

# ASSET ALLOCATION MONTHLY

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FOR PROFESSIONAL INVESTORS



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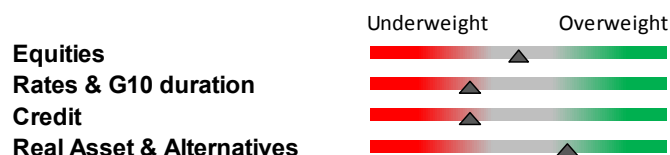
## SUMMARY

- Upbeat market in October, led by Japanese equities
- ECB asset purchase 'recalibration': still accommodative
- EM: renewed idiosyncratic risks?
- Asset allocation:
  - Stay neutral equities and slightly underweight core fixed income
  - Long EM versus US equities
  - Closed US small caps versus large caps
  - Closed AUD bonds vs. UST
  - Reduced IBEX versus MIB

## MARKET SUMMARY

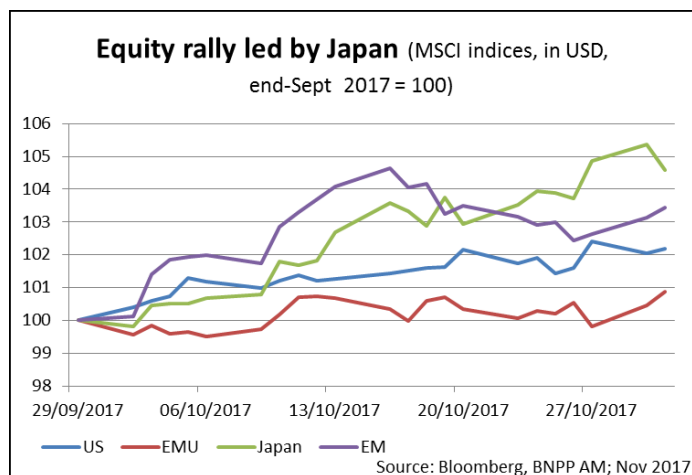
Equities' upward momentum continued throughout October. Overall, this was fuelled by improved macroeconomic indicators and improving investor sentiment. Japan led global equity markets, rising by 8.1% in local currency terms and by slightly less in US dollar terms due to the strengthening of the greenback. This resulted from Prime Minister Abe's snap election victory, which should allow accommodative monetary policies to be continued. Similarly, European risk assets were helped by Mario Draghi's dovish tone as the ECB President announced the well-telegraphed tapering of the central bank's asset purchase programme, carefully referred to as 'recalibration'. Political events in Catalonia injected moderate volatility into Spanish equities, but the IBEX still rose by 1.9% despite the region's declaration of independence being superseded by the Spanish central government taking control there. Other 'peripheral' equity markets underperformed, such as the Italian MIB, which helped our long Spain versus Italy equities position. At the sector level, European banks did poorly.

## SUMMARY ASSET ALLOCATION



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In the US, the S&P 500 index ended October up by 2.7%, marking the 12<sup>th</sup> successive monthly rise. Tax reform negotiations, the incoming chair at the US Federal Reserve (Fed), strong GDP growth numbers and robust global earnings all contributed to the gains. Eurozone government bonds enjoyed a boost post the ECB meeting, with 'periphery' sovereign bonds leading the rally.

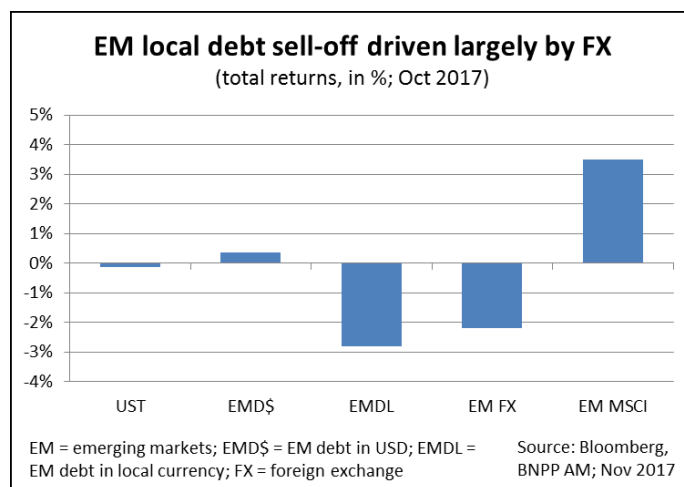
In the UK, one-year gilts finished slightly ahead after a volatile month in anticipation of the Bank of England's stance at its November monetary policy meeting. Commodities did well, driven by copper and energy following reports that OPEC production cuts would likely be extended. Meanwhile, iron ore softened during the second half of the month.

