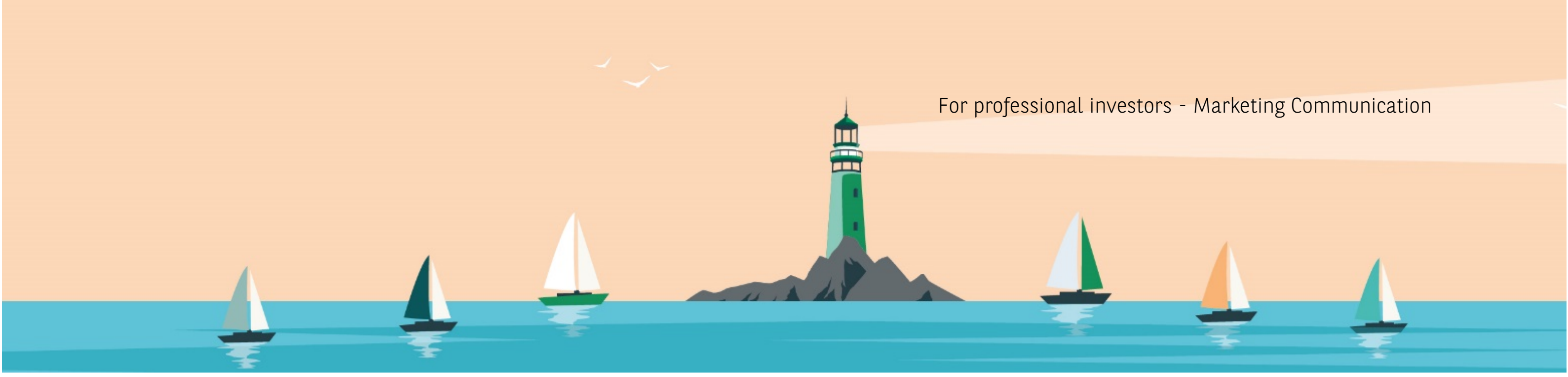

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Christophe Moulin
Head of multi-asset

Daniel Morris
Chief market strategist

KEY MARKET DRIVERS

- The US Federal Reserve is evidently less tolerant of above-target inflation than was believed
- The timing of tapering and the start of the hiking cycle remain dependent primarily on the recovery of the US labour market

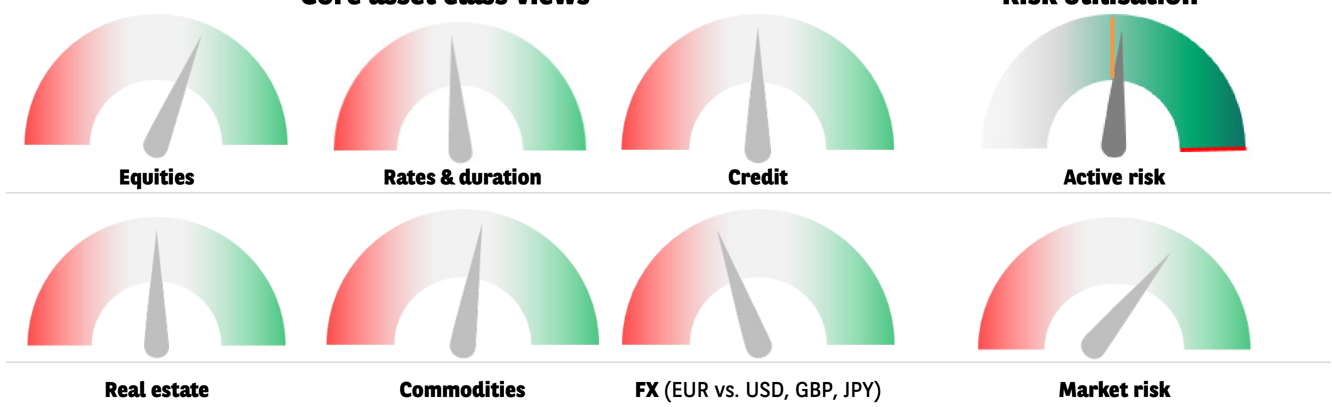
VIEWS & ASSET ALLOCATION

- Our medium-term scenario continues to favour risk and equities, given the fundamental factors and economic policy support

