

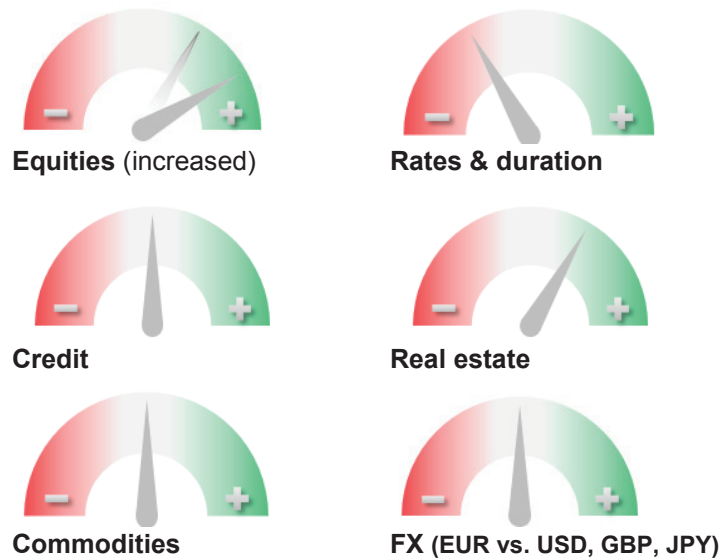


ASSET ALLOCATION MONTHLY

BNPPAM – Multi Asset, Quantitative and Solutions (MAQS)

BULLISH RISK ASSETS DESPITE THE FEBRUARY SCARE

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SUMMARY:

- Market review: the rebound in risky assets is ongoing, but prices are still below the pre-correction highs
- Should we worry about inflation? We see a modest pick-up rather than a take-off
- Can equities perform in a rising rate environment? Yes, but typically driven by strengthening earnings growth
- Which safe assets can offer protection in Fed tightening cycles? No silver bullet; bonds may not offer shelter

ASSET ALLOCATION:

- We took advantage of February's technical correction to add to our equity position in Europe
- We are still bullish on equities but we hedge part of our exposure ahead of political risks in Italy and Germany
- We opened a short GBP position versus USD (in addition to our long EUR/GBP) given our bearish view on Brexit



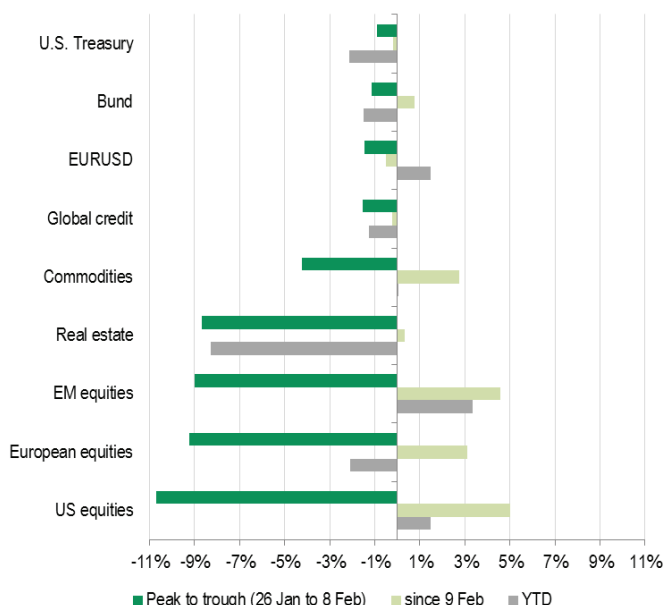
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MARKETS REVIEW: POST CORRECTION REBOUND

February started with a sharp correction in equity and volatility markets. This was mainly driven by technical rather than fundamental factors as we explained in our previous monthly. As a consequence, the fall was rather sharp, but also short-lived. The S&P 500 index, along with other major equity indices, started to rebound on 9 February. This bounce has been progressive, but also unequal between markets. US equities recovered about half of the ground lost, while European and Japanese equities lagged. Looking at the year-to-date (ytd) performance, US equities are still up while European stocks are down (see Figure 1). Emerging markets on the other hand were hit to a lesser extent by this technical correction and are still benefiting from a weak dollar. Latin America in particular has been performing strongly, up by more than 8% so far this year, with a complete recovery of the early February correction.

