

ASSET ALLOCATION MONTHLY

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FOR PROFESSIONAL INVESTORS



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SUMMARY

- ▶ **Market summary:** equities climb higher in low-vol environment
- ▶ **Crude market outlook – the new oil era**
- ▶ **Asset allocation:** long EM versus DM

SUMMARY ASSET ALLOCATION

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

MARKET SUMMARY

Equity markets continued to grind higher in September, reaching new highs while volatility dropped despite a geopolitically more agitated summer. The S&P 500 index broke above the 2 500 point level for the first time. European equities did even better with the German DAX index up by 6%. One driver was financials stocks, which benefited from a steepening yield curve. Across the English Channel, the FTSE 100 underperformed due to the rebound in sterling and a more hawkish tone from the Bank of England which signalled its intention to raise interest rates soon. Meanwhile, the US Federal Reserve started to reduce its sizeable balance sheet, inflated by several years of quantitative easing. This slow and cautious move had been well telegraphed by the Fed, so it did not destabilise markets as had the 2013 'taper tantrum'.

The performance of various asset classes in September illustrates the return of the 'Trumpflation' theme, i.e. the hope – kept alive by US President Donald Trump's recent statements – of significant tax cuts, which supported equities, while dragging down bonds. These trends came in an economic environment already supportive of equities, particularly in the eurozone. Another potentially good sign is that crude oil prices rose even as the Vienna meeting of OPEC oil producers and its partners did not provide news for the markets. At this point, investors have become less concerned about the geopolitical context as any tensions appear to have been brought under better control by international bodies. In the US, some headway has been made in Congress, and the Republican party may now come around to approving fiscal measures, whereas voters had thus far been disappointed by the lack of reforms. For the moment,



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investors are not overly concerned about the outcome of the German elections. This could change if negotiations on forming a new coalition become bogged down, especially as investors are starting to look more closely at polls in the run-up to Italian legislative elections, which are expected to take place in the spring of 2018. Central banks remain cautious on normalising their monetary policy as they seek to 'wean' the markets off generously available liquidity. Even when done gradually, this could prove to be tough at a time when equities look overvalued, especially in the US.

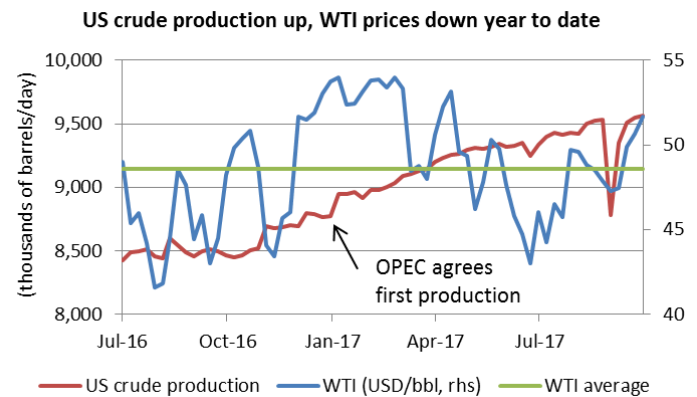
CRUDE MARKET OUTLOOK – THE NEW OIL ERA

Crude oil prices have been volatile this year. For example, WTI prices fell by close to 21% between early January and late June, and since then they have bounced back by 18%. These moves have been within a USD 40-60/bbl trading range, which is quite narrow compared with previous intra-year swings. The main reason behind this tighter trading range is that we have entered a new era for crude oil supply, one that is characterised by the continued rapid expansion of US shale production. This production boost has overwhelmed OPEC's efforts to cut supply; it is only in the last few months that prices have marched higher again, helped by stronger demand growth. But we expect the upside to be limited as we foresee US shale supply growth capping price gains over the next six to 12 months.

Supply – US shale is key

Technological advances in the extraction of US shale oil are defining this new era. US shale production has increased rapidly since 2012 and has played a major role in the market this year. After falling by 12% from mid-2015 to mid-2016, US crude production (48% of crude was extracted by shale producers in 2016, according to the IEA) has bounced back to close to the mid-2015 highs.

WTI prices rose last November after OPEC's announcement of production cuts, the first such reduction in eight years. However, the rally proved short-lived and WTI prices fell sharply in the first half of 2017, suggesting that the increase in US supply was more than offsetting the prospect of OPEC cuts (Figure 1). In the last few months, prices have bounced back, but in our view, this reflects stronger demand growth and falling inventories, especially in the US where stocks are at multi-year highs.



One of the key characteristics of US shale production is that efficiency gains have materially reduced the costs of producing crude. According to Barclays' research, for example, close to 80% of shale producers operated at a cost of below USD 60/bbl in late 2016. Furthermore, their research suggests that production costs have fallen further recently. In other words, innovations in the extraction of crude oil from shale fields are still ongoing. This has two clear implications for prices. First, they are likely to stay below the levels prior to the shale boom. Second, it suggests that shale production can respond rapidly when demand picks up, i.e. US crude supply is much more elastic than in the past.

