ASSET ALLOCATION FLASH

Multi-asset, Quantitative and Solutions (MAQS)

A technical rather than a fundamental correction

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FOR PROFESSIONAL INVESTORS

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SUMMARY

- **Global equities sold off aggressively** as higher bond yields finally dented January's sharp risk rally
- The sell-off was triggered by strong hourly earnings data in the US, but its magnitude appears to have been exacerbated by **technical market factors**
- **Solid growth fundamentals** and limited contagion from equity volatility to other markets such as rates, currencies and emerging markets (EM) are consistent with a technical dislocation in equity markets

ASSET ALLOCATION

- We **remain constructive on equity markets** where fundamentals are strong such as Europe, Japan and EM
- We **remain underweight fixed income** structurally given the risk of higher inflation and higher interest rates, but we have **taken profits tactically** after the sharp sell-off in Bunds

BNP PARIBAS ASSET MANAGEMENT

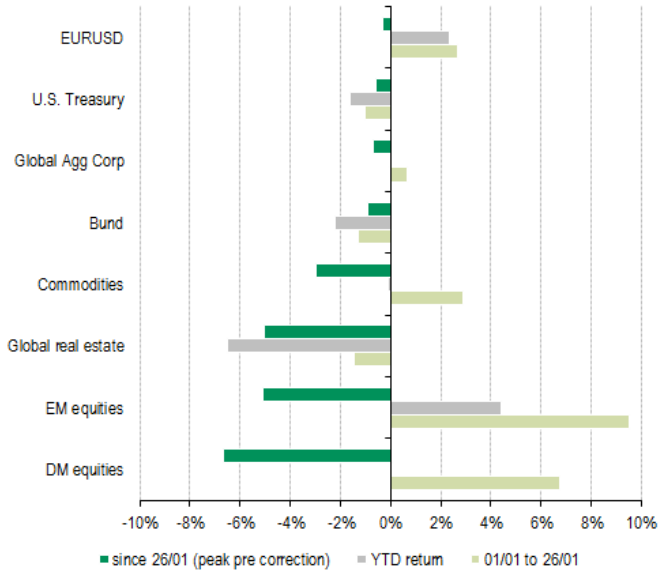
The asset manager for a changing world

A TECHNICAL RATHER THAN FUNDAMENTAL CORRECTION

2018 started on a very strong footing as financial markets priced in a reflation environment with both risky assets and bond yields rising for most of January. Most major equity markets started correcting in late January, but it was not until Friday 2 February that the correction in risky assets deepened. This followed an upside surprise in the latest data on average hourly earnings in the US, which rose to 2.9% YoY, beating consensus estimates of 2.6%.

The correction has been aggressive, but it has been concentrated in global equity markets (Figure 1). Indeed, the sell-off in other risky assets has been orderly. Government bonds had been falling over the course of the month and the equity plunge has so far not led to a typical 'flight to bond safety' as seen in recent years. The 4% fall in the US S&P 500 equity index on 5 February is the largest daily drop since August 2011 and the spike in US implied equity volatility (as reflected in the VIX index) was the biggest since April 2009.

Figure 1: February correction erases January performance mainly for equities



Source: Bloomberg and BNPP AM

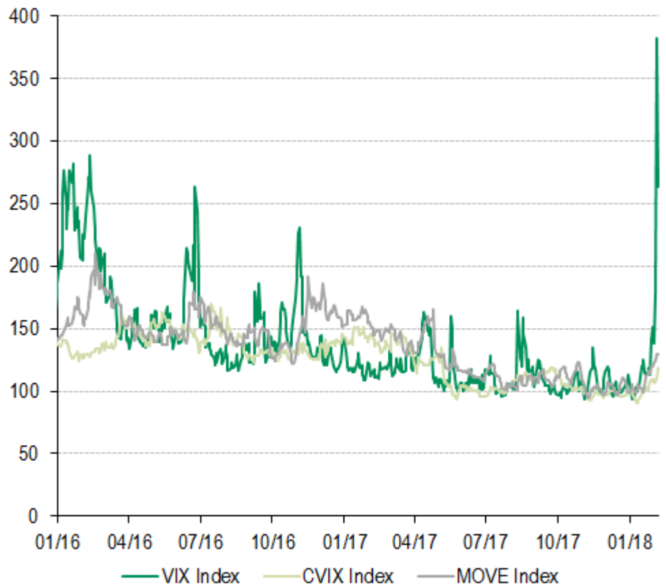
There are various reasons that make us believe that this correction is technically driven.

First, volatility in other markets has not spiked in a similar fashion. Rates and FX volatility, for example, had risen in January, but remain contained compared with the VIX (Figure 2). Other 'high-beta' assets such as commodities, EM currencies and bonds do not appear as dislocated.

Second, there is evidence that systematic strategies such as volatility targeting, risk parity, CTAs and short volatility are facing outflows as volatility rises.

Third, macroeconomic fundamentals remain on the whole robust. The strength in activity data is broad-based, with US and European puchasing managers' indices (PMIs) posting cyclical highs recently and EM GDP growth catching up with that in the developed world.

