

ASSET ALLOCATION MONTHLY

JULY 2017

FOR PROFESSIONAL INVESTORS



Colin Harte,
Head of Research, Active Asset Allocation
Multi Asset Solutions
colin.harte@bnpparibas.com
+44 20 7063 7277

SUMMARY

- ▶ **Inflation continues to disappoint**
- ▶ **Are central banks debating a change in their reaction functions?**
- ▶ **Bond markets are becoming unsettled**

SUMMARY ASSET ALLOCATION

Multi-asset	Active weights		Δ active weight
	Jun-17	Jul-17	
Equities	●	●	—
Duration	●	●	↑
Investment-grade	●	●	—
High-yield	●	●	—
Emerging market debt hard currency	●	●	—
Emerging market debt local currency	●	●	—
Real estate	●	●	—
Convertibles	●	●	—
Commodities	●	●	—
Cash	●	●	—

The first three weeks of the month saw risk assets continue to rally, while bond yields declined modestly. There has been a growing dichotomy between the economic outlook discounted by equity markets and the views discounted by fixed income markets so far this year. Equity markets had been posting virtually uninterrupted gains on the back of continued economic growth and an improved earnings outlook, while bond yields in all the major markets had fallen materially due to lower expected inflation suggesting slower monetary policy tightening. Part of the explanation for this divergence lays in the strength of survey data (soft data) and the more restrained picture painted by official data (hard data) such as GDP. Despite the gap between soft and hard data beginning to narrow in a number of economies, bond and equity pricing had reflected biases towards different future outcomes. Then came the speeches by ECB President Draghi and BoE Governor Carney at the ECB conference in Sintra, Portugal. These fuelled market concerns that central banks were beginning to debate potential changes to their reaction functions which would allow them to tighten policy even if inflation remained subdued. The result was a significant rise in European bond yields which spilled over into the US Treasury market and also hurt risk assets.

INFLATION CONTINUES TO DISAPPOINT

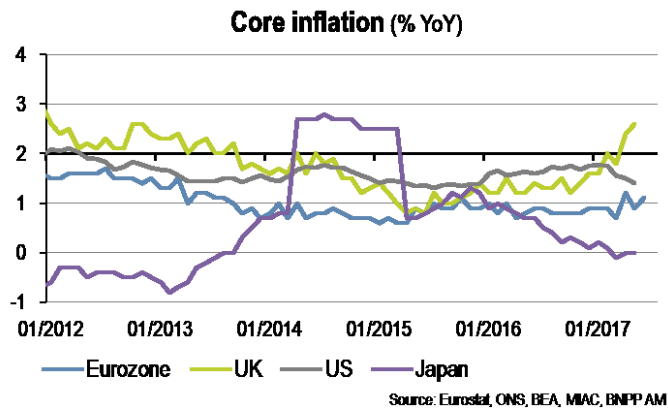
Inflation has remained sluggish in a number of economies, but the undershoot of inflation in the eurozone relative to the ECB target has been one of the more pronounced instances. Eurozone inflation has fallen from a high of 1.9% year-on-year in April to 1.4% YoY in May. In part, the weak inflation backdrop is due to base effects as higher oil prices drop out of the annual calculation (with more downwards pressure to come from



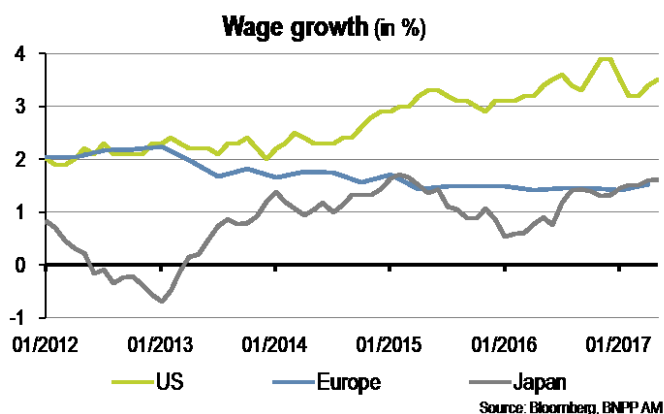
BNP PARIBAS
ASSET MANAGEMENT

The asset manager
for a changing
world

the recent softness in oil prices) and the continued weakness in wage inflation.



The absence of inflationary pressures from the labour markets has continued to surprise policymakers in the US and Europe, where de-facto full employment (in the US and Germany) would have been expected to lead to more material wage rises than seen currently.



ARE CENTRAL BANKS MULLING A CHANGE IN THEIR REACTION FUNCTIONS?

It has been central bank practice to set inflation targets and ease monetary policy if inflation undershoots the target and to tighten policy if inflation overshoots. Since the financial crisis of 2007-2008, the sluggish performance of most economies has meant inflation has tended to fall short of most central banks' targets and so policy has been inclined to be – very – accommodative. Where central banks have begun to tighten policy, as in the US, inflation has tended to be close to target, but still below it.

