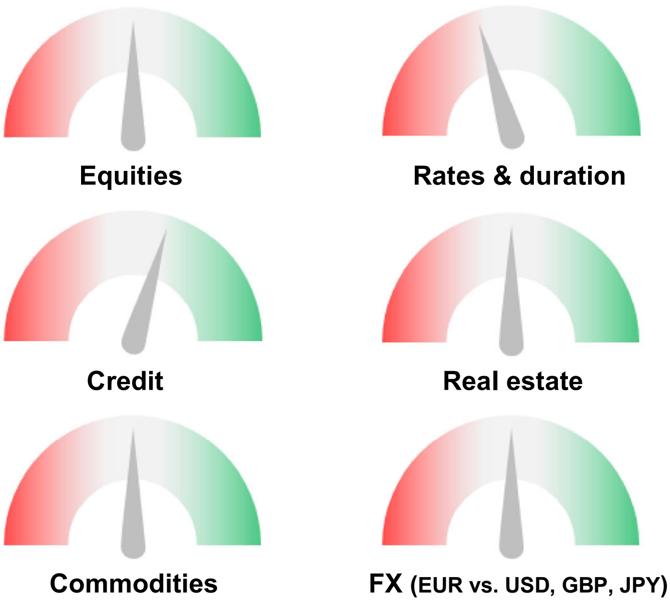
ASSET ALLOCATION QUARTERLY

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

MIND REFLATION RISKS

Asset allocation overview



Maximilian MOLDASCHL
Senior Multi-Asset Strategist, MAQS
maximilian.moldaschl@bnpparibas.com
+44 20 7063 7247

Guillermo FELICES
Head of Research and Strategy, MAQS
guillermo.felices@bnpparibas.com
+44 20 7063 7196

SUMMARY

- **Transitioning to a reflation regime? –** Several developments suggest that a move to a reflationary environment is a material risk, if not immediately. We explore supply shocks given ongoing de-globalisation; fiscal stimulus; and a more traditional route: an economic recovery, with a focus on Chinese policy easing.
- **Risks in fixed income more skewed than in equities –** A reflationary shock would represent a significant shift, and one that fixed income markets in particular are not priced for. We find that bond markets appear rich compared to equities across regions.
- **Need to be nimble –** We have long argued for the need for investors to be nimble in the current backdrop. Our base case remains 'fragile goldilocks', but the likelihood of our risk scenarios has increased.

ASSET ALLOCATION

- **Neutral equities –** With equities near all-time highs, and given the uncertain macro backdrop, we do not regard short-term risk/reward as very appealing.
- **Underweight core EMU duration –** Risks for fixed income markets are mounting, and a reflation environment is not priced by the bond market whatsoever. We continue to hold a short position in core EMU bonds.
- **Search for yield –** We expect the 'search for yield' to continue for the time being, so we are holding a high carry position in emerging market external debt.
- **Robust portfolios –** We continue to hold trades with asymmetries to our risk scenarios, e.g. long US breakeven inflation and several de-globalisation trades.

MARKET REVIEW: Q3 2019

Equity markets were mixed in the third quarter: developed markets rallied (+1.3%) after a poor performance in Q2 and outperformed their emerging market (EM) counterparts (-2.1%). As they were earlier this year, markets were affected by Sino-US trade war and monetary policy decisions.

The truce between presidents Trump and Xi on trade supported equities in July, but market volatility picked up in August and risk appetite soured after the US administration surprisingly announced a 10% tariff on a further USD 300 billion of Chinese imports. The conflict escalated further after China retaliated with a plan for levies on USD 75 billion of US goods. Both leaders eased tensions later in August, ahead of trade talks.

Equities rebounded in September driven by monetary policy. Indeed, what ECB president Draghi hinted at in July materialised in September: a dovish package of measures including a 10bp rate cut, the resumption of quantitative easing (at a pace of EUR 20 billion per month) and strong forward guidance. On the other side of the Atlantic, after July's 25bp cut, the US Federal Reserve lowered rates further to 2% from 2.25% in September. However, Fed chair Powell stressed the solid US outlook and the strong job market. In the UK, the Bank of England left rates unchanged, but warned that uncertainty around Brexit could weaken inflation, while growth has slowed, but has remained positive. The Bank of Japan, at its September policy meeting, left its monetary policy stance unchanged, but signalled its openness to possible additional easing, including lowering rates and expanding asset purchases.

Central bank action supported the bond market. After a positive performance in Q2, bonds rallied further over Q3. 10-year US Treasuries rose by 0.7%, while eurozone 'peripheral' bonds (+3.7%) outperformed German Bunds (+2.9%), led by Italian BTPs. Indeed, despite the political turmoil that resulted in the formation of a new coalition and a new government, Italian yields dropped, benefiting from a contraction of the BTP-Bund spread. In line with government bonds, credit markets also rallied, with US investment-grade and high-yield bonds up by 3.1% and 1.3%, respectively.

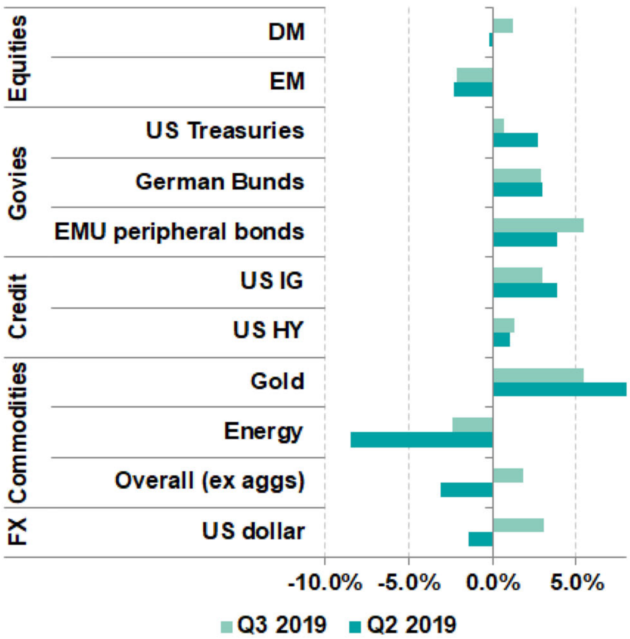
In currency markets, after weakening in Q2, the US dollar gained in Q3 against the euro (+3.9%) and sterling (+3.1%). The UK currency remained in the spotlight: after the drop in prior months, new hopes around a possible deal between the EU and the UK ahead of the UK's departure from the bloc triggered a rebound in September.

