For professional investors - Marketing Communication - February 2024

ASSET ALLOCATION MONTHLY - FEBRUARY 2024

An 'immaculate' base case

- The base case from the street is characterised by continued US exceptionalism for both growth and inflation. The rest of the world, notably continental Europe and the UK, are expected to suffer weaker growth. Falling inflation allows for easier monetary policy everywhere.
- This 'immaculate' US base case has been central to the 'everything rally' that kicked off at the end of 2023. But equity prices have rallied ahead of bonds and earnings expectations have softened. Risk premia moves favour fixed-income assets. The macroeconomic risk case, meanwhile, remains skewed towards weaker growth, inflation, and earnings.
- We took profits on half of our long duration positions at the end of 2023 but remain overweight duration, chiefly through long-dated US Treasury Inflation Protected Securities (TIPS), EU investment-grade corporate bonds, and local currency emerging market bonds (see table). We are short Japanese government bonds (JGBs).
- In equities, we took profits on modest long positions in the US and EM in January and are now positioned at the cautious end of neutral. Europe remains the area of greatest caution.

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BNP PARIBAS ASSET MANAGEMENT

The sustainable investor for a changing world

The 'immaculate' base case

Continued US exceptionalism is a key tenet of many street forecasts, including our own. The latest estimates of BNP Paribas Asset Management's economic research team mark-to-market US growth (higher) and inflation (lower) for 2024 and 2025, no longer foreseeing a spell of sub-trend growth and stickier inflation. Economic growth in Europe and the UK, by comparison, is expected to be weaker and substantially below trend.

While our research team is broadly in line with most economists' forecasts for US Federal Reserve (Fed) policy, the team is notably more dovish on the Bank of England. Market and consensus policy expectations are judged to be inappropriate given the weak state of the UK economy.

In Europe, while the team sees stagnant growth alongside quickly falling inflation justifying the European Central Bank (ECB) taking policy rates below neutral, the bank is expected to be hesitant to move before the Fed. Yet insofar as eurozone rates today are thought to be 200bp or more above neutral, increasingly anaemic growth and trend inflation argue for a quick reversal.

An 'immaculate' growth and inflation environment in the US, and strong policy support more broadly, have created fertile conditions for risk markets. US equities continued in January the trend from the end of 2023, charting gains and notching record highs. Most European markets also recorded a positive return.

What might unsteady the boat?

On our 12-18 month investment horizon, we see five chief areas of uncertainty. We will come back to each of these in coming monthlies.

• **Weaker growth outcomes** as the lagged impact of significant monetary tightening feeds through to economies and corporate earnings. The twin 'offsets' to higher interest rates that were central to supporting US growth in 2023 – fiscal easing and excess Covid-era savings – are expected to be less helpful in 2024[1]. Weaker nominal growth is consistent with continued margin normalisation and deeper job cuts.

• **More hawkish/less dovish central bank reaction functions**, with a lack of clarity on R-star (the neutral real rate of interest), and perceived benefits from treading carefully after the inflation burst of recent years. Fiscal dominance (partly linked to elections in many areas) may also support higher terminal rates.

• **Prospect of contagion from real assets to the real economy,** either via real estate or via channels such as non-bank lending, which make up a greater proportion of US bank loans than cars (and only just below credit cards). Pressure from higher rates, weaker growth/earnings, or simply less policy support are all possible triggers.

• **The impact of mega-caps**. Mega-capitalisation companies are growing more dominant, notably US and Asian technology/artificial intelligence companies, leading to rising concentration risk.

• **Deflationary deleveraging in China.** With the lack of a clear 'red line' for the government on when to stimulate growth, China's investment and property-leveraged growth model could come under threat as the authorities act too late or do too little. An escalation in trade tensions remains a risk, too, particularly around US elections.

[1] Note the latest forecasts from the Congressional Budget Office project a 1.8% swing in the US fiscal deficit from end-2022. https://www.cbo.gov/publication/59946

Fixed income, credit and currencies

Bond markets enjoyed a powerful rally at the end of last year, moves we took advantage of to take partial profits on long duration positions built up over the course of 2023. The gains came as markets began to price in a 'pivot' from central banks, away from rate hikes towards strong policy easing in 2024 and 2025. Rates in Japan have continued to move in the opposite direction.

