

ASSET ALLOCATION MONTHLY

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FOR PROFESSIONAL INVESTORS



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SUMMARY ASSET ALLOCATION



SUMMARY

- ▶ US and Japan led the equity rally in November; Europe and EM lagged
- ▶ Cyclical momentum persists in the eurozone and in the US
- ▶ Inflation remains subdued in the developed world
- ▶ EU and UK agree Brexit terms, but GBP could remain under pressure
- ▶ Asset allocation:
 - Neutral equities, but looking to add; slightly underweight core fixed income
 - Long EUR vs. GBP
 - Reduced Bund duration
 - Still constructive on EM equities



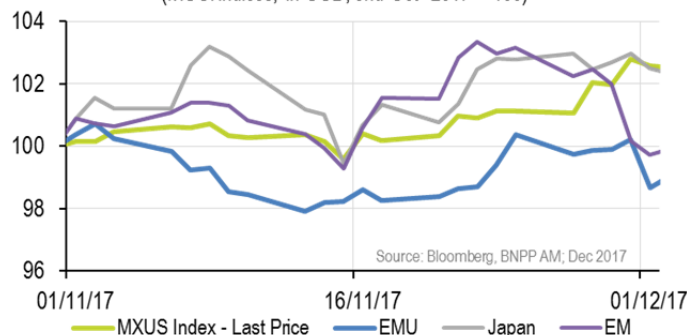
BNP PARIBAS
ASSET MANAGEMENT

The asset manager
for a changing
world

MARKET SUMMARY

Global equity markets had a mixed November. The US and Japan rallied by close to 3%, while eurozone (EMU) and emerging market (EM) equities ended the month broadly flat. EMU equities underperformed for most of the month, while EM equities corrected towards the end of it. Core rates markets were less eventful. US Treasury 10-year yields were broadly stable in a 2.30%-2.40% range, while German 10-year yields fluctuated between 0.33% and 0.43%. Despite these range-bound fixed-income markets, EUR/USD rose by close to 2%.

Figure 1: Eurozone lagged the global rally
(MSCI indices, in USD, end-Oct 2017 = 100)



Risky assets such as cyclical commodities (crude oil and base metals) and EM local currency debt rallied in tandem with global equity markets. All in all, these market moves continue to be consistent with an environment of solid growth and very low inflation in the developed world, notably in the US and Europe.

Looking ahead, we believe a key asset allocation question is whether such a 'goldilocks' climate can last for longer and what the likely events are that could disrupt it. We explore two key developments that underpin the 'goldilocks' environment: growth and inflation in the US and Europe. We also examine the latest news on Brexit and its implications for GBP.

CYCLICAL MOMENTUM REMAINS STRONG IN THE US AND EUROPE

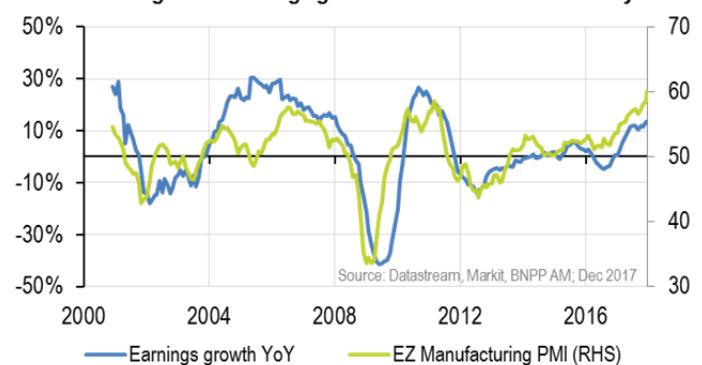
US employment growth and other activity indicators have remained solid and supportive of the equity rally. The prospect of tax cuts is also underpinning the US market. Indeed, a compromise bill is beginning to take shape in the House-Senate conference and there are indications that the tax reform bill could be voted on in both chambers before Christmas.

As ever, the devil will be in the detail of the tax plans. We expect the reform to lift both economic and earnings growth and, accordingly, we would expect equity markets to rally further as analysts revise up their earnings forecasts. There are two channels through which tax

reform can boost earnings: 1) directly in the income statement through lower tax rates, and 2) a drop in the share count as companies use repatriated cash (to be taxed at a lower rate under the plans) to buy back stock.

At this point, economic momentum is perhaps more evident in the eurozone where activity indicators, notably PMIs, remain very strong. Corporate earnings typically rise in tandem with the cyclical upswing. Together with currently reasonable equity valuations, we believe this makes European equity markets an interesting investment proposition.

