ASSET ALLOCATION MONTHLY

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FOR PROFESSIONAL INVESTORS

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SUMMARY INVESTMENT CLIMATE

- **Stronger growth and inflation…**
- **but no need for central banks to react quickly**
- **Equity markets have risen too quickly**

SUMMARY ASSET ALLOCATION

Multi-asset	Active weights Dec-16	Active weights Jan-17	Δ active weight
Equities	🔴	🔴	—
Duration	🟠	🟠	—
Investment Grade	🟠	🟠	—
High yield	🟠	🟠	—
Emerging market debt hard currency	🔴	🔴	—
Emerging market debt local currency	🟠	🟠	—
Real estate	🟠	🟠	—
Convertibles	🟢	🟢	—
Commodities	🔴	🔴	—
Cash	🟢	🟢	—

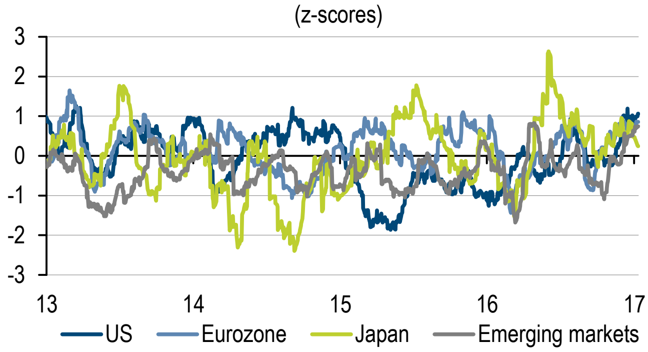
Stronger economic data and rising inflation: will central banks become soon more hawkish? Markets do not appear to be convinced. Equity markets continued their positive streak and 10-year government bond yields retreated. We are positive on the European economy, but find it hard to see what could cause US growth to accelerate. So we are wary of chasing the equity rally as we think equities are becoming priced for perfection, while risks are still looming. After we reduced our equity underweight – by adding to our overweight in small caps – in November, we have now diversified our equity underweight. Instead of being underweight just in Europe, we are now underweight in the US, Europe and Japan.

POSITIVE SURPRISES

Economic surprise indices have turned positive and look quite strong in the US, Europe and emerging economies. In Japan they have retreated somewhat.

Economic surprise indices

(z-scores)



Source: Bloomberg, BNPP IP

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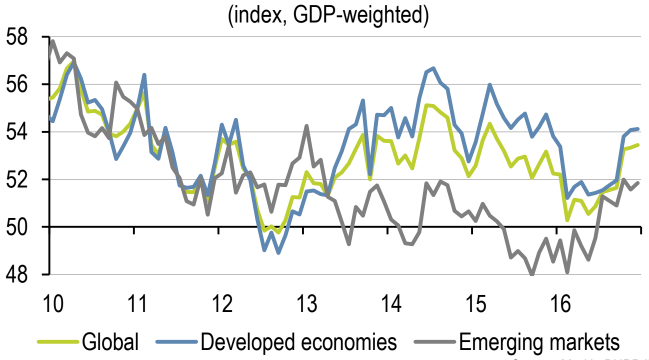
The asset manager for a changing world

What is driving these changes? We think it is mainly survey data. Purchasing managers indices (PMIs) have continued their uptrend. The improvement in the Markit PMIs was modest in December. Our global GDP-weighted composite PMI, which measures activity in the manufacturing and services sectors, increased by just a notch from 53.3 in November to 53.4 in December. In developed economies the index was unchanged at 54.1, while it rose by 0.2 points to 51.8 in emerging economies. This may look lacklustre, but these are the highest readings since late 2015 for developed economies and since late 2014 for emerging markets.