DOTS MATTER

The US Federal Reserve (Fed) moved markets. The latest 'dot plot' of the Federal Open Market Committee (FOMC), which gives the participants' assessment of the appropriate level for the federal funds rate, had 13 out of 18 participants showing a hike by the end of 2023, and the median dot indicated an increase of 50bp. This was more than the market had expected, with the consensus roughly split between one or no hikes in the 2023 dot. What was particularly interesting was that the 2023 rate dot moved but the forecast for core inflation in 2023 did not. The message from the Fed seems clear: The central bank is more sensitive to, and more willing to lean against, the risk of too much inflation than investors had imagined. That revelation posed a challenge to the reflation trade.

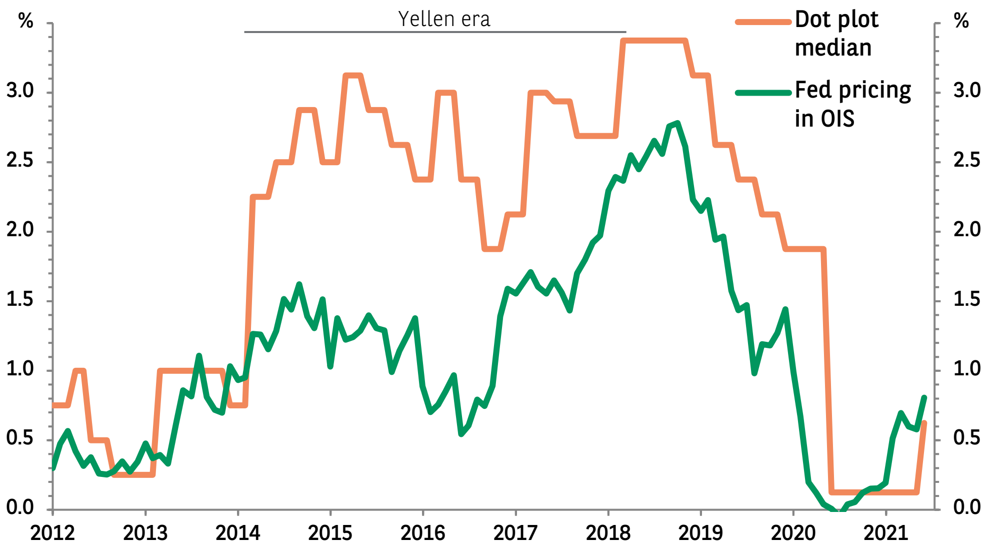
In a sense, however, the market had anticipated the Fed would eventually reach the conclusion that policy rate increases were necessary, or at the very least had factored in the possibility of higher rates. Expectations for the level of the fed funds rate in two years' time had shown two 25bp hikes since the beginning of



March, when the Senate passed Biden's USD 1.9 trillion coronavirus stimulus package. Despite the Fed's subsequent insistence that rate hikes were more distant, market prices continued to reflect the possibility of an earlier exit from the floor.

What was unusual about the gap between the market's forecasts and the Fed's own was that the market was the more hawkish, when historically the opposite has been true. Particularly once Janet Yellen became Fed chair, the bank's forecasts were consistently well above the market's. With Powell as chair, and particularly under the new Flexible Average Inflation Targeting (FAIT) framework, the Fed has become more dovish (see Exhibit 1).

