FOR PROFESSIONAL INVESTORS – 20 April 2020

ASSET ALLOCATION FLASH

BNPP AM – Multi Asset, Quantitative and Solutions (MAQS)

WAITING PATIENTLY TO ADD TO RISK

MONITORING THE VIRUS & ITS IMPLICATIONS

- **Tracking the virus:** Infections and fatalities due to COVID-19 appear to be past the peak in the Western world. The next hurdle for the authorities is deciding whether they can successfully ease lockdown restrictions.
- **Economic disruption and resumption:** Data shows significant damage in major economies, where the impact has surpassed analysts' expectations.
- **Policy responses:** More support is on the way as the US Federal Reserve commits to high-yield bond purchases and China ramps up fiscal easing. EU leaders have agreed on further support, but their efforts fall short of agreeing on a jointly guaranteed fiscal scheme (Eurobonds).
- **Sentiment and systemic market stresses:** Policy support is helping market volatility to fall. Weak economic data and easing lockdowns are the next test.

KEY VIEWS & ASSET ALLOCATION

- **Fundamental views:** Our base case is a recession in H1 and a gradual and bumpy recovery in H2. Such a U-shaped recovery will likely involve 'learning to live with the virus' via innovations in testing and a gradual economic resumption. The main downside risk stems from long and intermittent shutdowns that prolong a global recession. A bullish scenario would involve rapid progress on virus control and an economic resumption that leads to a healthy reflationary environment.
- **Strategy:** Our assessment of fundamentals and market dynamics suggest equity upside over the medium term. However, after a sharp rally from the March lows, we believe a setback is likely as markets assess the damage to economic and earnings prospects. We see core bond yields as asymmetric to the upside in the medium term given the current historically low yields and the aggressive fiscal easing measures.
- **Asset allocation:** We lowered our *Market Risk* exposure with a short in S&P 500 and by taking profits on our EMU equity overweight. We entered an overweight in EUR and USD investment-grade credit (vs. government bonds) and increased our short EMU government bond trade conviction. We closed a REITS RV trade.

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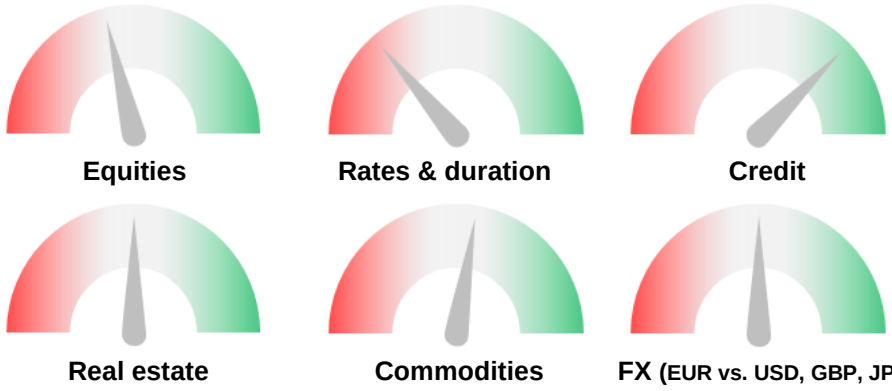
Core asset class views*



Risk utilisation**

* The core asset class views dashboard reflects the key views of the Investment Committee of the Multi-Asset team at MAQS. Other specific/tactical trades may be implemented in addition and are listed at the end of this publication. ** Risk utilisation/active risk is a measure of the tracking error (as a % of maximum tracking error) of an unconstrained theoretical portfolio, derived from core asset class views and from additional specific/tactical trades.

FUNDAMENTALS: MONITORING 4 PILLARS

We are monitoring the crisis via four key pillars: virus evolution; economic disruption and resumption; policy responses; and markets stress. To identify important turning points, we find it helpful to follow these pillars along five key phases. The first phase was market panic and a sharp unwinding of risk exposures. The second phase was aggressive policy support notably by the US Federal Reserve and the US Treasury. The third phase was virus control and lockdowns. The fourth is the assessment of the economic damage, and the fifth one is exit-strategies and 'learning to live' with the threat of the virus.

Figure 1: Phases of the crisis – currently assessing the economic damage (shaded column)

	Panic/risk-off	Policy support	Virus control	Economic damage	Exit-strategies
Virus evolution	Virus spreads beyond Asia	Infections soar in Western world	Infections reduced with lockdown	Assessing when to exit lockdowns	Asia ahead, western world to follow. News of tests/cures?
Economic disruption/ resumption	Little data available to assess damage	China PMIs hit, but activity resuming	Damage visible in Western world	Assessing extent of the damage	More clarity on regional differences
Policy responses	Aggressive Fed cuts	ECB PEPP, Fed open-ended QE. Aggressive fiscal	EA lacks fiscal backstop	China plans more fiscal	Will policy work? Debt monetisation?
Markets confidence -stress	Markets dysfunctional / liquidity dries up	Markets numb but more functional	Functional markets, vol far from lows	Will vol spike with bad macro news?	Risk of another relapse if exit strategies fail

