FOR PROFESSIONAL INVESTORS – 6 April 2018

ASSET ALLOCATION QUARTERLY

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

CONSTRUCTIVE ON RISK DESPITE HIGHER EQUITY VOLATILITY

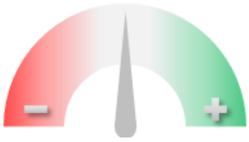
Asset allocation overview:

Equities (decreased)

Rates & duration (decreased)

Credit

Real estate



Commodities

FX (EUR vs. USD, GBP, JPY)

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SUMMARY:

- Four key developments have led to jittery markets and higher equity volatility in Q1: (i) concerns over inflation and reduced central bank accommodation; (ii) an escalation of trade protectionism; (iii) disappointing activity data, especially in Europe; and (iv) higher risk of more stringent regulation of the US information technology (IT) sector.
- Following a sharp rally in January, inflation concerns triggered the sell-off in February that was exacerbated by technical factors.
- Protectionism on the rise: the Trump administration caught markets off guard with new tariffs on Chinese goods. We believe the probability of a severe escalation is still small.
- Activity data fell short of market expectations, notably in Europe, but the fundamentals remain strong and we do not foresee a turn in the cycle in the near term. Together with still-muted inflation, this reaffirms our view of a macroeconomic environment that is supportive of equities.
- The US IT sector was the engine behind the US equity rally in the last few years. Investors are now reassessing this stock market leadership as selected tech giants face the risk of tighter regulation.

ASSET ALLOCATION:

- Our approach since the start of 2018 was to add risk to equities gradually, especially in markets with attractive valuations and solid earnings fundamentals such as EMU and Japan.
- However, given the escalation of risk associated with protectionism, we considered it prudent to reduce our exposure to equities. This adjustment reflects P&L management and not a change in our macro view: we continue to expect strong global growth and muted inflation.
- Following a significant rally in German Bunds, we have added to our underweight position in EMU duration.

MARKET REVIEW Q1 2018: EQUITY VOLATILITY IS BACK

The first quarter of 2018 started with an acceleration of the positive equity trend, low volatility as well as rising yields seen in 2017. This lasted until the end of January when financial markets sold off amid concerns over inflation that sparked a technical correction. Investors betting on prolonged low volatility levels were hit hard as the VIX index spiked higher. The index is now hovering at around 20, twice the 2017 levels. The macroeconomic fundamentals globally have remained robust and they have supported a tentative equity rebound.

However, this shock unearthed additional concerns making the equity market more sensitive to volatility.

First, US President Trump announced tariffs on steel and aluminium and unveiled a plan to tax Chinese goods over intellectual property rights breaches. As we pointed out in our Spotlight report on protectionism, this could hinder the globalisation dynamics and hurt the global economy by derailing global supply chains, especially if this escalates into a fully blown war.

Second, the tech sector had a bumpy March. It had been contributing significantly to global equity performance over the past few quarters. Protectionism concerns struck a first dent in this heavily-globalised sector. A further punch came from allegations that Facebook had misused private data. Concerns over the risk of more stringent regulation hurt shares in the social network before spreading to other tech companies such as Alphabet (Google's parent company).

Finally, activity data started to roll over including PMI indicators, especially in Europe. Market participants had expected stronger numbers, so the surprise weakness hurt financial assets. Notwithstanding these weaker indicators and the short-term market reactions, absolute data levels have remained high and firmly anchored in expansionary territory. Therefore we remain comfortable with our Goldilocks scenario of strong growth and muted inflation.

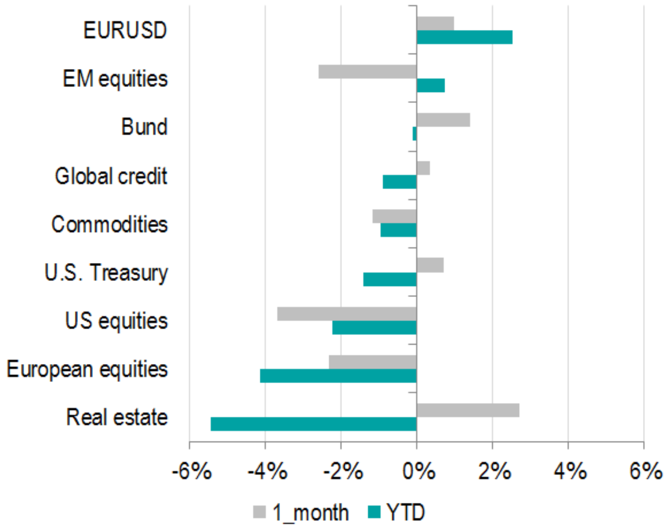
Looking at asset performance over Q1 2018, equities are the main laggards despite January's strong performance. UK and German equities are down by 8.2% and 6.4%, respectively (in local currency terms). The US S&P 500 lost a mere 1.2% over the quarter, but it is down by 8.1% since its late January peak.