Demand - the unsung hero

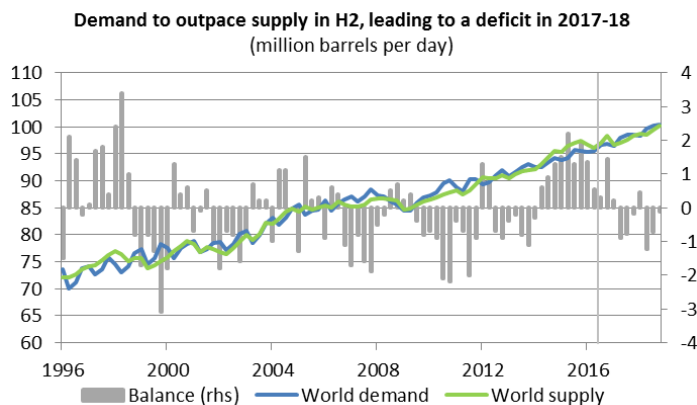
Despite the downward pressure on prices exerted by US shale producers, demand has been the unsung hero of the crude oil market. Demand growth was robust in the years that followed the global financial crisis and has gradually picked up in 2017 in line with stronger global GDP growth.

Demand from emerging market (EM) economies (non-OECD demand, in oil market jargon) has been the main source of the latest strong growth, and we expect this to continue to be the case over the next few quarters. We assume an annual growth rate of around 1.7%, equalling the average year-on-year growth rate since the global financial crisis.

Oil market balance – from surplus to slight deficit

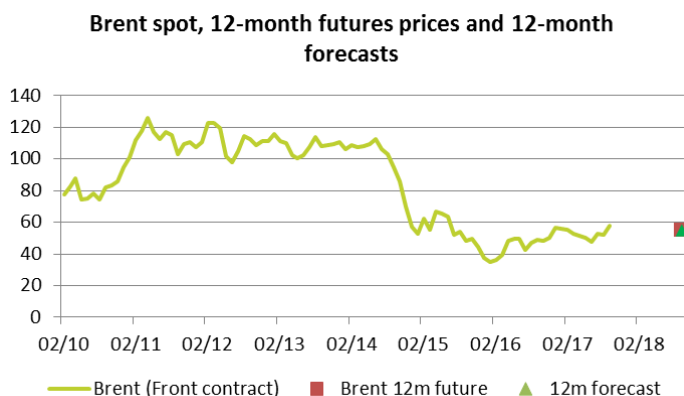
Combining our assumptions for demand growth with our assumption of a very gradual increase in OPEC supply from 2018, and a 5% increase in OECD supply (the same pace as in the 2010-15 shale boom years), we forecast a slight deficit in the global crude market over the next year or so. This follows at least three years of surpluses that coincided with the sharp correction in WTI prices from roughly USD 105/bbl in mid-2014 to below USD 30/bbl in early 2016 (Figure 2).

Another indicator that suggests a tightening crude oil market is the crude futures curve. The front end of the Brent futures curve, for example, recently shifted from contango (an upward-sloping curve) to backwardation (a downward-sloping curve) after close to three years. This means that demand pressure on supply in the physical (spot) market is pushing prices higher at the front end of the curve relative to contracts further out.



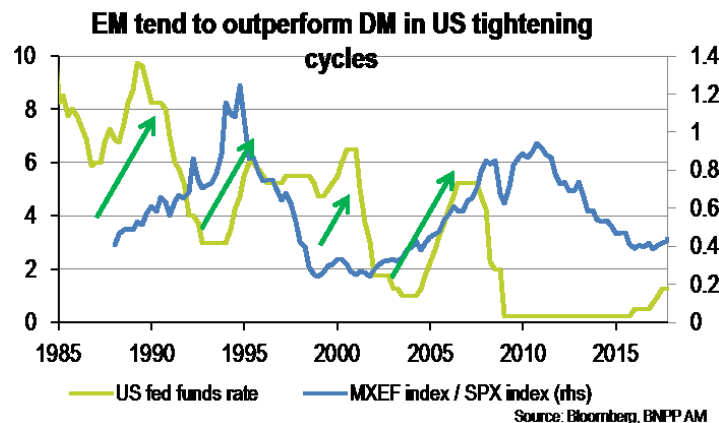
Price forecasts – limited upside

Looking ahead, we still see crude prices in a range of USD 40-60/bbl. This range is only a reference, of course. US shale production should cap the upside since supply responses are likely to be quick and large as prices approach the upper bound. At the same time, as prices approach the lower bound, OPEC is likely to threaten the market with sharper production cuts, which should help put a floor under prices. Furthermore, because demand is picking up, we would expect prices to drift to above the mid-range point of USD 50/bbl in our baseline scenario. We therefore forecast Brent at USD 55/bbl and WTI at USD 52/bbl in 12 months' time (Figures 3 and 4).