Figure 1 : Partial rebound for risk assets, but bonds and rate sensitive assets lag



source : Bloomberg, BNPP AM

Equity volatility markets were at the epicentre of the correction: the VIX index saw a violent spike higher. Levels have come down, but remain elevated compared to the pre-correction period now that most strategies betting on shorting volatilities have been stopped. In bond markets, the rising yield trend we saw in January continued steadily through February. Benchmark US Treasury yields are now hovering at around 2.90%. In Europe, yields stabilised. Bund yields are down slightly. Commodities had a mixed month with WTI crude oil falling to below the USD 60/barrel threshold before rallying back to USD 63.

INFLATION SCARE: A MODEST PICK-UP RATHER THAN A TAKE-OFF

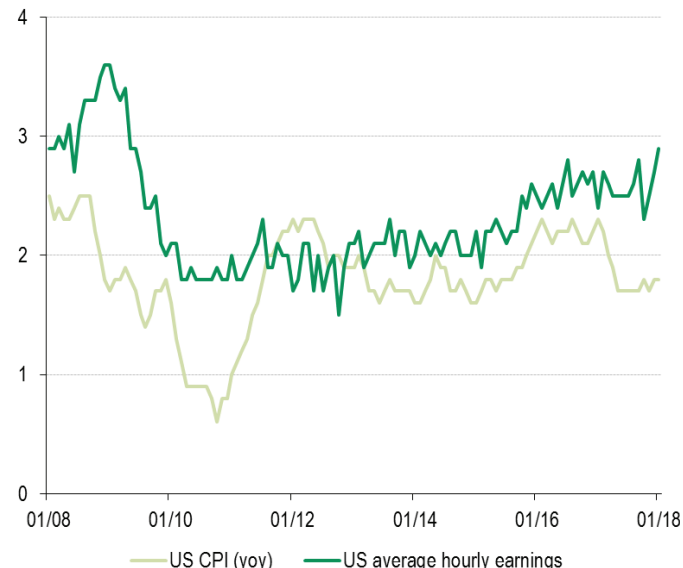
One of the themes the market has been exploring in recent months is inflation acceleration. The deflation theme is visible in our positioning across assets, including stretched shorts in rates and longs in energy (see below). Interestingly, equity markets appear to be taking the inflation narrative more light-heartedly as positioning there remains rather constructive. In our opinion, there are two important aspects to analyse: the cyclical dynamics of inflation and the structural ones.

Firstly, we note that the recent readings on US core CPI and average hourly earnings are by no means a game changer (see Figure 2). After months of negative surprises on US core inflation dynamics, it is only natural to expect positive surprises coming from these drivers:

- ▶ USD weakness lifting imported goods prices (thus, apparel was one of the biggest contributors to the uptick)
- ▶ base-effects from one-off price cuts in communication (Verizon plan) fading away in the coming months
- ▶ the secondary effects of hurricane damage (e.g. used car prices rose).

With this in mind, we have been anticipating a modest pick-up in US price dynamics in the short term which, however, is not to be confused with a take-off in inflation.

