

# ASSET ALLOCATION QUARTERLY – Q4 2017

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BNPP AM – Multi Asset and Quantitative Solutions (MAQS)

FOR PROFESSIONAL INVESTORS



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## Asset allocation overview:



**Equities**



**Commodities**



**Rates & duration**



**Real estate**



**Credit**



**FX (EUR vs. USD, GBP, JPY)**



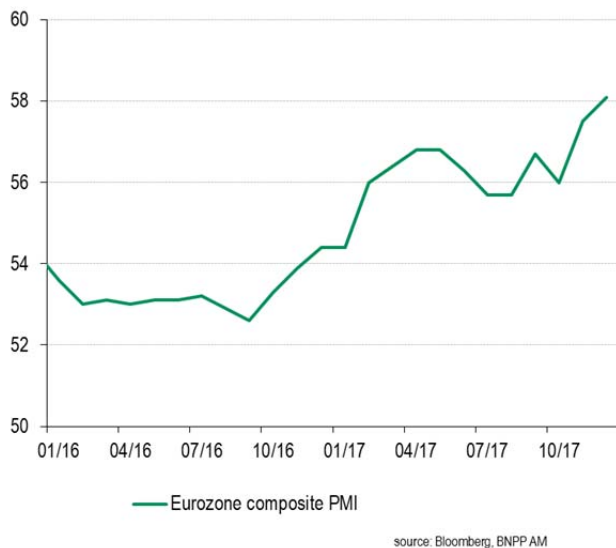
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## Q4 2017 MARKET REVIEW

Over the fourth quarter, economic developments continued to be positive. Global equity markets on balance posted positive returns over the quarter, while global bond markets were marginally more volatile with yields in most of them grinding slightly higher. Despite strong economic growth, inflation in most economies remained muted, with inflationary pressures undershooting most central banks' targets including those of the ECB and the US Federal Reserve (Fed).

**Figure 1:** Eurozone activity indicators have remained strong

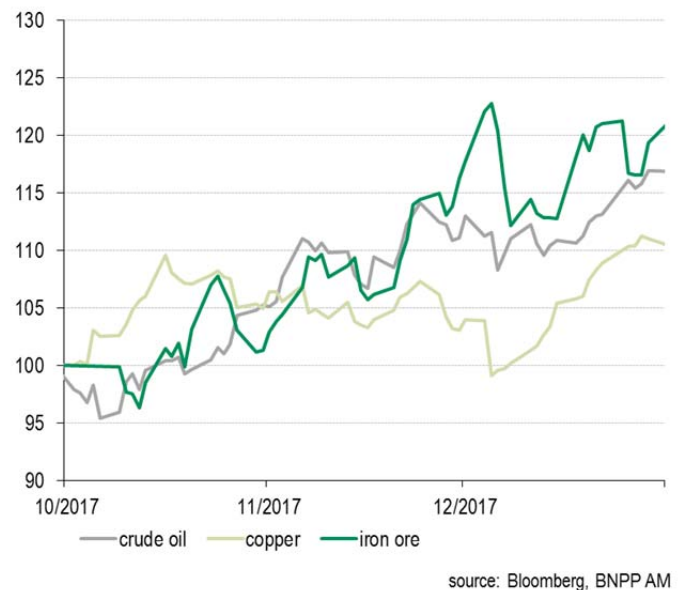


US equities continued to post strong positive gains over the fourth quarter and market indices touched highs in December as investors discounted the passage of the Trump administration's fiscal package, which occurred in late December. Conversely, the nearly USD 1trillion in underfunded tax-stimulus led to a modest grinding higher of US Treasury yields over the quarter. A key feature of the US Treasury market during the period was the tendency for the yield curve to flatten despite the fiscal stimulus package. This was partly due to rising interest-rate pressure at the short end of the yield curve as the Federal Open Market Committee (FOMC) held to its policy of gradual monetary tightening, and also due to more US corporate pension funds accelerating their liability-driven investment programmes before changes in the US corporate tax code take effect. Over the quarter, the US dollar continued to soften as financial markets largely discounted the likely path of FOMC tightening and focused

more on their belief that other leading central banks such as the ECB and the Bank of Japan (BoJ) would be more likely to make surprise monetary policy adjustments than the FOMC in the near term.