Composite PMIs
(index, GDP-weighted)



Source: Markit, BNPP IP

So while this data points to improved economic momentum, it also shows that emerging economies are lagging. This is even more so in the manufacturing sector. While the average manufacturing PMI for developed economies surged to 54.4, in emerging market it rose to only 51.0. For both regions this is a clear improvement from six months ago, but the gap between developed and emerging countries is the widest in more than a year. While developed and emerging economies' PMIs tended to be more aligned – or PMIs were higher in emerging economies – up to 2013, manufacturing PMIs have been consistently higher in developed economies since then.

In the US the ISM manufacturing and non-manufacturing indices have improved further, while consumer confidence, homebuilders' confidence and confidence among small business owners have surged. This is not just due to the end of any uncertainty over the election results, but also because of hopes of personal and corporate tax cuts and increased spending on infrastructure. Consumers, for example, have become more optimistic on their income outlook.

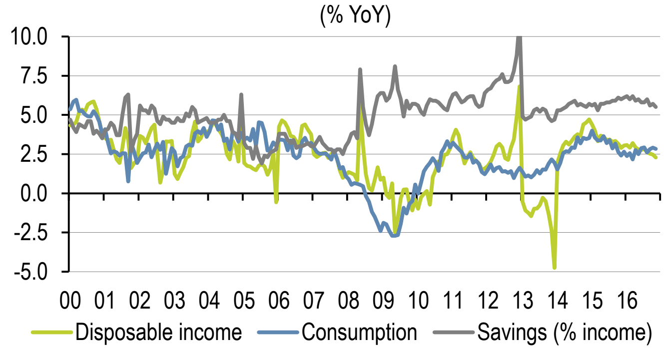
In the eurozone the Economic Sentiment Index jumped to its highest since 2007, with strong gains in Germany, France, the Netherlands and Belgium, but weakness in Spain and Italy. Spain should be less of a problem since growth has been strong and may just be moderating. In Italy the surveys may be adjusting to stagnant growth data after earlier optimism. In Germany the Ifo index rose to its highest in almost two years, pointing to a booming economy.

BUT WHAT WILL DRIVE GROWTH?

It's a strong signal that sentiment indicators are improving across such a broad range, but frankly, such hopes are not always fulfilled. We find it easiest to see a continuation of above-trend growth in the eurozone. There is still ample slack in the economy with the unemployment rate at 9.8% and business investment at a low level relative to GDP. Employment growth should support the domestic economy as well as low interest rates and the relatively cheap euro on a purchasing power basis.

For the US we find it harder to see faster growth. The labour market is showing signs of full employment as hourly earnings growth is accelerating, but employment growth is slowing gradually. As a result, nominal income growth has slowed marginally, but with inflation increasing, the impact has been more noticeable in real disposable income growth, which had receded to 2.3% YoY in November. This sets a speed limit on consumption growth unless consumers are now optimistic enough to lower their savings rate. After several years of deleveraging there is room for consumers to dip into their savings, but we think the financial crisis has made US consumers niftier. Moreover, pension shortfalls require a decent saving rate.

US households
(% YoY)



Source: Datastream, BNPP IP

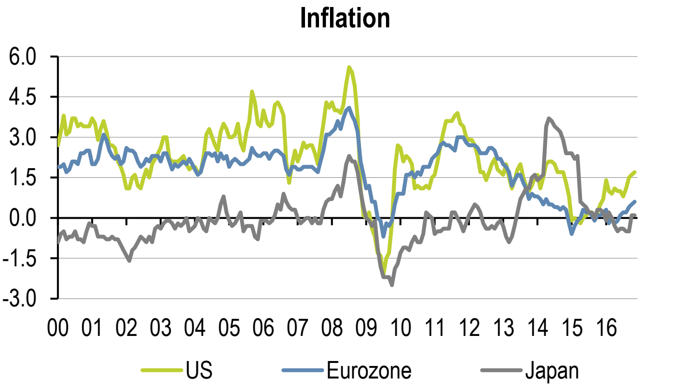
On the company side we have seen sharp rises in leverage in the past few years. Companies have locked in low interest rates, but this has not shown up in stronger investment. The profit recession of the past few quarters, which may be ending, does not bode well for business investment in the near term either. Orders for durable goods have been moving sideways and those for capital goods have only tentatively bottomed. Companies are still focused on returning funds to shareholders through dividends and equity buybacks.