So far, emerging markets have been affected less by the turbulence. Brazilian and Russian equities did best with +11.7% and +7.6%, respectively. This was helped by a weak US dollar which continued to depreciate moderately despite the continued Fed rate-rising cycle.

On the duration side, the quarter started with rising yields amid concerns over inflation and a potential acceleration in Fed policy tightening. However, markets switched to risk-off mode in February and March, which benefited haven assets such as US Treasuries and German Bunds. US and German 10-year bonds rallied by 21bp and 27bp respectively from their intra-quarter peaks.

Gold investors enjoyed the precious metal's haven status: gold has risen by 1.7% Ytd. On the other hand, industrial metals such as copper and iron ore did poorly amid steady supply and cautious investor sentiment over the economic cycle and the potential impact of a trade war on Chinese demand. Crude oil had a volatile quarter, but WTI ended up by7 7.5%, pushed higher by a tougher US stance towards Iran.

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



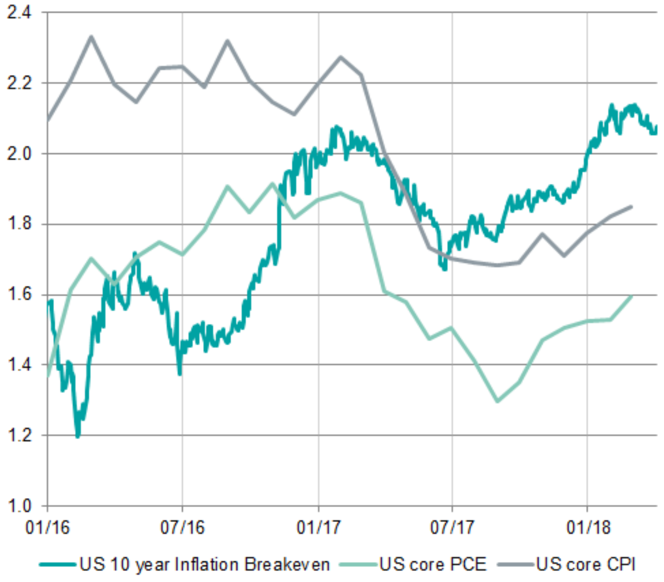
Source: Bloomberg, BNPP AM, as of 2 April 2018

HIGHER INFLATION PROSPECTS SPOOKED MARKETS

The main concern in investors' minds at the beginning of the year was the prospect of higher inflation, especially in the US. Market participants knew that any abrupt change towards reduced central bank accommodation could disrupt the low-volatility environment of the last few years. So far, the US Fed has managed to withdraw stimulus very gradually, largely because inflation, notably core inflation, has remained low. If markets take the view that inflation is on the rise, the low-volatility and risk-friendly environment could sour.

That is exactly what happened in early February. US breakeven inflation (BEI) had been rising since mid-December 2017, but it was strong hourly earnings data that tipped the balance. This lead to an abrupt market correction that was accelerated by strategies that hinged on a low-volatility environment. Some say perception is reality in markets: US core inflation (both on the CPI and PCE metrics) did increase over the same period, but it remains well below the Fed's 2% target (Figure 2).

