ASSET ALLOCATION MONTHLY

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FOR PROFESSIONAL INVESTORS

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SUMMARY

- **Markets are ignoring political uncertainty**
- **Global economy may struggle to live up to positive leading indicators**
- **High earnings expectations**
- **Overweight European real estate; duration exposure reduced**

SUMMARY ASSET ALLOCATION

Multi-asset	Active weights Feb-17	Active weights Mar-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	🟢	🟢	–

Last month I warned of a hangover after the sugar rush that followed the US presidential election. Although there were plenty of event risks in February, the hangover hasn't come. Leading indicators for the global economy have remained strong and corporate earnings have generally been supportive of equities. What has also helped is that bond yields have hardly reacted to higher inflation and a more hawkish tone from the US Federal Reserve. However, we think that the air is getting thinner for equity markets amid high hopes for earnings and somewhat rich valuations. In our asset allocation we have closed our overweight position in US small caps versus large caps and have implemented an overweight in eurozone real estate versus eurozone government bonds instead.

POLITICAL UNCERTAINTY IS HIGH

Equity markets have clearly anticipated a more business-friendly and expansionary policy in the US. But the first few weeks of the new administration have not been smooth. At 42%, President Trump's approval ratings are much lower than those for previous presidents right after their inauguration. From Reagan to Obama, early approval ratings ranged from 53% to 63% after their first few days in office. This means that political capital has to be built up before it can be spent.

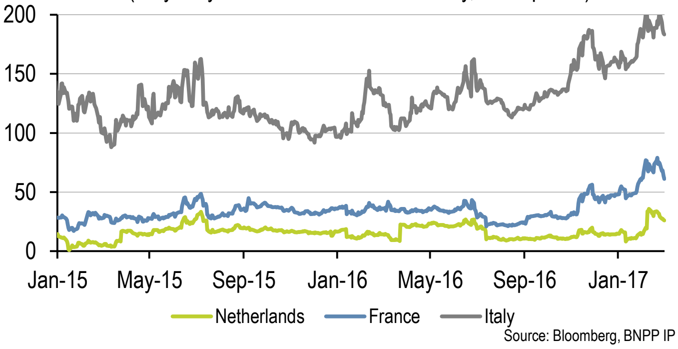
An attempt to do so was Trump's first speech before Congress. Here he sounded more presidential than before, but the public did not get more clarity on his plans for tax cuts, infrastructure spending or reforms. According to Trump there will be massive tax cuts for the middle class, the corporate tax rate will be lowered and defence and infrastructure spending will be raised sharply while entitlement spending will be untouched. That would lead to massive fiscal deficits at a time when the deficit is already set to widen and government debt is high.

So will these plans make it through Congress? We cannot be certain at this point and given the anticipation in the markets we would see this as an uncertainty. To underscore the point, confidence among small business owners has risen, even though respondents in the same survey say that business uncertainty has also surged.

In the eurozone the uncertainty has focused on the French elections. With the National Front's Marine Le Pen seen winning the first round of the presidential election and the surprising outcomes in the Brexit referendum and the US presidential election, French bond spreads versus Germany have widened. Interestingly, other markets have been less worried. French equities have moved much in line with the EURO STOXX 50 equity index. French sovereign credit default swap spreads (essentially the insurance premium for government bonds) have widened, but by less than the yields.

Eurozone risk spreads

(10-year yield differential with Germany, basis points)



Source: Bloomberg, BNPP IP

We are not overly worried about the French elections. Independent candidate Emmanuel Macron received a boost recently in the form of support from two influential politicians. In the polls he has moved ahead of François Fillon, who has vowed to carry on campaigning for the presidency even though he will be under juridical investigations for alleged fake jobs for his family. In the polls Fillon's lead over Le Pen has narrowed, but it is still more than 15 percentage points according to most polls, while Macron's lead over Le Pen in the second round is a robust and fairly stable 20 plus percentage points. But could the polls be wrong again as Brexit and the US presidential election have shown? Sure, but the margins in the US and the UK were much narrower than in France for the second round vote. Moreover, the polls in the US were not wrong in the sense that Hillary Clinton won the popular vote.

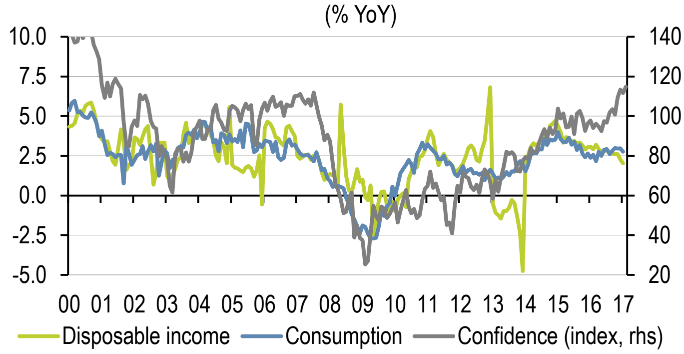
We are actually more worried about events in Italy than in France. We think the probability of a euro-sceptic party winning the elections in Italy is higher than in France. Moreover, Italy's economy is lagging: growth has so far been too low to even stabilise the government debt ratio. The ECB's asset purchases have suppressed Italian yields, in our view, but tapering the purchases – not on the agenda for now, we think – could change this.

