

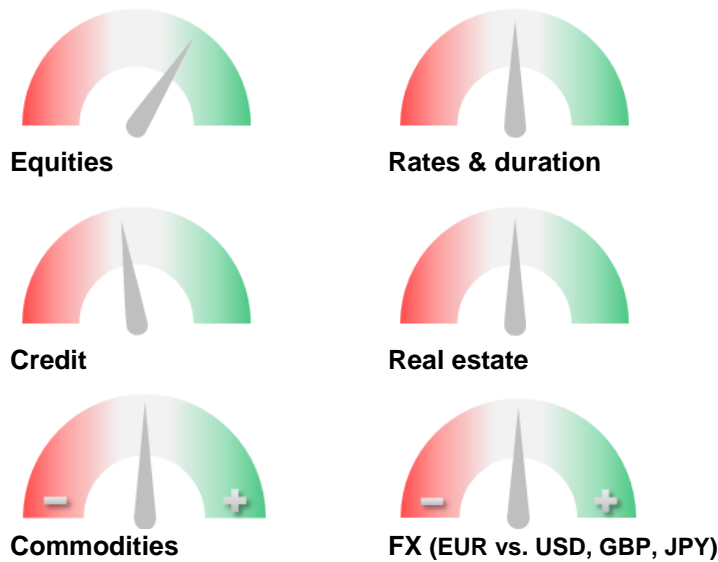


ASSET ALLOCATION MONTHLY

BNPP AM – Multi Asset, Quantitative and Solutions (MAQS)

DIGESTING RISKS FROM ITALY, GLOBAL GROWTH AND EM

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SUMMARY:

- Markets were hit by shocks coming from three sources in May: (i) an escalation of political risk related to Italy, (ii) weakening growth (notably in Europe); and (iii) a stronger USD, which led to stress in emerging markets.
- In Italy, market worries about fiscal excesses and the prospect of a clash between the new government and European authorities escalated. As a result, 'peripheral' eurozone debt sold off. Italian markets are likely to remain volatile in coming months as investors digest further news on political developments and economic data.
- There are signs of a growth slowdown, notably in the eurozone, according to recent data. However, we find it difficult to call a turn in the economic cycle yet. While the data have weakened, activity is still expanding both in the developed world and emerging markets.
- Emerging market stress was largely a consequence of higher US yields and USD strength. In our view, local debt offers value and currently lower US yields are reassuring, but we need to see the USD and global risk sentiment stabilise for EM debt to rally materially.

ASSET ALLOCATION:

- In terms of asset allocation, we have adjusted our positions to reflect the risks from Italy. Notably, we have reduced our long exposure to European equity and trimmed our underweight in Bunds to neutral.
- Despite that adjustment, we remain long European equities, where we see attractive valuations and good earnings fundamentals. This is consistent with our central scenario of robust growth and contained inflation.
- We have taken advantage of the sell-off in EM FX to add to our existing long EM local debt position. EM currencies are cheaper now, EM debt yields are high and we do not see any material risks from EM growth or external balances.



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ASSET MANAGEMENT

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MARKET REVIEW MAY 2018: DIGESTING RISKS FROM ITALY, GLOBAL GROWTH AND EM

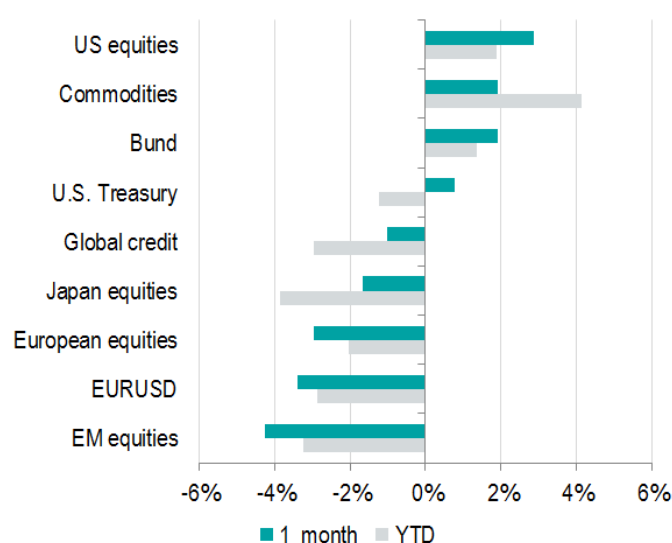
Global equity market performance was mixed in May with the US up by about 2.3%, driven by the information technology sector. Financials and insurance, on the other hand, finished below where they had started the month as the rise in US yields slowed down around mid-May after reaching a seven-year high. European equities underperformed, especially in the eurozone, with the EuroSTOXX 50 down by almost 4%. This followed a strong performance from April to mid-May. European equities were hit by an escalation of political uncertainty in Italy which was compounded by ongoing concerns about weakening growth in the euro area.