Elsewhere in commodities, gold posted highs, gaining 5.5% in Q3 and posting a double-digit year-to-date performance of 16.1%. The broad commodities index climbed by 1.8% in Q3, but with the energy sector lower after being affected by an oil supply shock in mid-September. Indeed, after the drone attack on Aramco facilities in Saudi Arabia, crude oil surged but then retreated after a report on Saudis' rapid resumption of production. Overall, crude oil posted a negative performance in Q3 (-5.4%).

On the macroeconomic front, US GDP growth slowed in Q2 (Q/Q 2% after 2.1%) and the ISM manufacturing index fell to its lowest since 2016 (49.1). Data improved in August with positive surprises in the job market (initial jobless claims of 204k vs. 215k cf) and industrial production (month-on-month 0.6% vs. 0.2% cf). Both US manufacturing and services activity expanded in August, with Markit PMI readings edging up to 51 after 50.3 and 50.9 after 50.7, respectively. There was positive data from the US housing market: existing home sales beat expectations in August (+1.3%), marking the strongest sales pace since March 2018.

In Europe, the latest PMI readings painted a weak picture: the Markit eurozone manufacturing and services indices dropped to 45.6 after 47 and 52 after 53.5, respectively. In China, activity slowed in August: industrial production grew by 4.4% YoY after 4.8%, fixed asset investment growth slowed to 5.5% YoY after 5.7% and retail sales grew by 7.5% YoY after 7.6%. However, PMI readings improved and came in better-than-expected in late September, with the Caixin Manufacturing PMI rising to 51.4 after 50.4. The key factors driving the improvement in September were an acceleration in infrastructure investment and improving consumer goods.

Figure 1: Q3 2019 returns – Developed market equities rebound; EM equities lag



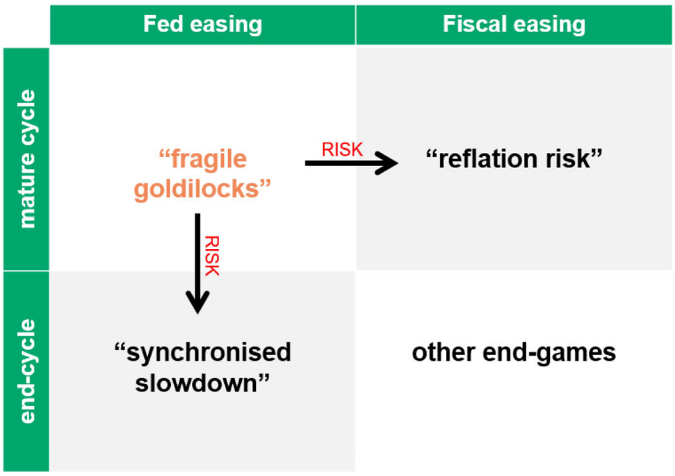
Source: Bloomberg and BNPP AM, as of 30/09/2019

TRANSITIONING TO A REFLATION REGIME?

Over the past few months, we have written extensively about our 'fragile goldilocks' base case – one where growth is soft, but not recessionary, and where monetary policy is supportive due to low inflation, albeit an environment possibly destabilised easily due to prevailing risks. This characterisation neatly describes the backdrop seen so far in 2019, especially from a markets' perspective, with both bonds and equities having posted strong gains so far this year.

However, where do we go from here? In Figure 2, we summarise the status-quo and remind investors of the two likely risk scenarios: a move to a reflationary environment (top right-hand quadrant) or a move to a recession (bottom left-hand quadrant).

Figure 2: 'Fragile goldilocks' & key risk scenarios



Source: BNPP AM, as of 30/09/2019

This time last month, with trade war rhetoric ratcheting higher and some macro data deteriorating further, it felt as if the slowdown scenario was gaining traction. Since then, sentiment around the US-China conflict has improved and several developments have reminded us that a move to a reflationary environment is possible, if not immediately.

Apart from the recent mini oil shock after market concerns over lost Saudi crude output, we see three bigger picture themes which need monitoring for a move to a more reflationary world:

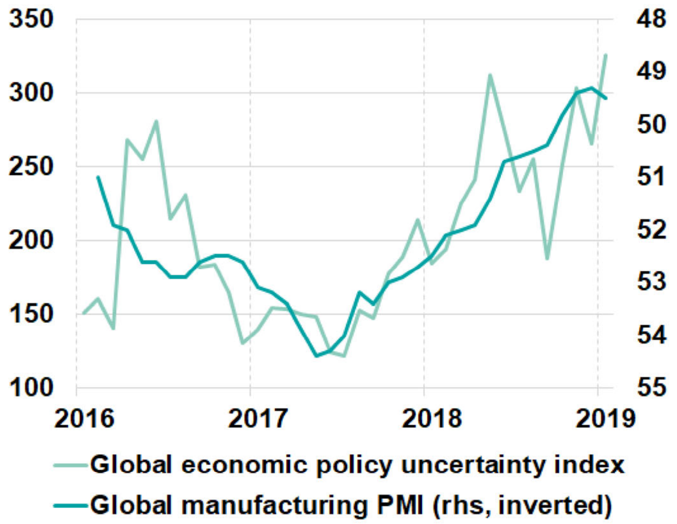
- Supply shocks & de-globalisation
- Fiscal stimulus
- Economic recovery & China policy easing.

