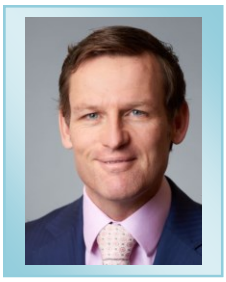
ASSET ALLOCATION MONTHLY

JUNE 2017

FOR PROFESSIONAL INVESTORS



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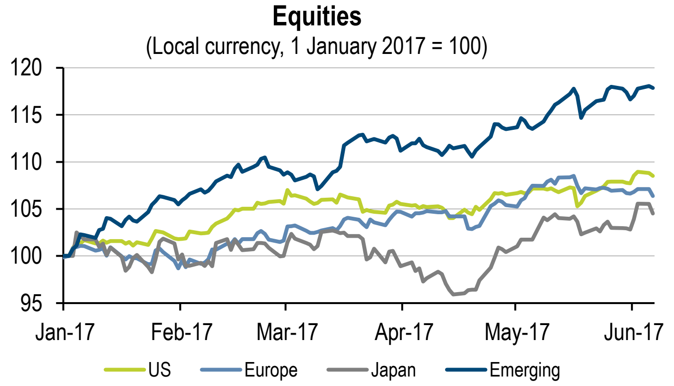
SUMMARY

- Inflation disappoints, but central banks carry on
- Is growth becoming more domestic?
- Now closed: underweight in developed equities
- Overweight real estate rotated from Europe to US
- Now closed: tactical short Bund duration and long Gilts versus Bunds

SUMMARY ASSET ALLOCATION

Multi-asset	Active weights May-17	Jun-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	🟢	🟡	⬇

Political turmoil in the US, new UK elections, the possibility of early Italian elections and central banks staying the course on monetary policy despite soft inflation numbers could not derail the equity rally, at least in US dollar terms.



Source: Datastream, BNPP AM

With the US dollar losing around 3% versus the euro, global equities were actually down by 1.3% in euros. We think that in general, equity markets are priced for a positive scenario for growth, inflation and earnings. Still, we have neutralised our equity underweight position. In real estate, we have shifted our overweight from Europe to the US.

CENTRAL BANKS STAY THE COURSE

Inflation has softened recently. In the US, the core CPI fell to 1.9% in April and the core PCE (the US Federal Reserve's preferred measure) slipped to 1.5%. There were temporary factors at work, but it was still the slowest pace of inflation since December 2015. In the eurozone, core inflation dropped to 0.9% in May and Japan's core CPI fell back into deflation in both March and April.

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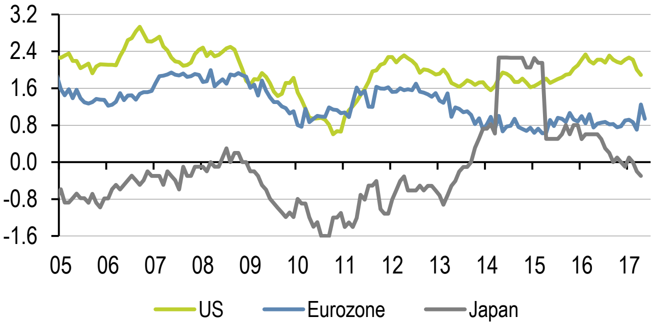
Inflation expectations, as measured by 5-year 5-year forward inflation swaps, have come down in the US and the eurozone. In China, where producer price inflation had surged to 7.8% YoY in February after years of deflation, it slowed to 6.4% in April. Producer prices typically follow commodity prices closely and this time was only slightly different: prices had increased by more than what was explained by commodity prices. Even so, the underlying trend had not been strong. Moreover, core consumer prices rose by just 2.1% in April.