## ECB ASSET PURCHASE PROGRAMME 'RECALIBRATION': STILL ACCOMMODATIVE

The outcome of the ECB's council meeting was broadly in line with market expectations – an extension of quantitative easing (QE) by nine months at EUR 30 billion a month and no change in forward guidance. The overall message from ECB President Draghi, however, was distinctively dovish, as reflected in the eurozone bond rally that followed. Mr Draghi stressed that the announced extension was open-ended and that the asset purchase programme would not stop suddenly. He also said that if macroeconomic conditions deteriorate, the ECB stood ready to buy more and/or buy for longer. Our worry remains that we have passed the peak of monetary policy accommodation and core inflation is not accelerating anywhere (latest number: 0.9%). At this point, the ECB has little ammunition left to fight disinflation when the next downturn comes.

## EMERGING MARKETS: RENEWED IDIOSYNCRATIC RISKS?

Emerging market (EM) local debt markets came under pressure in October, while EM equities and hard currency debt remained robust. EM equities rose by close to 3.5%, with a mixed performance across regions, while EM hard currency debt returned close to 0.5%. However, EM local debt fell by 2.85%, driven mainly by weaker EM currencies. The currency component of the JPM GBI local debt benchmark, for example, fell by c.2%. But this also masks some regional differences. Most of the weakness in currencies was concentrated in LatAm and CEMEA, while EM Asian currencies were either stable or rose against the US dollar.



It is hard to point out a single driver of the correction in EM. Ten-year US Treasury yields rose by close to 15bp in the last two weeks of October, but beyond that, the macroeconomic backdrop has not changed greatly. Several EM-specific factors were more damaging, especially against the backdrop of a strong performance year-to-date. In particular, concerns about worsening fundamentals in large EM countries such as South Africa, Turkey, Mexico and to a lesser extent Brazil hurt investor sentiment. We are still constructive on EM assets over the medium term if growth continues to accelerate, if commodity prices remain robust, and if US interest rates and the dollar do not rise too rapidly. It is difficult to call the end of the correction in the near term, but we will look for opportunities, while keeping our constructive medium to long-term outlook in mind.

## ASSET ALLOCATION: NEUTRAL EQUITIES, SLIGHT UNDERWEIGHT DURATION

We remain neutral on equities and keep a slight underweight position in core rates and duration. The neutral equity allocation reflects our view that robust

global growth will continue to support earnings growth. However, valuations, especially in the US, are now more challenging after a prolonged and solid rally year-to-date. We are therefore cautious about taking directional views, but are open to them if we see a further correction.

We keep our underweight exposure to core fixed-income markets, notably in Europe where we continue to see yields as too low relative to the fundamentals. In the US, Treasury yields should continue to drift higher if activity growth remains robust and inflationary pressures gradually pick up. This should allow the Fed to continue to raise interest rates at a very gradual pace.

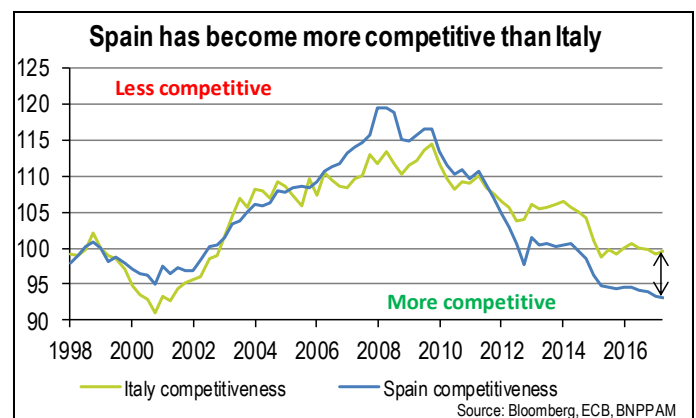
As mentioned last month, in early October, we implemented a long position in EM equities versus developed market equities, in particular versus US equities. This strategy is predicated on three key drivers. First, valuations on the MSCI EM index still look attractive compared to the S&P index overvaluation. On a 12-month forward P/E basis, the discount of EM versus US equities is historically high, especially compared to the 2006-2012 period. Second, EM growth is on an upswing, but is still below post-crisis highs so we believe it has room to accelerate further. Meanwhile, inflation is falling and is low compared to historical levels, leaving room for central banks to adopt an easing policy and bring EM rates down. Overall, the macroeconomic environment is good for EM equities. Third, investor positioning in EM equities is generally lighter than in US equities. Investors have been slow to return to EM assets after facing material losses in 2014-2015. According to IIF data, for instance, the proportion of EM assets in global portfolios is currently close to 13%, having peaked at 18% in 2011.

