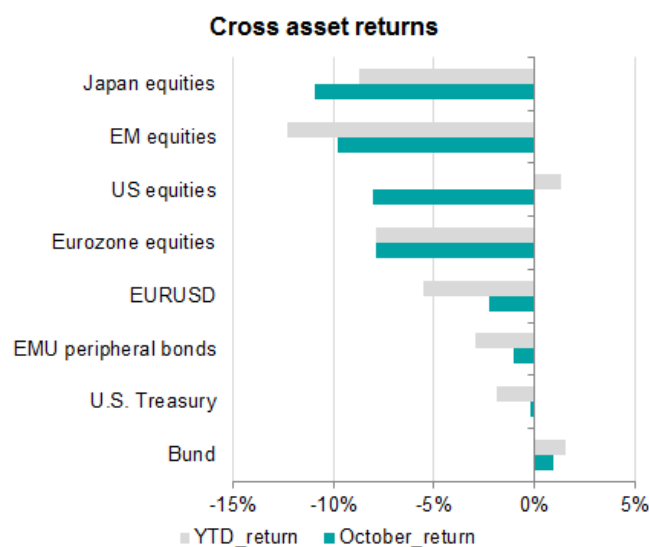
Financial markets had a turbulent October, echoing February’s rout. As was the case earlier this year, a sharp rise in US yields caused equities to sell off, hurting investor sentiment.

The extent of the equity market fall was similar to February’s. In the US, the S&P500 index dropped by nearly 10% before recovering partly to end the month down 6.9%. In other regions, the Nikkei fell by 9.1%, the EuroSTOXX600 by 7.9% and EM equities by 8.7%. Risk-off sentiment favoured defensive sectors with utilities and consumer staples bucking the trend with small gains in the US. The outlier was Brazil: the stock market rose by 10% on the month following the election of the more market-friendly presidential candidate. Looking at equity volatility, investor nervousness came back front-and-centre, with the VIX index jumping momentarily to above 25 points and ending the month at around 20 (for reference, the recent low was 11.1 at the start of October; the high in February’s sell-off was 37.3).

With a sell-off in rates at the heart of the wider risk wobble, fixed-income assets also suffered. Ten-year US Treasuries fell by 0.5% despite the risk-off mood. European government bonds were more mixed with ‘periphery’ bonds suffering, especially over Italian budget headlines and news that major rating agencies were reviewing their Italian debt ratings. German Bunds benefited from this risk-off mood and rallied by 0.6% in euro, but still lost 1.9% in USD terms. Corporate credit suffered with spreads widening by 60bp and 70bp in US and eurozone high-yield, respectively. In FX, the highlight was the stronger US dollar (DXY index ca. +2%), helped by a slightly more hawkish US Federal Reserve and higher rates. The Japanese yen rose slightly in this risk-averse month. In commodities, gold gained 2%, while crude oil and industrial metals sold off with the Bloomberg energy and industrial metals indices both down by 5.5% in October.

It is important to note that the macroeconomic indicators and fundamentals remained robust, especially in the US. Growth and earnings results were still strong, so the explanation for the correction explanation lies elsewhere. In our view, calm and steady market growth supported by loose monetary policies is fading away as market participants become more and more cautious and start to reassess risk premiums. As we mentioned in our previous monthly, global Sharpe ratios are structurally lower with increasing volatility and decreasing returns. In this report, we address more specifically the structural change unfolding in the bond market.