Core CPI

(% YoY)



Source: Datastream, BNPP AM

In our view, this shows how difficult it is to create inflation. Even in the US and Japan, where the unemployment rate is close to record lows, wage inflation has been muted. There may be several reasons for this. One is that there is still slack in the economy which limits the extent to which producers can set higher prices or the ability of workers to demand higher wages. But given the shape of the labour markets in the US and Japan, one would expect some wage growth. Perhaps companies do not want to pay higher wages as long as productivity growth is muted. Foreign competition may also be fierce, while domestic competition may have been fired up by internet trading, which has made it so much easier for consumers to compare prices. Anyway, our conclusion is that the reflation story has suffered a setback.

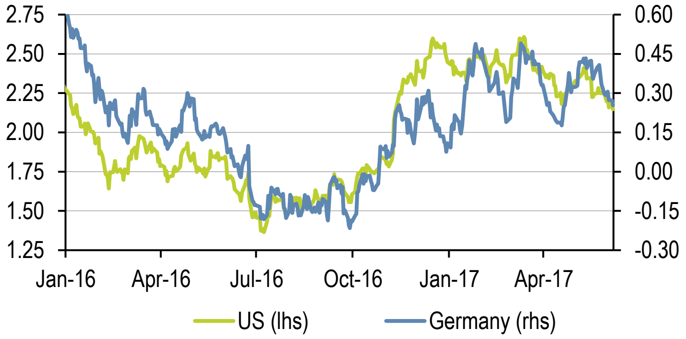
And yet, central banks do not seem to have changed their policies. Some policymakers at the Fed are concerned by the lower inflation and have said that if this persisted, it should have implications for the future path of interest rates. But the majority has stuck to the view that there will be two more rate rises this year. At the May meeting of the Federal Open Market Committee, policymakers agreed to gradually trim the Fed's balance sheet by setting slowly increasing limits for the amount of debt held by the Fed to roll off. In such an approach the amounts of debt reinvestment the Fed needs to do would gradually decline. According to the minutes of that meeting, nearly all policymakers agreed that, if the economy grows as expected, it should be appropriate to start reducing debt securities holdings this year.

At the ECB, the hawks have ruffled their feathers, but we still think that the bank will first have to establish that the risks it sees for the economy are now balanced. Currently, it sees those risks as tilted to the downside, but ECB president Draghi has acknowledged the outlook is improving. The ECB should also first remove the reference to 'lower interest rates if needed'. Those changes may come soon, to be followed by an announcement of the tapering of the ECB's asset purchase. That process may start next year. It may be well into 2018 before we see the first rate rise.

Japan's BoJ has stuck to its policy of keeping 10-year yields at zero, while in China the crackdown on shadow banking and interest-rate increases have continued.

Lower inflation and central banks in the process of or moving towards gradually removing extraordinary monetary stimulus have not missed their impact on bond markets. Add in political uncertainty in the US, the eurozone and the Middle East, and it is clear why bond yields have fallen. The US 10-year yield has broken out of its recent trading range to the downside. Germany's 10-year yield has fallen to the lower end of the range. The spread between two-year and 10-year yields in the US has fallen to below the levels seen before last November's US presidential election.

Ten-year yields

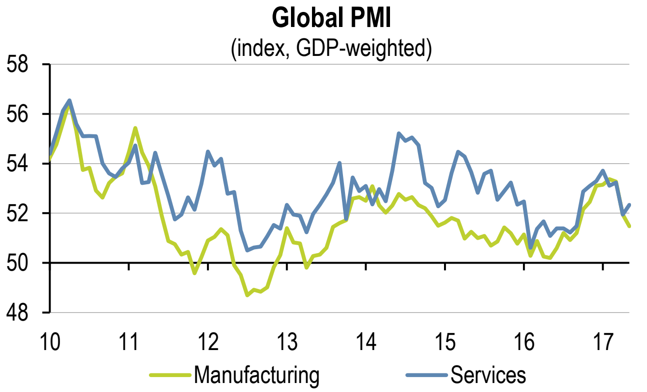


Source: Datastream, BNPP AM

Equities have hardly suffered. Perhaps the prospect of a goldilocks scenario with decent growth, low inflation and low interest rates has been enough to keep the rally going. Financials have lagged as a result, although energy did even worse as oil prices fell.