Figure 2: US BEI rose in Q1, while core inflation remained muted



Source: Bloomberg, BNPP AM, as of 2 April 2018

PROTECTIONISM: A DORMANT RISK THAT IS WAKING UP

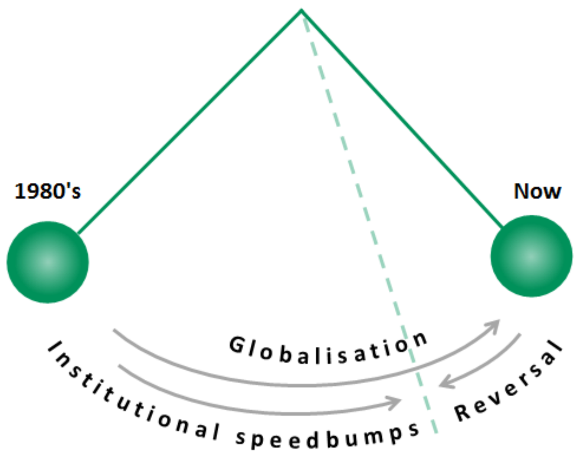
Another development that led to increased market volatility in Q1 was the escalation of trade protectionism. This started with the Trump administration announcement of tariffs on aluminium and steel imports. The US later imposed tariffs on Chinese imported good worth around USD 60 billion. China retaliated by announcing tariffs on 128 US products. A 25% charge on seamless steel pipes is consistent with tit-for-tat retaliation against the US steel and aluminium tariffs, so it looks likely that China will introduce more such measures if the US proceeds with the second batch of tariffs.

Markets were spooked by the prospect of the trade measures escalating into a fully blown trade war that could reverse the forces of globalisation. We believe the probability of a severe escalation is small at less than 10%. There are institutional hurdles that could prove difficult to overcome for President Trump's America First initiatives such as the US Congress, the WTO and financial markets themselves (Figure 3).

Nevertheless, this is a risk that we need to monitor and be prepared for. As we explained in our Spotlight report on protectionism, escalations can be rapid or gradual and if they are severe enough, they could have negative consequences for economic growth and most likely global equity markets.

Our base case remains one where we do not see any material escalation, but rather a world with trade tensions. This should not derail the late-cycle expansion. Tariff threats might be the US administration's gambit to start renegotiating trade deals with key partners. The renegotiation of NAFTA and the bilateral trade agreement with South Korea can be seen as good examples of this tactic.

Figure 3: Threats to globalisation: trade protectionism on the rise



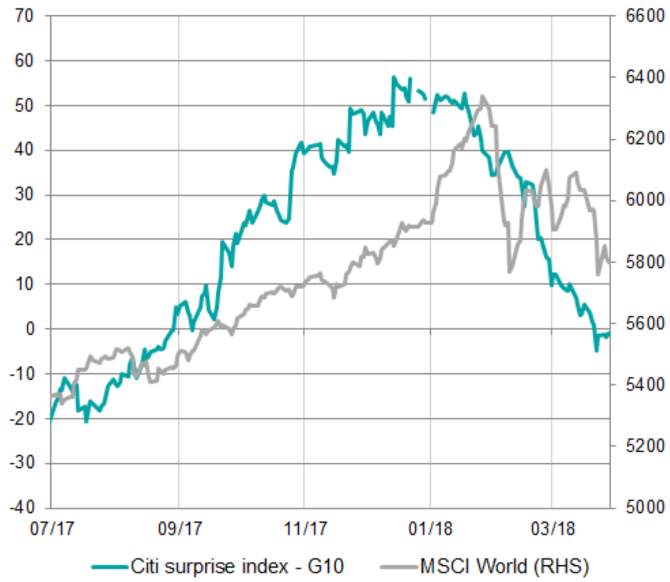
Source : BNPP AM, 2 April 2018

IS THE EUROZONE CYCLE TURNING OR JUST GOING THROUGH A SOFT PATCH?

So far this year, the global expansion has been strong and synchronised. However, financial markets are nervous about signs of weaker activity, especially in the eurozone (Figure 4). Survey data (PMIs) in particular came in below consensus estimates for a second month in a row in March.

However, we believe it is too soon to worry about a turn in the cycle in Europe. After all, the PMI data are still pointing to a solid expansion and we would not extrapolate a trend from two data points. Inflation has remained contained and the ECB should therefore be in no rush to accelerate its plans to normalise monetary policy. This reaffirms our view of a Goldilocks environment in the eurozone.

Figure 4: Activity data disappointed



Source : Bloomberg, BNPP AM, as of 2 April 2018

WILL REGULATORY RISKS DERAIL THE US IT SECTOR LEADERSHIP?

The IT sector was the engine behind the US equity rally in the last few years. But markets are now reassessing this leadership as US tech giants such as Facebook are facing the risk of tighter regulation following the alleged mishandling of private user information.