Figure 1: Another equity correction on higher rates

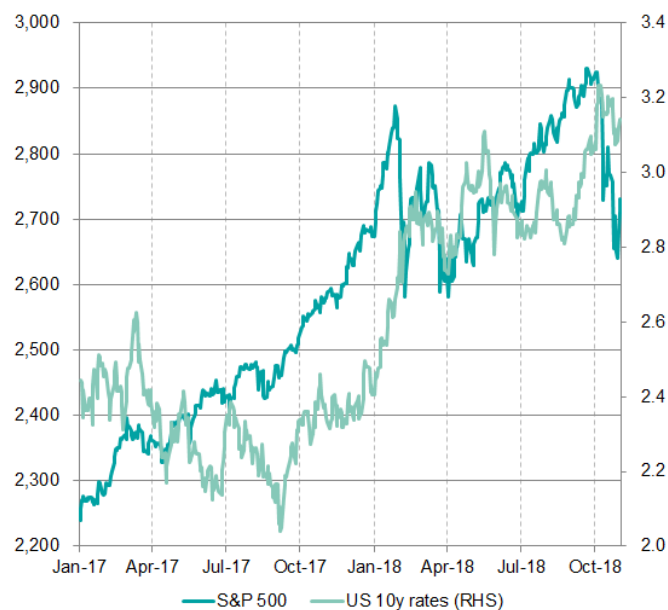


Source: Bloomberg and BNPP AM, as of 30/10/2018

## FIXED INCOME: SOMETHING STRUCTURAL IS GOING ON

Investors from many asset classes have been eyeing US rates markets closely over recent weeks, given the move higher in 10-year US Treasury (UST) yields and the associated equity market sell-off. In fact, as Figure 2 shows, this is the second time this year when a bond-market wobble feeds through into an equity market correction.

Figure 2: 10-year UST yields vs. S&P 500

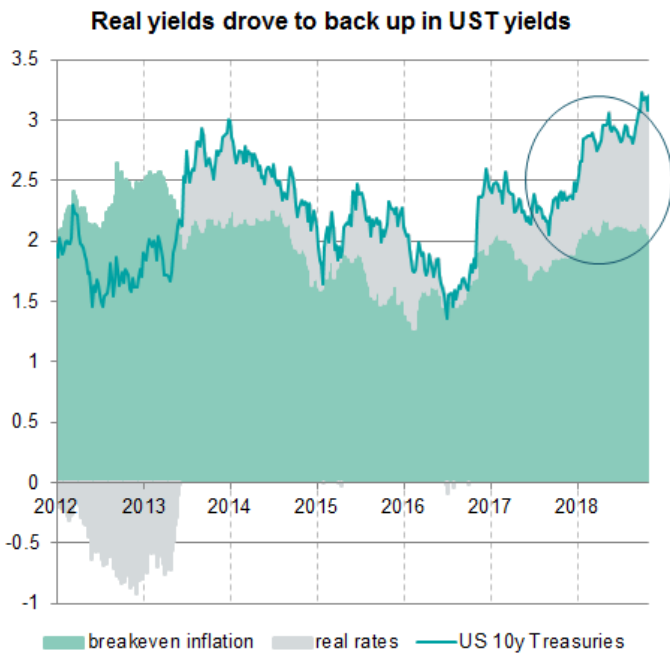


Source: Bloomberg and BNPP AM, as of 01/11/2018

We believe that US rates are moving higher structurally; it is telling that 10-year UST yields have decisively broken above the highs seen during the 2013 taper tantrum and have broken out of the multi-decade downward sloping yield channel which has contained price action in the fixed-income bull-trend since the mid-1980s.

Interestingly, when decomposing nominal yields into their real rate and breakeven inflation components, we find that this year's push higher in nominal yields was almost exclusively driven by higher real rates (Figure 3). Note that breakeven inflation rates (light green area in the chart) moved sideways for most of the year, with real rates (grey area) now above 1%, marking the highest level since 2011 and trading above their 2013 taper tantrum highs. And even during the recent equity market correction, yields did not reverse by much, with real yields in particular remaining near their highs.

**Figure 3: 10-year UST yield decomposed into real rates and break-evens**



Source: Bloomberg and BNPP AM, as of 26/10/2018

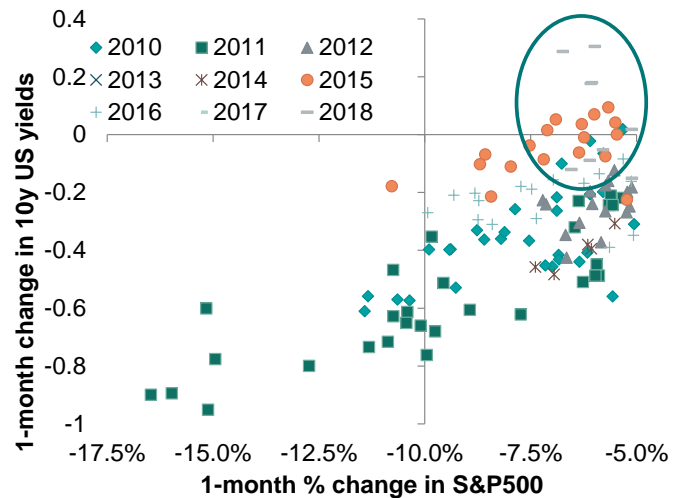
Put differently, the status-quo that many market participants were used to is changing. In particular, we find that this break to higher yields is occurring at an interesting juncture in terms of the macroeconomic backdrop, reinforcing our view of a structural shift in US fixed income due to:

- strong US growth
- expansionary fiscal policy requires more bond supply
- foreign buyer interest in USTs is dwindling

- the effects of the monetary policy actions of recent years – i.e., anchoring yields and depressing term premia – is fading.

