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Asset Allocation Monthly

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SUMMARY INVESTMENT CLIMATE

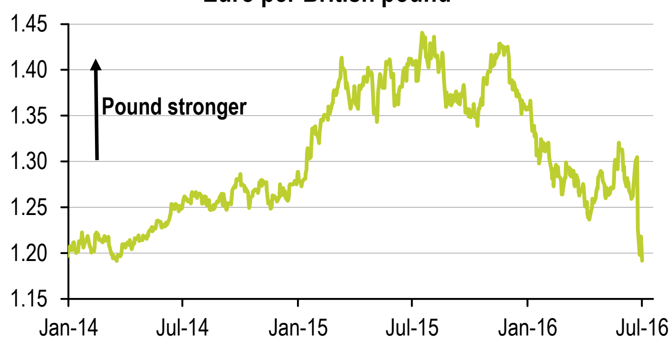
- **Risk assets quickly rebound after UK referendum**
- **Safe havens have remained in demand**
- **UK referendum a regional shock…**
- **… with global implications for monetary policy**
- **Challenging investment climate**

SUMMARY ASSET ALLOCATION

Multi-asset	Active weights		Δ active weight
	Jun-16	Jul-16	
Equities	●	●	–
Duration	●	●	–
Investment grade	●	●	–
High yield	●	●	–
Emerging market debt	●	●	–
Real estate	●	●	–
Commodities	●	●	–

The main event this past month was obviously the EU membership referendum in the UK. Most analysts, including us, had expected a majority of voters to support remaining in the EU, so the result came as a surprise. Accordingly, risk assets sold off and safe-haven assets benefited. However, market developments since the referendum have been interesting. Risk assets have rallied from their lows. US, European and emerging market equities have recouped most of the referendum-induced losses. Japan is still lagging as the Japanese yen has appreciated to a two-year high. UK equities are a mirror image of those in Japan; they are now higher than they were before the referendum as the British pound has fallen by close to 10% versus the euro.

Euro per British pound



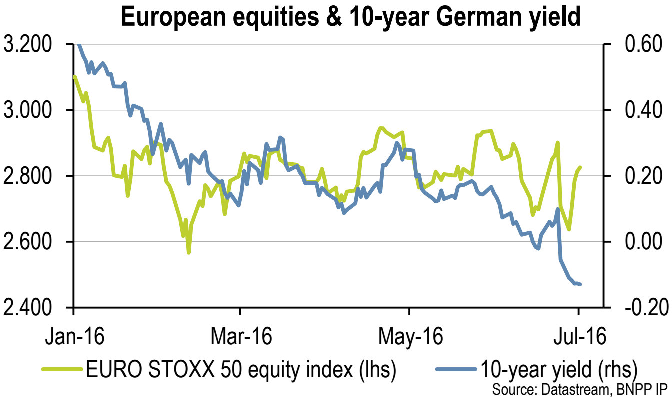
Source: Datastream, BNPP IP

While risk assets have mostly recovered, the bid for haven assets has persisted. German 10-year yields have turned negative, while US yields are close to their record low. Gold has surged. We think risk asset markets may be complacent. The global economy and the outlook for corporate earnings were not strong before the UK referendum and political uncertainty has increased significantly. We continue to regard the investment climate as challenging for risky assets.

The British referendum: a regional shock

The long-term consequences of the UK referendum outcome are difficult to assess at this point. In our view, it all depends on the level of economic integration between the UK and the EU after the UK exit. In the second half of this year and next year, we foresee a recession in the UK, albeit not a deep one. We think the economy will shrink in the final quarter of this year and the first quarter of next year. This would have a profound impact on the annual growth rates for this year and next. We have cut our forecast for this year from 1.9% to 1.5% and for next year from 2.4% to 0.0%. We expect growth to suffer as business investment drops with companies putting spending on hold in a climate of heightened uncertainty and unpredictability. We also foresee a slowdown in consumption, fed by the uncertainty and weaker sentiment as well as by falling house prices. Sterling's drop should boost inflation, curbing consumer spending power.

The eurozone economy could be impacted mainly through the sentiment and financial channels. Financial contagion has so far been limited: equity prices have bounced back quickly; risk spreads and yields on 'peripheral' sovereign bonds rose before the referendum, but have since come down.



It is only the spreads and yields on high-yield corporate bonds which are still somewhat higher than before the UK referendum. The weakening of the euro has actually eased financial conditions. We will have to wait and see to what extent business and consumer sentiment will be impacted. For now, we have cut our growth forecast for the eurozone for this year by a notch to 1.5%. For next year, we have trimmed our forecast by 0.4 percentage point to 1.4%. This should have hardly any impact on inflation, which we see rising gradually to 1.3% at the end of next year.

