ASSET ALLOCATION MONTHLY

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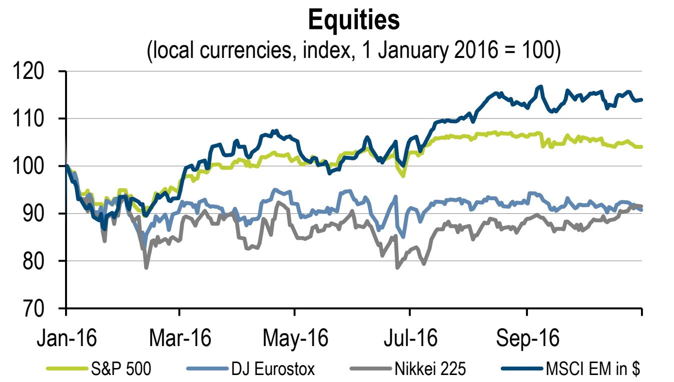
SUMMARY INVESTMENT CLIMATE

- Leading indicators improve, growth concerns remain
- Monetary policy changing course?
- Interest –rate concerns hit equities

SUMMARY ASSET ALLOCATION

Multi-asset	Active weights		Δ active weight
	Oct-16	Nov-16	
Equities	●	●	–
Duration	●	●	–
Investment grade	●	●	–
High yield	●	●	–
Emerging market debt	●	●	–
Real estate	●	●	–
Commodities	●	●	–

Risk assets struggled in October. Global equities fell by 1.8% in US dollars and eked out a gain of only 0.5% in euros due to the appreciation of the dollar.



Source: Datastream, BNPP IP

As an asset class, real estate showed bigger losses, while commodities were flat in US dollars. Bonds did not provide a safe haven: the global aggregate bond index fell by more than global equities. In fact, interest-rate concerns drove bond yields higher and equities lower. These concerns overwhelmed both positive earnings news from US companies and improved economic data. We think the investment climate remains challenging for risky assets. Our main scenario of modest growth has now been discounted fully and we see global equities as slightly expensive. Given the downside risks to growth, we remain underweight in global equities, with a preference for an underweight in Europe.

GROWTH REVIVAL?

Leading indicators have been positive lately. In October, the US Markit manufacturing purchasing managers' index

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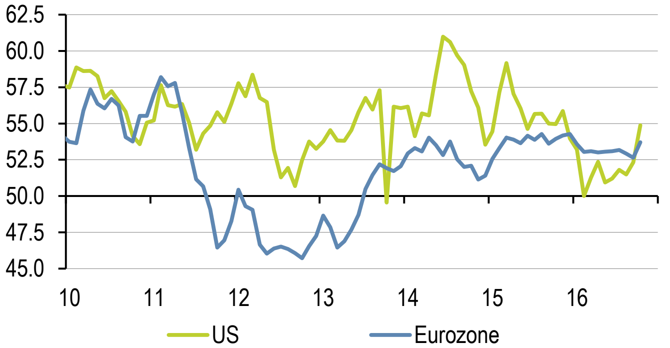
(PMI) jumped to 53.4 and the services PMI rose to 54.8, taking the composite index to an 11-month high of 54.9. The manufacturing and services PMIs in the eurozone both rose to 53.5 and the composite index reached 53.7.

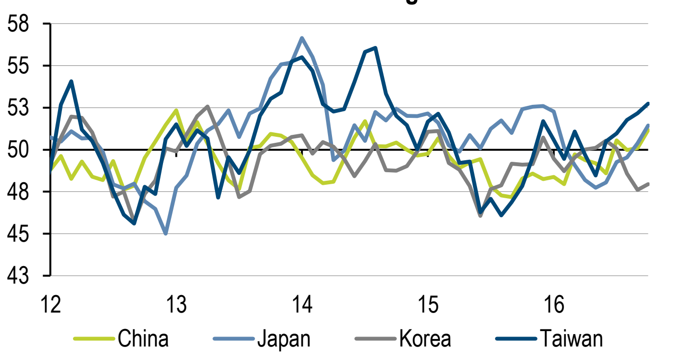
Composite PMIs



Source: Markit

China's manufacturing PMI slipped to 51.2, but this is still the highest level since July 2014. Broad-based gains are leaving our global GDP-weighted manufacturing PMI on track (not all countries have reported yet) to climb to 52.0, rising to 53.0 in developed economies and 50.2 in emerging markets. That would be the first positive reading in emerging markets since February 2015. In the US the improvement was confirmed by the ISM manufacturing index. In the eurozone the Economic Sentiment Index and the German Ifo index recouped the losses from earlier this year.