A continued rise in US yields will likely have important ramifications for many asset classes. For fixed income, it will likely boost other core market yields too. Equity markets may struggle if the yield rise is sudden and not accompanied by earnings strength. And for cross-asset investors, a changing bond/equity correlation presents challenges when thinking about how to hedge portfolios. Note that this is already evident in recent price action (Figure 4): equity corrections are seemingly not accompanied by bond market rallies anymore.

**Figure 4: Bonds less of a hedge to equity corrections**

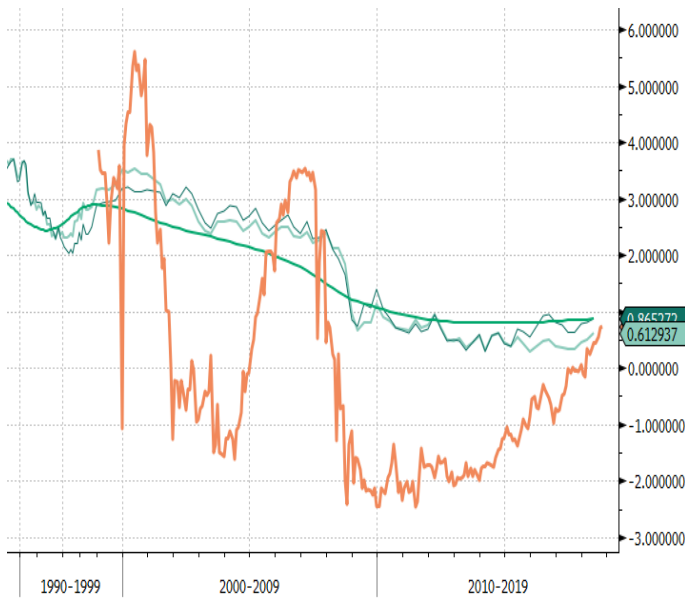


Source: Bloomberg and BNPP AM, as of 26/10/2018

### LATE CYCLE: BE TACTICAL

For us, it feels as if we are on the brink of an important shift in the macro/market backdrop, with major central bank policies going into reverse and markets facing quantitative tightening in the years to come. In fact, Figure 5 shows that Fed policy is already moving into restrictive territory. Real fed funds rates are near/crossing estimates of the natural rate ( $R^*$ ). This will eventually put a break on growth and inflation.

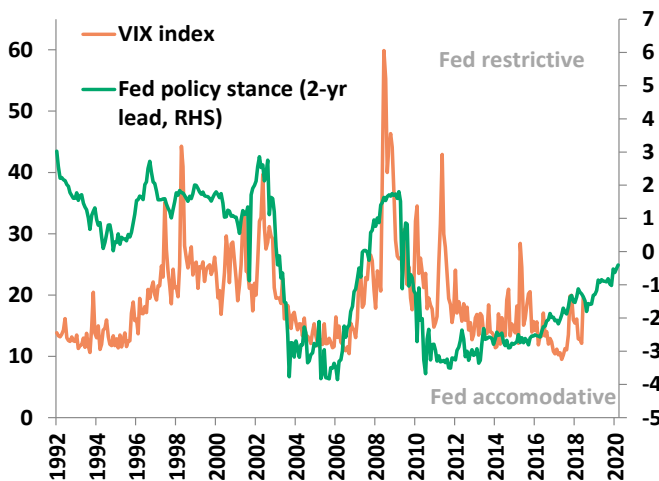
**Figure 5: The Fed Is moving into restrictive territory: Laubach Williams natural rate (R\*) & estimates (different greens) vs. real fed funds rates (orange)**



Source: Bloomberg and BNPP AM, as of 26/10/2018

Furthermore, the unwinding of QE – which has underpinned many asset classes in recent years – will, in our view, set many challenges for investors and asset allocators. QE has been a big contributor in depressing market volatility in recent years, so quantitative tightening should, all else being equal, reignite market volatility. We find a strong relationship between the Fed’s policy stance and the future level of equity volatility (Figure 6), with volatility on the rise as Fed policy enters restrictive territory.