Financial markets adopted a risk-off attitude, selling EMU 'peripheral' bonds in favour of the safety of core government bonds. This was especially true for Italian bonds: they sold off sharply, while German Bunds rallied, pushing the spread to 266bp, a level not seen since 2013. The flight-to-quality impacted government bonds across the EMU periphery, causing spreads to widen. On the macroeconomic front, activity indicators lost some momentum, but remained strong. The manufacturing PMI, for instance, fell to 55.5 after peaking at 60.6 last December.

In currencies, the US dollar index climbed further, up by 2.5% over the month. This reflects diverging growth prospects and interest rate differentials between the US and the rest of the developed world. The Japanese yen and the Swiss franc also benefitted from safe haven demand at the expense of the euro and sterling. EM currencies suffered due to higher US yields and a stronger dollar. External vulnerabilities in Argentina and Turkey caused their currencies to fall significantly.

In commodities, crude prices extended their year-to-date rally only to give back part of those gains towards the end of the month. Weaker crude prices and safe haven demand led to lower UST yields in the second half on the month. Gold fell slightly over the month despite the rise in market stress, mainly due to a stronger USD.

Figure 1: US equities continue to lead, while EM and Europe cool down in a softer macroeconomic environment



Source: Bloomberg, BNPP AM; as of 31 May 2018

ITALIAN POLITICAL RISKS ESCALATE

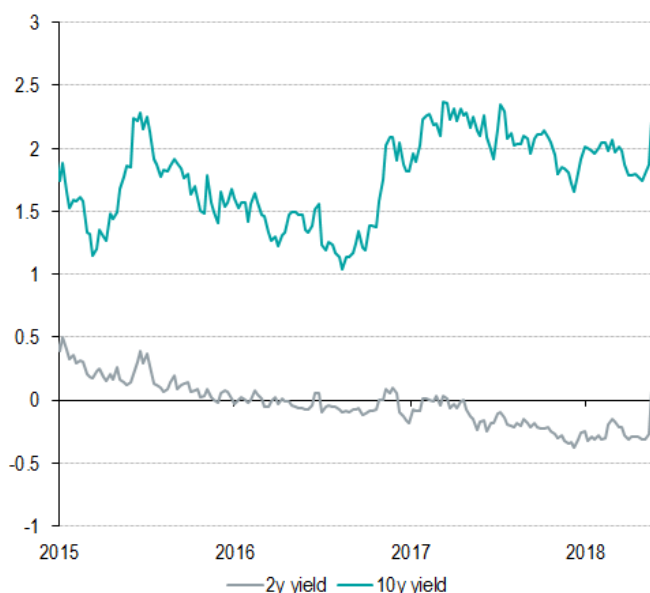
The results of the Italian general election were inconclusive, leaving the anti-establishment parties League and Five Star in a position to form a government which could command a majority in parliament. Initially, markets had doubts about this possibility as both parties had campaigned on juxtaposed programmes and League was committed to a centre-right coalition. President Mattarella's discussions with various politicians and parties eventually led to League and Five Star agreeing a joint platform and nominating Giuseppe Conte their candidate for prime minister.

The prospect of such an administration unsettled markets as the incorporation of League's flat 15% tax rate and Five Star's universal income policy would inevitably lead to a clash between the new government and the EU Commission over fiscal policy. The market's nervousness was further compounded when President Mattarella vetoed the coalition's nomination of Paolo Savona as finance minister and the PM designate returned the mandate to the president.

Savona had explicitly discussed the option of Italy leaving the euro, which raised concerns for President Mattarella as he considered that such a policy option had to be campaigned on in an election. The president then mandated Carlo Cottarelli to lead a technocratic administration. This triggered considerable political turmoil and led to a sharp sell-off in European equities and a significant widening in BTP spreads over core bonds (Figure 2).

Late in May, President Mattarella restarted talks with League and Five Star to see if an alternative nominee for finance minister could be found. Markets' initial fears calmed down, but overall, the risk of political uncertainties leading to further volatility remains high.