Asia manufacturing PMIs



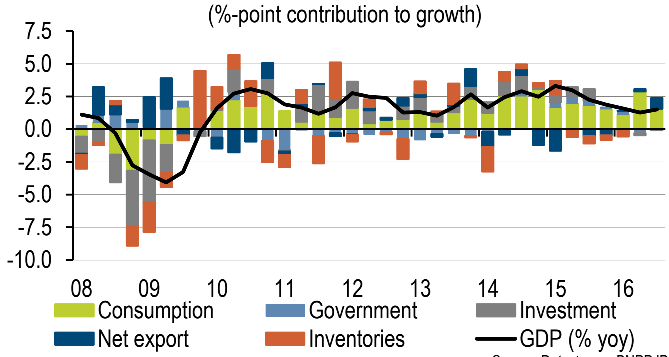
Source: Markit, BNPP IP

We do not foresee a strong growth revival, though. The eurozone economy's 1.4% QoQ annualised growth may accelerate in the fourth quarter, but with the tailwind of lower energy prices fading and the credit cycle turning slightly less supportive, any improvement should be limited. But the economy should still grow at slightly above trend. Growth in the UK surprised on the positive side in the third quarter. So far, the Brexit vote has left few marks on the economy, although we still expect business investment to suffer.

US economic growth of 2.9% QoQ annualised in the third quarter marks a strong improvement from the first half of the year when growth averaged only 1.1% QoQ annualised. In fact, the third-quarter pace was the fastest since the third quarter of 2014. That is where the positive news ends though; the details of the GDP report revealed weakness. Consumption growth slowed from a punchy 4.3% in the second quarter to a more modest 2.1% in the third. Business investment in structures was strong, but investment in equipment, which makes up a far larger part of business investment than structures, fell for the fourth straight quarter. Overall non-residential investment was slightly positive. Residential investment was negative.

US real GDP

(%-point contribution to growth)



Source: Datastream, BNPP IP

So what drove the strong headline number? One factor was a surge in exports, which was driven by soybean exports after droughts in Latin America. The other factor was a slight increase in inventories. Having been run down in the second quarter, companies added to inventories in the third. The swing contributed 0.6 percentage points to annualised GDP growth. Net exports added another 0.8 percentage points. So half the Q3 growth came from two unsustainable sources. Exports should fall back after the surge and inventories are still high relative to business sales. Moreover, growth in household real disposable income has lost some steam: after peaking at 4.7% in December 2014, the annual growth rate slowed to 2.1% in September. The September drop in capital goods orders excluding defence and aircraft, low capacity utilisation in manufacturing and modest profit growth do not bode well for investment. Thus, the US economy should slow from here.

Japanese data show an economy that is treading water. Chinese economic growth stabilised at 6.7% YoY in the third quarter. Industrial production growth has been around 6% YoY since this April, while real retail sales grew at 8.8% YoY in September. This stabilisation has come at a cost though: imbalances have increased further. Debt is growing too fast, housing bubbles have appeared in the bigger cities and investment is being propped up by government spending. The impact of fiscal and monetary stimulus looks set to fade from here. A negative scenario with a hard landing is a risk in our view, but with the 19th National Congress of the

Communist Party of China, due to be held next year, possibly deciding on far-reaching changes in the makeup of the party leadership, we expect the authorities to do everything they can to keep the economy stable. Russia and Brazil face headwinds from weak consumption and the need of fiscal austerity. Global trade has not shown signs of accelerating, so growth in emerging markets should move broadly sideways.

So, while the improvement of the leading indicators fits with the view that global growth has stabilised, we do not see many factors driving growth much higher.