**Figure 6: Volatility likely to increase...**

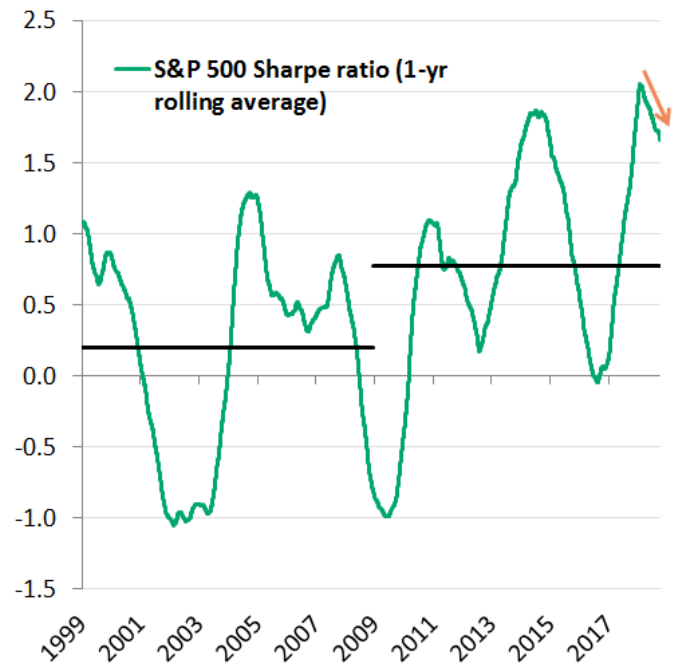


Source: Bloomberg and BNPP AM, as of 26/10/2018

With equity valuations looking more stretched and no central bank support underpinning markets, return expectations should be much lower for the foreseeable future. The result will be

much lower Sharpe ratios than many investors have become used to (Figure 7).

**Figure 7: ...And Sharpe ratio falling from QE highs**



Source: Bloomberg and BNPP AM, as of 26/10/2018

While Sharpe ratios took a hit during the macro shocks in the current cycle due to weak returns (Greece/eurozone ‘periphery’ crisis and China slowdown fears), average Sharpe ratios in the QE period have been high and their recent fall is due to lower returns and higher volatility.

To us, this means being ever more tactical when managing portfolios, trading when there are dislocations and broad ranges (such as during the recent equity sell-off) rather than being married to views, even though our investment horizon is normally longer-term.

With a more tactical approach, we have to rely on tools that help us to anticipate market moves and that complement our fundamental analysis. In particular, we rely on our in-house market dynamic indicators, which include measures of the ‘temperature’ in markets as well as our dynamic technical analysis, to help us time the market.

Both sets of tools were signalling, for example, that equity markets were vulnerable to a correction in September. Our ‘temperature’ indicators suggested that sentiment was too bullish in late September. Other metrics flagged complacency such as low levels of equity volatility and a narrowing breadth in the US equity rally. On the other hand, looking at our dynamic technical analysis, weekly and monthly cycle indicators in September were flagging the risk of a reversal in major equity markets.