Then there are headwinds for the US economy. One is obviously the strong US dollar. Another is the increase in government bond yields. This has led to a jump in mortgage rates and a slowdown in housing construction and sales. Car sales jumped to record levels in December (barring some incentive-driven surges in the past), but further strong growth rates from these levels look less likely, especially since problematic car loans are on the rise.

Emerging market exports have improved in nominal terms, but this was mostly driven by higher prices. With China's economy just stabilising, the disappointing recovery in Brazil and Turkey and Mexico facing severe currency problems, it is far from plain sailing for emerging markets.

HIGHER INFLATION: WILL CENTRAL BANKS REACT?

Inflation is on the rise. Our global GDP-weighted inflation index was up by 2% YoY in November. From March to August 2016 it had increased by just 1.7%. This was driven by developed economies, where average inflation has jumped from 0.4% YoY as recent as May to 1.0% in November. In the eurozone headline inflation jumped from 0.6% in November to 1.1% in December. In the US headline CPI inflation had increased to 1.7% in November. The Fed's preferred measure is lower at 1.4%, but also rising.



Source: Bloomberg, BNPP IP

Will central banks react to higher inflation? If so, we expect this to be just modestly. In December the US Federal Reserve signalled that three rate rises this year instead of just two had become more likely, although not all policymakers took this view. We think the Fed is not in a hurry and will wait to see what fiscal stimulus is coming first and may want to see more evidence of sustainable inflation. Even in the US inflation is driven by just a few product categories, while others are marked by deflation.

In the eurozone we think the hurdle for any ECB reaction is quite high. Sure, the hawks on the governing council will push for a quick tapering of asset purchases, but the ECB only in December extended its asset purchases to the end of 2017 at EUR 60 billion per month. Remember that the ECB then signalled the possibility of reaccelerating its asset purchases, but did not mention the option of a further reduction. According to ECB president Draghi, tapering purchases was not even addressed at the December meeting.

Keeping in mind the ECB's policy mistake of raising rates twice in 2011 only to reverse this within nine months, it looks easy for the ECB make another policy error. But we think that the ECB will be much more cautious this time. Policymakers should have learned from their mistakes and president Draghi is less hawkish than his predecessor. In fact it was after Draghi had just become president that the two 2011 rate rises were reversed. But as we signalled in our outlook for 2017[1], the direction of monetary policy is slowly changing from ever more stimulus to a steady or gradually less stimulative policy. In a positive scenario the eurozone economy should be strong enough by the end of the year for the ECB to taper its asset purchases. If not, the ECB has a problem since the limits to quantitative easing – especially the availability of eligible bonds for it to buy – may have become a serious issue by then.

In the UK, where inflation is rising due to the weakness in the British pound, the Bank of England may opt for less stimulus though.

In emerging markets we may seek rate rises in Mexico and Turkey, which are suffering from extreme currency weakness and slowing growth. But in Brazil, Russia and India falling inflation is enabling central banks to cut rates. In China the authorities have recently favoured monetary and fiscal stimulus over addressing financial and growth imbalances. Changes in rates or reserve requirements look unlikely at this point; the authorities prefer to manage money markets and the currency through liquidity operations.

One main reason why central banks may hold off is that the rise in inflation has been driven mainly by energy prices. Core inflation has been stable across OECD countries. Having fluctuated mainly below 1% since 2014, eurozone core inflation stood at 0.9% in December.