Exhibit 1: Two-year US policy rate forecasts



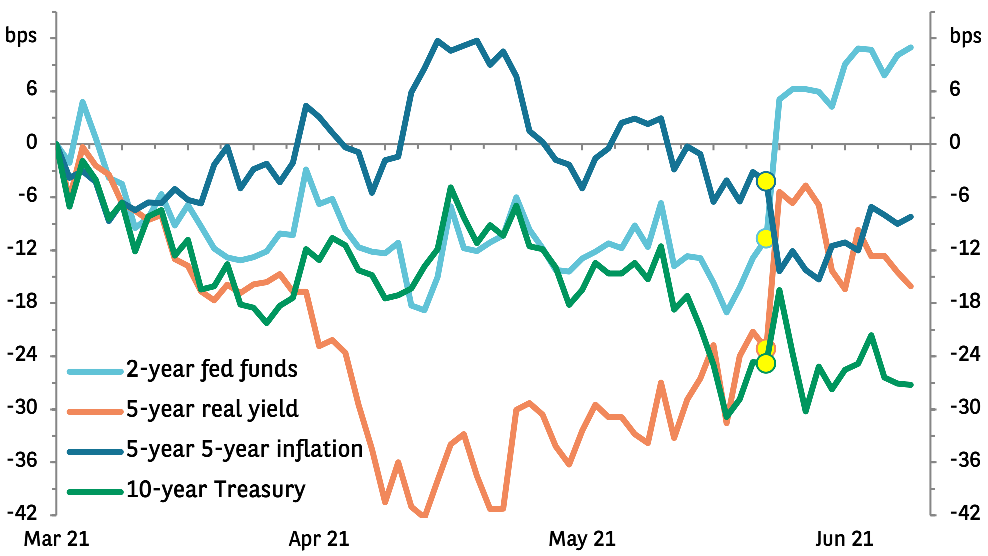
Data as at 30 June 2021. Sources: Bloomberg, BNP Paribas Asset Management.

There is arguably a difference in view between Powell and some members of the FOMC on the appropriate level of policy rates given the outlook for inflation. But not all the dots are created equal, and if Powell's dot was one of those that showed no hike by the end of 2023, the median may not be the most relevant indicator of the future path of rates.

FIXED INCOME

The market reaction to the FOMC was significant but in some cases, the initial move has unwound. At the front end, fed funds pricing in overnight index swaps (OIS) in two years jumped, but the end of June level is only 6bp higher than it was at the beginning of April and is consistent with two hikes in two years (see Exhibit 2). Further out, while 5-year real yields jumped up and 5-year breakevens jumped down, both more or less retraced those moves in the days that followed. But not everything is back to the way it was. Very long-term yields are down, and have continued to move lower, with the 30-year nominal rate below 2% at the time of writing, having been above 2.4% in mid-May.

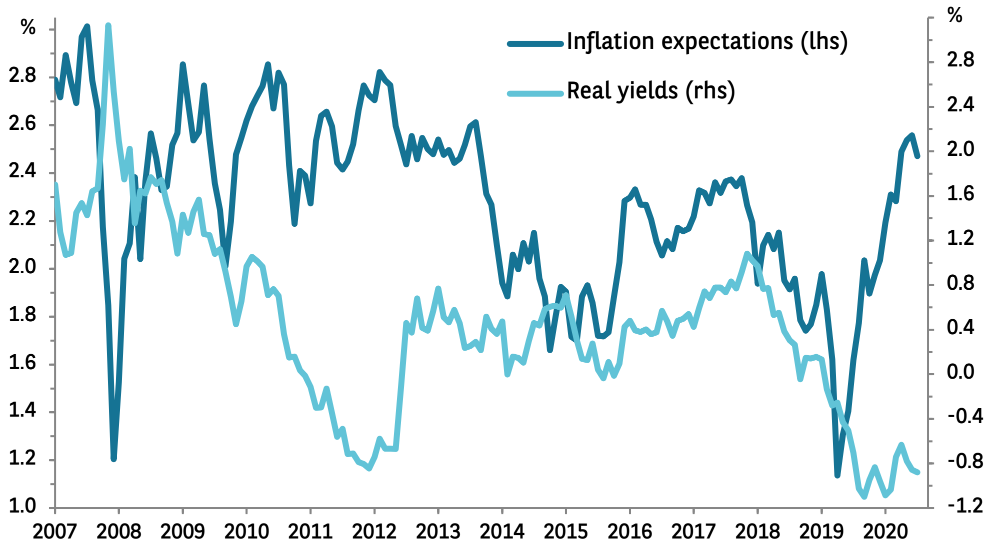
Exhibit 2: Change in rate from 31 March 2021



Data as at 30 June 2021. Note: Yellow dot indicates level prior to Fed meeting. Sources: Bloomberg, BNP Paribas Asset Management.