WILL THE REAL ECONOMY LIVE UP TO THE STRENGTH IN LEADING INDICATORS?

The economy is positive for equities, right? Yes, when you look at recent leading indicators. Our global GDP-weighted manufacturing PMI looks set to have held at a relatively strong level in February (some countries have yet to report). In February, the US ISM manufacturing index jumped to its highest since August 2014. In the eurozone the PMIs gained further in February, while the Economic Sentiment Index managed to rise by another notch and trade data from selected emerging markets showed signs of improvement. Yet headwinds are also developing. One of them is the rise in energy prices. Oil prices have almost doubled from their lows, boosting headline inflation. While it may look as if inflation is finally taking off after massive pump-priming efforts by leading central banks, this is not the type of inflation we have been waiting for eagerly. With low nominal GDP growth and low nominal wage growth, higher inflation is crimping consumer spending. In the US real disposable income fell by 0.2% MoM In January, cutting the annual growth rate to 2.0%.

US households

(% YoY)

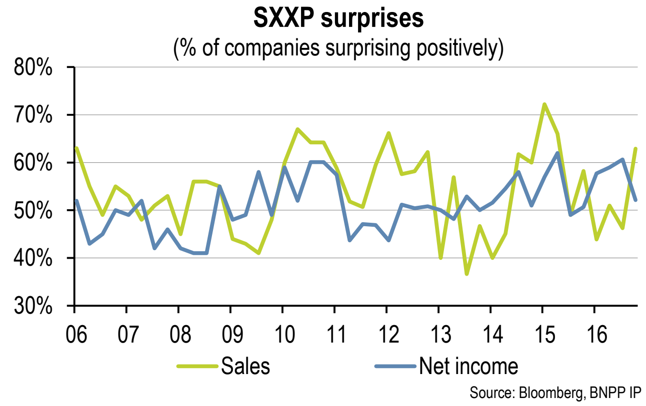


Source: Datastream, BNPP IP

In Japan and the eurozone real wages are falling as well. Employment growth adds some room for spending growth, but the pace may fall in the near term. Furthermore, the US economy has to cope with a strong US dollar. If the new administration goes for a Border Adjustment Tax, which would no longer tax exports, but would tax imports, the dollar could strengthen even further. In addition, the bank credit cycle has weakened lately. We are positive on the eurozone economy, where business investment has ample room to grow and employment can fall further. We are more neutral on the US, which is much more advanced in the cycle.

WILL POSITIVE EARNINGS MOMENTUM LAST?

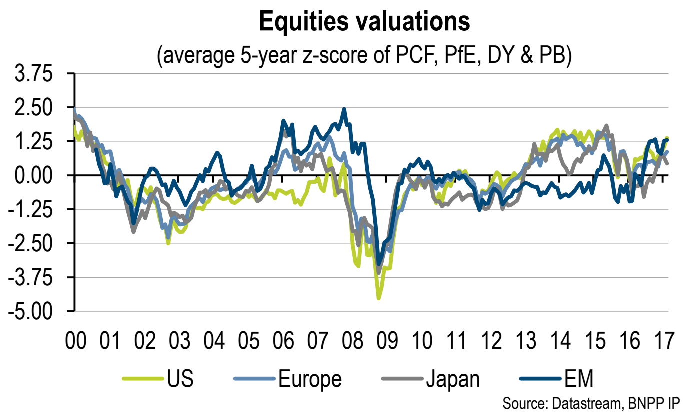
Recent earnings developments have been supportive of equities. In terms of surprise ratios, the US company reporting season has been uninspiring with the percentage of companies beating sales expectations below the long-term average and those surprising positively on net income holding at the average.



In the eurozone a relatively large number of the companies that have so far reported have done better on sales, but net income surprises have been average. Net income is growing in the US at 6.5% YoY, confirming that the earnings recession has ended. The eurozone is not there yet. After growth in net income in the third quarter, net profits slipped again in the fourth.

