ASSET ALLOCATION MONTHLY

September 2017

FOR PROFESSIONAL INVESTORS

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SUMMARY

- Risk assets: under the weather
- Upbeat global growth
- Asset allocation: back to underweight duration, still bearish on euro versus US dollar

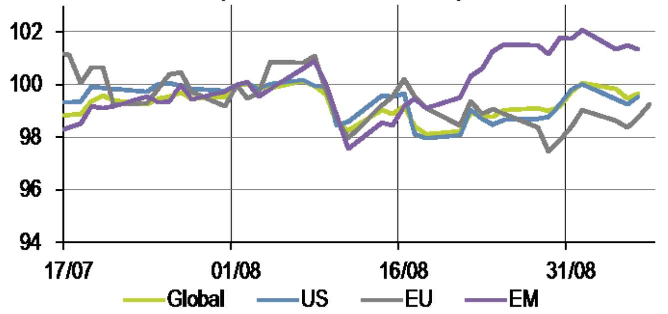
SUMMARY ASSET ALLOCATION

Multi-asset	Active weights Jul-17	Active weights Aug-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	🟠	🟠	–

VOLATILE SUMMER

August was generally positive in terms of macroeconomic data, but there was more of a stir from (geo)political issues. US President Trump's jawboning against a threatening North Korea tempered risk assets during most of the month. Global equities retreated as volatility spiked. However, a late rebound meant they ended the month flattish overall. The US S&P 500 index was unchanged over the month, with information technology and utilities making up for the weakness in the energy, telecommunication services and financial sectors. European equities finished slightly down, with bond proxies such as real estate and utilities outperforming. Emerging markets rallied to finish the month up slightly, largely driven by IT stocks.

Equity indexes
(index, 01/08/2017=100)



Source: Bloomberg, BNPP AM

Haven assets benefited from the risk-averse backdrop. Gold rose by more than 4% over the month and silver by almost 6%. Bond markets did well, driven by risk-off investor sentiment and the absence of hawkish comments by leading central banks.

BNP PARIBAS ASSET MANAGEMENT

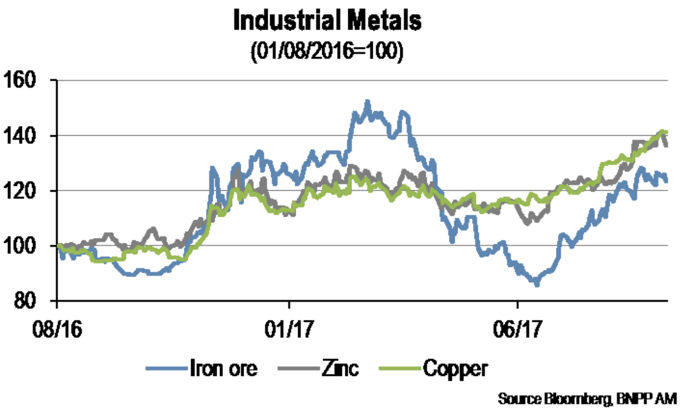
The asset manager for a changing world

The debt ceiling debate made a comeback in US politics as the limit on the US government's borrowing capacity will soon need an extension. It seems like another distraction from President Trump's reform agenda, driving the so-called Trump trades further into the past. Protectionism and reflation, which were the main two drivers of these trades, are now pretty much ignored by market participants. Inflation expectations have now totally retraced their post-election gains. Granted, President Trump has had difficulties implementing his agenda, especially in areas where he needs Congressional approval, such as tax reform. That said, we still think that reform talk will be followed by action, especially as the mid-term elections approach.

