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Asset Allocation Monthly

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SUMMARY INVESTMENT CLIMATE

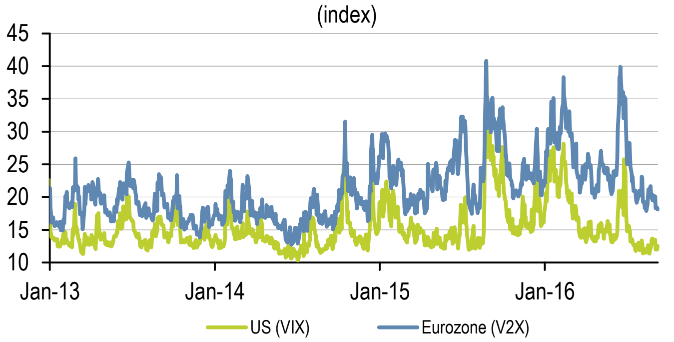
- **Will low market volatility last?**
- **Debate about rate hikes in the US takes new twist**
- **Other major central banks still easing**
- **Asset allocation: underweight equities with a hedge**

SUMMARY ASSET ALLOCATION

Multi-asset	Active weights		Δ active weight
	Jul-16	Sep-16	
Equities	🔴	🔴	▬
Duration	🟡	🟡	▬
Investment grade	🟡	🟡	▬
High yield	🟡	🟡	▬
Emerging market debt	🔴	🔴	▬
Real estate	🟡	🟡	▬
Commodities	🔴	🔴	▬

Since the volatility after June's UK referendum, financial markets have been eerily quiet. The VIX index, which measures volatility in US equities, has fallen to close to a record low. In Europe, volatility has been somewhat higher, which is probably mostly due to lingering political risk.

Equity market volatility
(index)



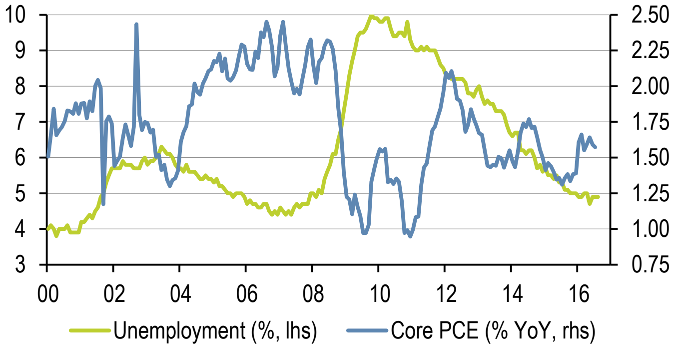
Source: Bloomberg, BNPP IP

Developed equity markets have recovered from their Brexit dip and have lately trended sideways to slightly higher. Emerging markets have done better: they are up by almost 30% from their January dip, in US dollar terms. Apart from the outlook for growth and earnings, which we see both as mediocre, we think monetary policy and the outlook for emerging markets are the key factors for today's investment climate.

Just one rate hike in the US or two after all?

Several Federal Reserve policymakers have lately hinted at the possibility of an imminent interest-rate rose, however, without being very precise on the timing. They see US inflation and the labour market as getting closer to the Fed's targets of 2% inflation and full employment. Developments in the labour market have actually been more convincing: the unemployment rate has fallen to below 5%, a level thought to be low enough to start generating wage gains and inflation. However, estimates of where this level actually is have fallen over time. Some signs of wage pressures have started to emerge, but inflation is still well off the Fed's target. The core PCE deflator has been stuck at 1.6% for five months through July and has slowed to 1.4% on a three-month annualised basis.

US unemployment and inflation



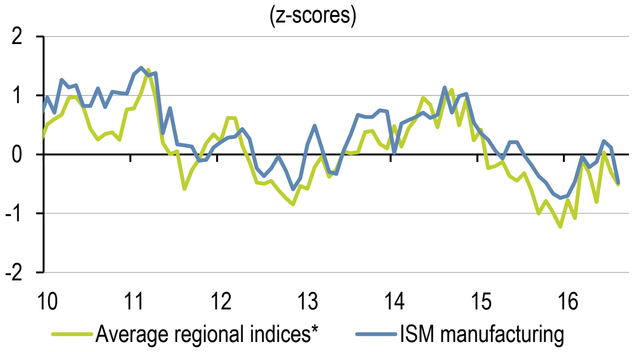
Source: Datastream, BNPP IP

Still, in a closely-watched speech at the Fed's annual Jackson Hole conference, Fed chair Yellen said the case for higher rates had strengthened in recent months. An interview with Fed vice-chair Fisher had an even greater impact. He said Yellen's comments were consistent with the possibility of two rate hikes this year.