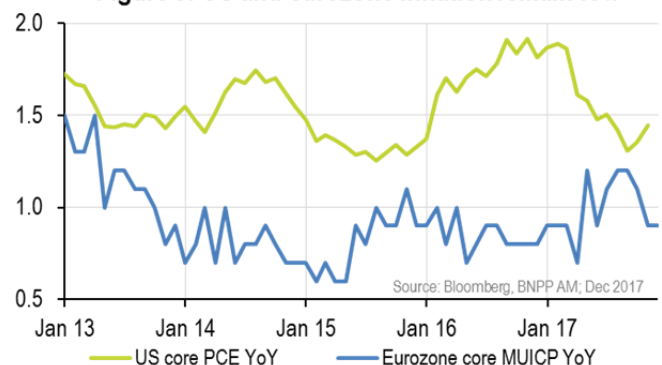
Figure 2: Earnings growth follows economic activity



INFLATION REMAINS SUBDUED IN THE DEVELOPED WORLD

One of the key assumptions of our central macroeconomic scenario is that inflation is likely to remain low in 2018. Admittedly, that has been the norm over the past few years and most of the key inflation metrics that central banks and markets follow, notably core inflation, remain subdued in large economies (Figure 3). A key risk to our view is that inflation starts moving higher, leading market participants to reprice the currently gradual pace of monetary policy normalisation that markets are discounting for major central banks such as the US Federal Reserve and the ECB.

Figure 3: US and eurozone inflation remain low



Some recent inflation data has indeed ticked higher. For instance, US PPI inflation rose to 3.1% in November from

2.8% in October. Personal consumption PPI inflation, which tracks pipeline price pressures for CPI inflation, rose to 3.0% YoY, with the core component up by 2.4%, marking the strongest reading since April. In Japan, PPI has risen for 11 consecutive months and UK CPI inflation accelerated to above 3% in November.

As expected, the Fed raised US rates by another 25bp and updated its economic projections. These now show stronger US growth, but FOMC policymakers still see low US core inflation in 2018. The ECB also upgraded its growth projections, but its language on inflation and wage growth remained very cautious. Overall, the monetary policy outlook has not changed materially, in our view.

EU AND UK AGREE ‘DIVORCE’ TERMS

The terms of the UK exit from the EU have now been agreed, setting the stage for the next round of negotiations on the future (trade) relationship between the UK and the EU. Markets have begun to discount a ‘softer’ Brexit and a trade regime that will be closer to continued participation in the single market.

However, this optimism is likely to be damped over time as the EU is most likely to favour a model akin to the EU-Canada trade deal. While this would be materially better than no deal, it does not cover financial services and this is likely to be negative for the UK economy given its comparative advantage in the financial industry. Even if the trade regime ends up being ‘Canada-plus’ and includes some financial services, it is unlikely to be as advantageous as continued participation in the single market. Longer term, such a regime would imply sterling weakening to around 0.90-0.95 on the EUR/GBP exchange rate given the UK current account position.

ASSET ALLOCATION: WAITING TO ADD TO EQUITIES; ADDED TO UNDERWEIGHT DURATION

We are currently neutral on equities, but we are waiting for opportunities to add long exposure. We think the time might soon be right given our technical assessment of the recent correction in some markets, notably in Europe.

Regionally, we are looking to add exposure in Europe and Japan, where we are constructive over a six to 12-month horizon. We are less bullish on the US, mainly due to valuation considerations.

In core fixed-income markets we are slightly underweight. We believe that the risk-reward payoff is asymmetric as yields in some core markets, notably Germany, are too low relative to the fundamental drivers. Longer term, we are more neutral as we expect inflation to remain low and

demand from global investors (notably the official sector) to limit the upside potential for yields.

Over the past month, we have taken three active decisions in portfolios:

OPENED LONG EUR VERSUS GBP

As said, we see an eventual Brexit changing the trading regime between the EU and the UK, leading to higher tariffs than was the case in the single market and supply chain disruptions which will likely impair UK productivity. As a result, GBP should depreciate significantly against the euro. That adjustment has already started. EUR/GBP has rallied from below 0.80 before the June 2016 UK referendum on EU membership, but we expect a further rise to 0.94-0.96 post Brexit.

A ‘softer’ Brexit (as opposed to a ‘hard’ Brexit where only WTO rules govern trade) would still be disruptive and in the medium term, GBP would still undergo a significant depreciation as the most likely trade deal with the EU would be substantially less advantageous to the UK than being a member of the single market. The main risks to this position are a clear improvement in the eventual trade deal or a more hawkish Bank of England.

We initiated the position at half the intended size, leaving room to add to it in the case of a short-term pullback caused by factors that, in our assessment, are unrelated to our medium-term view of a weaker GBP.