Despite strong European economic activity data over the quarter, European equities corrected as the recovery in the euro on the foreign exchanges raised investor concerns about future earnings growth. The continuing debate about the speed and magnitude of the ECB's withdrawal from quantitative easing (QE) also unsettled equity markets. This same issue unnerved European bond markets over the quarter, although overall yield volatility was range-bound, with 10-year Bund yields falling to a low of 0.30% in early December before edging higher to close the year at 0.42%. Despite mixed economic data, UK equities rose over the quarter, partly fuelled by the continuing strengthening of commodities prices.

**Figure 2:** Commodities did well in Q4 2017 (index = 100 on 01/10/2017)



Despite the continued inflation overshoot and the Bank of England's decision to raise rates by 0.25% in October, the gilt market remained within a relatively tight trading range. The agreement between the EU and the UK on Brexit 'divorce' terms and the decision to proceed to the next stage of negotiations underpinned a bounce in sterling. However, we continue to believe the EUR/GBP rate will need to rise towards 0.93-0.96 given that we expect a future trade deal between the UK and the EU to be more like the EU-Canada deal than the current single market agreement. This would mean that sterling would need to

depreciate marginally further against the euro to establish a new equilibrium exchange rate.

Japanese equities delivered positive returns over the quarter as the relationship between the yen and Japanese equities continued to unravel. The equity market has partly been fuelled by the continued strength of the domestic economy. While yields remained relatively stable, BoJ Governor Kuroda undertook a kite-flying exercise to signal that the bank would not maintain its current policy stance indefinitely as he warned of the long-term damages to the financial system of a zero-rate policy.

**Figure 3:** Eurozone equities lagged behind the global rally in Q4 2017



Economic data from China on balance continued to surprise positively, and Chinese equities delivered positive returns over the quarter. The overall pace of economic expansion in China along with strong synchronised global growth enabled commodities to rise further over the quarter.

## MARKET OUTLOOK AND ASSET ALLOCATION

Financial markets are currently largely biased towards discounting the 'Goldilocks scenario' of strong global growth and low inflation. This has now mostly been reflected in asset prices, particularly those of US assets. The major risk to this scenario is an acceleration in inflation, especially in the US, which would force the FOMC to tighten policy more aggressively than currently

discounted by markets. There is still a risk of a global economic slowdown triggered by a deceleration in China and of an autonomous slowdown in investment and consumption, but we do not foresee either of these happening in 2018.

'Goldilocks' – the combination of strong and synchronised growth, low inflation and accommodative monetary policy – remains supportive of risky assets. While we have been neutral on equities, we have been waiting for a pull-back to add a long exposure in Europe. The 6% correction in European equities since November/December 2017 afforded us an opportunity to establish such a long position in the first week of January. European equities remain cheaper overall than other developed market equities and we expect 2018 European earnings growth to exceed consensus estimates (11% vs. 9%) given the strong growth outlook in the region. While the strong euro was a material headwind in 2017, we believe there is now a lower chance of material gains in the coming months.

**Figure 4:** Adding to European equities



We remain structurally short fixed income given the current historically low yields. In addition, low inflation is already reflected in fixed-income assets under the 'Goldilocks' scenario. The principal risks remain less accommodative monetary policy and/or an inflation surprise.

We are constructive on emerging markets, and neutral on credit, commodities and the euro versus major currencies.