Recent comments by President Trump and Senator Rubio have added fuel to the fire by suggesting closer scrutiny of the new economy monopolies including Amazon. According to President Trump, Amazon is paying the loss-making federal post system too little for its package delivery services.

Looking beyond the regulatory risks and the side effects of tech sector practices, the cyclical backdrop remains supportive of earnings growth by US tech giants.

ASSET ALLOCATION

Our approach since the start of 2018 was to add risk to equities gradually, especially in markets with attractive valuations and solid earnings fundamentals such as EMU and Japan.

We were also active in terms of hedging exposures against political risks, notably the Italian elections in early March.

Reduced equity exposure in EMU and Japan

Despite strong macroeconomic data for most of Q1, EMU equities have lagged other equity markets, partly because of the strength of the euro versus other currencies. This is seen as denting company earnings and hence a drag on equity performance.

The spike in risk associated with protectionism has hit eurozone equities along with other markets. The correction meant that our positions reached technical levels that exposed them to the risk of a further sell-off and took them close to our stop losses.

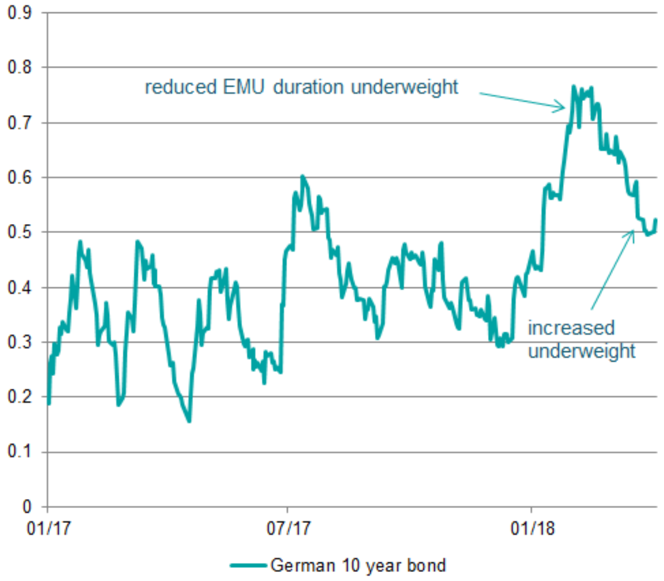
Therefore we considered it prudent to reduce our exposure to both EMU and Japanese equities. This adjustment reflects profit and loss (P/L) management and does not mark a change in our macroeconomic view: we continue to expect strong global growth and muted inflation.

Increased underweight EMU duration

In fixed income, we remain underweight EMU duration, but we have managed the size of that exposure tactically.

German Bund yields have fallen by roughly 25bp to 0.5% from the 2018 highs of early February which were reached shortly after we reduced our short EMU duration exposure tactically in late January. The fall in Bund yields reflects a combination of factors including weaker (soft) activity data in the eurozone; persistently low inflation and a rise in risk aversion.

Figure 5: After January selloff, German Bunds have rallied significantly (yield, in %)



Source: Bloomberg, BNPP AM, as of 5 April 2018

All these factors have now been discounted largely and we remain confident that the economic outlook will not deteriorate markedly in the next few months. This should allow for policy normalisation by the ECB later in the year, putting upward pressure on yields.

We had signalled that 0.5% in Bund yields would be an attractive level to add to our structural short exposure. With Bund yields falling to below 0.5% in late March and bouncing off the 200-day moving average at around 0.476%, we decided to add to our short exposure in EMU duration.

STRATEGIC OVERVIEW OF KEY POSITION CHANGES IN Q1 2018

The BNPP AM MAQS team made the following strategic calls:

JANUARY:

LONG EMU EQUITIES OPEN 05/01/2018

- Above-consensus forecasts in a robust macroeconomic environment

LONG JAPANESE EQUITIES OPEN 12/01/2018

- Above-consensus forecasts in a robust macroeconomic environment

LONG US VS. UK INFLATION CLOSED 24/01/2018

- We took profits as the position reached the target level. Opened on 19/04/2017

UNDERWEIGHT EMU DURATION REDUCED 31/01/2017

- We took partial profits following the sharp rise in yields.

FEBRUARY:

LONG EMU EQUITIES INCREASED 07/02/2018

- 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

- We opted to partially hedge our exposure before Italian elections in the case of a market-unfriendly outcome.