MARKETS IN RISK-ON MODE

According to our proprietary risk indicator, markets have been in risk-on mode since early November. But it has given off a stronger positive signal since early December. We think market sentiment has been heavily impacted by the US election outcome and the prospect of fiscal stimulus through lower income and corporate taxes and

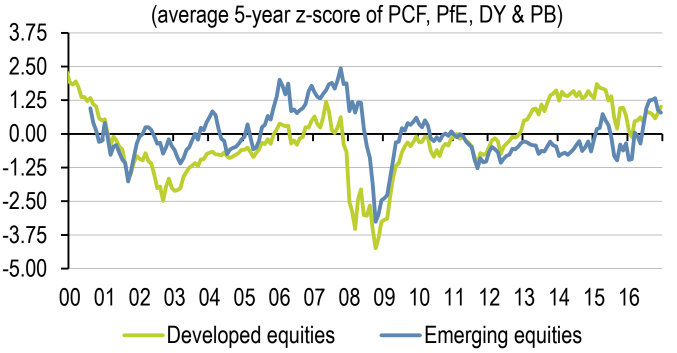
[1] See also Beyond the shadow of quantitative easing, the 2017 Investment Outlook by BNP Paribas Investment Partners

higher infrastructure spending. But it has also been driven by positive economic surprises and upward earnings revisions.

We think that equity markets have gotten ahead of themselves. Our valuation metrics, which include equity prices versus long-term historical earnings, price-to-forward earnings, price-to-cash flow and price-to-book ratios as well as dividend yield, point to equities now being on the expensive side. Equities were overvalued in the US for most of 2016 and the eurozone and Japan have caught up recently. Emerging market valuations have improved on average in the past three months, but they remain somewhat rich. The recent improvement was driven by Asia and Latin America, while valuations in eastern Europe, the Middle East and Africa have worsened.

Equity valuations

(average 5-year z-score of PCF, PfE, DY & PB)

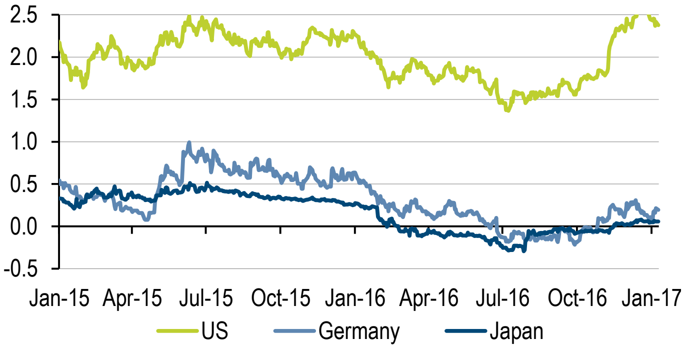


Source: Datastream, BNPP IP

Overvaluation is the main reason of our equity underweight. We actually have a neutral view on the earnings outlook globally. Earnings momentum – the pace at which earnings estimates are upgraded – has been strong recently, but it has been discounted rapidly. We are also cautious due to the downward risks from developments in China, global protectionism or a further rise in inflation and bond yields in the US. In December we diversified our equity underweight from Europe to include the US and Japan and cut our underweight by adding to our overweight in US small caps. This asset class should benefit from fiscal stimulus and should be somewhat insulated from any protectionism.

Our duration view is neutral. In the US bond yields have risen to reflect stronger growth and higher inflation. Of course, if president-elect Trump gets what he wants on fiscal stimulus, this could go much further. But that would also risk stimulating an economy which is already close to full capacity and would thus lead to higher inflation, faster Fed tightening and a stronger US dollar. These correcting mechanisms should limit any rise in yields. Record short duration positions in US government bonds among investors should also limit the upside potential for yields. In the eurozone German yields have retreated from their December peaks. Risk spreads on ‘peripheral’ bonds are in the middle of their three-month ranges, except for Portuguese bonds where the ECB is approaching limits. But overall, we think the ECB’s recent extension of its asset purchases to the end of this year should keep a lid on yields. Within government bonds we prefer the US over the eurozone where the risk of rising ‘peripheral’ yields lingers. We like US government bonds mainly for their higher carry.