With the rally in yields that followed the Fed meeting, we saw an opportunity to implement a short position in US Treasury yields. We anticipate that rising real yields should be the primary driver of any nominal yield move, so we also implemented a short in US real rates. Inflation expectations are not far from their post-Global Financial Crisis average while real yields remain near historical lows (see Exhibit 3), despite the looming taper of the Fed's quantitative easing (QE) programme and the message in the dots that the FOMC will respond to evidence of rising inflationary pressure.

Exhibit 3: Ten-year inflation expectations and real yields



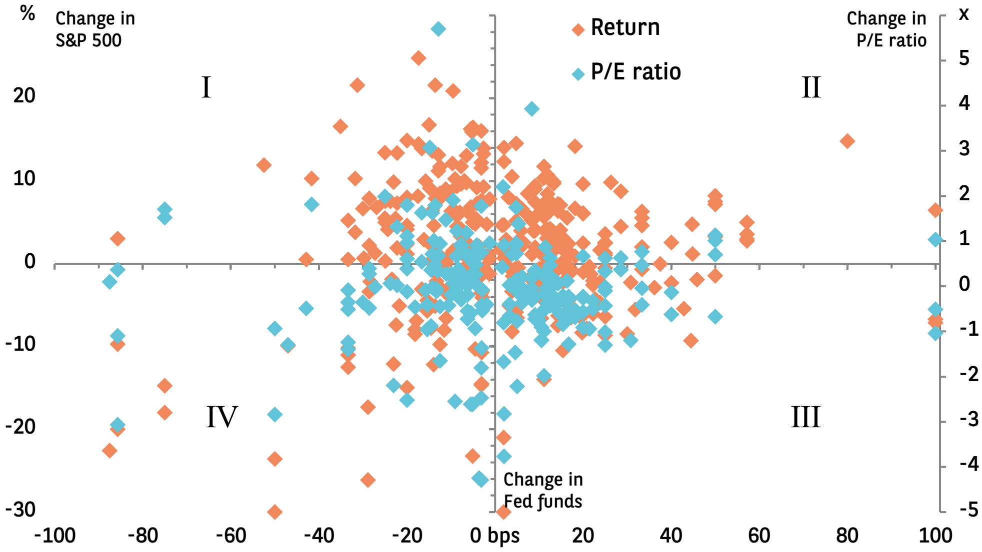
Data as at 30 June 2021. Sources: Bloomberg, BNP Paribas Asset Management

EQUITIES AND POLICY RATES

Some investors are concerned that the prospect of tighter monetary policy (initially via tapering and then through rising policy rates) poses a risk to equities, particularly if, as we expect, the result is higher real yields. We are less concerned, although there are potential implications for the reflation trades such as value vs. growth.

The correlation between returns for equities and changes in the fed funds rate has swung widely over time from nearly -100% to +100%, averaging about -6% since 1972. To illustrate this another way, consider the scatter plot (Exhibit 4), which shows the quarterly change in the fed funds rate on the x-axis, the change in the S&P 500 on the left y-axis (orange dots), and the change in the forward P/E ratio on the right axis (blue dots). Half of the orange dots are in quadrants II or IV, meaning that equities rise when rates are rising, or fall when rates are falling (a positive correlation). Quadrant II often corresponds to a period of economic recovery when the Fed is beginning a hiking cycle and corporate profits are rising. Quadrant four is the opposite scenario: The economy is moving into recession, the Fed is cutting rates, and profit expectations are falling.