Figure 2: Italian political turmoil pushed yields higher



Source: Bloomberg, BNPP AM; as of 31 May 2018

Given these uncertainties, what are the potential paths for Italy? If League and Five Star can find a candidate for finance minister that is

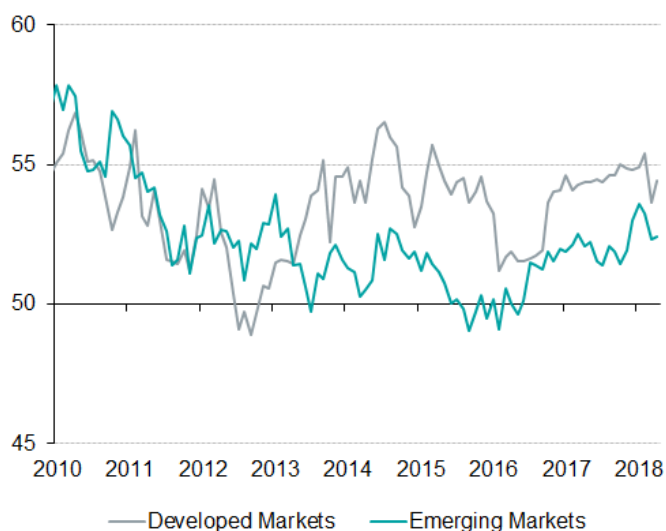
acceptable to President Mattarella, they are likely to form the next government. A technocratic administration would be unlikely to survive a no-confidence vote, leaving the president with no option other than to call fresh elections which would take place in August/September.

Over the next few months, markets are likely to remain volatile given the uncertainty associated with either an anti-establishment coalition challenging the EU Commission in terms of fiscal policy or the heightened risk of an election which could become a vote on Italian participation in the euro. Longer term, the outcome will depend on the political choices of the Italian electorate.

SLOWER GLOBAL GROWTH, NOT A MAJOR TURN IN THE CYCLE

Global markets have started to price in concerns about growth, notably in the eurozone where soft (survey) data has weakened for three months in a row. A slowdown is also visible in Japan, but less so in the US and emerging economies. In our view, the cycles in the eurozone and Japan have lost momentum, but they are not yet pointing to a turn. Indeed, looking at PMI data for the developed markets and for the emerging economies, one can see soft patches, but both indicators are still above 50, which means that activity is still expanding (Figure 3).

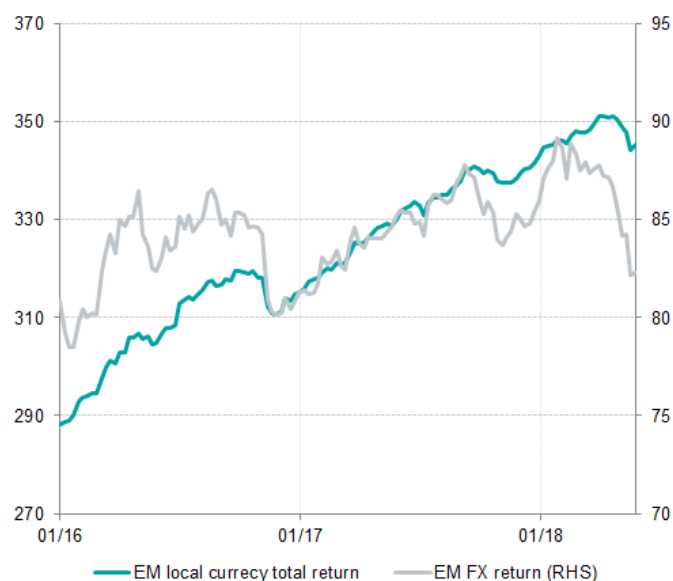
Figure 3: EM and DM activity (PMIs) weaker but still expanding



Source: Haver Analytics, BNPP AM; as of 30 May 2018

Mid and late-cycle slowdowns are quite common and markets do react to them. For now, we prefer to monitor them carefully and to use market corrections as buying opportunities in those asset classes where we see good fundamentals and attractive valuations.

Figure 4: EM stress – a casualty of the stronger USD rather than EM fundamentals



Source: Bloomberg, BNPP AM; as of 25 May 2018

STRONGER US DOLLAR LEADS TO EM STRESS

Another notable development since early April has been the sell-off in EM assets, notably EM currencies. Holding EM debt and equity were consensus positions for most of 2017 and their unwinding has shaken EM assets.

We see EM stress largely as a consequence of higher US yields and USD strength. The turmoil was amplified by sharp currency depreciations in Turkey and Argentina where the fundamentals are poor. But generally, we see the EM growth fundamentals as robust and the external imbalances as solid, especially after deficits turned into surpluses over the past five years.