SHORT GBP/USD OPEN 21/02/2018

- In addition to our long EUR/GBP, we opened a short GBP/USD to re flect our bearish view on the Brexit process.

MARCH:

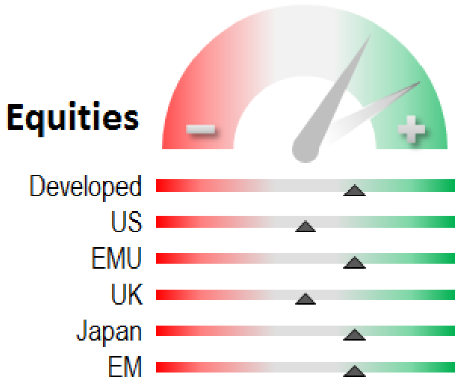
LONG EMU AND JAPAN EQUITIES REDUCED 23/03/2018

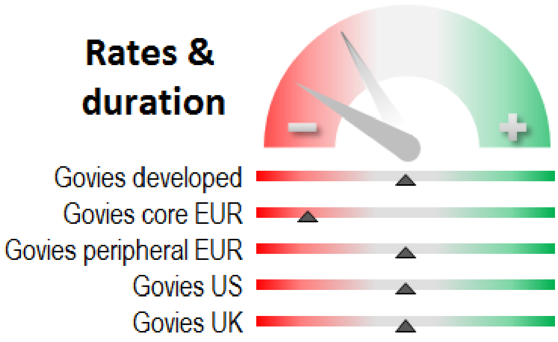
- We reduced our exposure to cope with more volatile markets, but remain confident in our Goldilocks scenario.

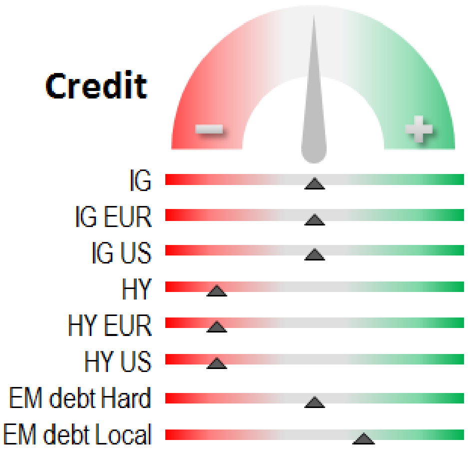
UNDERWEIGHT EMU DURATION INCREASED 21/03/2018

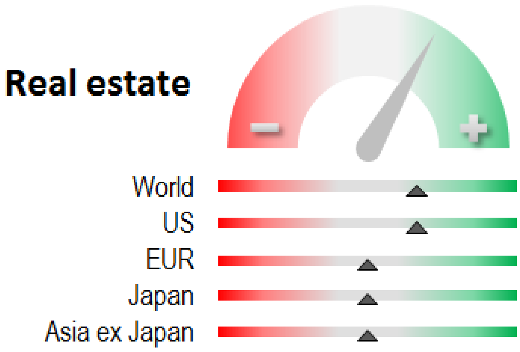
- Following a significant rally in German Bunds, we have added to our underweight position.

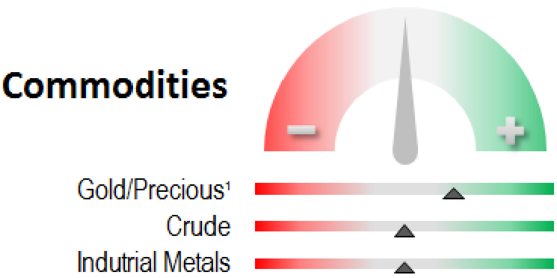
ASSET ALLOCATION DASHBOARD[1]



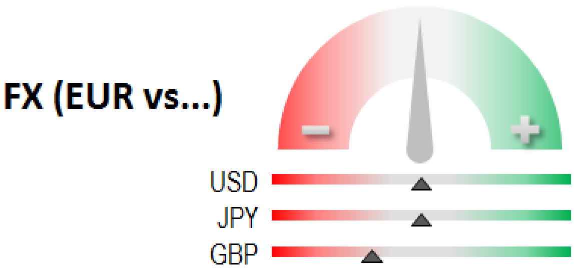








1: only selective portfolios



[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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