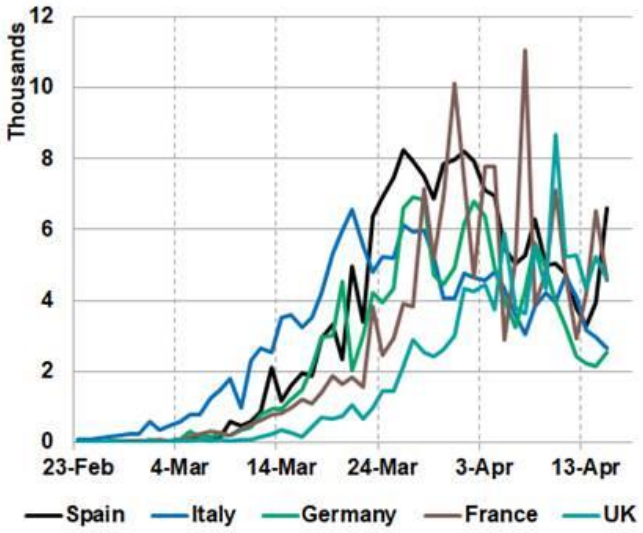
Source: BNPP AM, as of 20/04/2020

We believe we are currently in the transition from 'virus control' to 'assessing the economic damage' from the crisis. So far, the combination of policy support and the perception of virus control in the Western world is giving risky assets a boost. However, we don't think we are out of the woods because there is huge uncertainty about the economic damage. We are only starting to learn about it now. Another source of uncertainty is the risk of another spike in contagion and infections, especially if the Western world decides to relax the lockdowns too soon. Both the extent of the economic damage and the success of exit strategies will be important to assess the direction of financial markets.

Virus evolution: from virus control to exit strategies

The main news in terms of virus evolution in recent weeks has been that the number of infections and fatalities appears to have peaked in Europe. Italy and Spain have been the two countries most affected and we have seen a significant drop both in new infections and deaths. Figure 2 shows that these trends are also visible in other large European economies.

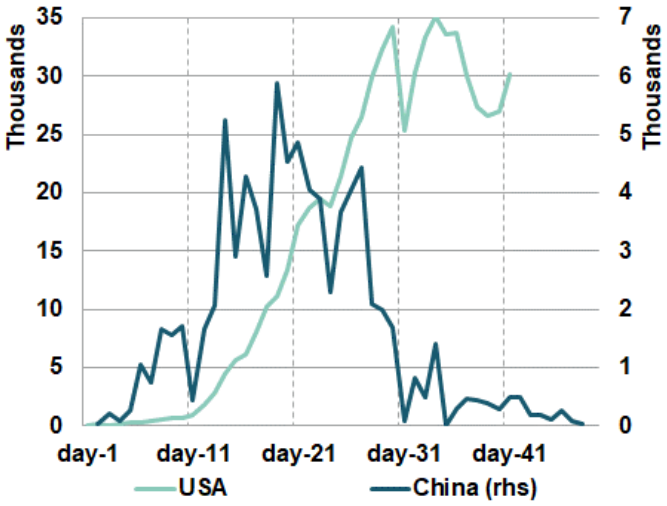
Figure 2: New infections in Europe falling since early April



Source: worldometers.info and BNPP AM, as of 17/04/2020

Over in the US, infections and fatalities also appear to be stabilising, albeit at high levels (Figure 3). This tentative turn is certainly giving markets a sense of direction. Finally, in Asia, there has been a small rise in infections mainly due to people coming from abroad. Stricter controls have been implemented in some countries, but in general, these are far from the severe lockdowns that are in place in the Western hemisphere.

Figure 3: New infections in the US stabilising at high levels



Source: worldometers.info and BNPP AM, as of 17/04/2020

To the extent that infections and deaths continue on a downward path, the discussion on the virus evolution is likely to shift towards the timing and the key elements of various exit strategies, including news on medical innovations and testing.

In terms of exit strategies, Germany is ahead in Europe: the authorities have announced that schools will reopen in May. In

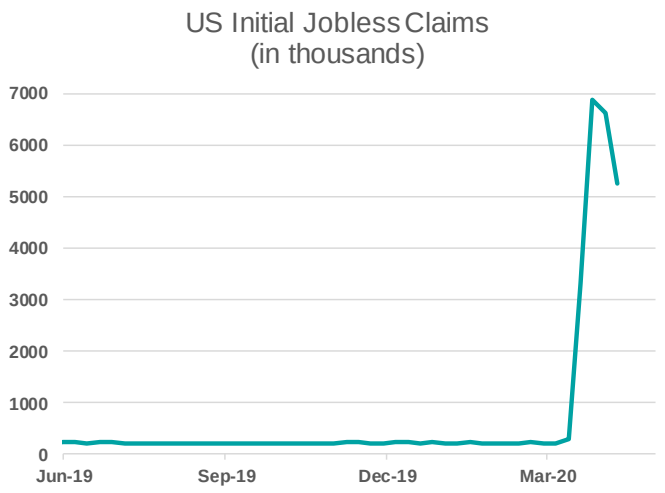
the US, President Trump announced a plan to ease the lockdown and resume business activity. The plan consists of three phases and gives guidelines to states on how to ease restrictions conditional on progress in virus control. In terms of medical innovations, a vaccine would be a game changer, but while there is news of progress, it is unlikely that one will be ready very soon. We expect news on innovations in testing, including greater availability of tests, sooner than news on a vaccine.