We think there are several preconditions for a rate hike. Of course, the economy and the labour market should be strong enough. Growth was dreadful in the first half, but with the drag from inventories fading, the second half should be better. Probably not stellar, but strong enough. However, the labour market report for August, published in early September, in our view did not seal the case for a rate increase this month since employment growth slowed as well as the growth momentum in hourly earnings. Equally, we believe the Fed cannot be confident that inflation is approaching its 2% target. It sees low headline inflation (0.8% on the PCE deflator) as mainly driven by low energy prices and (now passed) US dollar strength. Indeed, both effects should be transitory, but as mentioned, core inflation has been stagnant for a while. The third precondition would be that markets should at least partly discount a rate hike. The recently more hawkish Fed comments had pushed up the market-implied probability of action at this month's policy meeting to just above 40% in late August and the odds of at least one rate hike in December had jumped to above 60%. The likelihood receded somewhat after the August labour market report and with the sudden drop into contraction territory of the ISM manufacturing index signalling a weakening of producer confidence.

US producer confidence

(z-scores)



* Philly Fed index, Empire State index, Chicago Fed PMI

Source: Datastream, BNPP IP

A low probability could keep the Fed on the sidelines since it does not want to surprise the markets. Whether the current market probability is still high enough for the Fed is a close call, in our view.

At this point, we expect the Fed to opt to wait until December. The latest comments had been aimed at preparing the ground for a hike this month, but now there appears to be no need to rush. Although the Fed gradually wants to normalise rates to prevent financial instability from developing, its room to manoeuvre is limited. The 'neutral' fed funds rate, the level above which rates would start to cool down the economy, has fallen over time, which makes current monetary policy less accommodative than when this 'natural' rate is high. Moreover, the ECB may soon announce additional stimulus measures.

Other major central banks stuck in easy mode

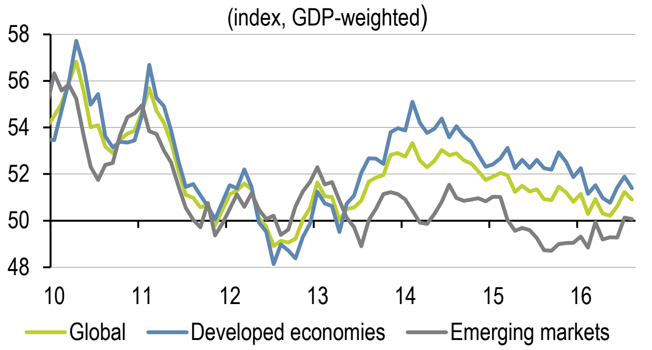
We expect the ECB to decide this month to extend the maturity of its EUR 80 billion monthly asset purchase programme from March 2017 to September 2017. The Bank of Japan has announced a comprehensive reassessment of its monetary policy this month, which we expect to result in additional easing as well. After initial hesitance, the Bank of England cut interest rates and restarted quantitative easing in the wake of the Brexit vote and may cut rates again soon. Should the Fed decide to raise rates already in September, there is a chance that the markets will reprice the possibility of two rate increases this year and more aggressive tightening next year. Apart from resulting in a stronger US dollar, this could also upset bond and equity markets. One can argue that central banks should not be held prisoner to financial markets, but we think the Fed just is not willing to take such risks. Thus, gradual tightening looks more likely to us.

A revival of emerging markets?

Emerging market economic performance has been sub-par for years now. Russia and Brazil have gone through deep recessions, while Chinese growth has been slowing persistently. Slow growth in global trade and unfavourable credit cycles have left their marks on several emerging economies. Meanwhile, profit growth in emerging markets has lagged profit growth in developed economies since 2011. Developments in China in particular have caused market corrections, following bubbles on its equity markets and sudden depreciations of its currency. We think that the market correction at the start of the year was not so much about the Fed's rate rise, which happened two weeks earlier, as it was about fears of a hard landing of Chinese growth. Those fears have now ebbed and the recessions in Russia and Brazil have started to bottom. Monetary and fiscally induced growth in China and a stabilisation in commodity prices have further improved sentiment. Emerging equities have outperformed developed equities strongly since January. Credit spreads have narrowed, especially in hard currency emerging market debt. Will this rally turn into a genuine revival of emerging market economies and assets?