When it comes to exogenous factors, the biggest risk to this trade is a material rally in the US dollar. In the last few years, a stronger dollar has been associated with weaker EM vs. US equities. However, we now see the US dollar strengthening only gradually versus major currencies, notably the euro. Another commonly mentioned risk is that of higher US yields due to more aggressive-than-expected Fed policy normalisation. We are less worried about this risk because the Fed is likely to raise rates very gradually in the face of weak inflation. Furthermore, historically, EM equities have outperformed DM during Fed tightening cycles. Looking at the sectors, EM and US equity indices have similar IT weights, so this provides a hedge in the case of a tech sell-off. Moreover, we favour EM IT as we expect a structural surge fuelled by rising middle class demand.

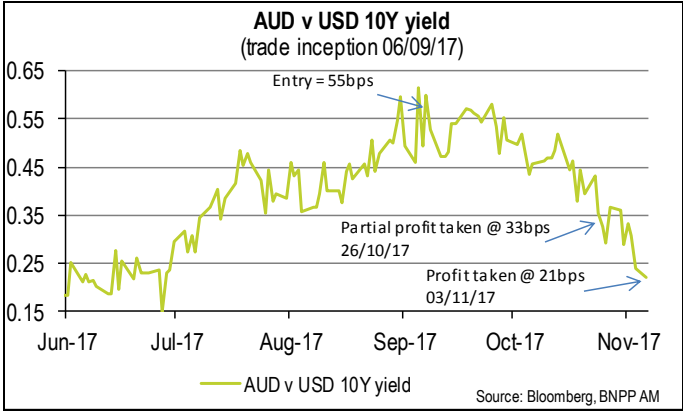
We closed our overweight in US small cap versus large cap at a profit. This tactical position was based on the relative underperformance of small caps since earlier in 2017 and the renewed momentum of the 'Trump trade' due to tax reform returning to centre stage in the US. Small-cap companies rallied swiftly as they would benefit

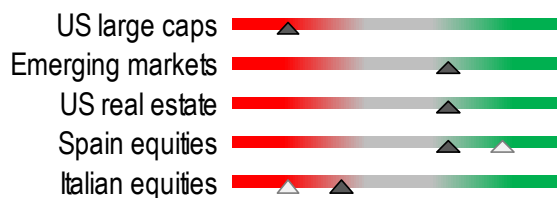
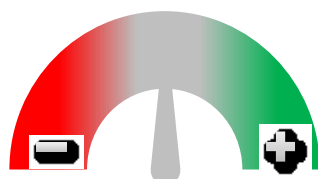
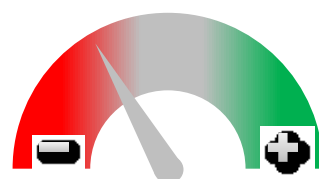
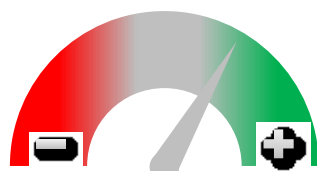
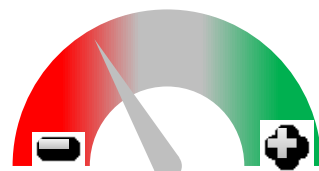
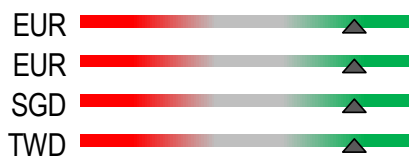
more from a corporate tax cut since they tend to pay higher effective tax rates.