GROWTH: CHANGES UNDERWAY?

Global PMIs continue to signal a positive outlook for the world economy. Our GDP-weighted composite PMI rose to 53.4 in May, its highest since January 2014. This was driven in particular by the composite PMIs in eurozone countries. Looking beyond the headlines, we are seeing some subtle changes. Services sectors looked buoyant in most countries for which this data is available, with the exception of Brazil, where the index fell to below 50. But manufacturing PMIs, which are available for a much broader range of countries, slipped marginally in developed economies and emerging markets. China's official manufacturing PMI held steady after a fall in April, but the Markit manufacturing PMI slipped to below 50, feeding market concerns about the outlook for this country.

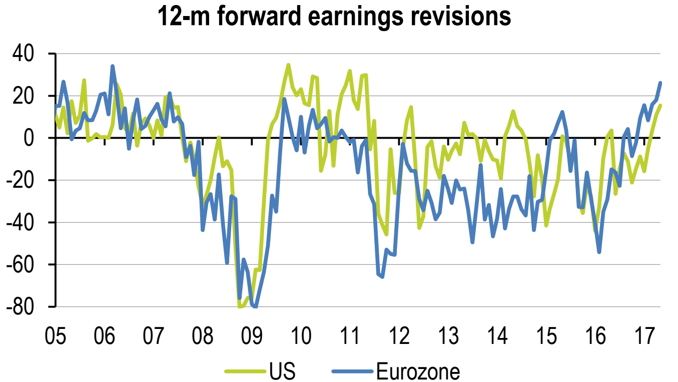


Source: Markit, BNPP AM

Leaving aside the availability of data, a shift from manufacturing to services may have implications. Trade growth, which had accelerated recently and was part of the reflation story, may slow again. There are tentative signs that this is already happening in emerging markets. This could have an impact on industrial production, where growth is typically more cyclical than in the services sector. In the eurozone the leading indicators are super strong, while tailwinds for the economy such as the sharp drop in energy prices and in the euro in 2014, which supported growth in 2015 and 2017, are fading. In the US employment growth disappointed in May, while orders and shipments of durable goods have basically moved sideways for two months now. We do not want to argue here for a sharp slowdown in global growth, but we do want to warn against overly optimistic views.

EQUITIES: UNDERWEIGHT CLOSED

In our asset allocation we have closed our equity underweight. This long-standing strategy has obviously been a drag on performance, although at several points we hedged it with options strategies. Anyway, our fundamental views on equities have not changed. We think equities are expensive, especially so in the US. On several current valuation measures, US valuations are more than one standard deviation above their five-year or long-term average. When we look at forward PEs and relate those to nominal or real interest rates, we come to the same conclusion: equities are priced for a very positive growth and inflation scenario. However, markets have ignored valuations and have continued to move higher. Upward revisions to earnings estimates have been supportive.



Source: Datastream, BNPP IP

We think that earnings expectations are high, especially in the UK. So we have kept our underweight in UK equities versus the eurozone. This strategy did well initially, but uncertainty over the general election and signs of a slowing economy have undermined the British pound, which has actually supported UK equities. In our asset allocation we are now neutral on the US and Japan, overweight the eurozone and underweight the UK.

OVERWEIGHT REAL ESTATE ROTATED FROM EUROPE TO US

In real estate we have taken profits on our overweight in Europe. In an improving economy with still low rates, the asset class had done well. Since eurozone real estate now looks even more expensive versus its net asset value, we decided to take profits. In the US valuations look attractive and demand should continue to improve given the robust labour market and other demand indicators. New supply is limited, which should also benefit the asset class. Higher interest rates are a risk, but given the positive factors just mentioned, we are willing to take it.