Local debt now offers value after a material sell-off in EM FX and we feel reassured by the lower US yields. However, we will need the USD and global risk sentiment to stabilise for EM debt to rally.



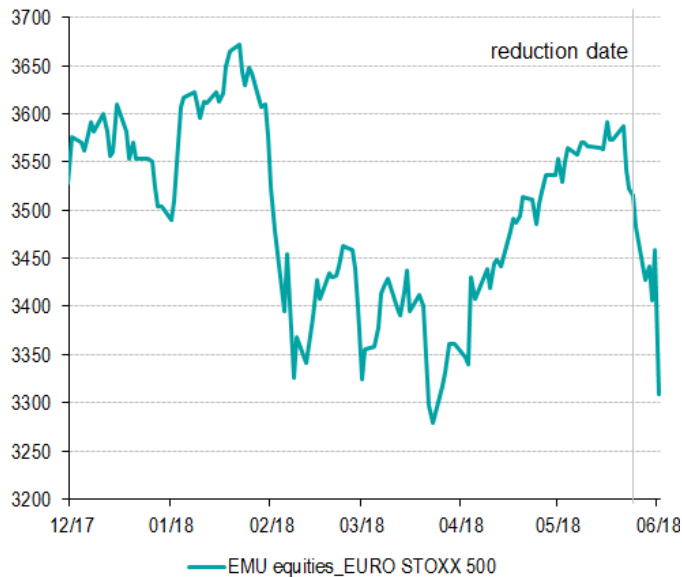
ASSET ALLOCATION: ADJUSTMENTS AMID ITALIAN POLITICAL RISKS

We have adjusted our positions to reflect the risks from Italy. Notably, we have trimmed our long European equity exposure (Figure 5) and are now neutral on Bunds (Figure 6). However, we remain long European equities since valuations are attractive and earnings fundamentals are good. This fits with our central scenario of robust growth and contained inflation.

In FX, we have closed our GBP versus USD short and the GBP versus EUR short. Our negative view on Brexit has evolved towards a softer transition, notably because the Irish border issue, which could force the UK to continue to participate in the European customs union. On the long USD leg, investors have now discounted a more hawkish FOMC, raising short rates significantly. On the long EUR leg, political tension and softer growth have boosted the risk of a weaker euro.

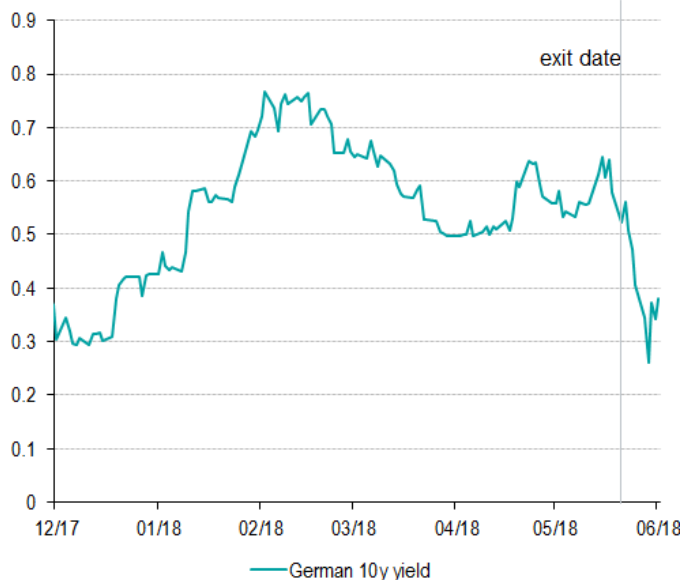
We took advantage of the EM FX sell-off to add to our long local EM debt position. Currencies are cheaper, debt yields are high and we do not see any material risks from EM growth or external balances.

Figure 5: We reduced our EMU equity exposure



source: Bloomberg, BNPP AM; as of 31 May 2018

Figure 6: We cut our underweight position on Bunds (10y yields,%)