Figure 2: Volatility index VIX spiked sharply on the correction (index 01/01/2018=100)



Source: Bloomberg and BNPP AM

Inflation has remained low, but markets have fundamentally reassessed the inflation outlook. Under our central scenario ('Goldilocks'), we assume inflation in the US will close the year at 2.0%, while our main alternative scenario ('inflation surprise') assumes US inflation rises to 3.0% by the end of 2018. Given the recent compression of core yields, we believe some re-rating of fixed-income yields was inevitable, even in our central scenario.

We flagged the tension between robust fundamentals and fragile market dynamics in our 2018 Investment Outlook.

We noted that such tension could lead to sharp corrections and potentially a more defensive stance.

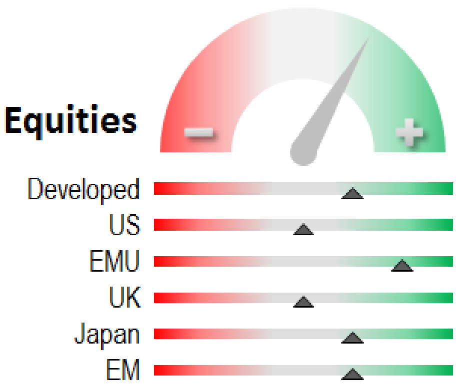
Following this correction, our view remains that it is too early to shift away from our central scenario or to call an end to the late-cycle expansion. We are still constructive on risk assets and would cautiously take the current correction as an opportunity to add long equity exposure in our portfolios.

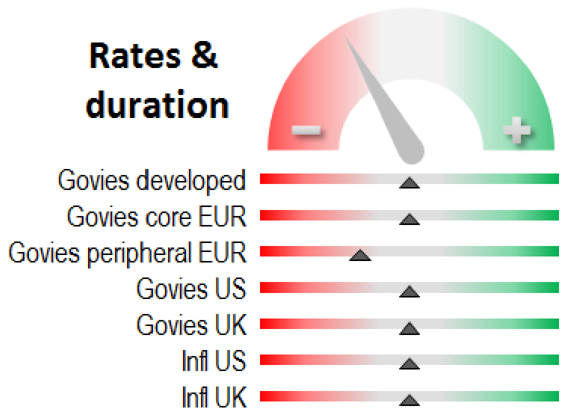
In particular, we would be looking for opportunities in equity markets where the correction is material and the fundamentals are strong such as in European equities. The EuroSTOXX 50 index is near technical levels that look appealing to us. The monthly series, for example, is close to the 20-month moving average (Figure 3). We also favour Japanese and EM equities. We remain underweight fixed income structurally given the risk of higher inflation and higher rates, but we have taken profits tactically after the sharp sell-off in Bunds.

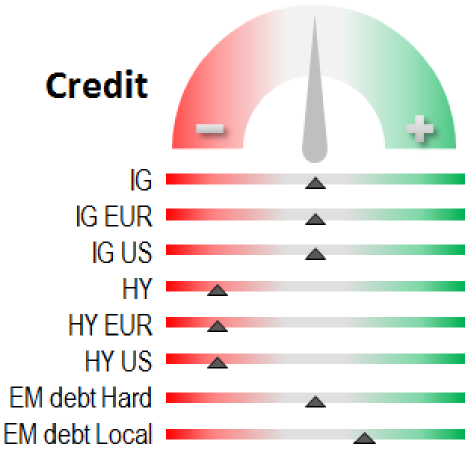
Figure 3: EuroSTOXX 50 down to 20 MA (monthly basis)

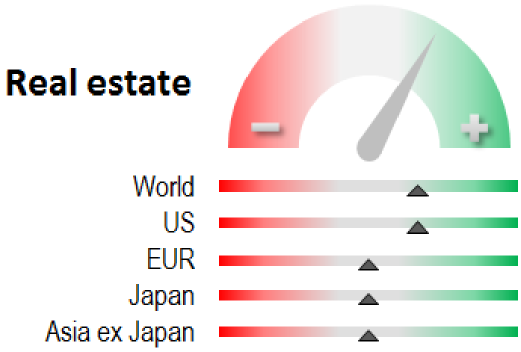
Source: Bloomberg and BNPP AM

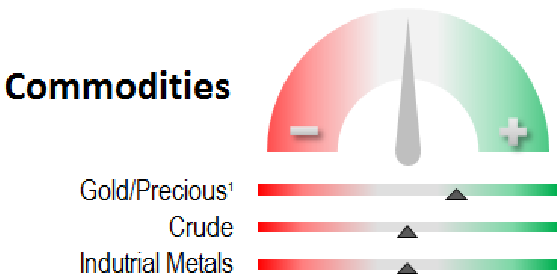
ASSET ALLOCATION DASHBOARD[1]



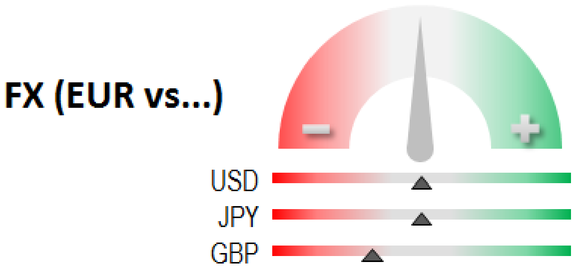








1: only selective portfolios



[1] 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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