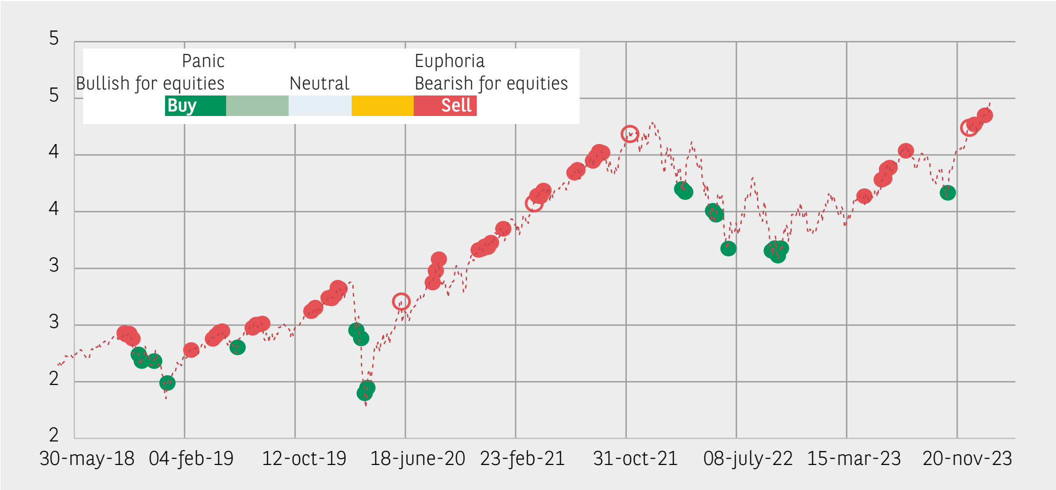
We still favour long-dated US real yields, where current valuations lock in attractive risk-adjusted returns in our view. We are also maintaining positions in European investment-grade (IG) corporate bonds and EM local currency debt. Unlike US investment-grade credit and high-yield spreads, EUR investment-grade bond spreads continue to offer generous compensation for default risk and potential further spread compression. Yield curves are broadly flat, but given the low spreads, this is less concerning. EM local currency debt, meanwhile, offers an attractive 6% yield alongside a resilient macroeconomic environment.

Equity valuations leave little margin for error

Unlike bonds, equity valuations appear priced for perfection, leaving little margin for error in our view. Earlier this year, we decided to take profits on our modest long equity position in the US and EM (Latin America). Our continued short position in European equities and modest long position in the UK leave us with a neutral view on equities over our investment horizon, within a more cautious view on risk overall (see table below).

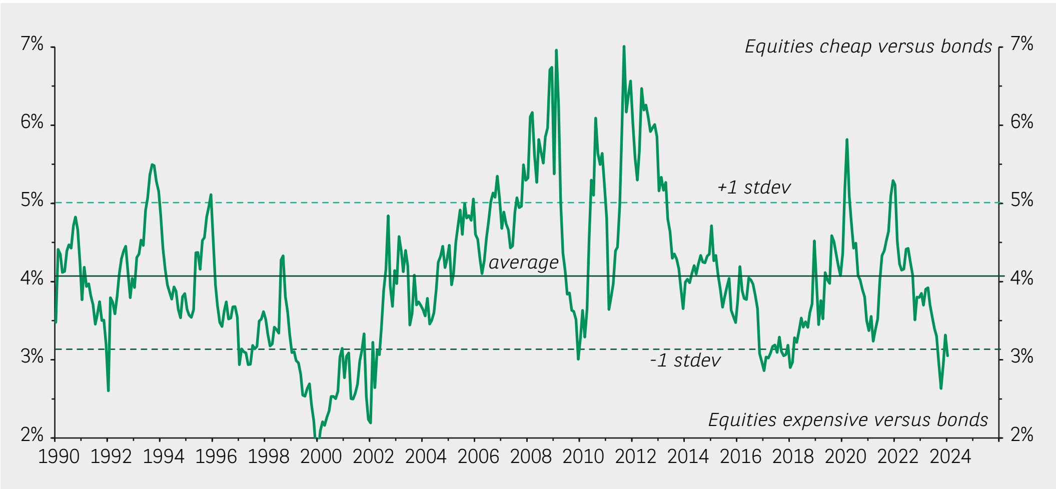
To be sure, equity valuations have been boosted by euphoric price gains – which caused our market temperature gauge to flash red in December and January (i.e., sell; see Exhibit 1) – and falling earnings expectations. As equity indices have reached new highs this year, expected earnings for the current calendar year have moved lower (by 1% for global equities overall). Europe, our area of the greatest caution, looks particularly weak, with a 1.5-2% fall in expected 2024 earnings set against a still-lofty level of earnings anticipated for this point in the cycle.

Exhibit 1
US market temperature nearing red



Data as at 9 February 2024. Sources: BNP Paribas Asset Management.

Exhibit 2
S&P 500 equity risk premium



Data as at 31 January 2024. Sources: BNP Paribas Asset Management.

Our asset class views

	Strongly dislike	Dislike	Neutral	Favour	Strongly favour
PRR/risk appetite		X			
Asset allocation			Equities Real Estate Commodities Cash	Government bonds Credit	
Equity regions		Europe ex-UK	US UK Japan EM		
Equity style/size			EU large cap EU small cap US large cap US small cap		
Sovereign bonds		Japan	Australia Europe UK	US linkers US MBS EMD (local)	
Credit			EMD US IG US HY EUR HY	EU IG	
Commodities			Energy Base metals	Precious metals	
FX			USD, EUR, AUD, GBP, JPY	EM FX	

Twelve-month, risk-adjusted view. The above view(s) represent our judgement as at the date of this presentation and may be subject to change without notice. Data as at February 2024. Sources: BNP Paribas Asset Management.

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VIEWPOINT

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