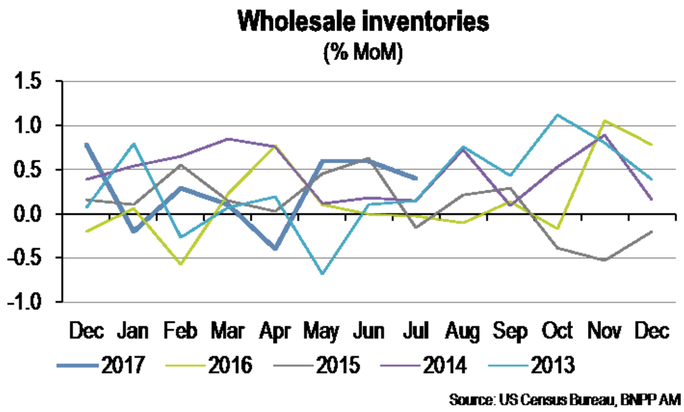
UPBEAT GLOBAL GROWTH

Among the best performers in August, industrial metals such as copper, iron ore and zinc benefited from a solid macroeconomic environment. In particular, the Chinese PMI surprised to the upside at 51.7, up from 51.4 in July. That said, non-manufacturing PMI was weaker at 53.4.

At this point, industrial metals prices are starting to look overblown. Another reason for the rally in industrial metals is speculation. Even though the Chinese authorities have not yet tackled the overproduction issue by implementing supply-side reforms, investors appear to have anticipated such curbs, which may come after the October's Communist Party Congress. Overcapacity and the reduction of the economic stimulus could then start to be addressed more firmly.



In developed markets, the macroeconomic backdrop looks encouraging. US Q2 GDP growth has been revised up to 3% after the first quarter's 1.2%. This was led by higher revisions to personal consumption expenditure and non-residential fixed investment.
On business investment, the Dallas Fed capex outlook rose to its highest level since January. Wholesale inventories were upbeat, with MoM growth higher than in previous years.



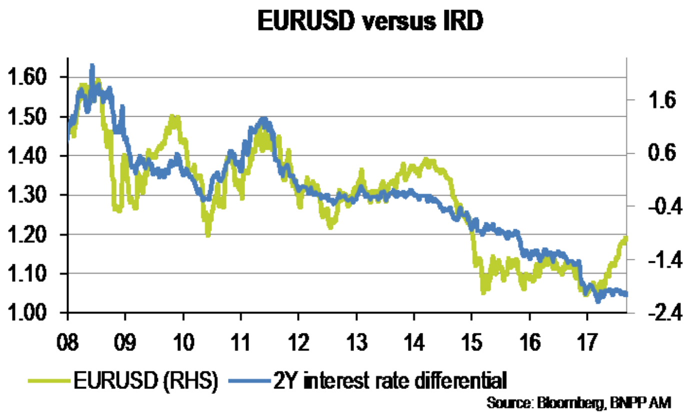
Consumer confidence rose to 122.9, its highest since 2000 (excluding March). Expectations of higher income have improved, which should be positive for consumer spending growth.

The latest European figures were also encouraging, with French consumer spending growing by 2.1% YoY. German consumer confidence rose to a 16-year high.

On the monetary policy side, the annual central banker forum in Jackson Hole turned out to be a non-event in terms of market-moving news. Both the ECB and the US Federal Reserve appear to be taking great care to not normalise policy too quickly, which should support a stronger global growth recovery.

ASSET ALLOCATION

Heading into the Jackson Hole meeting, we took profits on our tactical neutral duration. Bond markets have corrected from the sell-off that followed the summer's ECB central bankers' forum in Sintra, Portugal. We are now back to our strategic underweight duration since we continue to expect a progressive increase in interest rates.



We remain bearish on EUR/USD. The currency pair has decoupled from the interest-rate differential in anticipation of the ECB turning more hawkish than the Fed. Since this is not our base case, we are bearish on the euro.

We took profits on our tactical short position after Brazilian equities recovered from the drop triggered by the political scandal surrounding President Temer.

On the credit side, we took profits on our long US versus euro corporate credit strategy opened in July last year. The valuation rationale has weakened, while political risk has shifted from Europe to the US. That said, we are maintaining the credit underweight we implemented in mid-January, with a preference for USD high-yield bonds. Performance has been held back by the negative carry effect, but our rationale remains intact: the macroeconomic backdrop is not improving, the fatter-tail environment persists and valuations look stretched. Non-commodity defaults are on the rise. Shareholder-friendly actions, which tend to hurt bondholders, are on the rise, including M&A activity. Cash flow to debt dynamics remain subdued.