Manufacturing PMI

(index, GDP-weighted)

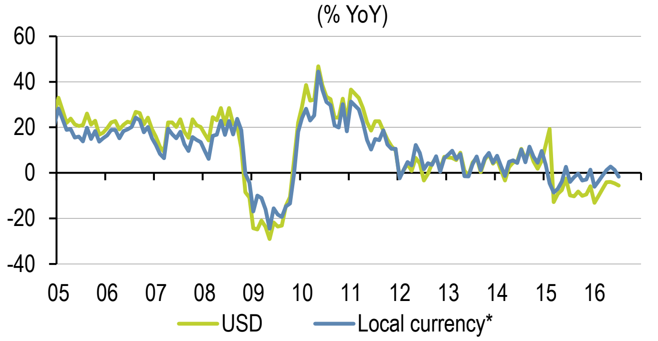


Source: Markit, BNPP IP

We think the signs are still somewhat thin. Markit manufacturing PMIs bottomed in February and were on average above the 50 watershed in July for the first time since March 2015. August saw a further improvement in a number of countries, but not China, South Korea and Turkey. The average non-manufacturing PMI has improved less. Hard data have hardly confirmed the bounce. In July, industrial production slipped back to 6% YoY growth in China and improved in South Korea, but contracted again in Taiwan and Thailand. Growth slowed in Russia and Poland. Trade growth is lacklustre if not negative; independent of whether you look at nominal values in US dollars, in local currencies or at volumes. The global manufacturing sector may benefit from the end of the inventory overhang in the US and other countries, but we do not see strong growth going forward.

Early reporting emerging markets exports

(% YoY)



* Country data weighted by nominal trade in USD. Includes Brazil, Chile, China, India, Korea, Taiwan

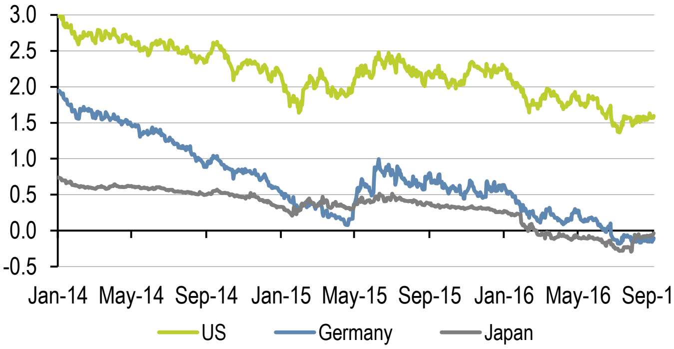
Source: Bloomberg, BNPP IP

US GDP growth should recover to its modest trend. Growth in the eurozone has been stable, but lately there have been more signs of a slight deceleration than acceleration. China is struggling with a real estate bubble in the larger cities and with a credit bubble. Brazil should be bottoming, but steep drops in employment and income combined with high real interest rates and the need for stiff fiscal austerity stand in the way of a vigorous recovery. Inflation is low in many countries. In China, producer prices have recently fallen more slowly, but this is mostly due to bottoming commodity prices. We expect producer prices to be stuck in modest deflation. In Japan, inflation has recently fallen even further below the central bank's 2% target and it slipped significantly in South Korea in August. Thus, the challenging environment for corporate profits in emerging markets has not yet changed. We would need to see stronger signs of sustainable improvement before adding to our emerging market exposure.

Defensive on equities, with a hedge

We think that low interest rates and bond yields are still the main characteristic of the current investment climate. US and German 10-year yields have risen from their dip in July, but German yields have remained negative. Many bondholders have benefited from the drop in yields in recent years as prices of the underlying bonds rose. But for many institutional investors such as insurers or pension funds, these gains have been outweighed by higher discounted liabilities. Banks have felt a negative impact through narrower interest margins. But things will likely get trickier when (government) bonds with relatively high coupons are about to mature. Will investors seek to maintain issuer quality, accepting negative yields in the process, or will they search for higher-yielding assets, accepting greater risk? Some have no other option than to invest in government bonds for part of their portfolios, but we believe that for most, the search for yield will continue.