Below we explore these in more detail. A reflationary shock, especially one involving fiscal expansion, would represent a significant shift in the outlook, something that we have not seen in recent decades and, crucially, something that markets are not priced for given their reliance on monetary policy post the great financial crisis.

A supply shock from de-globalisation?

We have long held the view that the ongoing trade tensions between China and the US are part of a de-globalisation trend that includes political rifts such as Brexit and the populist outcry in Europe. This process has various characteristics that matter for the global economy and financial markets. First, de-globalisation is unlikely to stop any time soon. This makes it a significant source of uncertainty for the global economy. In fact, the recent rise in a widely monitored measure of global policy uncertainty (Baker and Bloom, et al.) coincides with the rise in China-US tensions (Figure 3).

Figure 3: Increased policy uncertainty coincides with manufacturing slowdown



Source: Bloomberg and BNPP AM, as of 30/09/2019

Second, the uncertainty is already hurting global growth, with the manufacturing sector at the epicentre. Figure 3 shows that global manufacturing sentiment is highly correlated with the rise in global policy uncertainty.

We have also commented before on the visible slowdown in trade and business investment, which we see as part of the same de-globalisation force.

Finally, many observers forget that the nature of this global shock is quite different because it is not just a hit to demand, but rather a blow to supply. These tensions involve dismantling or at least re-directing the way goods and services are being produced (i.e. the supply chains) in major economies, from China and the US to the UK and Europe.

Persistent supply shocks can lead to lower trend growth in some of these economies. If trend growth is hurt materially, the pressure of aggregate demand on now weaker supply could be greater than previously thought. As a result, such shocks can potentially lead to greater inflationary pressures than previously envisaged.

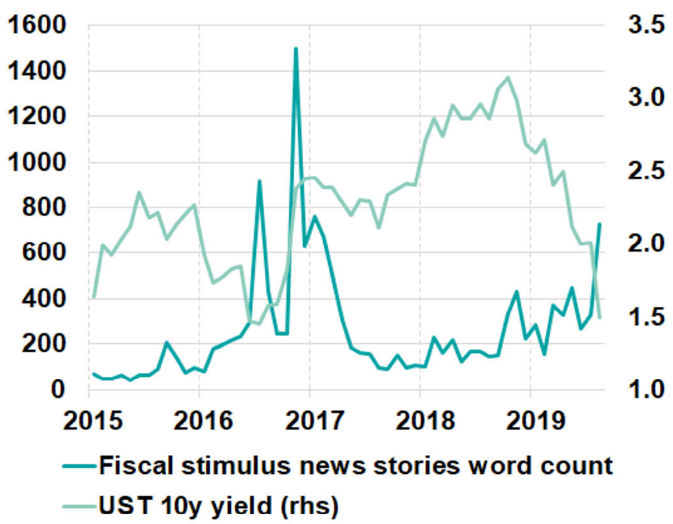
Fiscal stimulus around the corner?

Another important development that has the potential of supporting reflation is the prospect of more expansionary fiscal policy. This is usually a positive demand shock as it involves higher government spending or lower taxes. Over the past few years, major economies have taken different approaches to fiscal policy. The US and China have been more active than Germany, for example. However, the reality is that when it comes to countercyclical policy, monetary policy is usually the first line of defence. Fiscal policy comes second because it tends to be slowed down by political deliberations and it is currently constrained by high debt levels, especially in advanced economies.

Debt levels have been particularly important in the eurozone. The ECB has done much of the legwork when it comes to supporting the economy, while fiscal efforts have been limited. This is partially due to institutional hurdles and a conservative stance in northern Europe – e.g. Germany has a constitutional bias towards balanced budgets, while political power is limited as the ruling coalition is at risk. However, it is also due to high debt levels in the 'periphery', and euro-wide fiscal constraints.

At its latest policy meeting, the ECB launched yet another set of monetary easing measures, including quantitative easing (QE). However, president Draghi clearly said that the ECB was reaching its limits and actively called for fiscal policy to play a larger role.

Figure 4: Yields do not like fiscal stimulus



Source: Bloomberg and BNPP AM, as of 30/09/2019

Further fiscal stimulus is also a possibility in the US where president Trump will try to keep the economy in good health as he campaigns for re-election. Fiscal stimulus is also on the agenda if a more leftist faction of the Democratic party comes to power in the next election. The buzz about renewed fiscal efforts is certainly becoming louder. For instance, the news story word count for 'fiscal stimulus' has picked up rapidly.

Interestingly, fixed income markets have not reacted to this shift. Indeed, Figure 4 shows that US Treasury yields fell notably in August despite the 'fiscal buzz'. This could reflect scepticism about the ability of the authorities in these large economies to embark on material fiscal expansion. It could also reflect the fact that as the global economy slows, market participants and economic agents continue to expect central bank easing to be the first line of defence and that it will take time for markets to shift away from this paradigm.