Macro disruption and business resumption: larger-than-expected economic damage

The uncertainty around the economic damage from the corona shock is still huge. As we enter the 'assessing the damage' phase, market participants including ourselves are learning quickly about the negative impact that the shutdowns are having.

Most of the attention has been on the US where the damage so far is huge. Jobless claims data, which reflect new unemployment insurance claims, has soared to unprecedented levels in the last three weekly reports (Figure 4).

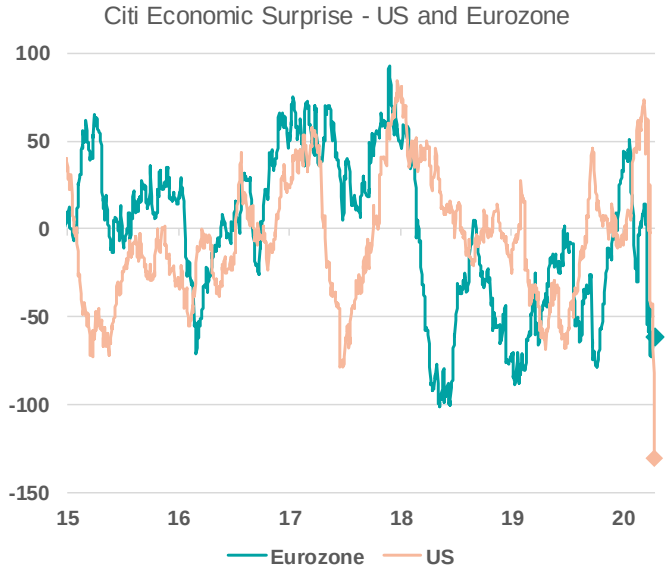
Figure 4: An unprecedented spike in US jobless claims



Source: Bloomberg and BNPP AM, as of 20/04/2020

A gauge for how deep the cracks are in the US economy is the fact that economic data surprises have been sharply negative since March. Indeed, the negative surprises are the worst in the last five years and not far from the levels reached in the global financial crisis. Surprises are also negative in the eurozone, albeit less dramatic relative to those in the US and to recent history (Figure 5).

Figure 5: US economic surprises deeply negative



Source: Bloomberg and BNPP AM, as of 20/04/2020

Another area of market focus will be the effect of the shutdowns on corporate earnings. We are early into Q1 reporting in the US, so we don't have the full picture yet. With only 40 companies having reported so far, surprises have been negative only for US financials. The remaining five (broad) sectors have seen positive surprises (relative to consensus expectations of -10% EPS growth for Q1). In the case of financials, profits have been dented by the large provisions for credit losses expected in Q1.

We have repeatedly made the point that business activity is resuming gradually in China. This is the result of the aggressive and quick shutdown that was put in place early in the year in various parts of the country. China, and Asia more generally, is clearly ahead in terms of returning to a 'new normal'.

The extent of the economic disruption globally is also apparent in the dislocation in crude oil markets. The fact that OPEC and Russia (also known as OPEC+) didn't initially agree on production cuts meant that the oil markets experienced a negative supply and demand shock. Over the last couple of weeks, prices have remained under pressure despite a new global production deal that would involve both OPEC+ and the G20 countries.

Indeed, last week, OPEC+ committed to a 10mb/d cut, while G20 ministers agreed to cut a further 5 mb/d. Given the difficulty for most producers outside of core-OPEC to implement large cuts rapidly, the agreement leaves the G20 cuts as too little to stabilise the market. Ultimately, we believe low oil prices will force all producers to contribute to the market rebalancing. And as expectations for crude demand recover, we expect oil prices to bounce back in the months to come.

Policy responses: more fiscal initiatives and central bank support in major economies

Since our latest update, the Fed has increased its support to US markets, this time by committing to buy high-yield corporate debt and ETFs. This is a bold move. Only a few weeks ago, the Fed technically lacked the ability to buy any corporate debt, let alone junk bonds. The high-yield ETF (HYG) has rallied sharply as a result (Figure 6).

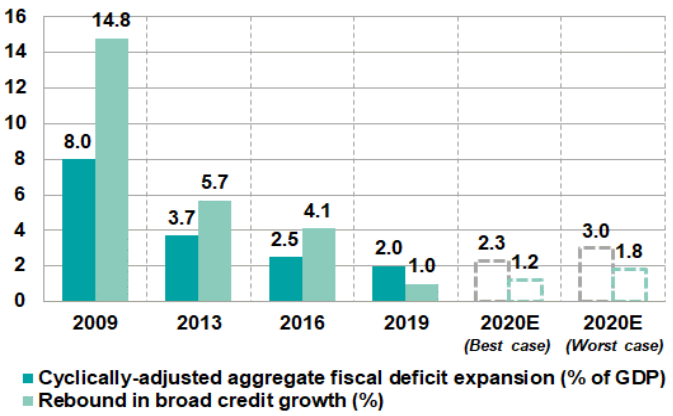
Figure 6: US HY credit ETF rallied sharply on Fed support

Source: Bloomberg and BNPP AM, as of 20/04/2020

If China has led in terms of virus control, it has lagged in terms of aggressive policy responses. The main reason is that China's stimulus has been targeted in order to avoid taking excessive debt. More recently, however, there have been signs that China is ramping up its fiscal policy action. News reports suggest this will be a combination of support for SMEs and consumers, new infrastructure projects and other investment initiatives such as incentives for the electric vehicles industry.