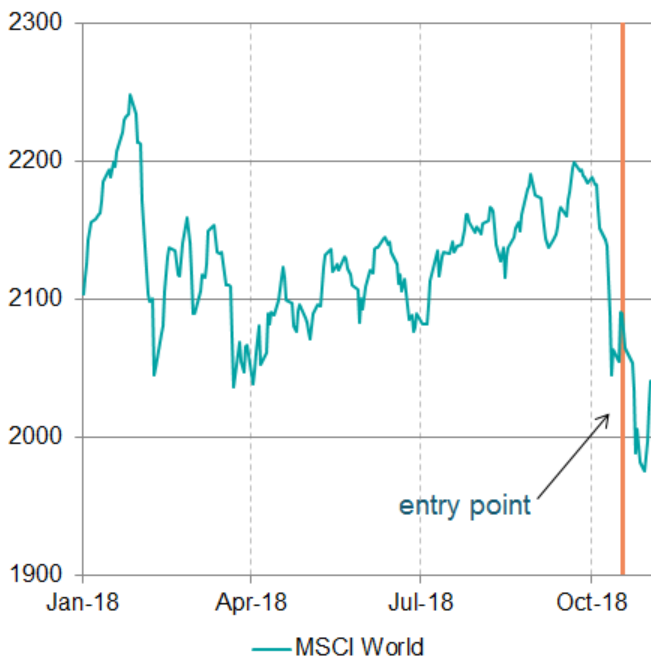
## ASSET ALLOCATION

There are two opposing forces at play in mature equity markets: an advanced, but robust cycle in the US and higher interest rates. As a result, we have taken a more tactical approach to risk-taking, relying more on our dynamic market analysis and not just on fundamentals.

Indeed, the October equity selloff provides a good illustration of why these tools are important. The back-up in yields that reaccelerated in late August did not come as a big surprise to most participants as they expected to see higher yields given the fundamentals. However, the timing of the selloff was more difficult to predict. After all, the US economy has remained strong and US company earnings in Q3 continued to surprise to the upside generally. In this context, both our ‘temperature’ measures and our dynamic technical analysis flagged that the selloff was likely reaching a bottom.

We took advantage of the correction to add equity exposure tactically by going long developed market equities, i.e., the MSCI World index (Figure 8). The largest weights in the index are the US (~64%), Europe (~23%) and Japan (~8%). On the fundamental side, we believe US growth should continue to support earnings growth. Europe and Japan have lower weights, but, as for the US, their indices also suffered close to 10% losses in October.

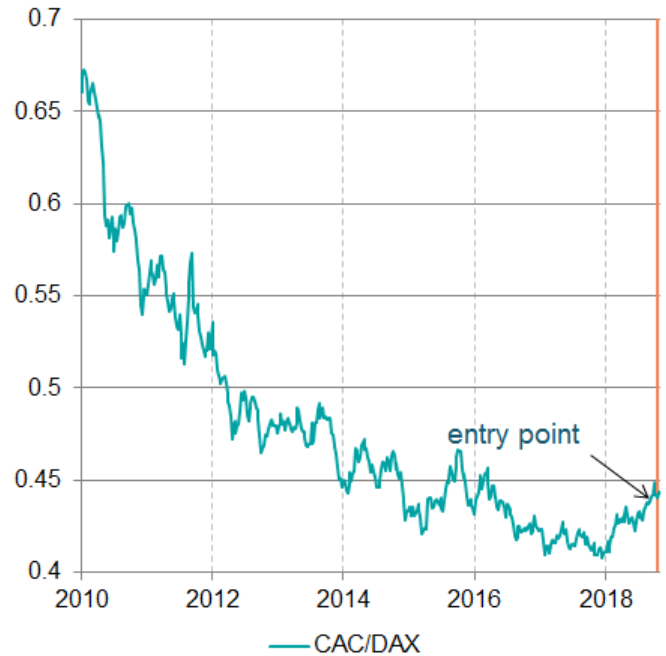
**Figure 8: Added developed market equity exposure in the October correction**



Source: Bloomberg, BNPP AM, as of 02/11/2018

We went long French equities relative to German equities since the CAC/DAX ratio was historically low. We see the French CAC as more insulated from trade protectionism than the DAX (Figure 9).