source: Bloomberg, BNPP AM; as of 31 May 2018



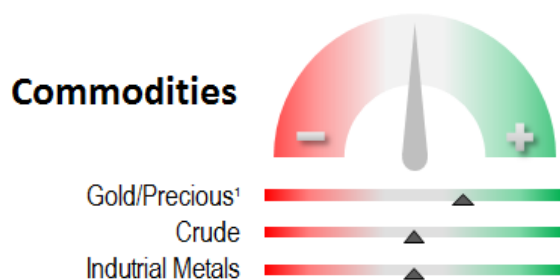
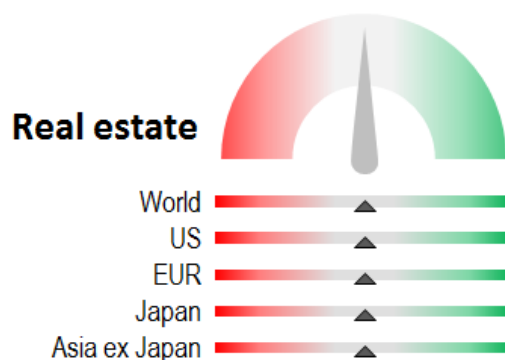
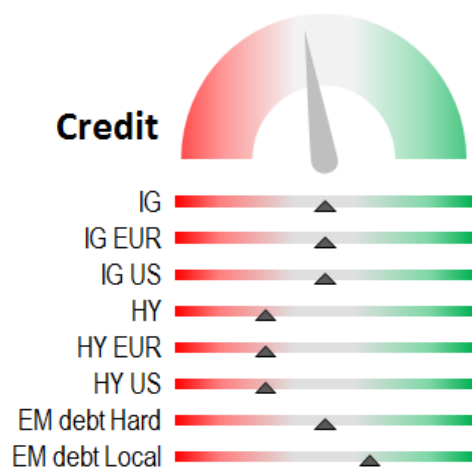
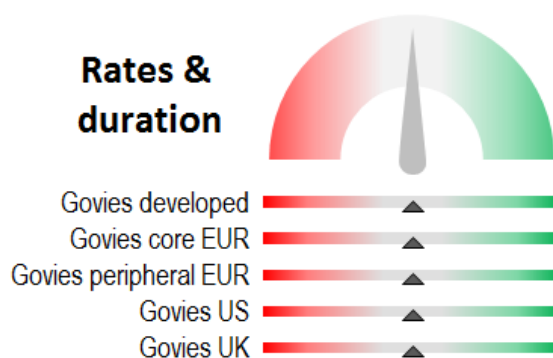
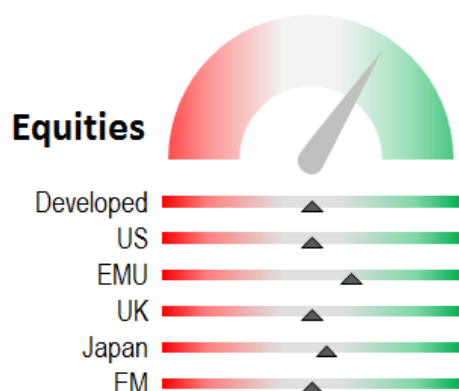
STRATEGIC OVERVIEW OF KEY POSITION CHANGES IN MAY 2018

The BNPP AM MAQS team made the following strategic calls:

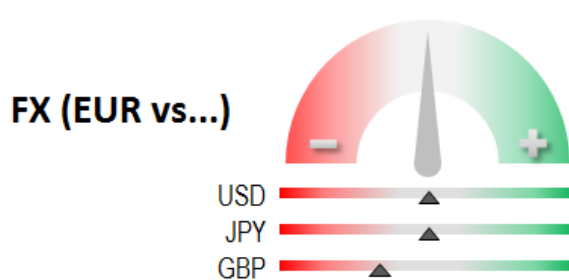
LONG EMU EQUITIES	REDUCED	23/05/2018
<ul style="list-style-type: none"> We have reduced risk in the face of Italian political risks and weaker growth. 		
SHORT GERMAN BUND	CLOSED	23/05/2018
<ul style="list-style-type: none"> Similar to our EMU equities move, Italian risks and weaker growth caused us to trim our underweight in Bunds. 		
LONG EUR/GBP	CLOSED	23/05/2018
<ul style="list-style-type: none"> We closed this position as political pressures rose on the euro and the likelihood of a softer Brexit increased. 		
SHORT GBP/USD	CLOSED	16/05/2018
<ul style="list-style-type: none"> We closed this position as the likelihood of a softer Brexit grew, in our view, and relative central bank policies moved to favour the GBP. 		
LONG EMERGING MARKET DEBT LOCAL CCY	INCREASED	14/05/2018
<ul style="list-style-type: none"> We took advantage of the EM FX downturn to add to our position. EM yields are higher and more stable UST yields and USD should support EM local debt. 		



ASSET ALLOCATION DASHBOARD¹



¹ only selective portfolios



¹ The dashboard shows the asset allocation in our portfolios and reflects the decisions of the Investment Committee of the Multi-Asset team at MAQS.

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