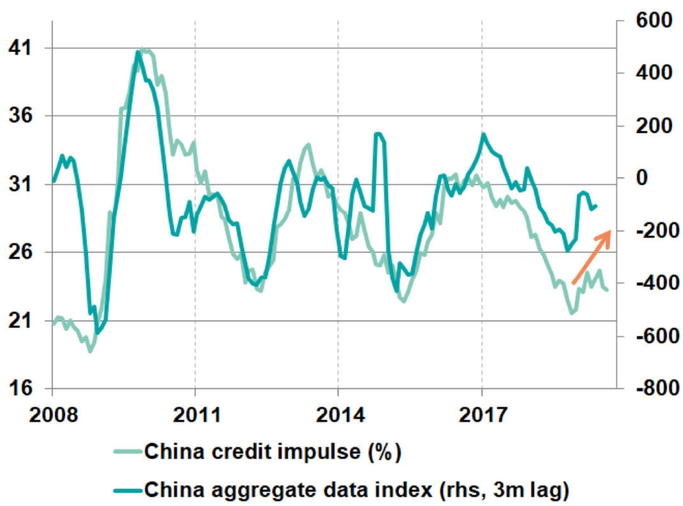
Economic recovery & Chinese easing

Thirdly, reflation could come about via a more traditional route – economic expansion. Sure, macro data in many developed market economies have remained sluggish given de-globalisation trends, especially in large economies geared towards manufacturing. However, there are also signs of hope.

As we have outlined previously, US domestic macro data has remained strong. Fed chair Powell pointed also this out at the latest policy meeting. The Fed still sees its recent rate cuts as a mid-cycle adjustment ('insurance cuts') due to external risks rather than domestic worries.

We are also still monitoring China easing closely. Whilst easing efforts have been more targeted than in prior cycles – given that policymakers are leveraging monetary and fiscal stimulus simultaneously, this can be a powerful force for the domestic economy. Indeed, as Figure 5 shows, China easing leads aggregate Chinese macro data by about three months, and is pointing upward. China easing of course matters for emerging markets, and EM and China-linked assets, albeit with a lag.

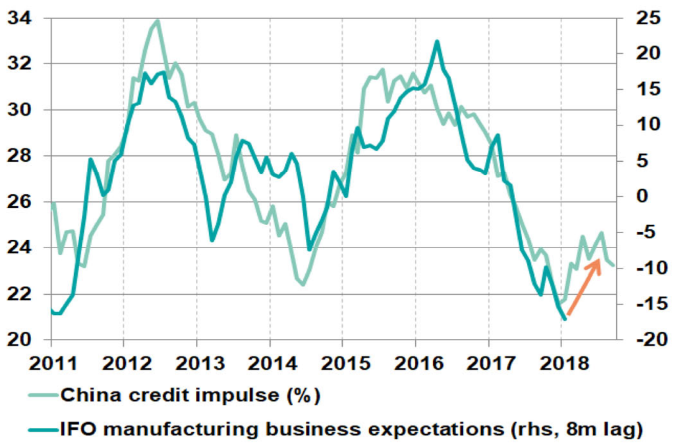
Figure 5: China stimulus to stabilise Chinese macro data?



Source: Bloomberg and BNPP AM, as of 30/09/2019

In addition, China easing cycles have previously translated into economic upswings in its large trading partners. Figure 6 shows how Chinese efforts have led German macro data with a multi-month lead, pointing to at least some future stabilisation.

Figure 6: China stimulus to help developed markets?



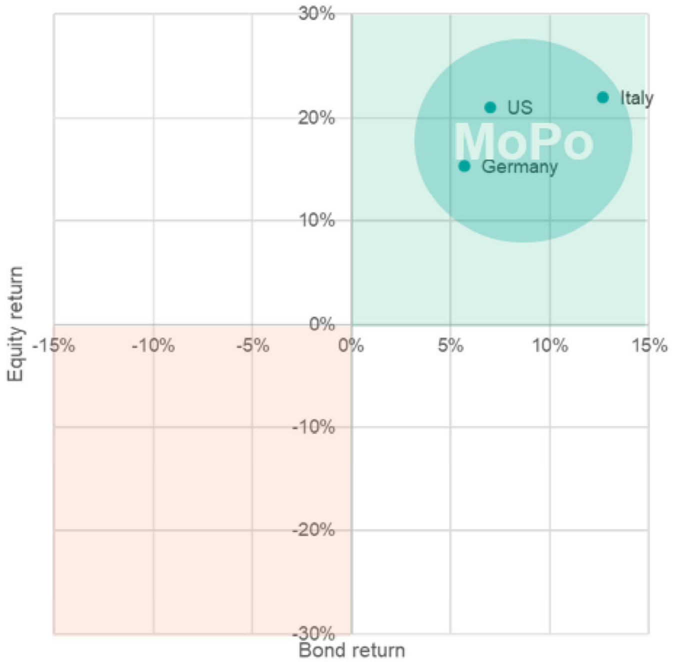
Source: Bloomberg and BNPP AM, as of 30/09/2019

Risks in fixed income more skewed than in equities

While all these developments require close monitoring, none is necessarily imminent and their time horizons could differ significantly. Equally, markets are unlikely to wait for absolute confirmation of any of these (or a combination of them). The 'job' of financial markets is to anticipate. As such, markets could knee jerk back and forth, pricing in some of these developments even before they have materialised fully.

Indeed, markets have become so used to monetary policy as the 'only game in town' that they are not priced for reflation, the fixed income market especially so. Returns so far this year are a case in point: both equities and bonds have rallied strongly, a symptom of monetary policy being priced (Figure 7).