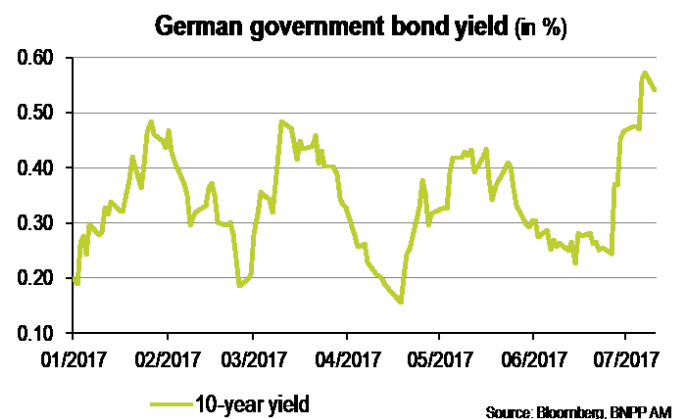
More recently, markets have begun to question the binary relationship between monetary policy and inflation targeting. Doubts have emerged as the US FOMC continues tightening in the face of soft data. A debate has erupted in the ECB governing council about the continued desirability of loose policy given the risks of

creating asset price bubbles. The FOMC is engaged in a similar debate. So are central banks considering a change in the nature of their reaction function, moving towards greater tolerance of an undershoot in inflation? This would mean a central bank would raise policy rates even if inflation was only at around 1% and only pursue aggressive easing if there was a threat of deflation. Recent remarks by Draghi, Carney and several FOMC officials have fuelled market concerns that such a policy shift is seriously being considered.

Such a shift in central bank policy would lead to higher real yields and a reappraisal of risk asset valuations. While we believe there is a lively debate as to whether the nature of reaction functions should be updated and we expect central bankers to become less accommodative than they have been, we feel that we are in the early stages of such a reassessment and the actual shift will not occur just yet.

BOND MARKETS BECOMING UNSETTLED

The concerns about central banks changing their reaction functions have unsettled bond markets globally. However, it appears that markets are more concerned by the potential change in policy by the ECB given the large proportion of eurozone government debt with negative interest rates and since the undershoot in inflation is more pronounced in the eurozone. Ten-year Bund yields have more than doubled from 24bp to 57bp in less than two weeks, pushing up yields globally.



While we expect the ECB to change its policy stance over the next 18 months, we feel that markets are prematurely expecting a rate rise from the ECB by year-end and as such we have taken the tactical decision to reduce our underweight in eurozone duration. Strategically, we remain underweight duration.

Apart from the move to trim our duration underweight, there have been no other changes to the portfolios.

ASSET ALLOCATION¹

Multi-asset		Active weights		Δ active weight	Fixed income		Active weights		Δ active weight
		Jun-17	Jul-17				Jun-17	Jul-17	
Equities		●	●	—	Euro govies		●	●	—
Duration		●	●	↑	Euro short dated		●	●	—
Investment-grade		●	●	—	US Govies		●	●	—
High-yield		●	●	—	Inflation-linked (EUR)		●	●	—
Emerging market debt hard currency		●	●	—	Investment-grade (EUR)		●	●	—
Emerging market debt local currency		●	●	—	High-yield (EUR)		●	●	—
Real estate		●	●	—	Investment-grade (USD)		●	●	—
Convertibles		●	●	—	High-yield (USD)		●	●	—
Commodities		●	●	—	Emerging market debt hard currency		●	●	—
Cash		●	●	—	Emerging market debt local currency		●	●	—

Equities		Active weights		Δ active weight	Foreign exchange		Active weights		Δ active weight
		Jun-17	Jul-17				Jun-17	Jul-17	
European large caps		●	●	—	AUD		●	●	—
European small caps		●	●	—	CAD		●	●	—
US large caps		●	●	—	CHF		●	●	—
US small caps		●	●	—	DKK		●	●	—
Japan		●	●	—	EUR		●	●	—
Emerging markets		●	●	—	GBP		●	●	—
					HKD		●	●	—
					JPY		●	●	—
					NOK		●	●	—
					NZD		●	●	—
					SEK		●	●	—
					SGD		●	●	—
					USD		●	●	—
					EM FX		●	●	—

Real estate		Active weights		Δ active weight
		Jun-17	Jul-17	
European real estate		●	●	—
US real estate		●	●	—
Asian real estate		●	●	—

KEY

Overweight: ● Neutral: ● Underweight: ●
 Increase: ↑ No change: — Decrease: ↓

¹ The tables reflect net positions versus the benchmark in the Multi Asset Solutions strategy model portfolio. Views on a particular asset class should not be seen in isolation, but in the context of the overall portfolio.

* Duration risk is managed independently of the underlying fixed-income allocation using government bond futures.