## STRATEGIC OVERVIEW OF KEY POSITION CHANGES – Q4 2017

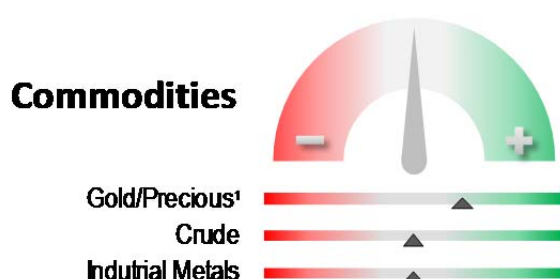
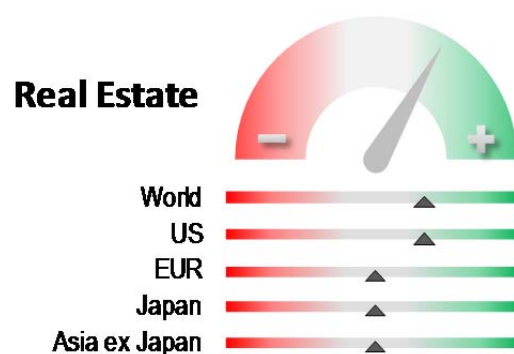
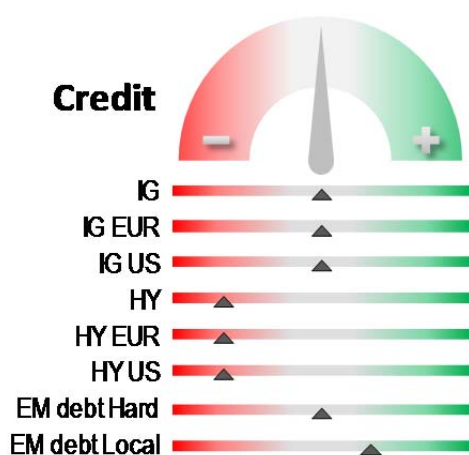
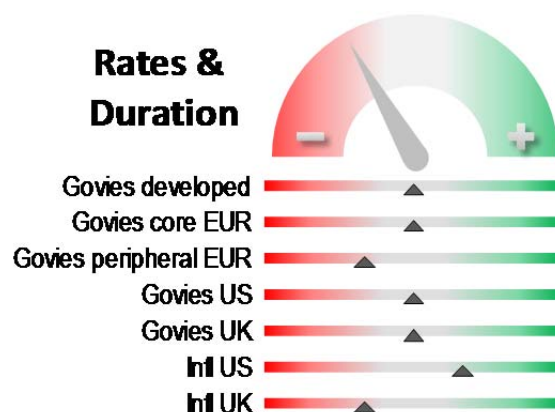
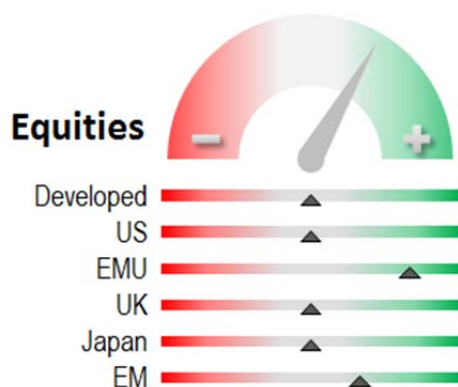
During the fourth quarter of 2017, the BNPP AM MAQS team made the following strategic calls:

<b>SHORT EUR INVESTMENT-GRADE VS. EMU BONDS</b>	<b>CLOSED</b>	<b>06/12/2017</b>
<ul style="list-style-type: none"><li>• Less conviction in IG credit underweight, especially versus long bonds, given political risk in eurozone periphery</li></ul>		
<b>LONG EUR/GBP</b>	<b>OPEN</b>	<b>24/11/2017</b>
<ul style="list-style-type: none"><li>• We believe Brexit will require further adjustment in the EUR/GBP exchange rate</li></ul>		
<b>SHORT EUR/USD</b>	<b>CLOSED</b>	<b>17/11/2017</b>
<ul style="list-style-type: none"><li>• We had less conviction on the US dollar side. Opened on 27/07/2017</li></ul>		
<b>LONG AUSTRALIAN BONDS VS. US BONDS</b>	<b>CLOSED</b>	<b>03/11/2017</b>
<ul style="list-style-type: none"><li>• We reached our profit target. Opened on 06/09/2017</li></ul>		
<b>LONG US SMALL CAPS VS. LARGE CAPS</b>	<b>CLOSED</b>	<b>18/10/2017</b>
<ul style="list-style-type: none"><li>• Closed to take profits. Opened on 19/09/2017</li></ul>		
<b>LONG SPANISH VS. ITALIAN EQUITIES</b>	<b>DECREASED</b>	<b>11/10/2017</b>
<ul style="list-style-type: none"><li>• Reduced position given greater political uncertainty after Catalonia referendum</li></ul>		
<b>LONG EMERGING MARKET EQUITIES</b>	<b>OPENED</b>	<b>11/10/2017</b>
<ul style="list-style-type: none"><li>• EM in the sweet spot of the cycle as global demand picks up in a lowflation world</li></ul>		

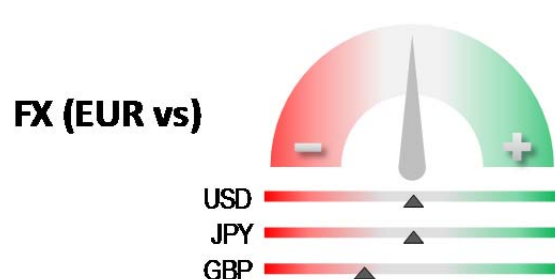




## ASSET ALLOCATION DASHBOARD<sup>1</sup>



<sup>1</sup>: only selective portfolios



<sup>1</sup> 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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