Figure 7: Year-to-date returns – driven by monetary policy

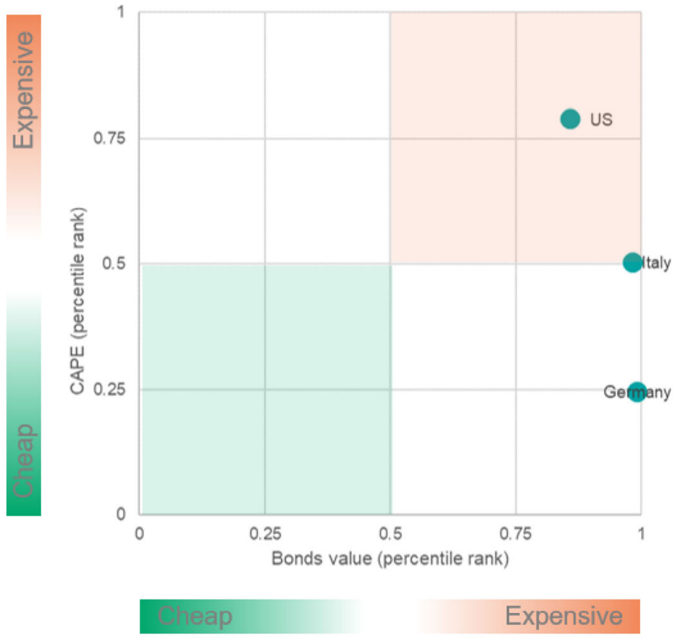


Source: Bloomberg and BNPP AM, as of 30/09/2019

From a valuation perspective, bond markets stand out across the regions as being rich. In Figure 8, we compare real yields and CAPE metrics to their long-term trends since 1990.

Put differently, with subdued inflation the norm, the lower-for-longer dynamic prevails and fixed income markets are biased towards expecting more of the same. As such, a shift to fiscal expansion, let alone, more radical alternatives or other reflationary environments, would be a huge game changer.

Figure 8: Equity vs. bond valuations: fixed income at risk



Source: Bloomberg and BNPP AM, as of 30/09/2019

NEED TO BE NIMBLE

'Fragile goldilocks' still the base case but less attractive risk/reward

Let's not forget that we are in an advanced stage of the economic expansion, with many asset prices looking rich. Risk/reward for holding strategic trades is not very attractive in other words.

Moreover, as we have said numerous times, the current backdrop is also quite fragile – i.e. most major economies are not on a strong enough footing to defend themselves against external shocks. With respect to the risk scenarios explored above and highlighted in Figure 2, the base case has become less probable and risk scenarios more likely.

All this suggests remaining nimble now. We have done exactly that in recent months, and with risky assets back near all-time highs, we have actually reduced our exposure back to neutral in recent weeks (see the *Asset Allocation* section below).

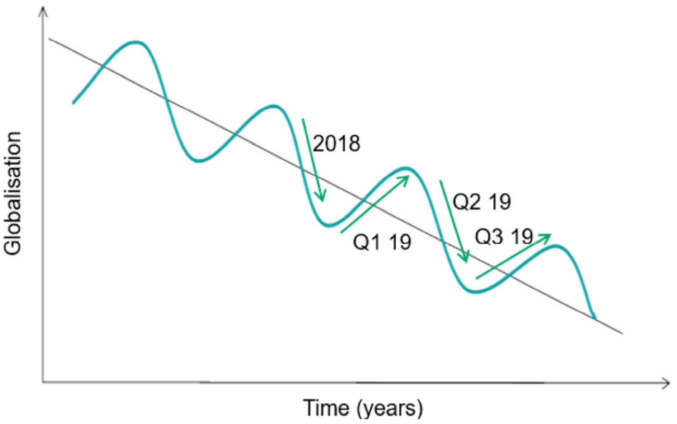
De-globalisation & policy uncertainty

We have highlighted our structural cautious view on de-globalisation often. To re-iterate, we believe that there is more than just trade to the conflict between the US and China. As such, we think that we are in a long-lasting de-globalisation trend, albeit with shorter-term cycles (Figure 9).

This is exactly how Sino-US tensions have evolved, but with an increasing frequency of tensions easing and re-accelerating. Moreover, these same gyrations have been evident in risky assets, with equities experiencing several setbacks as the trade war escalated, only to recover as sentiment improved again.

We have managed to successfully navigate these swings using a 'buy-on-dip' approach. Given the ongoing nature of the US-China conflict, we will remain in a nimble modus operandi.

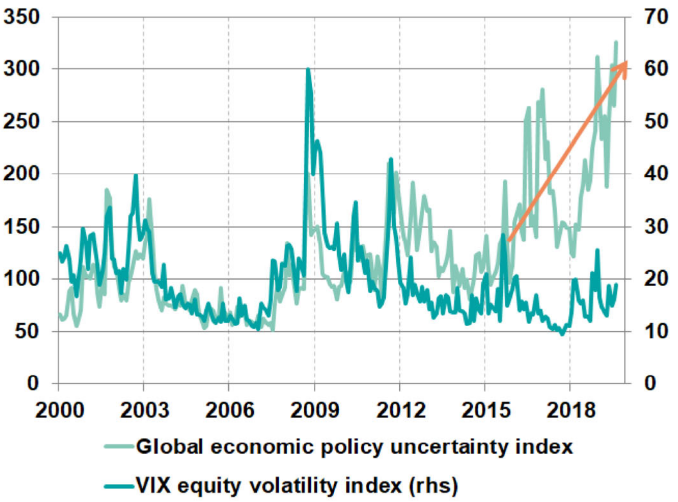
Figure 9: De-globalisation dynamics



Source: BNPP AM, as of 30/09/2019

Otherwise, as discussed above, markets are unlikely to wait for policy regime shifts to fully materialise before starting to price them in. Figure 10 is a case in point, and this should boost volatility over time – another reason to employ nimble thinking.