10-year government bond yields



Source: Datastream, BNPP IP

ASSET ALLOCATION[2]

Multi-asset	Active weights Dec-16	Active weights Jan-17	Δ active 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 Dec-16	Active weights Jan-17	Δ active weight
European large caps	🔴	🔴	⬆
European small caps	🟡	🟡	–
US large caps	🔴	🔴	⬇
US small caps	🟢	🟢	–
Japan	🟡	🔴	⬇
Emerging markets	🟡	🟡	–

Real estate	Active weights Dec-16	Active weights Jan-17	Δ active weight
European real estate	🟡	🟡	–
US real estate	🟡	🟡	–
Asian real estate	🟡	🟡	–

Fixed income	Active weights Dec-16	Active weights Jan-17	Δ active weight
Euro govies	🔴	🔴	–
Euro short dated	🟡	🟡	–
US Govies	🟢	🟢	–
Inflation linked (EUR)	🟡	🟡	–
Investment grade (EUR)	🟡	🟡	–
High Yield (EUR)	🟡	🟡	–
Investment grade (USD)	🟡	🟡	–
High Yield (USD)	🟡	🟡	–
Emergin market debt hard currency	🔴	🔴	–
Emergin market debt local currency	🟡	🟡	–

Foreign exchange	Active weights Dec-16	Active weights Jan-17	Δ active weight
AUD	🟡	🟡	–
CAD	🟡	🟡	–
CHF	🟡	🟡	–
DKK	🟡	🟡	–
EUR	🔴	🔴	–
GBP	🟡	🟡	–
HKD	🟡	🟡	–
JPY	🟡	🟡	–
NOK	🟡	🟡	–
NZD	🟡	🟡	–
SEK	🟢	🟢	–
SGD	🟡	🟡	–
USD	🟡	🟡	–
EM FX	🟡	🟡	–

[2] 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:	**Underweight**
Unchanged. Global equities are richly valued, in our view. Looking at the rally since November, we think that a lot of positive news and prospects have now been discounted. In our main scenario we see some improvement in earnings, but not enough for us to turn outright positive on equities. We see monetary policy as positive for the asset class: the Federal Reserve will likely raise US interest rates cautiously and the ECB has just extended its asset purchase programme. Our underweight reflects the high valuations and downside risks from a hard landing in China, increased protectionism or a rise in inflation and bond yields.	
Small-cap equities:	**Overweight**
Unchanged. We prefer small caps as they may benefit more from fiscal stimulus in the US than large caps. Hence, we prefer to be overweight US small caps. However, we also like small caps as they should to some extent be insulated from protectionism. That is valid for US and European small caps, so for those clients who face restrictions on investing in US small caps, we see European small caps is a viable alternative. We also regard this overweight as positive exposure to market risk and thus as a partial hedge of our generally cautious asset allocation.	
Government bonds:	**Neutral duration**
Unchanged. The rise in bond yields from October through December last year has lost steam. This fits with our view that further increases should be limited. There is still a lot of uncertainty about the size and timing of fiscal stimulus in the US. Moreover, even before the US elections we had seen some upward pressure on yields. The prospect of fiscal stimulus and gradually tighter monetary policy led to a sharp rise, but from here there appears to be less upward pressure. Global growth and inflation, while modest, may warrant somewhat 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.	
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 regard the carry as too low to justify an overweight position. Risk spreads have widened in the eurozone. Further widening is a risk, in our view.	
High-yield bonds:	**Neutral**
Unchanged. Spreads have fallen throughout the past 12 months, even taking into account the spikes in the general risk-off environment early in the year and the market volatility around the UK referendum on EU membership. Yields in the US are higher than in Europe, but corporate fundamentals have also worsened in the US. While we see this asset class as attractive in a low growth and low inflation environment and to some extent as shielded from the impact of higher rates, we do not have a tactical position at this point.	
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. The recent increase in US bond yields and the strong US dollar pose a risk for this asset class. We are 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. Oil prices have benefited from an agreement among oil-producing countries to cut production, although the rise was stronger in Brent than in West Texas Intermediate. We think production is being cut from relatively high levels and with US shale producers returning to the market, we doubt the agreement will lead to a sustained increase in prices. The carry on the asset class continues to be negative.	

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