Figure 2 : US CPI and hourly earnings remain modest despite positive surprises (% YoY)



source : Bloomberg, BNPP AM

Secondly, it is important to remember some of the structural reasons why inflation in the US and in the advanced economies generally has been low and is likely to remain subdued in the medium term: technology, globalisation and demographics to name a few. In a recent paper, the IMF found that roughly half of the decline in the share of national income paid to workers since the 1980s was due to technology¹ alone. With automation and artificial intelligence on the

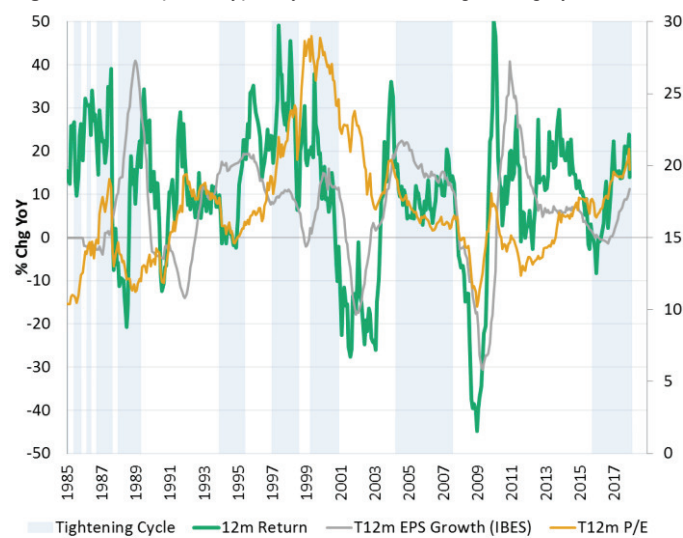
1: Drivers of Declining Labor Share of Income, IMF <https://blogs.imf.org/2017/04/12/drivers-of-declining-labor-share-of-income/>

verge of spreading across an ever-increasing number of sectors in the economy, it is hard to argue that disinflation is now behind us.

CAN EQUITIES RALLY IN FED TIGHTENING CYCLES?

January's rise in US Treasury yields in January ended up hurting risky assets in mid-February. In that context, market participants are asking themselves whether equities can rally as the US Federal Reserve continues to tighten its monetary policy and as government bond yields rise further. We address this issue by looking at the pattern of US equity returns during past Fed tightening cycles. Figure 3 shows annual returns for the S&P 500 together with valuations (12m forward PEs) and earnings growth.

Figure 3: US equities typically do well in Fed tightening cycles



source: Bloomberg and Factset, BNPP AM

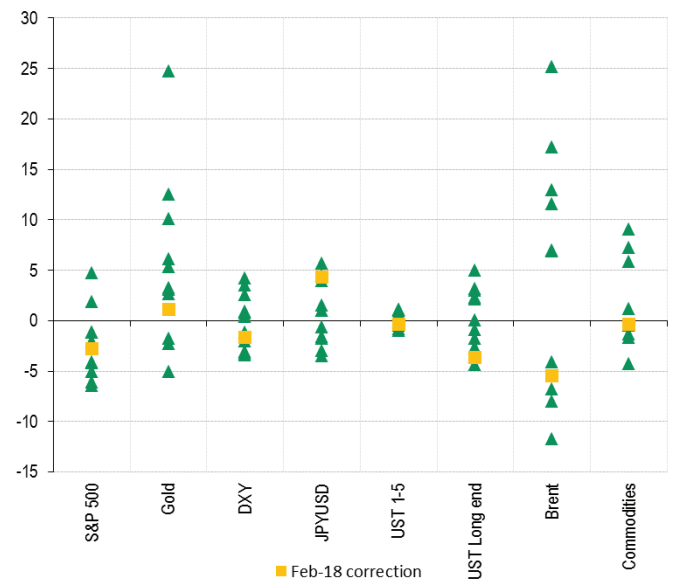
Three important points stand out. First, equity returns are generally positive during tightening cycles. Second, P/E ratios may expand initially, but tend to compress as the cycle progresses. Finally, earnings growth is generally positive as the Fed tightens. This is because the key driver of returns shifts from multiple (P/E) expansion to earnings growth. This is consistent with a more mature business cycle where economic growth is strong and supports corporate profits despite rising interest rates.

WHICH SAFE ASSETS CAN OFFER PROTECTION IN TIGHTENING CYCLES?