The fiscal expansion in China is already visible in the increase in lending (also known as total social financing) which rose by 12% y/y in March. This new round of fiscal stimulus will not be as aggressive as those in previous cycles, but it will be large enough to support domestic demand and commodity prices (Figure 7).

Figure 7: China's fiscal expansion matters but is unlikely match previous fiscal efforts



Source: Morgan Stanley and BNPP AM, as of 20/04/2020

In the Europe, the Eurogroup finally agreed on a EUR 500 billion package via the ESM bailout fund. It took a few days of tense negotiations, but it remains to be seen whether the package will sooth some of the fears of global investors, notably a revival of eurozone break-up risk. We see this agreement as kicking the can down the road since it doesn't really represent a true fiscal backstop such as jointly issued debt guaranteed by the member states (Eurobonds).

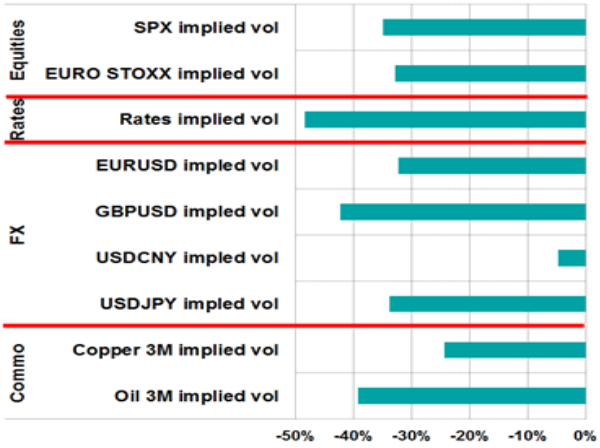
So far, break-up risk has remained contained (e.g. the EUR hasn't weakened materially). The cracks are more evident in Italian sovereign debt (BTPs) where spreads over German yields have been widening again despite an aggressive ECB asset purchase programme, the ESM deal, and other initiatives by the European Commission and the European Investment Bank. In our view, the acid test will be the risk to debt dynamics associated with the stagnation in Italy and potentially Spain.

Last but not least, global policy responses aimed at emerging market economies are finally on the way. The IMF has estimated that EM economies will need to spend USD 2.5 trillion in economic and healthcare aid packages to protect their economies and citizens from the coronavirus. Over 90 EM economies are in discussions with the IMF on access to lending facilities (which currently stand at USD1tn) and there are calls for additionally resources to be made available to the IMF (proposals have ranged from boosting the IMF's SDR capital by USD 400 billion-600 billion).

Sentiment and systemic market stresses: signs of more functional markets

As explained earlier, the first phase of the crisis was associated with panic and sharp risk reduction, so much so that it dislocated markets. Liquidity dried up and volatility spiked higher. Markets became more functional and volatility started to drop with the transition to the 'aggressive policy responses' phase. In fact, since the US equity market low at around 23 March volatility metrics have fallen materially in most asset classes (Figure 8).

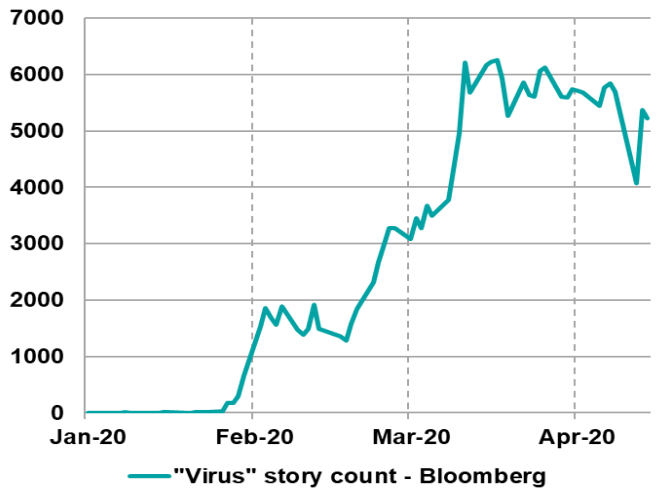
Figure 8: Volatility continues to fall across asset classes



Source: Bloomberg and BNPP AM, as of 17/04/2020

The sense of panic in the market was also evident in other indicators. A simple word count for 'virus' in Bloomberg news stories, for example, showed a huge increase as the crisis evolved. This has only started to stabilise from mid-March, coinciding with policy support and the drop in market volatility (Figure 9).