Without global financial contagion, we expect a British exit from the EU to have little impact on the rest of the world. Growth in the US could be slower in the last quarter of this year and the first quarter of next year, but in our view, this will have hardly any effect on the annual growth rates. Japan could suffer from the appreciation of the yen, which has acted as a haven in Asia. We have not changed our emerging market outlook: we foresee a further slowing in China and relatively modest growth in other Asian economies. We expect the Brazilian and Russian economies to stabilise, although in Brazil, any recovery should be shallow given the headwinds from fiscal austerity and the credit cycle.

Monetary policy: lower for longer again

We expect the outcome of the UK referendum to have profound implications for monetary policy. The Bank of England will likely cut interest rates, flanked by renewed further quantitative easing. The BoE has room to cut rates by 50bp before they enter negative territory. Given the market scepticism and the negative impact of rate cuts on banks' profitability, the BoE may be hesitant to cut rates all the way to zero, especially if it re-starts quantitative easing.

In the eurozone, the prospect of an extension of the ECB's asset purchase programme beyond March 2017 has been heightened. Triggers could be more subdued growth later this year, which should be foreshadowed by leading indicators beforehand, and inflation remaining far below the ECB's target of close to 2%.

In the US, the tightening cycle will likely be delayed once again. A 'remain vote' in the UK referendum was one of the conditions for an interest-rate rise by the Federal Reserve later this month. With that precondition now not fulfilled, the July option is off the table, in our view. Even a move in September now looks premature, leaving this

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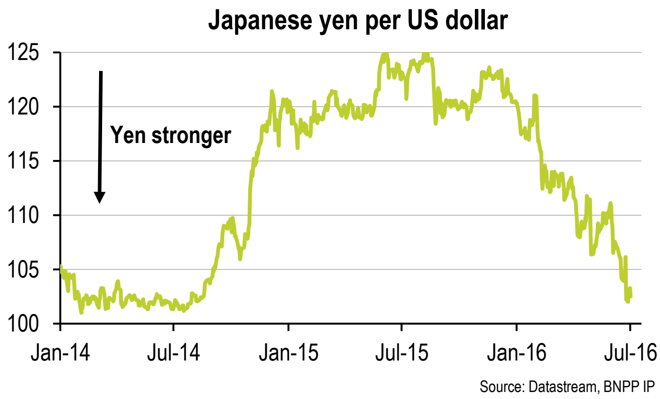
December as the moment when the Fed will raise rates further. Even one further increase this year would exceed current market expectations: fed funds futures discount a 0% probability of a hike before the November Fed policy meeting and a likelihood of just 8.6% for the December meeting. In fact, fed funds futures discount a (marginally) higher probability of a rate cut rather than an increase up to December and no hike before September 2017.

The Japanese authorities have expressed concerns about the strengthening of the yen. At 102 JPY per USD, the currency is roughly at levels seen after the depreciation in 2012 and in 2013 during the initial stages of 'Abenomics'. From the low by the middle of last year, the yen has gained almost 20%. While this should be positive for consumer spending power, yen appreciation should damp inflation and hurt Japanese company profitability. More easing by the Bank of Japan is likely, in our view. First and foremost, we expect an increase in the pace of asset purchases, although cutting policy rates deeper into negative territory, flanked by measures to mitigate the negative impact on banks' profitability, is also a possibility.



So overall, while the impact of the UK referendum result on global growth and inflation should be limited, we think it will keep monetary policy at a more stimulative stance than before.

Challenging investment climate

The outlook for risky assets is challenging. A period of high political uncertainty, not just in the UK, but also in the eurozone and in the US, lies ahead. Although not strong before the UK referendum, the global economy should be able to weather the regional shock of the Brexit vote. But we see asset valuations as generally high given the heightened uncertainty. Equity markets have recently behaved as if a UK exit from the EU does not make any difference. Risk spreads on eurozone 'peripheral' government bonds have fallen on the prospect of more monetary easing. Risk spreads on corporate bonds and emerging market debt have also narrowed. As I mentioned in the introduction, investors may be complacent. We have held on to our cautious asset allocation, including an underweight position in global equities (with a preference for an underweight in Europe), an underweight in emerging market debt in hard currency and an underweight in commodities.

We have closed our underweight in European equities versus the US and Japan. When we took the position in April, investor appetite was skewed towards European equities. However, we expected only very modest earnings growth in the eurozone and regarded the dividend pay-out ratio as unsustainable. In Japan, we expected more monetary easing. Since inception of the trade, investor positioning has moved away from Europe. Earnings estimates for 2017 have stabilised in the US and Europe, but at a relatively lower level in Europe, so we see more room for improvement there. The dividend sustainability issue was most pronounced in the UK. However, with the British pound weakening and therefore foreign earnings set to increase in sterling terms, paying a sustainable dividend should become less of an issue for UK companies. So far, we have not seen any additional monetary easing in Japan, but we certainly do not rule it out in the near future. All in all, with many of the arguments for the position shifting, especially the positioning argument which made this a tactical trade anyway, we decided to close it.