Investors also worry which safe- haven assets they can rely on when yields rise. In Fed easing cycles, for instance, bonds typically rally in the face of negative shocks to risky assets. Bond allocations therefore help to reduce volatility and protect performance in risky portfolios. In Fed tightening cycles, higher rates can be the source of the shock to equities and other risky assets, as was the case in the February correction. To understand the behaviour of safe assets in such a correction, we assessed their performance in months when the S&P

500 has dropped by more than 5% during Fed tightening cycles since 1980 (see Figure 4).

Figure 4 : Safe asset price reactions to market corrections in Fed tightening cycles : no silver bullet



source : Bloomberg, BNPP AM

The following results stand out. Gold generally delivered positive returns. Only on a few occasions did gold prices fall and when they did, the losses were not material. The performance of the USD and the JPY has been mixed and so has been that of Brent crude, a real asset that some see as offering inflation protection. Long US Treasuries also had a mixed performance. This is not surprising because rising yields can damage risk assets, especially if they respond to inflation concerns. Finally, shorter-term US Treasuries also had a mixed performance, but their losses tended to be more muted.

We see two key takeaways from this analysis. First, it makes sense to consider options structures (e.g. equity puts) to protect risky portfolios. Second, we need to be prepared to re-risk and be close to cash (low duration) rather than hold long bonds if there are developments that merit a more defensive asset allocation.

ASSET ALLOCATION

Our road map so far this year has been to add to equity risk gradually in markets with good fundamentals and reasonable valuations such as Europe and Japan. We have also been structurally underweight fixed income given our view of gradually rising inflation and monetary policy normalisation.

In February we decided to take advantage of the correction to add to our equity longs in Europe.

We also decided to hedge part of that exposure given the risks associated with the Italian elections and the risk of failure to form a grand coalition in Germany.

Finally, we decided to add to our short GBP exposure which so far has been expressed against the EUR by going short Sterling versus the USD.

Increased long EMU equities on technical sell-off

As said, our conviction on the solid macro-economic backdrop and the Goldilocks scenario is unchanged. Therefore we have used the correction to increase tactically our position in European equities. This has enabled us to make the most of the market rebound.

Figure 5 : EuroSTOXX 50 rebounding after technical sell-off



source : Bloomberg, BNPP AM

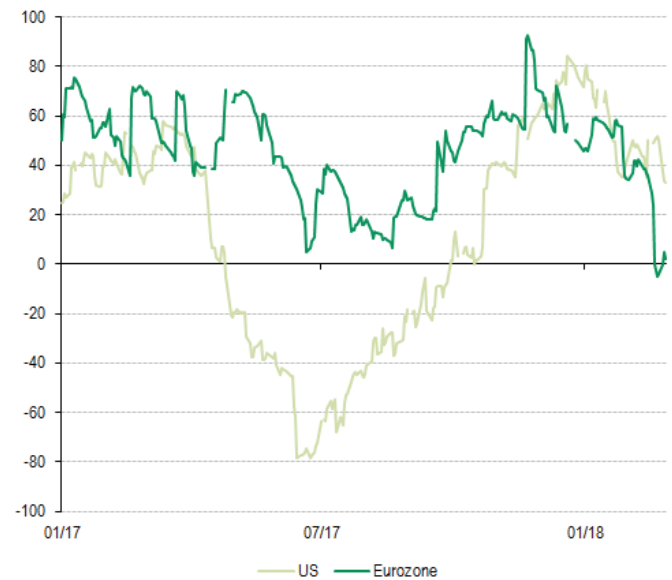
Partial hedge of equity exposure on political risks

The base case scenario for our macroeconomic roadmap remains 'Goldilocks' – healthy growth and subdued inflation. There is not enough evidence to challenge our assessment at this stage. We remain constructive on equity markets with upside potential from margin expansion, operational leverage and beta to global growth. Our preferred regions are Europe, Japan and the emerging markets. Despite the beneficial macroeconomic backdrop for risk assets, it is important to note a few risks.