**Figure 9: Long French equities relative to German equities as the latter seem more exposed to trade tensions**



Source: Bloomberg, BNPP AM, as of 02/11/2018

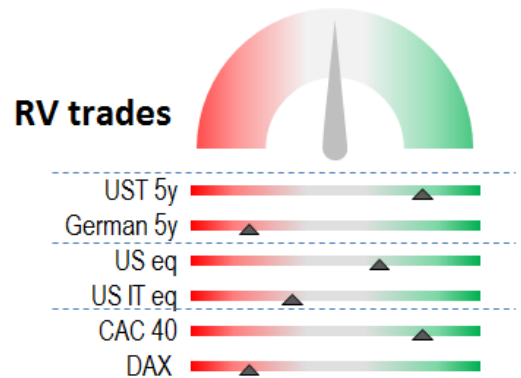
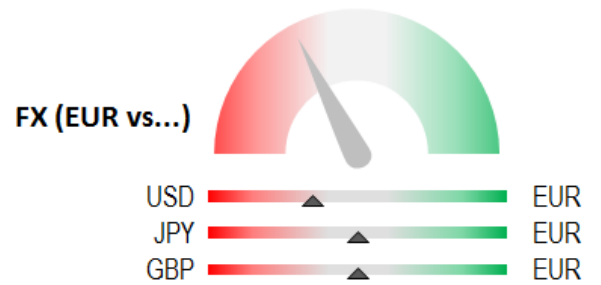
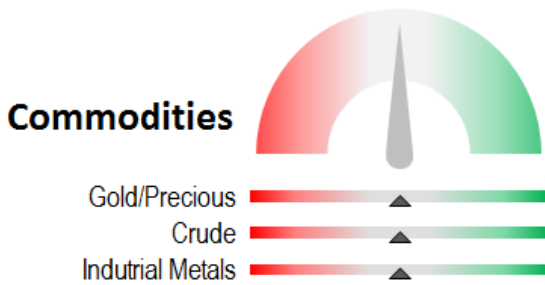
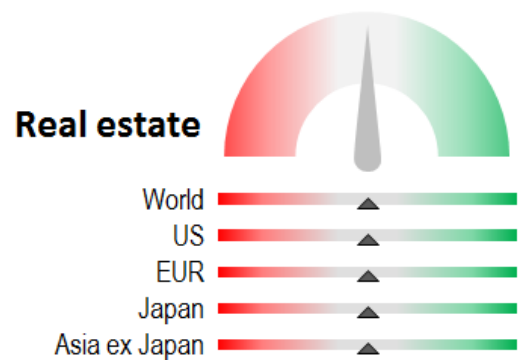
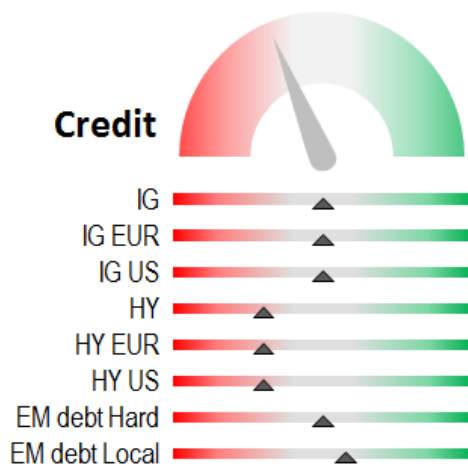
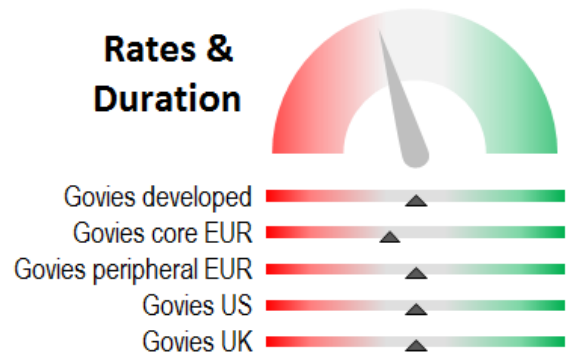
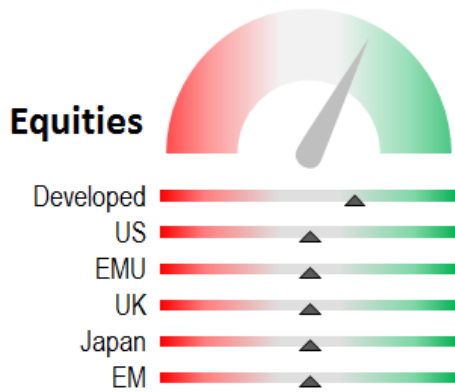
We added a long position in USD vs. the currencies of Asian manufacturing exporters that benefit from China, notably, the Korean won, the Thai baht, the Taiwanese dollar and the Singapore dollar. These are low-yielding currencies, which means that the carry costs of shorting them are almost zero.

We believe these currencies could weaken further if China-US tensions escalate. Going short creates a good hedge against the risk of de-globalisation and greater trade protectionism.

Finally, we remain underweight EMU duration as we see yields as too low historically and given where the economic cycle is in the eurozone. We also remain short EUR/USD as a hedge against an escalation of Italian political risk as well as the risk of higher inflation in the US.



# 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 authors, as of November 2018. Individual portfolio management teams may hold different views and may make different investment decisions for different clients.

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