Exhibit 4: Quarterly change in fed funds, S&P 500 and forward P/E ratio



Data as at 30 June 2021. Sources: Bloomberg, BNP Paribas Asset Management

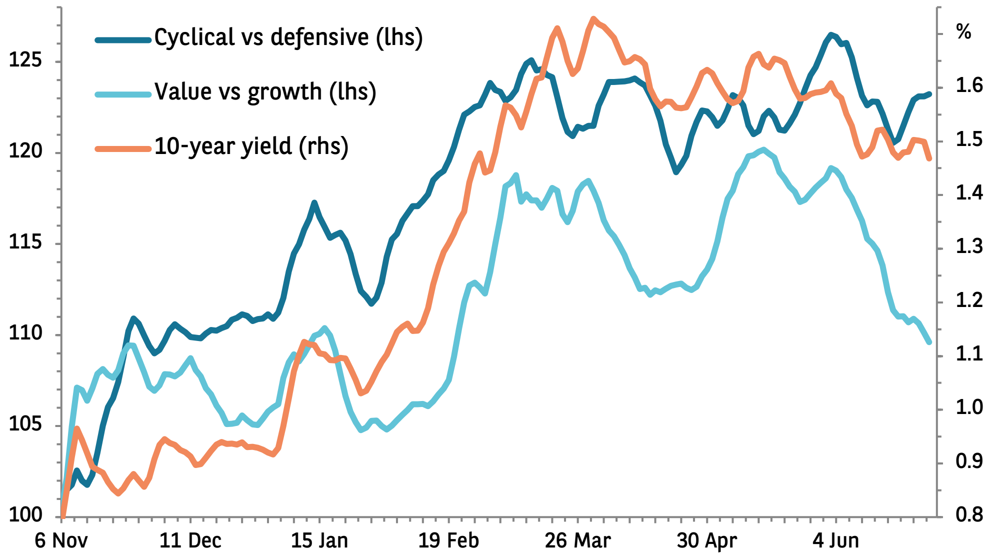
Quadrant I would seem to correspond to much of the post-GFC period, with the Fed cutting rates to support growth, the discount rate for equities falling, and prices rising. In fact, this combination has occurred less often than it did before the GFC. Finally, the scenario that worries investors today – rising rates and falling equity prices (quadrant III) – tends to be a late cycle phenomenon, when the cumulative increase in interest rates finally causes equities to roll over, particularly if the Fed is raising rates to bring inflation down. The impact of changes in policy rates on equity market valuations (the blue dots in the chart), is equally varied, though rising rates correspond with falling P/E ratios about twice as often as with rising ratios.

EQUITY REFLATION TRADES

Even as rates rise, we anticipate ongoing gains for equities through the rest of this year, albeit at a slower pace than in the first half. It is worth keeping in mind that continued robust earnings growth, combined with more modest price gains, will inevitably reverse some of the P/E ratio expansion that has occurred this year.

How well supported are the reflation trades, given the new interest-rate outlook? We are more confident that cyclical sectors, regions and countries (such as emerging markets and Japan) will continue to outperform given that the key driver is the global economic recovery as opposed to the level of interest rates. The relative performance of cyclicals has nonetheless been lacklustre over the last few months, although this has been at least partly due to a lagging automotive sector, hindered by semiconductor shortages, while the traditionally more defensive healthcare sector has outperformed thanks to restored access to healthcare for non-Covid related procedures (see Exhibit 5).

Exhibit 5: US equity index relative returns and Treasury yields



Data as at 30 June 2021. Sources: Bloomberg, Barclays, Russell, BNP Paribas Asset Management.

Value stocks have underperformed growth stocks recently by more than one would expect, given that Treasury yields have in fact risen slightly through the end of the month. Since 11 June, the Russell 1000 value index has dropped by 1.4% while growth gained 4.0%. Value has been held back primarily by financials as the market anticipates higher funding costs for banks. On top of this, worries about a less positive growth outlook due to a more hawkish Fed and a roll-over in lead indicators have weighed on the performance of value stocks, which tend to be more cyclical. The gain for growth shares, however, was highly concentrated in technology, which is reminiscent of the performance of US equities prior to the pandemic, when mega-cap tech accounted for the bulk of the broad index returns. While tech makes up about 50% of the growth index, it contributed over two-thirds of the recent returns.

We do not anticipate a re-emergence of the pre-pandemic equity return pattern quite yet. As longer maturity yields rise, value stocks should resume their outperformance. Valuations are still heavily in value's favour; the z-score of the relative forward multiple of value vs. growth is -1.1, not much higher than the peak discount level of -1.4 seen last August. The earnings outlook remains supportive, in our view. Forward EPS estimates for growth stocks are already 25% higher than pre-pandemic levels, while for value they are just 4% higher and momentum is good.

MARKET DYNAMICS INPUTS

In the short run, equity indices have been developing in recent weeks in a lateral consolidation. Our indicators continue to signal that global equities are due for a breather. Market developments are more significant beneath the surface, with some value/cyclicals being penalised while some growth style stocks have rebounded. At this stage, our indicators continue to warn us not to chase the new highs on some indices before we see deeper setbacks.