ASSET ALLOCATION[1]

Multi-asset	Active weights		Δ active
	May-17	Jun-17	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		Δ active
	May-17	Jun-17	weight
European large caps	🔴	🟡	⬆
European small caps	🟡	🟡	➖
US large caps	🔴	🟡	⬆
US small caps	🟡	🟡	➖
Japan	🔴	🟡	⬆
Emerging markets	🟡	🟡	➖

Real estate	Active weights		Δ active
	May-17	Jun-17	weight
European real estate	🟢	🟡	⬇
US real estate	🟡	🟢	⬆
Asian real estate	🟡	🟡	➖

Fixed income	Active weights		Δ active
	May-17	Jun-17	weight
Euro govies	🔴	🔴	➖
Euro short dated	🟡	🟡	➖
US Govies	🟢	🟢	➖
Inflation linked (EUR)	🟡	🟡	➖
Investment grade (EUR)	🟡	🟡	➖
High Yield (EUR)	🟡	🟡	➖
Investment grade (USD)	🟡	🟡	➖
High Yield (USD)	🔴	🔴	➖
Emergin market debt hard currency	🔴	🔴	➖
Emergin market debt local currency	🟢	🟢	➖

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

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

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[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

Changed. Some fundamental factors are keeping us cautious. We think valuations are rich and earnings expectations are high. However, markets have ignored this and with positive earnings momentum in the eurozone and an increasing number of analysts upgrading earnings expectations for the eurozone and the US, we do not see an imminent catalyst for a downtrend in developed equities. We think consensus earnings expectations for UK companies are too high though. Given the positive factors for the eurozone, including the economic cycle, monetary policy, earnings momentum and earnings revisions and market momentum, we are overweight eurozone equities versus the UK. We are neutral on the US and Japan.

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: Short duration

Changed. Lower-than-expected inflation date has raised questions about the reflation narrative. This has caused US Treasury yields to fall to below the trading range that had been in place since the US presidential election. With the short end of the yield curve higher after the Fed’s recent rate rises and with more tightening to come, the curve has flattened. In Germany, developments are comparable, although more muted. Political risk in Italy has pushed bond spreads versus Bunds back above to 200bp. Given the generally low level of yields versus real growth and inflation, we are structurally short duration. We closed our tactical short Bund duration after yields had increased early May. We also took profit on our long Gilts versus Bunds after spreads had narrowed while macro factors had become somewhat more favourable for Bunds.

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 remain historically low in general. However, the currently low yields entail a risk of an asymmetric payoff. If the global economy strengthens and inflation sets off, government bond yields may rise, pushing up investment-grade yields. In an economic slowdown, credit may suffer from wider risk spreads, pushing yields higher.

High-yield bonds: Underweight

Unchanged. Spreads have narrowed 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 reached extreme levels. 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 or pressure on global growth from protectionism or a downturn in China.

Emerging market bonds: Neutral

Unchanged. We are underweight hard currency emerging market debt, but overweight local currency bonds. We think sovereign balance sheets have not improved by much, which does not justify the relatively low spreads on hard currency debt. We think valuations are more attractive in local currency bonds. If emerging currencies continue to appreciate, this should benefit local currency bonds. Central banks in some large issuing countries are cutting interest rates, which should further support local currency bonds.

Real estate securities:	**Overweight**
Changed. After the strong performance of European real estate, valuations have become extreme, in our view. We therefore decided to take profits on our overweight. In the US we see valuations as less demanding and even positive, while the balance of supply and demand also looks supportive. Rising interest rates and yields are a risk for the asset class that we are willing to take at this point given the positive factors. Setting up this strategy versus government bonds should mitigate the interest-rate risk in real estate.	
Commodities:	**Neutral**
Unchanged. Oil prices have remained choppy. Since the end of February, Brent oil prices have 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 inventories in the US are high. So 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.	

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