Asset allocation[1]

Multi-asset	Active weights Jun-16	Active weights Jul-16	Δ active weight
Equities	Underweight	Underweight	No change
Duration	Neutral	Neutral	No change
Investment grade	Neutral	Neutral	No change
High yield	Neutral	Neutral	No change
Emerging market debt	Underweight	Underweight	No change
Real estate	Neutral	Neutral	No change
Commodities	Underweight	Underweight	No change

Equities	Active weights Jun-16	Active weights Jul-16	Δ active weight
European large caps	Underweight	Underweight	Increase
European small caps	Neutral	Neutral	No change
US large caps	Overweight	Neutral	Decrease
US small caps	Neutral	Neutral	No change
Japan	Overweight	Neutral	Decrease
Emerging markets	Neutral	Neutral	No change

Real estate	Active weights Jun-16	Active weights Jul-16	Δ active weight
European Real Estate	Neutral	Neutral	No change
US Real Estate	Neutral	Neutral	No change
Asian Real Estate	Neutral	Neutral	No change

Fixed income	Active weights Jun-16	Active weights Jul-16	Δ active weight
Euro Govies	Underweight	Underweight	No change
Euro Short Dated	Neutral	Neutral	No change
US Govies	Overweight	Overweight	No change
Investment Grade (EUR)	Neutral	Neutral	No change
Investment Grade (US)	Neutral	Neutral	No change
Euro Inflation Linked	Neutral	Neutral	No change
High Yield (EUR)	Neutral	Neutral	No change
High Yield (USD)	Neutral	Neutral	No change
Emerging Bonds USD	Underweight	Underweight	No change
Emerging Bonds Local Ccy	Neutral	Neutral	No change

Foreign exchange	Active weights Jun-16	Active weights Jul-16	Δ active weight
AUD	Neutral	Neutral	No change
CAD	Neutral	Neutral	No change
CHF	Neutral	Neutral	No change
DKK	Neutral	Neutral	No change
EUR	Neutral	Neutral	No change
GBP	Underweight	Underweight	No change
HKD	Neutral	Neutral	No change
JPY	Overweight	Overweight	No change
NOK	Neutral	Neutral	No change
NZD	Neutral	Neutral	No change
SEK	Neutral	Neutral	No change
SGD	Neutral	Neutral	No change
USD	Overweight	Overweight	No change
EM FX	Neutral	Neutral	No change

KEY		
Overweight:	Neutral:	Underweight:
Increase:	No change:	Decrease:

[1] The tables reflect net positions versus the benchmark within 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.

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Equities	Underweight
Changed. We are underweight global equities versus cash, with a preference for an underweight in Europe. We think equity valuations are stretched given the high political uncertainty and the outlook for modest growth, inflation and earnings. Easy monetary policy should be positive, but the marginal impact has diminished over time. We closed our regional underweight in Europe versus the US and Japan.	
Small-cap equities:	**Neutral**
Unchanged. European small caps are benefiting from domestically driven eurozone growth. But valuations look stretched. Merger and acquisition activity, which should be beneficial for small caps, has slowed notably. In a challenging environment for risky assets, small caps could underperform large caps. We now prefer to be neutral.	
Government bonds:	**Neutral duration**
Unchanged. Our overall duration exposure is neutral as we see upside risks for yields coming from (tighter) US monetary policy, while global growth and inflation warrant higher yields, but asset purchases by the ECB and the BoJ are providing a powerful counterweight. We expect higher total returns in the US due to higher carry and a steeper yield curve. In Europe, we see political risks affecting primarily some ‘peripheral' government bond markets.	
Investment-grade corporate bonds:	**Neutral**
Unchanged. 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. In the eurozone, we think the carry is too low, though, to justify an overweight position.	
High-yield bonds	**Neutral**
Unchanged. Credit spreads in the US increased only temporarily around the time of the EU membership referendum in the UK, but further tightening is implausible, in our view, as some fundamental factors have deteriorated marginally: rating downgrades have recently outnumbered upgrades and default rates have increasingly been driven by a pick-up in commodity producer distress. Slower M&A activity is also positive for bondholders. European high-yield bonds have suffered more from the fallout over the UK referendum outcome, which makes sense given the bigger impact on the UK and eurozone economies.	
Emerging market bonds	**Underweight**
Unchanged. Emerging market growth indicators have hardly picked up and political changes and reforms are making little progress. The rebound in commodity prices has been supportive, but we are concerned that this may have come too early and is overdone. Our cross-asset valuation tools indicate that emerging equities and currencies discount more negativity than bonds. Given the upward momentum in currencies, we prefer to be underweight in hard currency debt versus US Treasuries.	
Real estate securities:	**Neutral**
Unchanged. European real estate has been a main victim of the UK referendum outcome. We are seeing positive real estate fundamentals such as attractive dividend yields, positive supply factors and low funding costs. Valuations have improved in Europe, but so have the risks	

Commodities	Underweight
Unchanged. While still low, commodity prices have rallied impressively in percentage terms. However, due to the large negative carry, the return on commodities is still negative year-to-date. The combination of a premature rally, given the ample supply and large inventories, and the negative carry limits the attractiveness of the asset class, in our view.	

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