Firstly, European politics return to the spotlight with Italian general elections and Germany's SPD vote on joining the coalition with the CDU. We agree with the market assessment of a high likelihood of the SPD accepting the coalition agreement. In Italy, there is a wide range of potential outcomes – grand coalition, centre-right coalition, no agreement (more uncertainty), the Five Star movement entering into power, etc.

While we acknowledge the difficulty in forecasting election outcomes, we are puzzled by the complacency among investors who seem to be betting on a best-case scenario, i.e. a grand coalition. The recent outperformance of Italian assets may quickly be called into question if market expectations do not materialise.

Figure 6 : Despite robust fundamentals, economic surprise indicators are starting to roll over in Europe



source : Bloomberg, BNPP AM

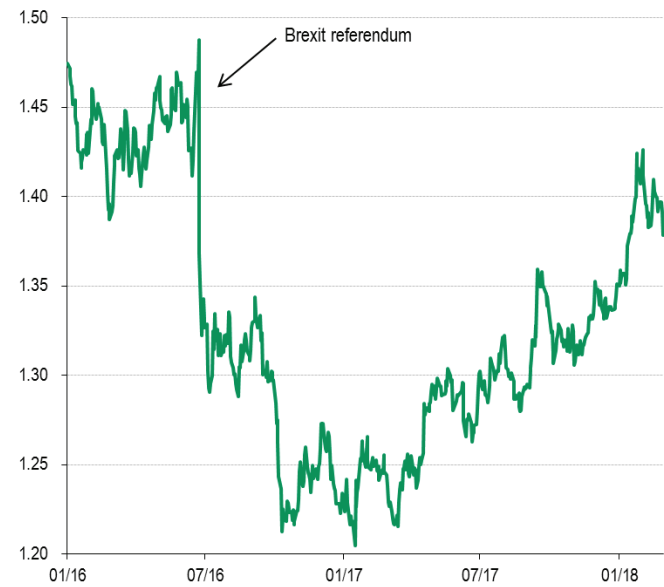
Last but not least, it is worth highlighting the roll-over in European soft data (e.g. PMI and confidence misses). The data remains generally robust and the level of economic activity is high, however, market expectations seem to have adjusted quickly to the point where a period of short-term negative surprises is not unlikely. As long as this remains a contained roll-over of economic indicators (rather than a major turn), this is not necessarily a major risk for European equities which have been held back by a strong EUR in the past few months. The euro could adjust if growth expectations versus other countries are marked down.

Short GBP versus USD

Looking at the current account, a deterioration of the UK position relative to the US should play against the GBP. The UK c/a deficit is now at 4.0% of GDP, while it is at 2.5% in the US. Moreover, post-Brexit, one would expect fall in UK foreign direct investment flows unless the UK remains in the single market. This is politically difficult for the current Conservative administration.

This also highlights the political risk related to the Brexit negotiations and the turmoil within the Conservative party which could cost Prime Minister May her support in Parliament and open the door to a Labour government. A significant shift to the left in terms of economic policy would mark a major risk for UK assets and GBP. Market participants appear to be ignoring such a scenario so far. On the US leg of this position, the dollar could benefit from growing inflation concerns. These could lead markets to anticipate additional interest rates hikes.