We have reduced our exposure to Spanish equities in the face of short-term political uncertainty. Nevertheless, we retain conviction in our long IBEX vs. FTSE MIB strategy in the medium term. Firstly, structural reform success in Spain should continue to bear fruit in the form of improved competitiveness of domestic companies. Italy, on the other hand, has been lagging behind and the current frontrunners for next year's elections show no appetite for labour and product market reform. Second, we continue to think that cyclical growth in Spain will outpace growth in Italy given the sustained improvement in the labour market and healthier support from the banking sector. Third, we expect IBEX companies to benefit from a cyclical turnaround in Latin America where there is substantial revenue exposure for the biggest weights in the index such as Santander, BBVA, Telefonica. Last but not least, although we acknowledge the higher risk of short-term volatility due to political events, we do not see Catalan independence as a scenario with a high likelihood.



We reached the target for the AUD vs. USD bond strategy (20bp differential). The rationale has played out in terms of the convergence of macroeconomic indicators between the US and Australian economies, with the latter struggling to meet high market expectations. In the US, on the other hand, the bar was relatively low for a positive surprise. This has pushed market participants to reprice the probability of a Fed rate rise in December from 33% (when we initiated the strategy) to 90% today. US inflation expectations have stabilised, as we anticipated, which has helped the strategy. Last but not least, the sell-off in iron ore prices has contributed to Australian bonds' outperformance. Stretched positioning in US Treasuries makes us cautious on further yield convergence in the short term.



**ASSET ALLOCATION<sup>1</sup>****Equities****Rates & G10 Duration****Real Assets & Alternatives****Credit****FX Strategies****SHORT****LONG**

Current: ▲

Previous month: △

<sup>1</sup> 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.





<b>Equities:</b>	<b>Neutral</b>
<p><b>Changed.</b> We remain overall neutral on equities. We are overweight EM versus US equities, taking a longer-term position as we forecast improvements in the emerging market middle class, in particular in the information technology sector. Relative valuations also favour EM over DM stocks. We have used US equities as a funding leg versus US listed real estate (see rationale in the box on real estate below). We have reduced our long Spain versus Italy position due to higher short-term volatility, although we retain conviction in the trade.</p>	
<b>Small-cap equities:</b>	<b>Neutral</b>
<p><b>Reduced to neutral.</b> We have closed our long US small cap versus large cap position to after a good performance following the renewed momentum of tax reform discussions.</p>	
<b>Government bonds:</b>	<b>Underweight duration</b>
<p><b>Changed.</b> We remain strategically positioned for a progressive increase in interest rates globally, hence our outright underweight position. We took profits on our relative value trade long Australian bonds versus US Treasuries as yields converged and reached our target level. We first reduced the position at the end of October and closed the remaining part in early November.</p>	
<b>Investment-grade corporate bonds:</b>	<b>Neutral</b>
<p><b>Unchanged.</b> 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 in general remain historically low. However, the currently low yields entail a risk of an asymmetric pay-off. If the global economy continues to strengthen and inflation emerges, government bond yields may rise, pushing up investment-grade yields.</p>	
<b>High-yield bonds:</b>	<b>Underweight</b>
<p><b>Unchanged.</b> 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, pressure on global growth from protectionism or a downturn in China.</p>	
<b>Emerging market bonds:</b>	<b>Overweight</b>
<p><b>Unchanged.</b> We remain overweight in local currency bonds. We believe valuations are more attractive in these bonds where we can benefit from positive carry. Global EM currencies remain undervalued and many central banks in emerging markets are easing policy.</p>	
<b>Real-estate securities:</b>	<b>Overweight</b>
<p><b>Unchanged.</b> We are overweight US real estate versus equities. 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 historical lows. Rising interest rates and yields are a risk that we are willing to take at this point, given the positive factors. We are overweight real estate versus US equities to hedge market movements and focus on the low valuation of real estate securities compared to more expensive broad equities.</p>	
<b>Commodities:</b>	<b>Neutral</b>

**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 risks to growth in China are keeping us from moving to an overweight.

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