10-year government bond yields



Source: Datastream, BNPP IP

This does not preclude market corrections. Equity markets have done well despite mediocre corporate profits, although we think developed equities are currently richly priced, while political risks linger in Europe. Monetary policy and the search for yield should be positive factors, but if the Fed raises US rates in September with a possible follow-up hike in December, equities face another hurdle to climb. We have hedged our underweight in equities to some extent with an overweight in US small caps versus large caps. Apart from acting as a hedge if the equity rally continues, we also think that the earnings outlook for small caps has improved and that mergers and acquisitions are positive for small caps.

Asset allocation[1]

Multi-asset	Active weights		Δ active weight
	Jul-16	Sep-16	
Equities	🔴	🔴	▬
Duration	🟡	🟡	▬
Investment grade	🟡	🟡	▬
High yield	🟡	🟡	▬
Emerging market debt	🔴	🔴	▬
Real estate	🟡	🟡	▬
Commodities	🔴	🔴	▬

Equities	Active weights		Δ active weight
	Jul-16	Sep-16	
European large caps	🔴	🔴	▬
European small caps	🟡	🟡	▬
US large caps	🟡	🔴	⬇
US small caps	🟡	🟢	⬆
Japan	🟡	🟡	▬
Emerging markets	🟡	🟡	▬

Real estate	Active weights		Δ active weight
	Jul-16	Sep-16	
European Real Estate	🟡	🟡	▬
US Real Estate	🟡	🟡	▬
Asian Real Estate	🟡	🟡	▬

Fixed income	Active weights		Δ active weight
	Jul-16	Sep-16	
Euro Govies	🔴	🔴	⬇
Euro Short Dated	🟡	🟡	▬
US Govies	🟢	🟢	▬
Investment Grade (EUR)	🟡	🟡	▬
Investment Grade (US)	🟡	🟡	▬
Euro Inflation Linked	🟡	🟢	⬆
High Yield (EUR)	🟡	🟡	▬
High Yield (USD)	🟡	🟡	▬
Emerging Bonds USD	🔴	🔴	▬
Emerging Bonds Local Ccy	🟡	🟡	▬

Foreign exchange	Active weights		Δ active weight
	Jul-16	Sep-16	
AUD	🟡	🟡	▬
CAD	🟡	🟡	▬
CHF	🟡	🟡	▬
DKK	🟡	🟡	▬
EUR	🟡	🔴	⬇
GBP	🔴	🔴	▬
HKD	🟡	🟡	▬
JPY	🔴	🟡	⬆
NOK	🟡	🟡	▬
NZD	🟡	🟡	▬
SEK	🟡	🟢	⬆
SGD	🟡	🟡	▬
USD	🟢	🟢	⬇
EM FX	🟡	🟡	▬

KEY		
Overweight: 🟢	Neutral: 🟡	Underweight: 🔴
Increase: ⬆	No change: ▬	Decrease: ⬇

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[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.

Equities	**Underweight**
Unchanged. We are underweight global equities versus cash, with a preference for an underweight in Europe or developed economies. We think current equity valuations are stretched given the high political uncertainty and the outlook for widespread modest growth, inflation and company earnings. Easy monetary policy should be positive, but its marginal impact has diminished over time, in our view.	
Small-cap equities:	**Overweight**
Changed. We are now overweight small caps versus large-cap equities in the US since we believe that the earnings outlook for US small caps has improved. Our view is that large amounts of cash on bigger companies' balance sheets and low appetite for capital expenditure should drive mergers and acquisitions, which should support small-cap stocks. We also see this positive exposure to market risk as a partial hedge against our cautious asset allocation.	
Government bonds:	**Neutral duration**
Unchanged. Our overall duration exposure is neutral as we see upside risks for yields coming from (tighter) US monetary policy. Global growth and inflation, while modest, also warrant higher yields, but asset purchases by the ECB and the Bank of Japan are providing powerful counterweights. 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 selected '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.	
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. We are seeing positive real estate fundamentals such as attractive dividend yields, positive supply factors and low funding costs, but high valuations and interest-rate volatility are risks.	

Commodities	**Underweight**

Unchanged. While still low, commodity prices have rallied impressively in percentage terms. 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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