Figure 7 : GBP has recovered substantially since Brexit vote in 2016



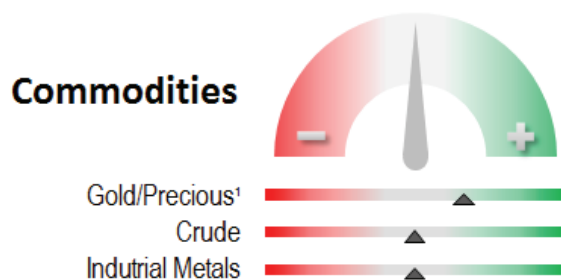
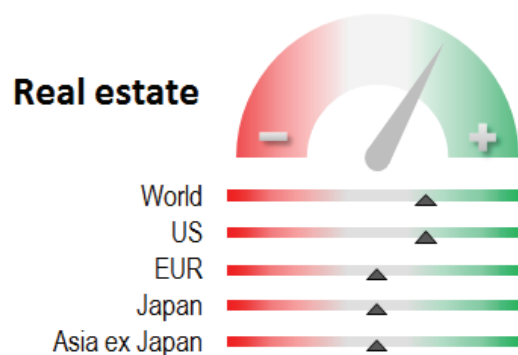
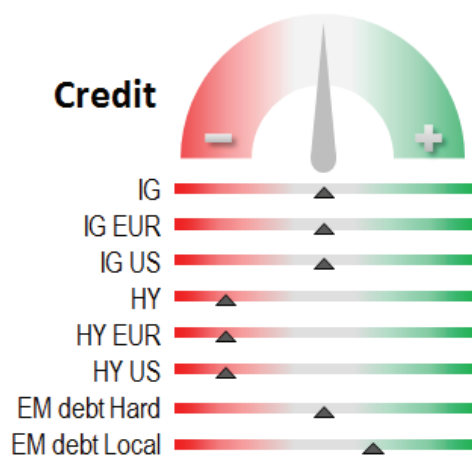
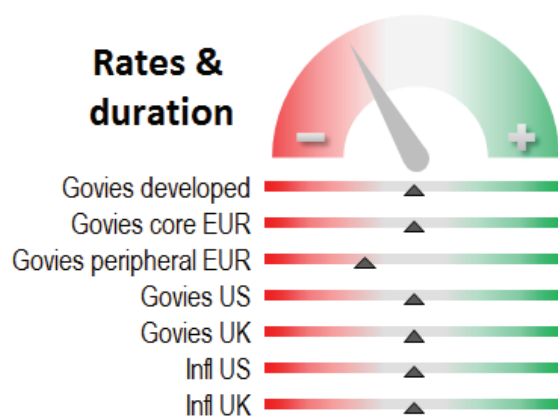
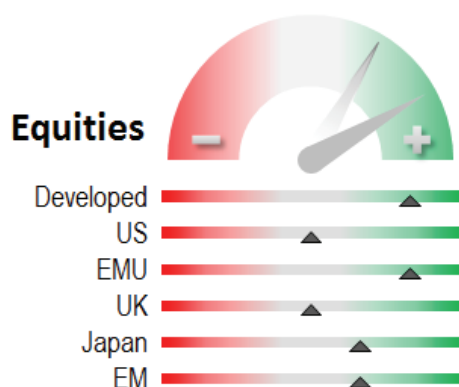
STRATEGIC OVERVIEW OF KEY POSITION CHANGES IN FEB 2018

In February 2018, the BNPP AM MAQS team made the following strategic calls:

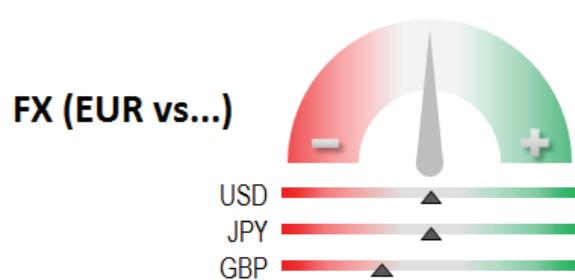
| | | |
|--|------------------|-------------------|
| LONG EMU EQUITIES | INCREASED | 07/02/2018 |
| <ul style="list-style-type: none">Given the technical sell-off and our bullish view on risk assets, we took the opportunity to increase the position | | |
| PARTIAL HEDGE OF EMU EQUITIES | OPEN | 28/02/2018 |
| <ul style="list-style-type: none">We have opted to partially hedge our equity exposure before Italian elections in case of market unfriendly outcome | | |
| SHORT GBP/USD | OPEN | 21/02/2018 |
| <ul style="list-style-type: none">In addition to our long EUR/GBP, we opened a short GBP/USD to reflect our bearish view on Brexit | | |



ASSET ALLOCATION DASHBOARD¹



¹: only selective portfolios



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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