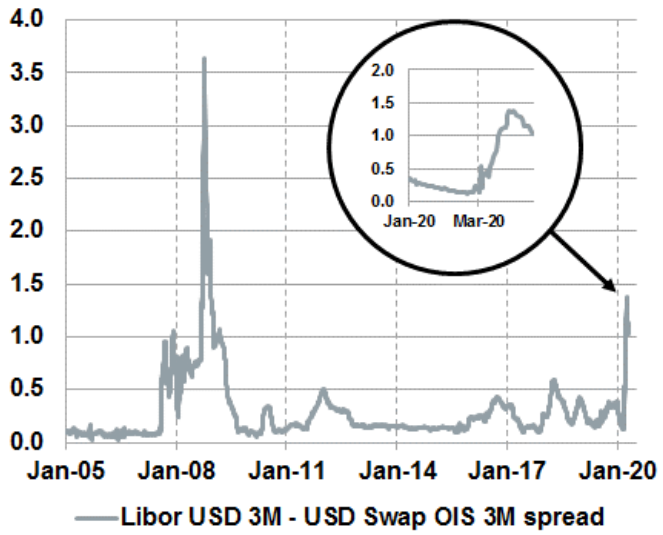
Figure 9: Word count for 'virus' in news stories gradually falling



Source: Bloomberg and BNPP AM, as of 20/04/2020

Other indicators of market stress such as stress funding markets captured, for example, by Libor vs. OIS spreads also spiked higher as the crisis heightened, but they have started to stabilise recently (Figure 10).

Figure 10: Measures of systemic stress easing: Libor-OIS



Source: Bloomberg and BNPP AM, as of 20/04/2020

Overall, this suggests that market measures of systemic stress are starting to ease, even if they remain at levels that are high relative to pre-crisis norms.

MARKET DYNAMICS INPUTS

Besides our fundamental views, our 'market dynamics' inputs form the other major pillar in our investment process. This pillar is split into our proprietary 'market technical' and 'market temperature' inputs, forming a helpful addition in timing markets alongside our fundamental views.

Overall, 'market dynamics' are suggesting that the medium-term risk/reward for risky assets has become attractive again after the recent sell-off, but in the short term, there is a risk of a setback.

Market technicals

In our market technicals toolbox, we monitor markets through the dynamics of prices in multiple timeframes.

For equity markets, the medium to long-term timeframes had been bullish for some time and continue to be so for now. On daily dynamics, most markets bounced from the critical levels in the bottomish configurations reached during the accelerated sell-off in March. After a rapid rally, the short-term technicals are flagging a possible leg down in the very near term.

For commodities and commodity-related markets, our technical signals have started flagging interesting opportunities as they suggest a high likelihood of a major reversal and thus a medium-term opportunity to buy commodity assets (crude oil, copper) and commodity currencies (especially the AUD vs. USD).

The long-term bearish cycle on commodities wasn't completed during the concerns over a hard landing in China in 2016, but it is now showing signs of exhaustion. Interestingly, in equity RV space, the technicals also flag an opportunity to be long UK equities vs. other developed markets, especially US stocks. This is in line with the trends seen for commodity markets.

Finally, for core fixed income markets, the technicals still flag a move higher in yields in the medium term, but there are no clear directional signals for the short term.

Market temperature

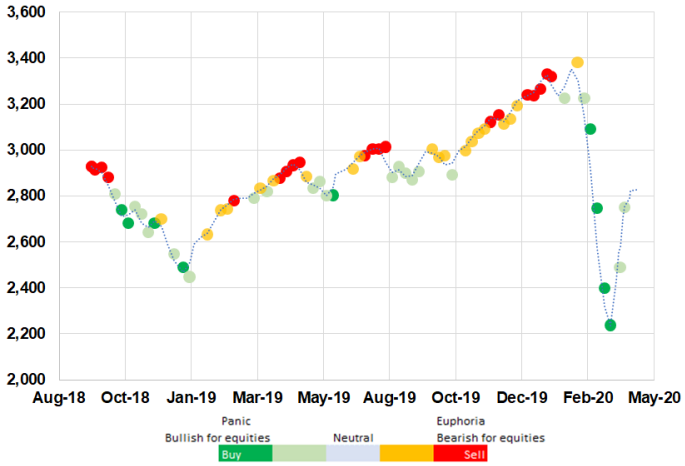
Sentiment, positioning and other statistical indicators underpin our 'market temperature' framework.

Regular readers will recall that we had warned not to chase markets higher in January as our assessment of the market's temperature was 'hot', or dark red – usually an environment prone to corrections.

Since then, the market temperature went all the way to 'dark green', which is usually a contrarian buy signal. Indeed, the selloff in March had all the ingredients of a panic event with several 'temperature' indicators reaching multi-year records. The configuration was comparable to the one seen in November 2008, with signs of capitulation emerging across markets.

In the sharp bounce since the market bottom, the temperature has become light green, marking a less aggressive buy signal (Figure 11).

Figure 11: Market temperature light green



Source: Bloomberg and BNPP AM, as of 17/04/2020

KEYS VIEWS & ASSET ALLOCATION

Our base case is a recession in H1 and a gradual and bumpy recovery in H2. Such a U-shaped recovery will likely involve 'learning to live with the virus' via innovations in testing and a gradual economic resumption. The main downside risk stems from long and intermittent shutdowns that prolong a global recession. A bullish scenario would involve rapid progress on virus control and an economic resumption that leads to a healthy reflationary environment.

In this uncertain environment, we remain nimble in our approach, using both the fundamental and market dynamics pillars of our investment process to identify opportunities, both in the short and medium term.

We think that equity prices have room to rally further in the medium term under our base case. In the near term, however, after the sharp rally in recent sessions, a setback is possible as markets assess the damage to the economic and earnings prospects and the risk of a relapse in the spread of the virus.