Equities:	Neutral
<p>Unchanged. Some fundamental factors are keeping us cautious: we regard valuations as rich and earnings expectations as high. However, markets have so far ignored this and with positive earnings momentum in the eurozone and more and more analysts upgrading their expectations for eurozone and US earnings, we do not see an imminent catalyst for a downtrend in developed equities. Given that consensus earnings expectations for UK companies look too high and reflecting the positive economic cycle, monetary policy and market momentum in the eurozone, we are overweight eurozone equities versus the UK. We are neutral on the US and Japan.</p>	
Small-cap equities:	Neutral
<p>Unchanged. European small-cap equities have rallied in line with large caps, but in the US, small caps have lagged large caps so far this year after their strong outperformance following the US presidential election. On several valuation measures, small caps are trading at a premium to large caps, both in the US and in Europe. In the US, earnings momentum has weakened.</p>	
Government bonds:	Neutral duration
<p>Changed. Given the rise in government bond yields globally and in Europe in particular, we trimmed the size of our underweight in European government bonds. We feel the back-up is an overreaction to the early stages of the debate on changing central bank reaction functions. This move is tactical and any material drop in yields would cause us to restore our full strategic duration underweight.</p>	
Investment-grade corporate bonds:	Neutral
<p>Unchanged. Risk spreads have remained low in the US and Europe. We view the macroeconomic fundamentals as generally positive for this asset class. Defaults are low, credit conditions continue to improve and yields remain historically low in general. However, the currently low yields entail a risk of an asymmetric payoff. If the global economy strengthens and inflation sets off, government bond yields may rise, pushing up investment-grade yields. In an economic slowdown, credit may suffer from wider risk spreads, pushing yields higher.</p>	
High-yield bonds:	Underweight
<p>Unchanged. Spreads have fallen to such an extent that we see US high-yield as expensive relative to our macroeconomically driven fair-value model. The gap between model spreads and actual spreads has narrowed too far, in our view. Meanwhile, company fundamentals such as debt levels and interest payments relative to profits or cash flow have worsened. We think current spreads do not offer adequate compensation for risks such as higher inflation and yields or pressure on global growth from protectionism or a downturn in China.</p>	
Emerging market bonds:	Neutral
<p>Unchanged. We are underweight hard currency emerging market debt, but overweight local currency bonds. We think sovereign balance sheets have not improved by much, which does not justify the relatively low spreads on hard currency debt. We believe valuations are more attractive in local currency bonds. If emerging currencies continue to appreciate, this should benefit these bonds. Central banks in some large issuing countries are cutting interest rates, which should further support local currency bonds.</p>	
Real estate securities:	Overweight
<p>Unchanged. We are overweight US real estate. The sector has been lagging over the past year as market participants have focused mainly on bad news while ignoring factors such as a positive supply-demand balance. This has taken valuations to historically low levels. Rising interest rates and yields are a risk that we are willing to take at this point given the positive factors. We are overweight versus US equities to hedge market movements and focus on the low valuation of real estate securities compared to more expensive broad equities.</p>	



Commodities:**Neutral**

Unchanged. Oil prices have remained choppy. Since the end of February, Brent oil has traded at between USD 45.50 and USD 54 per barrel. The OPEC deal to curb production appears to be holding, but US shale production is rising and US inventories are high. Markets have recently questioned whether the OPEC deal is enough to put a floor under prices. Over time, we expect the market to become more balanced, but the negative carry on the asset class as well as the growth risks in China keep us from moving to an overweight.

DISCLAIMER

BNP PARIBAS ASSET MANAGEMENT UK Limited, “the investment company”, is authorised and regulated by the Financial Conduct Authority. Registered in England No: 02474627, registered office: 5 Aldermanbury Square, London, England, EC2V 7BP, United Kingdom.

This material is issued and has been prepared by the investment management company.

This material is produced for information purposes only and does not constitute:

1. an offer to buy nor a solicitation to sell, nor shall it form the basis of or be relied upon in connection with any contract or commitment whatsoever or
2. investment advice.

Opinions included in this material constitute the judgment of the investment management company at the time specified and may be subject to change without notice. The investment management company is not obliged to update or alter the information or opinions contained within this material. Investors should consult their own legal and tax advisors in respect of legal, accounting, domicile and tax advice prior to investing in the financial instrument(s) in order to make an independent determination of the suitability and consequences of an investment therein, if permitted. Please note that different types of investments, if contained within this material, involve varying degrees of risk and there can be no assurance that any specific investment may either be suitable, appropriate or profitable for an investor's investment portfolio.

Given the economic and market risks, there can be no assurance that the financial instrument(s) will achieve its/their investment objectives. Returns may be affected by, amongst other things, investment strategies or objectives of the financial instrument(s) and material market and economic conditions, including interest rates, market terms and general market conditions. The different strategies applied to the financial instruments may have a significant effect on the results portrayed in this material.

This document is directed only at person(s) who have professional experience in matters relating to investments (“relevant persons”). Any investment or investment activity to which this document relates is available only to and will be engaged in only with Professional Clients as defined in the rules of the Financial Conduct Authority. Any person who is not a relevant person should not act or rely on this document or any of its contents.

All information referred to in the present document is available on www.bnpparibas-am.com