Figure 10: Volatility to follow policy uncertainty higher



Source: Bloomberg and BNPP AM, as of 30/09/2019

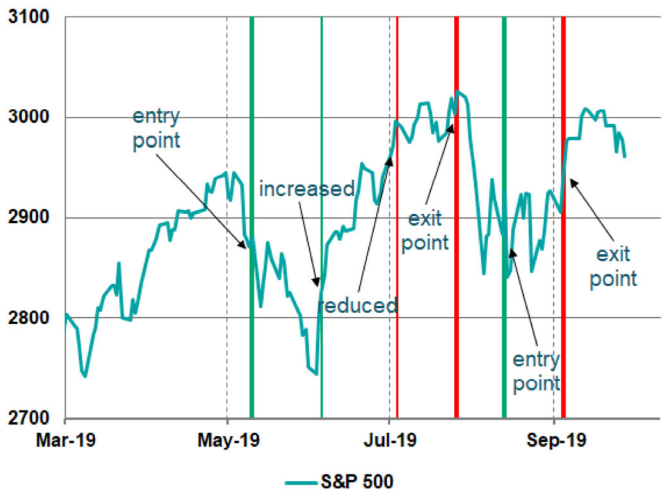
ASSET ALLOCATION

Neutral equities after navigating dips YTD

After successfully navigating the zigzag equity price action of recent months (Figure 11), we have once again neutralised our equity view. With prices near all-time highs, and given the uncertain macro backdrop detailed above, we do not see short-term risk/reward as very appealing.

We are monitoring the upcoming company earnings seasons closely as the consensus is not looking constructive again.

Figure 11: Neutral equities now



Source: Bloomberg and BNPP AM, as of 30/09/2019

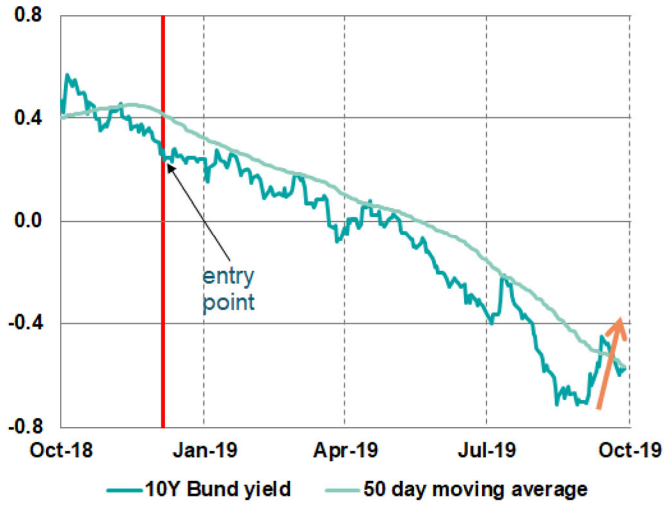
Risks to FI mounting: Underweight core EMU duration

As discussed above, the risks for fixed income markets are mounting, and a reflation environment is not priced in by the bond market at all.

Absent a recession, core yields are thus vulnerable to the upside, as also evident from a valuation perspective (see above). We thus continue to be short core EMU bonds, even though this trade has gone against us for several months.

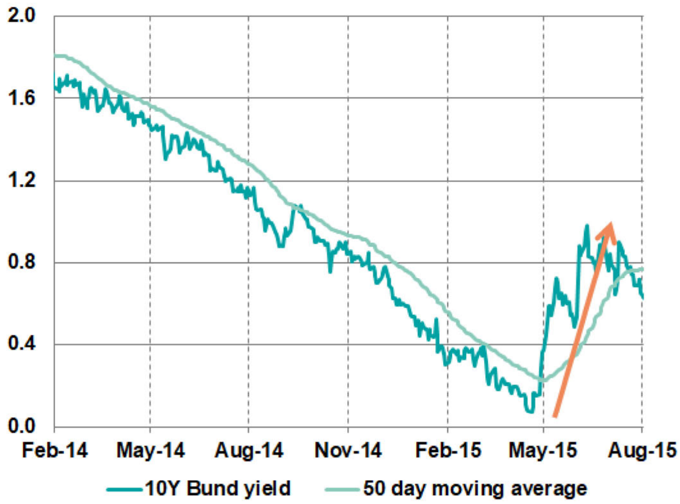
From a technical perspective, our proprietary market dynamic and timing signals are also pointing to a possible inflection point in recent trading. Indeed, we are watching a key yield resistance stemming from the 50-day moving average. So far, this has contained bullish bond price action as the market anticipated quantitative easing by the ECB (Figure 12). We note there was a similar dynamic in 2014-2015: the bond market rallied sharply in anticipation of ECB easing, price action was bound by the 50-day MA, but unwound swiftly once this key resistance was breached significantly (Figure 13).

Figure 12: Still underweight core EMU duration



Source: Bloomberg and BNPP AM, as of 30/09/2019

Figure 13: German Bund yields in 2014-2015



Source: Bloomberg and BNPP AM, as of 30/09/2019

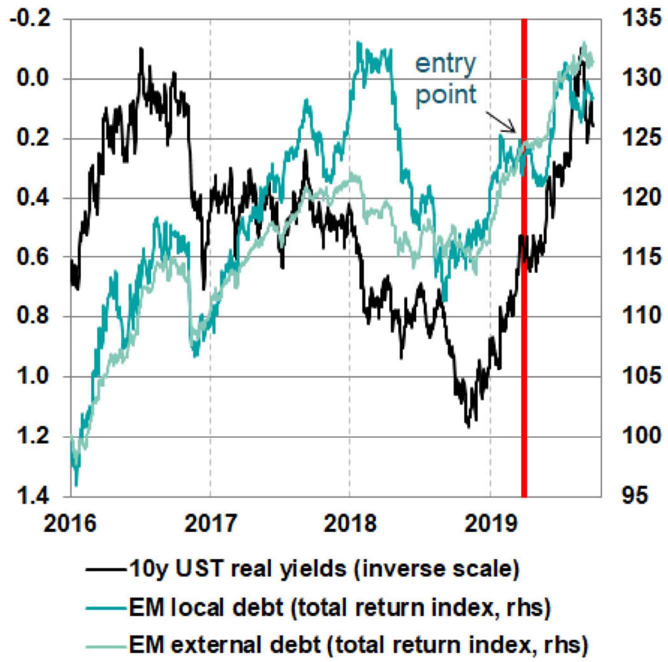
Search for yield: overweight EM hard currency debt

Elsewhere, we expect the search for yield to continue for the time being, so we hold a high carry EM external debt position. This market has historically done well when real yields were stable or falling, and has done well since inception for similar reasons (Figure 14).