SUBTLE SHIFTS IN MONETARY POLICY

The Federal Reserve left interest rates unchanged at its November policy meeting, as expected, but it hinted more clearly at a December rate rise. The Fed's statement mentioned that inflation had increased somewhat this year and its wording provided another intimation: instead of waiting for further evidence of continued progress towards its targets, it said the Fed was waiting for just *some* further evidence. It also said that the case for a rate rise had continued to strengthen. Given that September's decision to leave rates on hold was characterised in the meeting minutes as a close call, a rate rise in December now looks like the base case for the Fed. In other words, only a severe weakening of the data or heightened market volatility would keep the Fed from hiking. In November only two voting policymakers dissented by favouring a rate hike now, down from three in September. In our view, the usually dovish president of the Boston Fed switched sides, having been assured by a commitment of a hike in December. With recent economic data pointing to growth at around the trend rate and the Fed's 2% inflation and full employment targets coming into sight, we think a subtle shift is taking place in monetary policy expectations. For years markets have discounted fewer US rate increases than the median policymaker forecast. Most of the adjustment has so far come from the policymakers, narrowing the gap between market assumptions and policymaker expectations. The discrepancy is now small, but it could well be that the next move has to come from the markets, which are currently discounting only one rate rise next year after an increase in December.

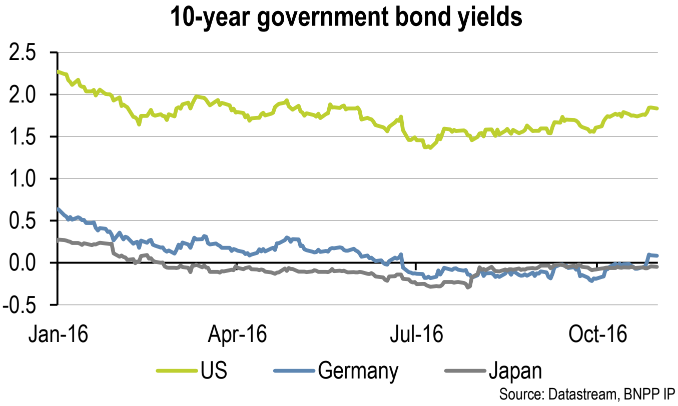
In the eurozone the tapering genie is out of the bottle. While the ECB has continued to deny that tapering is currently under discussion in the governing council, market speculation has continued. In his press conference after the October policy meeting, president Draghi acknowledged that the ECB would not halt its asset purchases abruptly. We expect that in December the ECB will announce an extension of its asset purchase programme beyond March 2017, most likely by six months. Committees within the ECB are currently investigating ways for a smooth functioning of the programme, so some of the self-imposed limits on eligible bonds could be relaxed. While our base case is that the ECB will keep the pace of the monthly purchases at EUR 80 billion, we would not rule out that the hawks on the council will successfully push for a slower monthly pace. That would essentially be tapering, but there would be one main difference in timing with the Fed's tapering from December 2013 to October 2014. The Fed quickly established a path of lowering its asset purchases by USD 10 billion per month and finished the process in 11 months. Even if the ECB slowed the pace of its asset purchases after March, it could deny it had started tapering. And even if it did not do so, it would signal that this would be a gradual process. But still, the direction of monetary policy changes is shifting.

Elsewhere in developed economies, central banks in Canada and Australia kept their policy rates unchanged. But the Bank of Canada admitted that further easing measures had been discussed as exports have been slow and the bubble-like housing market could be turning. Setting labour market weakness and low inflation against a strong housing market and robust credit growth, the Reserve Bank of Australia indicated it preferred to look past low inflation for now.

In emerging markets the Banco do Brasil stole the show with its first rate cut in just over three years. The 25bp cut to 14% was modest and leaves real rates high. But the BdB wants to restore its credibility after losing it in 2012. The BdB wants to see more progress in falling inflation and fiscal reforms before continuing a gradual easing process. But even if only to offset the upward pressure on real rates from falling inflation, more cuts are to be expected. In general in emerging markets, we see more of an easing bias rather than the prospect of tightening due to falling inflation.

INTEREST-RATE CONCERNS

As mentioned in the introduction, risk assets have come under pressure. This may have been driven by political developments in the US. At this point, the polls still point to a Democratic victory in the presidential elections, but the odds of a Republican win have risen lately. Given the lack of transparency of Donald Trump's plans, increased investor uncertainty should benefit government bonds. But this is not what we have seen lately. Of course, bond yields could have risen on the perception that Trump's plans would lead to a wider fiscal deficit. But we think that the shifts on monetary policy described above offer a better explanation for the recent rise in yields and the sell-off in risk assets. We think equity valuations were high relative to historical price-earnings ratios. Relative to government bonds, the overvaluation of equities was less clear, but for a while, it has looked to us like equities were priced for perfection: some GDP growth, low inflation and low bond yields. We have maintained our underweight in global equities, not so much because we see a further rise in yields (we believe this will be limited and only gradual), but more so because of the risk of a more negative growth scenario amid adverse developments in China.