Looking ahead, we think that current earnings estimates are elevated. Top-down, the consensus in the US is for roughly 10% earnings growth in 2017. Bottom-up expectations are for 12.9% growth for global equities with somewhat higher expectations for Europe and emerging markets and somewhat lower for the US and Japan. Earnings momentum – which we define as the three-months change in bottom-up forward earnings – has turned positive in all major regions and is relatively strong in emerging markets. However, markets have so far moved much in line with this earnings momentum, so stronger earnings are widely discounted. We see justification for strong earnings expectations only in a scenario with strong and synchronised growth acceleration in the global economy, without inflationary pressures emerging. In scenarios with lower growth or rising inflation we think earnings growth may disappoint.

We regard equities generally as currently somewhat overvalued. Global equities are slightly overvalued on almost all measures we use and mostly so according to the price-to-cash-earnings ratio. This is driven primarily by the US and less so by Europe and emerging markets. We see valuations in Japan as neutral. In different regions and countries, equity valuations look generally more stretched on price-earnings ratios than on price-to-book ratios. Markets that stand out as expensive on different measures include the US, China and Brazil, while Indonesia and Mexico look cheap, in our view.



Looking ahead and across our different growth scenarios, we also regard valuations as stretched relative to what we expect for growth, bond yields and other macroeconomic indicators.

Thus, overall we think that equity markets are priced for a very positive scenario with strong growth and low inflation, to which we assign a fairly low probability. A global shock to demand from a hard landing in China or significant protectionism or a scenario with high inflation and rising bond yields would be detrimental for equities. Hence, the equity underweight in our asset allocation.

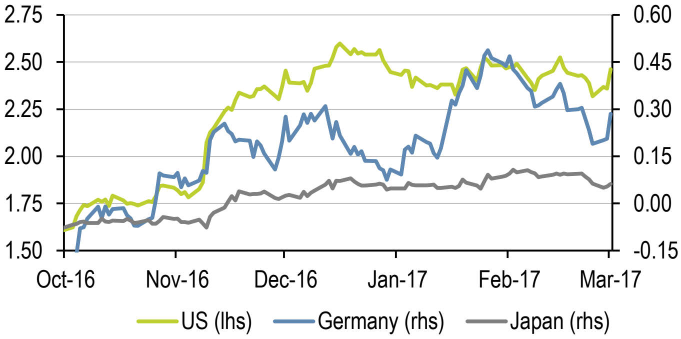
FED GETTING READY FOR THE NEXT HIKE

Risk assets also had to cope recently with a more hawkish Fed. In her semi-annual testimony before Congress, Fed chair Yellen pointed to the risk of letting the economy run hot eventually resulting in the need to raise rates rapidly. She said the Federal Open Market Committee (FOMC) would assess whether employment and inflation were continuing to develop in line with the Fed's expectations and if further adjustments of the federal funds rate were appropriate. The probability of a rate rise at the FOMC meeting later this month as discounted by fed funds futures rose from 32% before Yellen's speech to more than 40% thereafter.

This relative hawkishness was also reflected in the minutes of the January FOMC meeting. Many policymakers saw a need to raise rates fairly soon. A few noted that raising rates in a timely manner, potentially at an upcoming policy meeting, would give the Fed greater flexibility in responding to subsequent changes in economic conditions. Several policymakers warned that waiting too long would risk an overheated economy. There was a broad consensus that discussions about the size of the Fed's balance sheet and reinvestment of maturing bonds should start soon, but this topic was not discussed in January. But this was not all.

Recently a number of Fed policymakers have pointed to the need for imminent action. The probability of a rate rise in March has now reached 88%, clearly high enough for the Fed to raise rates if it wanted to. What we think is clear from this discussion is that the Fed has changed its assessment of the risks. Deflation is no longer the main issue; the risk of an overheated economy is now bigger, in its view. It is also clear that the Fed wants its traditional monetary policy tool back. Raising rates now would create room for adjustments when the Fed starts lightening its asset-laden balance sheet.

Ten-year yields



Source: Datastream, BNPP IP

Bond markets have hardly been impressed though. The 10-year yield on US government bonds had jumped to 2.6% in December, but is currently just below 2.5%. At 0.3%, German yields are holding at the mid-November level, while two-year yields have fallen to below -0.8%. Especially when French yields rose, two-year German yields acted as a safe haven.

Do bond markets have a different view from equity markets? Probably yes, to some extent. We think bond markets are rightly looking through the energy-driven inflation spike. Luckily, so is the ECB. But we also think that government bond markets are still distorted by low official interest rates and quantitative easing in Japan and the eurozone. Nevertheless, with our cautious asset allocation, which includes an underweight in developed equities, an underweight in emerging market debt in hard currency and an underweight in commodities, we have reduced our duration exposure somewhat. This renders our allocation less exposed to upward moves in risk assets.