In the yield sphere, our indicators suggested in June that the setback could be over and that the bullish trend (rising yields) could resume. We expect both US and European bond yields to be higher in coming months.

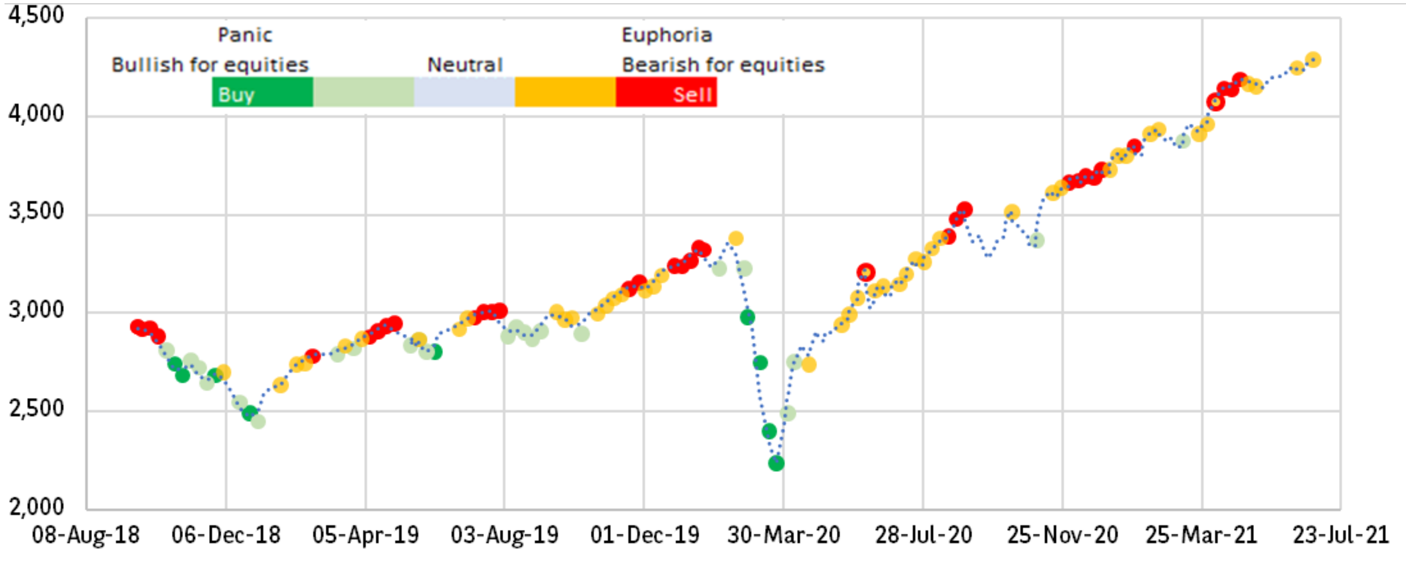
The US dollar has resumed its bearish trend. It paused again after reaching major support levels, but our indicators are definitely pointing to further USD weakness in the coming months.

Our blended 'market temperature' indicator is approaching the alert zone. The S&P 500 made fresh all-time highs but market internals continued to deteriorate. Volumes remained well below the Covid-19 era average. Most constituent equities struggled to match the S&P 500 rise. For example, only 6% of SPX members have made new 52-week highs. In addition, selectivity remained among the main US indices. A significant improvement in participation would be necessary to sustain the current rise and avoid a correction in the coming weeks.

In recent weeks, our proprietary 'market dynamics' toolbox – consisting of 'market technicals' and 'market temperature' signals – has suggested that the risk of a pullback in the short run remains.

Exhibit 6: Evolution of market temperature since July 2018 (S&P 500)

All temperatures shown except neutral



Data as at 30 June 2021. Sources: Bloomberg, BNP Paribas Asset Management.

ASSET ALLOCATION

The market environment now essentially reflects the timing of Fed tapering/tightening, as well as the 'peak data' theme. The latter opened a debate on whether the focus should be on the level of marginal change in macroeconomic data. In this context, we have seen a rotation out of the reflation trade post-FOMC, via the outperformance of US equities through the growth part and a flatter US yield curve. The repricing of the Fed terminal rate to sub-2% levels is raising questions about the steady state for a US economic expansion, with the lower potential GDP growth rate and longer-term inflation expectations implied by these levels.