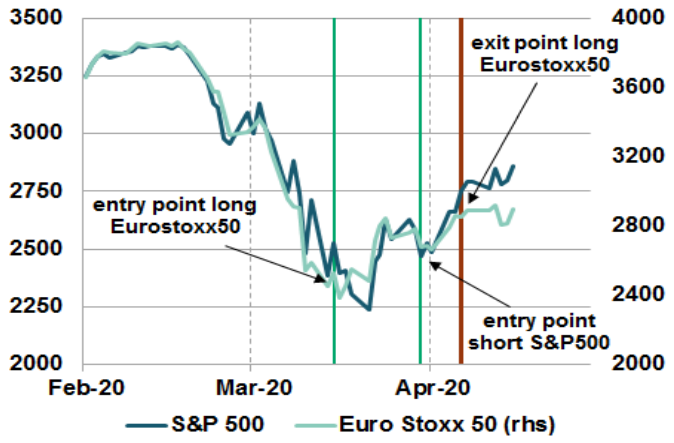
Elsewhere, we see core bond yields as asymmetric to the upside in the medium term given the currently historically low yields and the aggressive fiscal easing.

Recent changes to positioning

We made several changes to our asset allocation since our *Asset Allocation Flash* on 30 March.

First, we reduced our *Market Risk* exposure by introducing a short on the US S&P 500 equity index and by taking profits on our EMU equity overweight (Figure 12). We also took profits on two call spread structures in US and European equities.

Figure 12: Recent price action in S&P 500 and EuroSTOXX

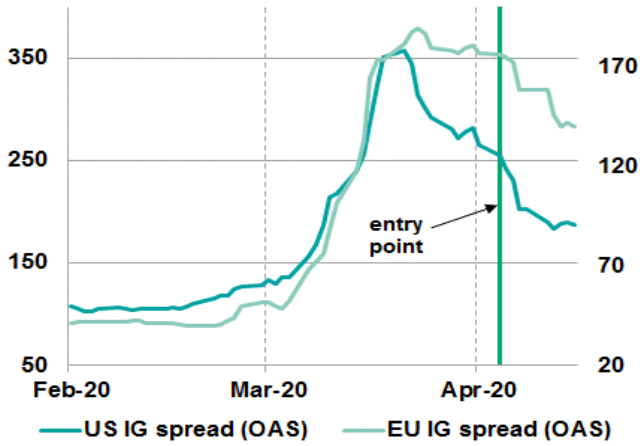


Source: Bloomberg and BNPP AM, as of 17/04/2020

As said, we see a high risk of a short-term setback given the sharp rally recently. Our net equity exposure is now slightly negative. We still hold risk exposure via long commodity-linked assets such as UK equites, global commodities and a long AUD/USD. We remain overweight EM equities.

Elsewhere, we recently bought investment-grade corporate bonds in the US and Europe. As the Fed and the ECB are prepared to buy IG credit under their QE programmes, we see the asset class as a close substitute for government bonds in terms of safety, but one with much more attractive expected returns, especially given the recent widening in spreads (Figure 13). We think that in a balanced portfolio, it makes sense to switch exposure from government bonds to IG credit.

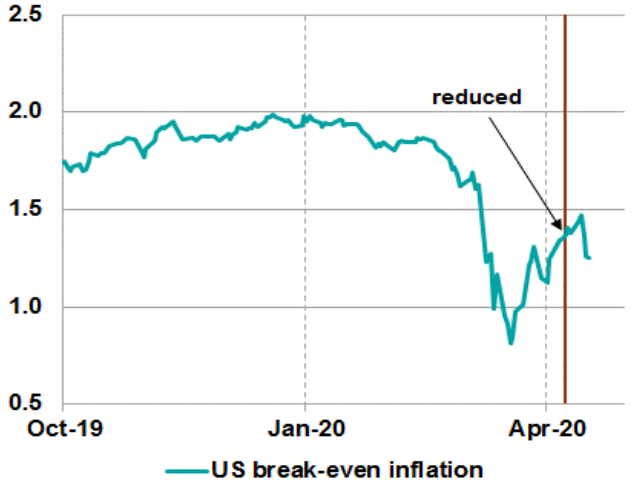
Figure 13: IG credit spreads falling with central bank support



Source: Bloomberg and BNPP AM, as of 17/04/2020

In government bond space, we slightly increased our conviction on our EMU bond short and still see core yields as asymmetrically skewed to the upside due to the large-scale fiscal policy measures and the chance of increased bond issuance. Elsewhere, after a quick comeback, we reduced part of our exposure to US breakeven inflation (Figure 14).

Figure 14: US breakeven inflation starting to recover



Source: Bloomberg and BNPP AM, as of 17/04/2020

Finally, we cut our EMU REITS RV trade (vs. EMU equities and bonds) as we think the REITS sub-asset class would be at risk in a 'higher core yields' scenario.

Current asset allocation stance

Equities: we are long UK and EM equities, but have a tactical short in US equities against that, leaving us net short equities currently.

- **Rationale:** UK and EM equity valuations are historically attractive and have opened up more than for US equities. China is more advanced that the Western world in terms of business resumption and it is an important source of demand for commodities. Both UK and EM equities are directly linked to China and commodities.