Easing efforts by China have allowed the spread component of this position to narrow in recent months, a phenomenon that was also evident in the prior easing cycle and one that should support our trade going forward.

Other carry assets, such as REITs, remain on our radar.

Figure 14: Still overweight EM hard currency debt

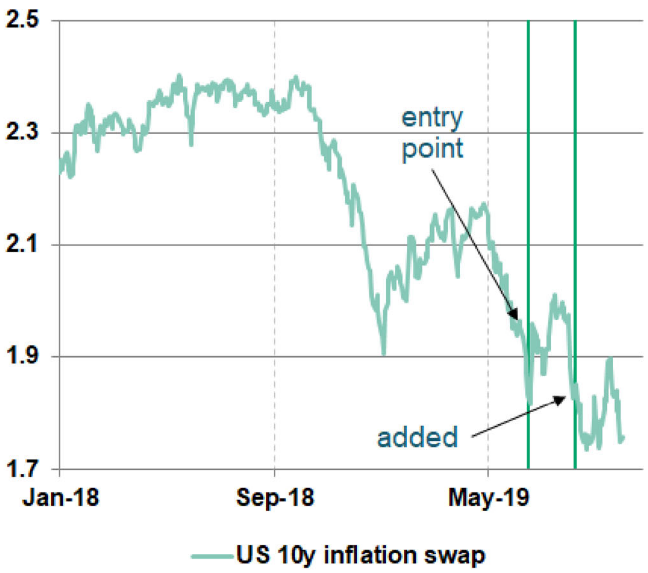


Source: Bloomberg and BNPP AM, as of 30/09/2019

Reflation hedge: long US breakeven inflation

We are long US breakeven inflation, driven by a valuation view. And this can be seen as a hedge to the reflationary forces discussed above. After breakevens fell further after inception of the trade – to even more stretched valuations – we added to this position (Figure 15).

Figure 15: Long US breakeven inflation



Source: Bloomberg and BNPP AM, as of 30/09/2019

De-globalisation trades

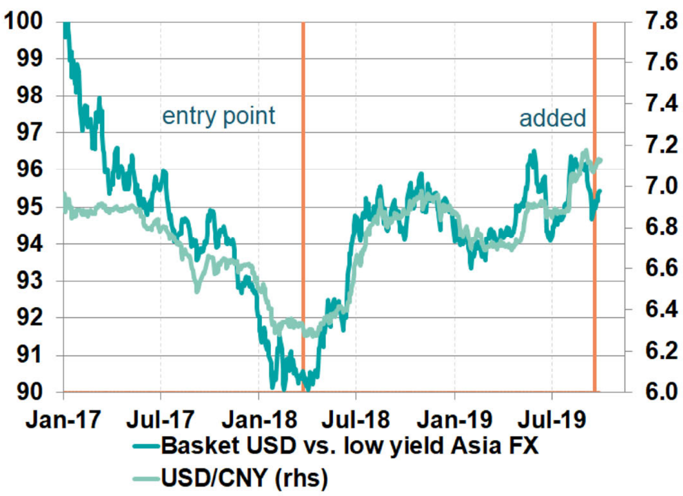
Finally, regular readers will be familiar with our efforts at building robust portfolios. Given our structural cautious view on de-globalisation, we have held several trades with asymmetries around an escalation of tensions between the US and China.

One such trade is a long French CAC/short German DAX position. We believe Germany is more exposed to manufacturing weakness and trade war concerns. This relative value trade has continued to do well.

Elsewhere, we are long the US dollar versus low-yielding Asian currency crosses. Our basket is correlated to USD/CNY and has done well in periods of trade war stress (Figure 16). In the recent pullback, we added exposure to this basket trade, albeit exiting THB given that its correlation to CNY and the other pairs has fallen recently.

It is worth noting that the carry cost of our basket is low – these are low-yielding currencies – this bodes well for constructing positions intended to be held for long periods.

Figure 16: Adding to long USD vs. Asia FX



Source: Bloomberg and BNPP AM, as of 30/09/2019

STRATEGIC OVERVIEW OF KEY POSITION CHANGES IN Q3 2019

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

JULY:

LONG 5Y US VS. GERMANY BONDS CLOSED 01/07/19

- Having rallied over the first half of the year, US Treasuries might be affected by upcoming Fed decisions and the trade truce between US and China. Therefore, we took profits and closed the position.

LONG EUR BREAKEVEN INFLATION OPEN 03/07/19

- For funds that have not been able to implement the long USD breakeven trade, we opened a long position in EUR breakeven inflation via swaps.

LONG DM EQUITIES VIA OPTIONS REDUCED 03/07/19

- For flexible funds, we reduced the position and shifted from calls to call spreads.

LONG DM EQUITIES CLOSED 26/07/19

- With ‘goldilocks’ priced in more and more, the short-term risk/reward looked unattractive heading into the July FOMC meeting. After a good run, we took profits.

LONG EUR BREAKEVEN INFLATION CLOSED 26/07/19

- Following ECB dovishness, after EUR inflation breakeven rates priced sharply higher, we took profits on this trade.

AUGUST:

SHORT CAD VS NOK CLOSED 01/08/19

- Our trade hit its stop loss and we closed the position.

LONG US BREAKEVEN INFLATION INCREASED 07/08/19

- The July FOMC meeting confirmed the Fed’s dovish stance. This is likely to push inflation expectations higher. Therefore, we added to our long breakeven trade.