In our view, the loose stance of fiscal and monetary policy (notably in the US) should support risky assets and higher bond yields. Cyclically-sensitive assets (e.g. commodities, Japan and US value stocks) have the potential to perform well in H2. Growth in other major economies that have been hit by Covid (e.g. Europe and emerging markets (EM) ex-Asia) should accelerate as vaccinations lead to reopenings. Our medium-term scenario continues to favour risk and equities, given the fundamental factors and economic policy support.

"The market environment now essentially reflects the timing of Fed tapering/tightening, as well as the 'peak data' theme."

The multi-asset investment committee has kept its allocation to risk broadly unchanged over the past month, at the level of its long-term risk target. The committee's net equity exposure remains long via positions in US value, EM equities, Chinese equities and Japanese equities against a short position in EMU large caps. The regional equity exposure seeks to find a balance between the 'growth/quality' and 'value/cyclical' styles that helps insulate against rates volatility, while providing a diversified allocation.

Elsewhere, the investment committee is long other risky assets such as commodities and EM local debt, and holds other positions to diversify portfolios, such as long gold.

Equities ↑ (new)

We are long equities. We are long EM equities given our view that Chinese/Asian earnings growth will remain supported by a dynamic technology and e-commerce sector as well as a strong high-end manufacturing sector. Both are part of Beijing's strategy for a 'new China' and should benefit other EM MSCI index heavyweights such as South Korea and Taiwan. Also, Japanese equities are well placed to benefit from a broadening global recovery, a cash-rich corporate sector and valuations that still look cheap.

Equities still look attractive versus bonds, despite the all-time highs reached in recent weeks, so equities remain a relatively attractive option even if absolute valuations (e.g. P/E ratios) appear high. We express our bullish US view via US value stocks, which are cheaper than the mega-cap heavy S&P 500 and still have room to catch up.

We are long EMU small caps versus large caps. Small caps are likely to continue to outperform in an economic recovery. They should benefit from being high beta and from their more attractive valuations relative to large caps.

We have recently reduced risk slightly by taking profits on our long EMU listed real estate position. REITs have recovered recently, but the outlook is challenging due to the risk of renewed rent controls in Germany and the structural changes to commercial and retail real estate businesses.

Government bonds ↓ (new)

We have initiated a short position in US government bonds. Being underweight duration is a strategic view of the investment committee and we see the recent price action as an attractive opportunity to go short USTs.

We have also opened a short US TIPS position. US real yields are historically low and look asymmetric to the upside, especially if US employment reaccelerates and rates markets starts pricing in Fed tapering sooner than currently expected. This trade is a good hedge to the long risk exposures in the multi-asset portfolios.

In April, we added to our underweight position in EMU bonds, given our view that EMU yields should continue to rise, supported by the eurozone reopening, rising inflation expectations and a dovish ECB. EMU yields are historically low, notably real rates in core countries such as Germany.

We are long EM local currency debt. We see room for further spread compression in the current search for yield. Higher US real yields are a risk, but we expect the Fed's dovish approach to tapering to limit the upside. As for EM currencies, we see plenty of room for appreciation, especially if the US dollar resumes its downtrend.

Credit ⇔ (unchanged)

Currencies € ↓ (new)
We have added a short EUR/NOK position. The Norwegian krone should be supported by a more hawkish Norgesbank in H2, positive prospects for oil prices, cheap real effective exchange rate (REER) valuations and no exuberance in positioning.

Commodities ↑ (new)
We are bullish on commodities over the medium term. We believe crude oil is supported by recovering global demand and constrained supply from OPEC and the US shale industry. We like base metals, given the ongoing electrification and clean energy transition and the limited supply responses, especially in copper. We are long gold, but we have cut our tactical long exposure. Gold can be seen as a currency that cannot be debased by central banks and one that is a good hedge against the risk of inflation.

Thematics ↑ (new)
This month, we added a long position in US infrastructure to benefit from President Biden's infrastructure spending plans. This adds to our positions in various investment themes: Global environment, energy transition and artificial intelligence.

From cover page: *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. ** 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.

DISCLAIMER