Government bonds: we are short core EUR bonds, we are long US breakeven inflation, short USTs via options and in USD curve steepener via options.

- **Rationale:** core yields are close to historical lows. Central bank purchases will try to contain yields, but they can easily rise as they price huge fiscal policy expansion and increased bond issuance. Yields could also rise if the fiscal and monetary boost results in inflation and not growth.

Credit: we are long USD and EUR investment-grade credit (funded with government bonds).

- **Rationale:** ECB and Fed support to IG credit make the sub-asset class a high-quality substitute for government bonds. It has room to rally following the March market dislocation.

EM: we are long emerging market USD debt.

- **Rationale:** EM hard currency debt is the safest sub-asset class within EM and the crisis has made valuations appealing with spreads at about 600bp over UST yields. Despite aggressive global policy stimulus, more stable commodity prices and an early recovery in China (helped by fiscal stimulus) should support the asset class.

Long commodity assets: we are long aggregate commodities (ex Ags) and long AUD/USD. Separately, we still see gold as an attractive asset and are long the yellow metal.

- **Rationale:** Cyclical commodities are at levels not seen since the 1970s and they usually outperform in the early stages of a recovery. The agreement between OPEC and Russia (OPEC+) and the G20 countries to cut crude production should help the oil market in the medium term, making the upside attractive as demand recovers. Gold should be seen as a currency that cannot be debased by central banks and one that is a good hedge against the risk of a more inflationary world.

PORTFOLIO CORNER

Risk utilisation

The active risk in our portfolios is currently at around 51% of our target (Figure 15). In recent days, we reduced our risk utilisation as we closed our EMU equity overweight.

Figure 15: Current level of active risk*

* Risk utilisation/active risk is a measure of the tracking error (as a percentage of maximum tracking error) of an unconstrained theoretical portfolio, derived from core asset class views and from additional specific/tactical trades. Source: BNPP AM, as of 17/04/2020

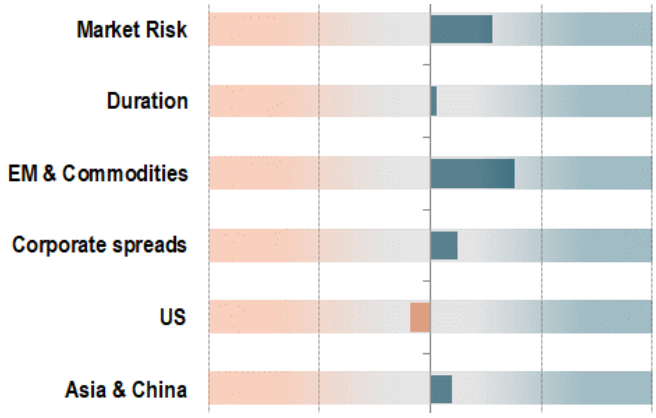
Core views and resulting factor exposures in MFA

The main factor exposures of our core views are currently geared towards ***Market Risk*** and ***EM & Commodities*** (Figure 16). *Market Risk* has reduced significantly recently given our short on S&P 500 and as we took profits on our EMU equity long. The remaining *Market Risk* stems from longs in UK/EM equities, commodities, AUD/USD and EM HC debt.

The ***EM & Commodities*** factor is pronounced given the exposures to several EM and commodity related assets.

Duration is near neutral as our EMU bond short is counteracted by our EMD HC overweight. ***Corporate spreads*** is now also overweight given our new longs in IG credit.

Figure 16: Current factor exposures* from core asset views



* The factor exposure shown is for an unconstrained theoretical portfolio and derived from core asset class views. These factors will be projected onto individual portfolios considering constraints. Additional specific/ tactical trades may be implemented and these will not be visible in the factor profile. They are listed at the end of this publication.
Source: BNPP AM, as of 17/04/2020