REDUCED BUND DURATION

Bund yields were at 0.32% prior to the latest ECB meeting. At that time, we felt there was a reasonable chance that ECB rhetoric would turn hawkish and trigger a rise in yields. First, economic activity in the eurozone had continued to expand at a very healthy pace, which should help to close the output gap and restore upward pressure on prices. Second, we thought it was likely that the overly dovish message from the previous meeting which sought to avoid a market ‘tantrum’ would be beefed up and a change in tone would affect markets.

We tactically reduced duration in a number of portfolios. We recognise the risk that Bund yields could fall below 0.2%. At this level, we would feel comfortable about adding to our short exposure as long as the original rationale had not changed. Equally, we would be comfortable taking profits if yields rallied to 0.5%.

The main risks to the strategy are: (i) The ECB remains dovish or to the extent that it would turn hawkish, this was discounted already; (ii) European inflation continues to undershoot expectations; (iii) the US FOMC disappoints market expectations on monetary tightening and USD depreciates versus the euro.

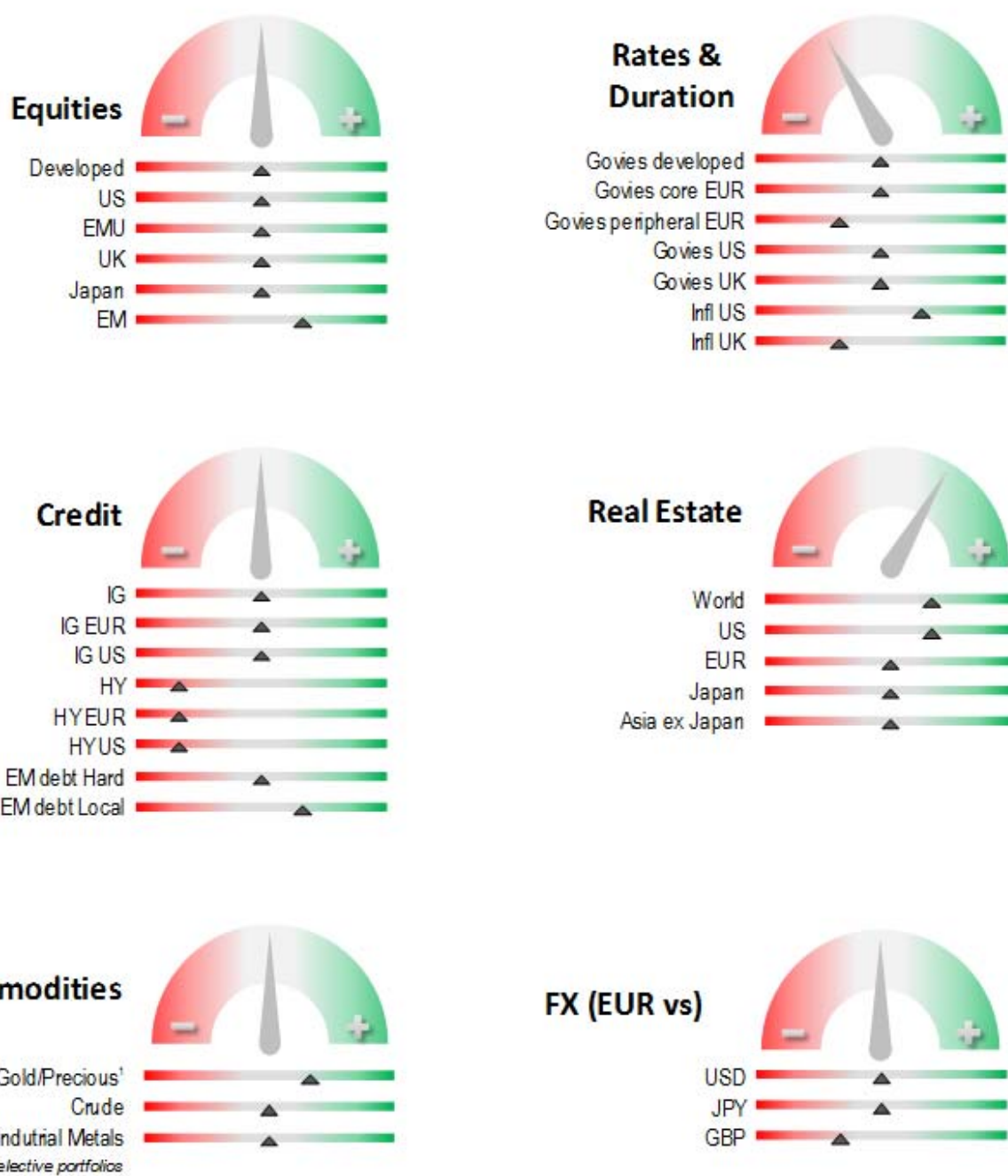
STILL POSITIVE ON EMERGING MARKET EQUITIES

We added EM equity exposure to our Parvest Multi-Asset Income Emerging fund¹. The main reasons are: (i) the macroeconomic backdrop is supportive of EM equities; notably, economic growth has room to expand further, while further tightening by the Fed is likely to be gradual in our central case of muted inflation; (ii) investor positioning and reasonable valuations mean that there is scope for the share of EM equities in global portfolios to increase; (iii) the MSCI EM equity index has fallen by about 5% from its late-November peak, marking the biggest pullback this year and offering us an opportunity to add to our long exposure.

Our constructive view on EM equities had already been implemented in a wide range of portfolios via a long EM equities versus US equities position in November. The main risks that could play against this strategy are an acceleration in US Fed tightening, weaker-than-expected growth in China and/or the US, and a stronger USD.

¹ Investments in the fund are subject to market fluctuations and the risks inherent in investments in securities. The value of investments and the income they generate may go down as well as up and it is possible that investors will not recover their initial outlay. Investing in emerging markets, or specialised or restricted sectors is likely to be subject to a higher than average volatility due to a high degree of concentration, greater uncertainty because less information is available, there is less liquidity, or due to greater sensitivity to changes in market conditions (social, political and economic conditions). Some emerging markets offer less security than the majority of international developed markets. For this reason, services for portfolio transactions, liquidation and conservation on behalf of funds invested in emerging markets may carry greater risk. For a complete description and definition of risks, please consult the last available prospectus and KIID of the funds, which are available from www.bnpparibas-am.lu.

ASSET ALLOCATION DASHBOARD²