ASSET ALLOCATION[1]

Multi-asset	Active weights Jul-17	Active weights Aug-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 Jul-17	Active weights Aug-17	Δ active weight
European large caps	🟡	🟡	–
European small caps	🟡	🟡	–
US large caps	🟡	🟡	–
US small caps	🟡	🟡	–
Japan	🟡	🟡	–
Emerging markets	🟢	🟡	⇩

Real estate	Active weights Jul-17	Active weights Aug-17	Δ active weight
European real estate	🟡	🟡	–
US real estate	🟢	🟢	–
Asian real estate	🟡	🟡	–

Fixed income	Active weights Jul-17	Active weights Aug-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)	🔴	🔴	–
Emerging market debt hard currency	🟡	🟡	–
Emerging market debt local currency	🟢	🟢	–

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

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:	**Neutral**
Unchanged. Selected fundamental factors are keeping us cautious: we regard valuations as generally rich and earnings expectations on the whole as high. However, markets have so far ignored this, with positive earnings momentum in the eurozone and more and more analysts upgrading their expectations for eurozone and US earnings. Given that consensus earnings expectations for UK companies look too high to us, and reflecting the positive economic cycle, still-favourable monetary policy and encouraging market momentum in the eurozone, we remain overweight eurozone equities versus the UK. We are neutral on the US and Japan. We took profits on our tactical short after Brazilian equities recovered from the drop over the political scandal surrounding President Temer, in the Emerging Market Income Fund.	
Small-cap equities:	**Neutral**
Unchanged. European small-cap equities have rallied in line with large caps, but in the US, small caps have lagged large caps so far this year after their strong outperformance following the US presidential election. On several valuation measures, small caps are trading at a premium to large caps, both in the US and in Europe. In the US, earnings momentum has weakened.	
Government bonds:	**Underweight duration**
Changed. Given the decline in government bond yields globally and in Europe in particular, we restored our underweight in European government bonds. We feel the rise in yields after 'Sintra' was an overreaction to the early stages of the debate on changing central bank reaction functions.	
Investment-grade corporate bonds:	**Neutral**
Unchanged. Risk spreads have remained low in the US and Europe. We view the macroeconomic fundamentals as generally positive for this asset class: defaults are low, credit conditions continue to improve and yields in general remain historically low. However, the currently low yields entail a risk of an asymmetric payoff. If the global economy continues to strengthen and inflation emerges, government bond yields may rise, pushing up investment-grade yields.	
High-yield bonds:	**Underweight**
Unchanged. Spreads have fallen to such an extent that we see US high-yield as expensive relative to our macroeconomically driven fair-value model. The gap between model spreads and actual spreads has narrowed too far, in our view. Meanwhile, company fundamentals such as debt levels and interest payments relative to profits or cash flow have worsened. We think current spreads do not offer adequate compensation for risks such as higher inflation and yields, pressure on global growth from protectionism or a downturn in China.	
Emerging market bonds:	**Neutral**
Unchanged. We closed our underweight in hard currency emerging market debt, but remain overweight in local currency bonds. We believe valuations are more attractive in local currency bonds. Global EM currencies remain undervalued and many central banks in emerging markets are easing policy.	
Real estate securities:	**Overweight**
Unchanged. We are overweight US real estate. The sector has been lagging over the past year as market participants have focused mainly on bad news while ignoring factors such as a positive supply-demand balance. This has taken valuations to historically low levels. Rising interest rates and yields are a risk that we are willing to take at this point given the positive factors. We are overweight real estate versus US equities to hedge market movements and focus on the low valuation of real estate securities compared to more expensive broad equities.	

Commodities:	**Neutral**
Unchanged. Oil prices have remained choppy. Since the end of February, Brent oil has traded at between USD 45.50 and USD 54 per barrel. The OPEC deal to curb production appears to be holding, but US shale production is rising and US inventories are high. Markets have recently questioned whether the OPEC deal is enough to put a floor under prices. Over time, we expect the market to become more balanced, but the negative carry on the asset class as well as the growth risks in China keep us from moving to an overweight.	