Specific/tactical views implemented outside of MFA

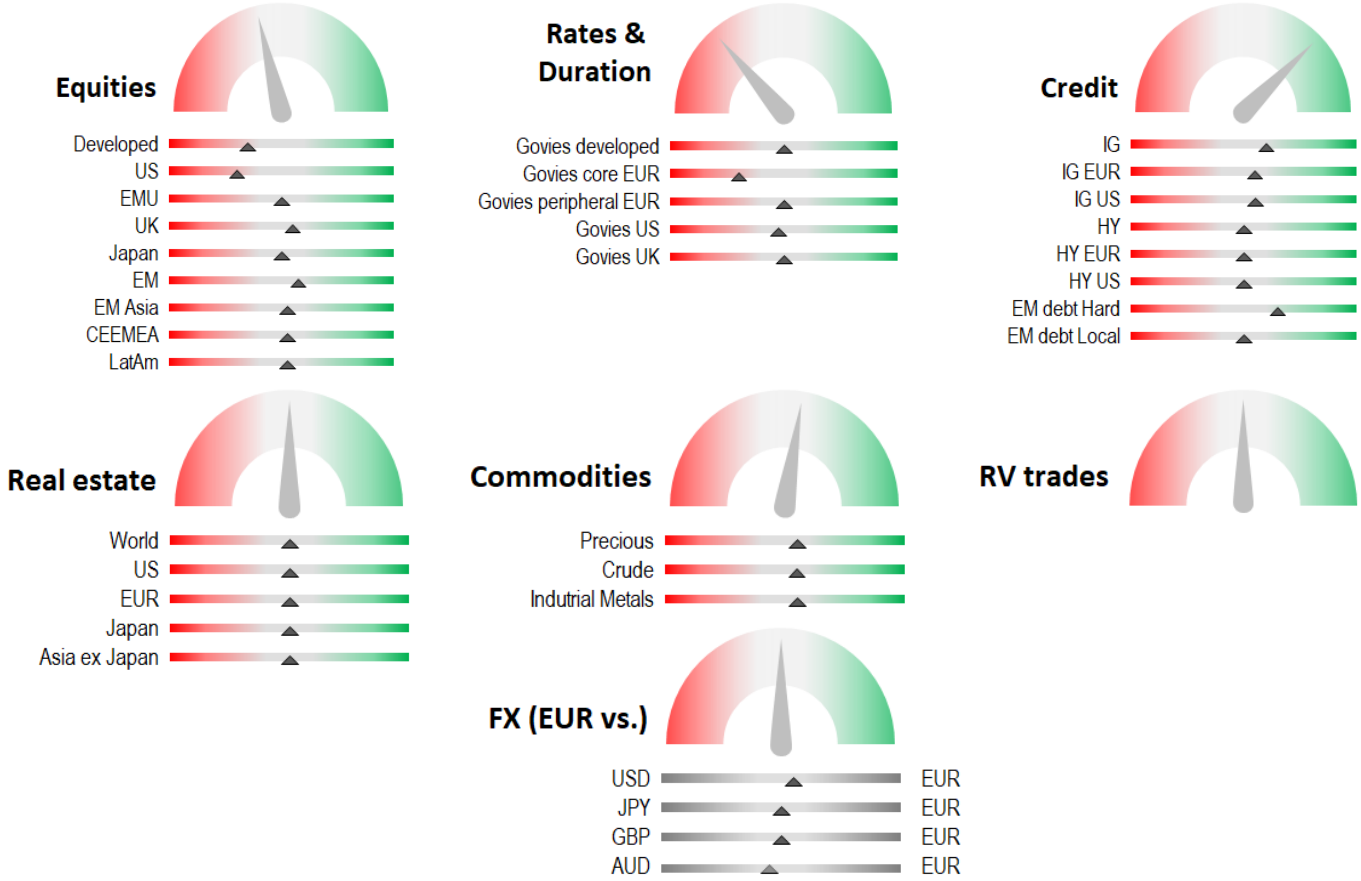
We implement some trades outside of our MFA portfolio optimiser. Such trades are either tactical or specific (i.e. we do not want a trade to be factorised across the book of business) or the asset in question is out of the scope of our optimiser.

These trades are listed at the back of this publication.

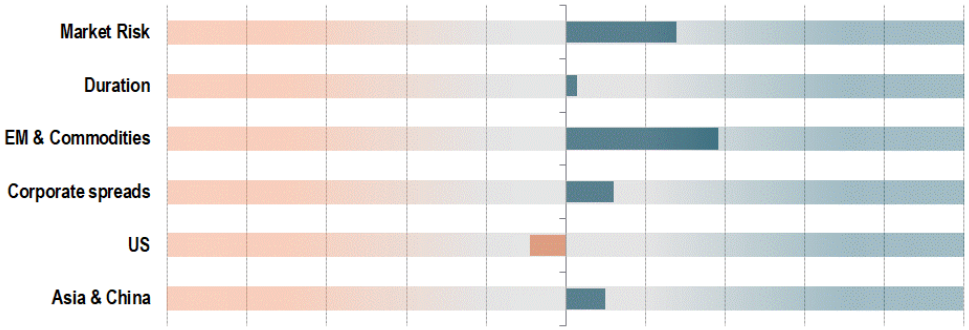
RISK UTILISATION[1]

CORE ASSET CLASS VIEWS & FACTOR EXPOSURE

Core asset class views[2]



Factor exposure[3]



[1] Risk utilisation/ active risk is a measure of the tracking error (as a % of maximum tracking error) of an unconstrained theoretical portfolio, derived from core asset class views and from additional specific/tactical trades.
[2] The core asset class views dashboard reflects the key views of the Investment Committee of the Multi-Asset team at MAQS.
[3] The factor exposure shown is for an unconstrained theoretical portfolio, derived from core asset class views. These factors will be projected onto individual portfolios considering constraints. Other specific/tactical trades may be implemented in addition and will not be visible in the factor profile

SPECIFIC/TACTICAL TRADES[4]

Trade	Asset class	Specific/Tactical
Long US Breakeven inflation	Rates & duration	Tactical & specific
Long gold	Commodities	Specific
Long puts on US treasuries	Rates & duration	Specific
Long call spreads on S&P 500	Equities	Tactical & specific
Long USD 2s10s steepener via CMS spread caps	Rates & duration	Specific

[4] Specific/tactical trades are implemented in addition to the core asset class views and will not be visible in the factor profiles shown elsewhere in the document.

Views expressed are those of the Investment Committee of MAQS, as of April 2020. Individual portfolio management teams outside of MAQS may hold different views and may make different investment decisions for different clients.

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As at April 2020.