² The dashboard shows the asset allocation in our portfolios and reflects the decisions of the Investment Committee of the Multi-Asset team at MAQS.

| | |
|--|-----------------------------|
| Equities: | Neutral |
| <p><i>Unchanged.</i> We remain neutral on equities, but would add to any long exposure on dips. We are constructive on European equities whose valuations are not high, in our view; also, the eurozone economic upswing should translate into strong earnings growth. We are constructive on Japan and EM markets over the medium term.</p> | |
| Government bonds: | Underweight duration |
| <p><i>Changed.</i> We remain strategically positioned for a progressive increase in interest rates globally, hence our outright underweight position. We have added to that position in recent days by going short Bunds as we seek to take advantage of the recent fall in Bund yields and the possibility of a more hawkish tone from the ECB in the months to come.</p> | |
| Corporate bonds: | Neutral |
| <p><i>Unchanged.</i> The slow pace at which central banks are unwinding their accommodative policies should contain the yields of high-quality bonds. High-yield could suffer as credit quality deteriorates in the context of a maturing credit cycle and very rich valuations. We are neutral on EM hard currency debt: valuations are high, but robust global growth and higher commodity prices justify the currently tight spreads. We are overweight EM local debt given its high real yields, the room for currency appreciation, and with low inflation allowing EM central banks to maintain their accommodative policies.</p> | |
| Real estate: | Overweight |
| <p><i>Unchanged.</i> We are overweight US real estate versus equities. Robust growth and its attractive discount to net asset values (NAV) are supporting the sector. Rising interest rates and yields are risks that we are willing to take at this point, given the positive factors. Our overweight acts as a hedge to market movements. It reflects the low valuation of real estate securities compared to more expensive broad equities.</p> | |
| Commodities: | Neutral |
| <p><i>Unchanged.</i> We are neutral on energy and base metals and have long gold positions. Late stages in economic cycles are typically good for commodities demand, but supply responses vary for energy and metals. In base metals, notably copper, there is limited room to add to supply, but prices have rallied materially. In crude oil markets, strong demand and OPEC production cuts are supportive of prices, but the ability of US shale producers to increase supply relatively quickly is limiting the upside potential for prices. For gold, higher US real interest rates and the US dollar are negatives, but gold is usually a good hedge when the need for risk aversion grows and/or inflation rises.</p> | |
| FX (EUR vs. USD, GBP and JPY): | Neutral |
| <p><i>Changed.</i> We took a long EUR/GBP position in November to reflect our view that the UK-EU trade regime after Brexit will likely be damaging for GBP, even though the market has taken a more constructive view (of a 'soft' Brexit) following the recent agreement of the exit terms between the UK and the EU. We are neutral on the EUR versus USD and the JPY.</p> | |

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