We prefer to be underweight in European equities since we have doubts about the sustainability of dividend payments. Third-quarter US earnings have been looking gradually less good as the latest earnings season progressed. With almost 80% of the companies in the S&P500 having reported so far, three quarters have beaten earnings expectations. This is lower than earlier in the reporting season and lower than in the previous quarter. The 56% of companies reporting better-than-expected revenues is essentially unchanged from the previous two quarters. Growth in earnings per share has turned positive, partly due to significant share buybacks. In the eurozone, growth and earnings surprise ratios have been higher than in the US. These positive developments have been overshadowed by the rise in yields though. For full-year 2016 earnings, analyst expectations have come down to the level of our more conservative forecasts. For 2017, we think they are still somewhat high.

Oil prices have joined in the sell-off of risk assets. That would only be natural in a risk-off environment, but the selling was also fuelled by a lack of cooperation within OPEC on production curbs. Furthermore, non-OPEC member Russia does not seem inclined to join in and from the lows in January prices have gone up to levels were US shale producers are coming back to the market. We have kept our underweight in commodities.

ASSET ALLOCATION[1]

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

Equities	Active weights Oct-16	Active weights Nov-16	Δ active weight
European large caps	🔴	🔴	▬
European small caps	🟡	🟡	▬
US large caps	🔴	🔴	▬
US small caps	🟢	🟢	▬
Japan	🟡	🟡	▬
Emerging markets	🟡	🟡	▬

Real estate	Active weights Oct-16	Active weights Nov-16	Δ active weight
European Real Estate	🟡	🟡	▬
US Real Estate	🟡	🟡	▬
Asian Real Estate	🟡	🟡	▬

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

Fixed income	Active weights Oct-16	Active weights Nov-16	Δ active weight
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 Oct-16	Active weights Nov-16	Δ active weight
AUD	🟡	🟡	▬
CAD	🟡	🟡	▬
CHF	🟡	🟡	▬
DKK	🟡	🟡	▬
EUR	🔴	🔴	▬
GBP	🟡	🟡	▬
HKD	🟡	🟡	▬
JPY	🟡	🟡	▬
NOK	🟡	🟡	▬
NZD	🟡	🟡	▬
SEK	🟢	🟢	▬
SGD	🟡	🟡	▬
USD	🟡	🟡	▬
EM FX	🟡	🟡	▬

[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. Equities have come under pressure lately, mainly due to higher bond yields, but also due to heightened political uncertainty. We regard equities as somewhat expensive relative to their own history. They may look cheap versus bonds, but they were priced for a perfect scenario with some growth, low inflation and low bond yields. The recent company earnings season has been positive. Analysts' earnings expectations for this year have come down to our cautious views; for next year, expectations are still high. We are underweight, partly as a hedge for the risk of a more negative economic environment. We have partly hedged our position for upside risks through attractively valued out-of-the-money call options on the US S&P500 index.

Small-cap equities:	**Overweight**

Unchanged. Fundamental factors such as relative valuations, the US economic cycle and the earnings outlook are neutral in our view, although the earnings outlook has improved from a couple of months ago. We are overweight as we believe that large amounts of cash on bigger companies' balance sheets and a generally low appetite for capital expenditure will drive mergers and acquisitions, which in turn should support small-cap stocks. We also see this overweight as positive exposure to market risk and thus as a partial hedge against our generally cautious asset allocation.

Government bonds:	**Neutral duration**

Unchanged. Our overall duration exposure is neutral since we see upside risks for yields coming from (eventually 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. European political risks should primarily affect 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 to justify an overweight position. With the ECB for now hesitating to provide additional stimulus, risk spreads have widened in the eurozone. Further widening is a risk going forward.

High-yield bonds	**Neutral**

Unchanged. Spreads have fallen throughout the year, even with 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 shielded from the possible 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. 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. Oil prices have joined in the sell-off of risk assets. That would only be natural in a risk-off environment, but the selling was also fuelled by a lack of cooperation within OPEC on production curbs. Furthermore, non-OPEC member Russia does not seem inclined to join in and from the lows in January prices have gone up to levels were US shale producers are coming back to the market. We have kept our underweight in commodities.	

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