LONG US EQUITIES OPENED 13/08/19

- As our ‘fragile goldilocks’ base case suggests buying market dips, we used recent correction to open a long position in US equities.

SEPTEMBER:

LONG US EQUITIES CLOSED 04/09/19

- As both fundamentals and technicals are less supportive, we turned neutral on equities and took profits ahead of the FOMC meeting.

LONG DM EQUITIES VIA OPTIONS CLOSED 09/09/19

- As our options approached expiry and technicals showed that we were close to the top, we closed the Eurostoxx call spreads in flexible portfolios.

SHORT ITALIAN BTPS OPEN 09/09/19

- The rally in BTPs suggested that Italian bonds were pricing in aggressive ECB policy action. Given the material risk of disappointment from the ECB meeting, we entered a short position in BTPs ahead of the meeting.

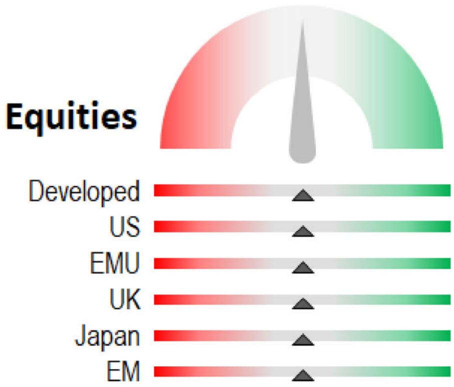
SHORT ITALIAN BTPS CLOSED 13/09/19

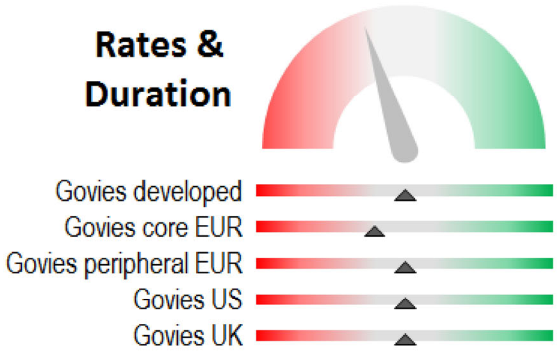
- The ECB did not disappoint, so we closed the position.

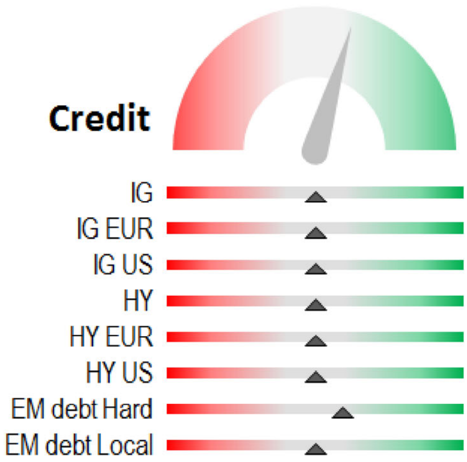
LONG USD VS ASIAN CURRENCIES INCREASED 18/09/19

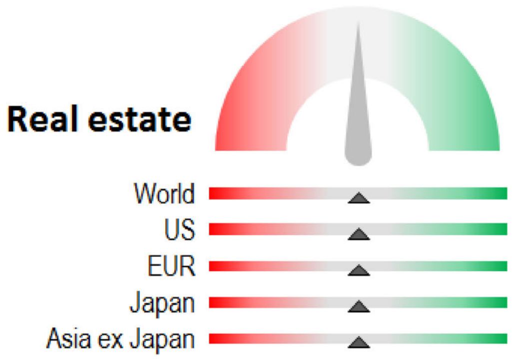
- We added to this trade given the recent pull-back. Our view is that de-globalisation risks are here to stay. Given that the correlation between the Thai Baht and other Asian currencies has recently fallen, we removed THB from our basket.

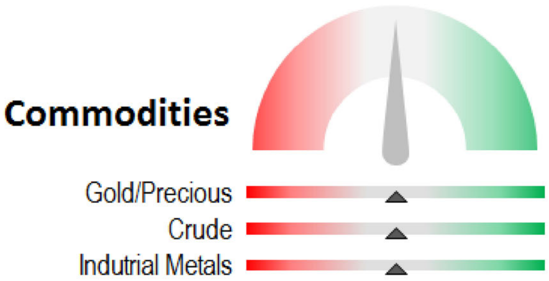
CORE ASSET ALLOCATION DASHBOARD[1]

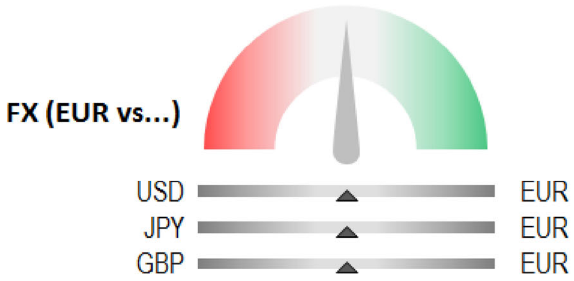


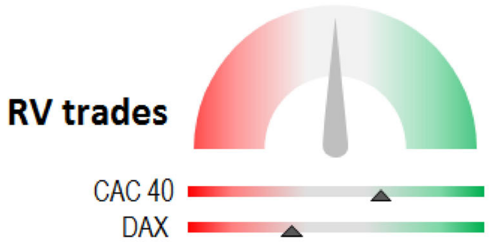












[1] The dashboard shows the asset allocation in our portfolios and reflects the decisions of the Investment Committee of the Multi-Asset team at MAQS.

Views expressed are those of the Investment Committee of MAQS, as of September 2019. Individual portfolio management teams outside of MAQS may hold different views and may make different investment decisions for different clients.

DISCLAIMER