ASSET ALLOCATION: LONG EM VERSUS DM

We have implemented a long position in emerging market equities versus developed markets. This is a long-term strategy as we forecast a positive development in EM, notably led by the information technology sector, which should benefit from an expanding middle class that still lags behind that in developed countries in terms of IT and internet market penetration. We note that tightening cycles by the Fed have not systematically hurt EM. The opposite has actually been the case as rate-rise cycles tend to accompany improved global growth which typically helps EM equities more than DM equities.



We took a long position in US small caps versus large caps in mid-September. The trade is in line with our positive view on the US dollar. A weak dollar benefited US large caps more than small caps, but as the currency starts to rebound amid an improving US economy and with the Fed more firmly on the road to monetary policy normalisation, this trend should reverse. Such an about-face would favour small caps, which are typically more domestically focused and would suffer less than large caps were the dollar to rise further. Further support for small caps comes from Trump policy hopes. Market participants had priced out the 'Trump trade', but we expect it to regain momentum, in particular in the case of tax reform. If implemented, the projected corporate tax cut should favour small caps since many large caps tend to pay a lower tax rate already.

We closed our short UK versus long eurozone equities position. The trade has suffered from the improved UK economic performance on the back of a weak sterling, while the eurozone has had to deal with a stronger euro. It looks like this trend won't reverse in the short term. Moreover, our new forecasts for UK company earnings are less pessimistic. As a result, our conviction on this trade has diminished and we opted for the more prudent option to cut the position.

We implemented a long position on 10-year Australian government bonds versus US Treasuries. The yields have been diverging in recent months and we do not see this trend going much further. On the one hand, Australian bonds have been hurt by higher commodity

prices and an improved macroeconomic environment. On the other hand, US Treasuries have benefited from the Fed's dovish tone after several disappointing inflation reports. As a result, UST yields are already low and more likely to suffer from positive macroeconomic surprises, while Australian bond yields are high and more likely to

react to negative surprises. Therefore, we have positioned our portfolios for yield convergence.

ASSET ALLOCATION¹

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

| Equities | | Active weights | | Δ active |
|---------------------|--|----------------|--------|----------|
| | | Sep-17 | Oct-17 | weight |
| European large caps | | ● | ● | — |
| European small caps | | ● | ● | — |
| US large caps | | ● | ● | — |
| US small caps | | ● | ● | — |
| Japan | | ● | ● | — |
| Emerging markets | | ● | ● | — |

| Real estate | | Active weights | | Δ active |
|----------------------|--|----------------|--------|----------|
| | | Sep-17 | Oct-17 | weight |
| European real estate | | ● | ● | — |
| US real estate | | ● | ● | — |
| Asian real estate | | ● | ● | — |

| Fixed income | | Active weights | | Δ active |
|-------------------------------------|--|----------------|--------|----------|
| | | Sep-17 | Oct-17 | weight |
| Euro govies | | ● | ● | — |
| Euro short dated | | ● | ● | — |
| US Govies | | ● | ● | — |
| Inflation-linked (EUR) | | ● | ● | — |
| Investment-grade (EUR) | | ● | ● | — |
| High-yield (EUR) | | ● | ● | — |
| Investment-grade (USD) | | ● | ● | — |
| High-yield (USD) | | ● | ● | — |
| Emerging market debt hard currency | | ● | ● | — |
| Emerging market debt local currency | | ● | ● | — |

| Foreign exchange | | Active weights | | Δ active |
|------------------|--|----------------|--------|----------|
| | | Sep-17 | Oct-17 | weight |
| AUD | | ● | ● | — |
| CAD | | ● | ● | — |
| CHF | | ● | ● | — |
| DKK | | ● | ● | — |
| EUR | | ● | ● | — |
| GBP | | ● | ● | — |
| HKD | | ● | ● | — |
| JPY | | ● | ● | — |
| NOK | | ● | ● | — |
| NZD | | ● | ● | — |
| SEK | | ● | ● | — |
| SGD | | ● | ● | — |
| USD | | ● | ● | — |
| EM FX | | ● | ● | — |

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>Changed. We remain neutral on equities, but our cautious stance is improving as macroeconomic indicators are starting to indicate better global growth. We are overweight EM versus DM 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 closed our relative value short UK versus eurozone trade at a loss. A strong euro and weak sterling were instrumental in the underperformance.</p> | |
| Small-cap equities: | Overweight |
| <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. We have implemented a long US small cap versus large cap position to benefit from the renewed momentum of tax reform discussions.</p> | |
| Government bonds: | Underweight duration |
| <p>Changed. We remain strategically positioned for a progressive increase in interest rates globally, hence our outright underweight position. On a relative basis, we have invested in Australian government debt versus US Treasuries. Indeed, yields have decoupled recently and in our view, Australian bonds have more of a chance to rally now, while US yields are more likely to rise.</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 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> | |
| 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, pressure on global growth from protectionism or a downturn in China.</p> | |
| Emerging market bonds: | Neutral |
| <p>Unchanged. 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> | |
| Real estate securities: | Overweight |
| <p>Unchanged. 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> | |



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

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