ASSET ALLOCATION[1]

Fixed income	Active weights Feb-17	Active weights Mar-17	Δ active weight
Euro govies	Neutral	Underweight	Decrease
Euro short dated	Neutral	Neutral	No change
US Govies	Overweight	Overweight	No change
Inflation linked (EUR)	Neutral	Neutral	No change
Investment grade (EUR)	Neutral	Neutral	No change
High Yield (EUR)	Neutral	Neutral	No change
Investment grade (USD)	Neutral	Neutral	No change
High Yield (USD)	Underweight	Underweight	No change
Emergin market debt hard currency	Underweight	Underweight	No change
Emergin market debt local currency	Neutral	Neutral	No change

Multi-asset	Active weights Feb-17	Active weights Mar-17	Δ active weight
Equities	Underweight	Underweight	No change
Duration	Neutral	Underweight	Decrease
Investment Grade	Neutral	Neutral	No change
High yield	Underweight	Underweight	No change
Emerging market debt hard currency	Underweight	Underweight	No change
Emerging market debt local currency	Neutral	Neutral	No change
Real estate	Neutral	Overweight	Increase
Convertibles	Overweight	Overweight	No change
Commodities	Underweight	Underweight	No change
Cash	Overweight	Overweight	No change

Foreign exchange	Active weights Feb-17	Active weights Mar-17	Δ active weight
AUD	Neutral	Neutral	No change
CAD	Neutral	Neutral	No change
CHF	Neutral	Neutral	No change
DKK	Neutral	Neutral	No change
EUR	Underweight	Underweight	No change
GBP	Neutral	Neutral	No change
HKD	Neutral	Neutral	No change
JPY	Neutral	Neutral	No change
NOK	Neutral	Neutral	No change
NZD	Neutral	Neutral	No change
SEK	Overweight	Overweight	No change
SGD	Neutral	Neutral	No change
USD	Overweight	Overweight	No change
EM FX	Underweight	Underweight	No change

Equities	Active weights Feb-17	Active weights Mar-17	Δ active weight
European large caps	Underweight	Underweight	No change
European small caps	Neutral	Neutral	No change
US large caps	Underweight	Underweight	Increase
US small caps	Overweight	Neutral	Decrease
Japan	Underweight	Underweight	No change
Emerging markets	Neutral	Neutral	No change

Real estate	Active weights Feb-17	Active weights Mar-17	Δ active weight
European real estate	Neutral	Overweight	Increase
US real estate	Neutral	Neutral	No change
Asian real estate	Neutral	Neutral	No change

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:	**Underweight**
Unchanged. Global equities are richly valued, in our view. Looking at the rally since November, we think 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 actually think that consensus earnings estimates are too high. We see monetary policy as positive for the asset class: the Federal Reserve will likely raise US interest rates cautiously and the ECB will continue its asset purchase programme. Our underweight reflects high valuations and high expectations for earnings, as well as downside risks from a hard landing in China, increased protectionism or a rise in inflation and bond yields.	
Small-cap equities:	**Neutral**
Changed. US small caps have benefited from expectations of domestically oriented fiscal stimulus in the US and from its perceived nature as a hedge against protectionism. These factors were quickly discounted after the US presidential election, causing US small caps to outperform large caps. Amid high uncertainty this strategy has lost some lustre. We have prudently taken profits.	
Government bonds:	**Short duration**
Changed. 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 election we had seen upward pressure on yields. The prospect of fiscal stimulus and gradually tighter monetary policy led to a sharp rise, but from here on, the upside looks limited. 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 slightly shortened the duration of our government bond holdings.	
Investment-grade corporate bonds:	**Neutral**
Unchanged. Risk spreads have continued to narrow in the US, while moving sideways at a historically low level in Europe. 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. However, the low yields risk an asymmetric payoff. If the global economy strengthens and inflation sets off, government bond yields may rise, pushing up investment-grade yields. In an economic slowdown credit may suffer from wider risk spreads.	
High-yield bonds:	**Underweight**
Unchanged. Spreads have narrowed to such an extent that we see US high-yield as expensive relative to our macro-economically driven fair-value model. The gap between our model and actual spreads has reached extreme levels. Meanwhile corporate fundamentals such as debt levels and interest payments relative to profits or cash flow have worsened. We do not think that low spreads compensate for risks such as higher inflation and yields or pressure on global growth from protectionism or possible adverse developments in China.	
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:	Overweight
Changed. Following the profit-taking on our small caps versus large caps strategy and given our cautious asset allocation, we looked for another hedge for upside moves in risk assets. We see our overweight in eurozone real estate versus eurozone government bonds in this light. Relative to the underlying assets, eurozone listed real estate is not cheap, but its dividend yields are high relative to credit yields. We are positive on the eurozone economy, so demand factors should be positive for real estate, while new supply is still limited. Setting up this strategy versus government bonds mitigates the interest-rate risk in real estate.	
Commodities:	**Underweight**
Unchanged. Oil prices have benefited from the agreement among oil-producing countries to cut production, although the rise was stronger in Brent crude 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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