

MID-YEAR INVESTMENT OUTLOOK

JULY 2022

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Chronicle of a recession foretold

- Our view is that the FOMC should be taking policy rates into restrictive territory as “expeditiously” as possible. After the June FOMC meeting, policy rates are currently at 1.50% - 1.75%. We anticipate another 75bp hike in July, and then 50bp in September, November and December.
- Policy rates could stay elevated for far longer than markets are currently pricing in. Investors, we believe, have yet to fully comprehend this new reality.
- Core inflation will continue to reflect momentum in shelter costs, food costs and higher wages. The risk is that inflation is more entrenched and structural than is widely appreciated, and that a modest slowdown is not going to be sufficient to vanquish it. A period of below-trend, possibly negative, growth will be required to drive the unemployment rate higher.
- Equity markets, however, do not yet reflect this scenario. Consensus estimates are for year-on-year earnings growth of 9% next year in the US, while a recession could see double-digit declines. Europe faces the risk of a cut-off in gas deliveries this winter.
- Chinese and Japanese equities offer better risk-reward.



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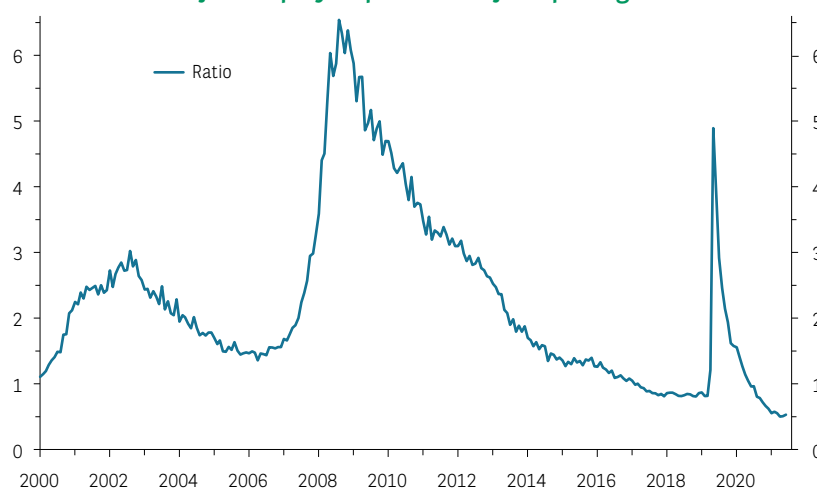
"The US is experiencing the largest imbalance between labour demand and supply since the 1960s."

FIXED INCOME

United States

The US is experiencing the largest imbalance between labour demand and supply since the 1960s (see Exhibit 1). The US Federal Reserve's (Fed) strategy is to weaken demand in order to remove these excess jobs, without reducing actual jobs and driving up the unemployment rate (i.e., an ideal soft landing). In reality, we think such an outcome is extremely hard to engineer. It might also not be enough to bring wage pressures in line with productivity gains and the inflation target. Recent comments from Fed officials acknowledge as much. Chair Powell has recognised that policymakers now see a need for the policy stance to go into restrictive territory, and he warned that such an outcome might inflict some discomfort on the economy. While diplomatic to say it, he was essentially warning that a significant slowdown was the best-case scenario, and that a full recession was quite probable (even if it does not feature in the Summary of Economic Projections (SEP)).

Exhibit 1: Ratio of unemployed persons to job openings

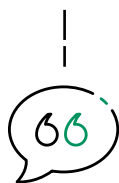


Data as at 21 July 2022. Sources: US Department of Labor, BNP Paribas Asset Management.

Helpfully, the US economy is slowing, as it must. Recent Purchasing Manager Indices (PMIs) point to a contracting economy, if not (yet) a recession. Inflationary pressures, however, remain strong. The latest Consumer Price Index (CPI) and Personal Consumption Expenditure (PCE) inflation data reveal ongoing strength in underlying inflation and a broadening of price increases across categories. The proportion of core categories experiencing inflation rates above 5% has increased further, indicating the breadth of inflation pressures. Inflation is still spreading beyond core goods to non-services, reflecting wage gains.

A significant contribution to CPI inflation is coming from rents and owner's equivalent rent. These costs remain in "catch-up" mode compared to more timely rental market data series and are likely to contribute to higher inflation for many more months. Supply chain blockages, which drove up prices for certain goods categories, remain problematic. Used car prices have not meaningfully declined, and new vehicle prices continue to rise as manufacturers pass on higher costs.

In the near term, markets can be susceptible to changing narratives, exaggerated by positioning. A case in point is the pivot from inflation concerns to recession concerns that occurred in mid-June, and drove 10-



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year Treasury yields from 3.48% to an intra-day low of 2.75% in early July, as well as lowered the WTI crude oil price from USD 120 per barrel (pbl) to USD 98 pbl. The reassessment seems to have been triggered by the strength of the June CPI data – which invited a more aggressive Fed response – and the deterioration in European PMI and US ISM surveys, which confirmed that tightening financial conditions and energy prices were already acting as a brake on economic activity.

A few questions arise from this episode.

- How much monetary tightening is actually needed to slow the economy and choke off inflation?
- Is the Federal Reserve able to calibrate this level of tightening and deliver it?
- How will financial markets react as policy proceeds on this path?

The United States is facing a combination of strong but softening demand following an excessively easy monetary and fiscal policy response to the pandemic, large negative supply shocks from associated lockdowns, the reversal of globalization, and the Ukraine conflict. With headline and core inflation already far above target and threatening to de-anchor inflation expectations, and a very tight labour market driving up wages, the appropriate policy response is a combination of tighter fiscal and/or monetary policies. When inflation is above target in an economy already at full employment and with demand pushing up against constrained supply, an inflation-targeting central bank should respond by seeking to reduce demand. As one analyst put it to us recently, the Fed’s objective should be to “right-size” output versus the economy’s productive capacity.

Our view is that the FOMC should be taking policy rates into restrictive territory as “expeditiously” as possible. After the June FOMC meeting, policy rates are currently at 1.50% - 1.75%. We anticipate another 75bp hike in July, and then 50bp in September, November and December. This would take rates to 3.75% - 4.00% by the end of 2022, which is higher than market pricing for rates at 3.35% for end 2022. We think the Fed will have little choice in the matter, as core inflation will continue to reflect momentum in shelter costs, food costs and higher wages. Realistically, one has to anticipate ongoing supply disruptions from the Ukraine conflict and China’s rolling Covid lockdowns, which will further support inflation. If Powell is true to his word that he will look to keep raising rates until he has “compelling evidence” that inflation is declining, the hiking cycle could last for some time yet. Additional hikes are possible, indeed probable, in 2023, but will depend on the growth backdrop in the US and abroad.

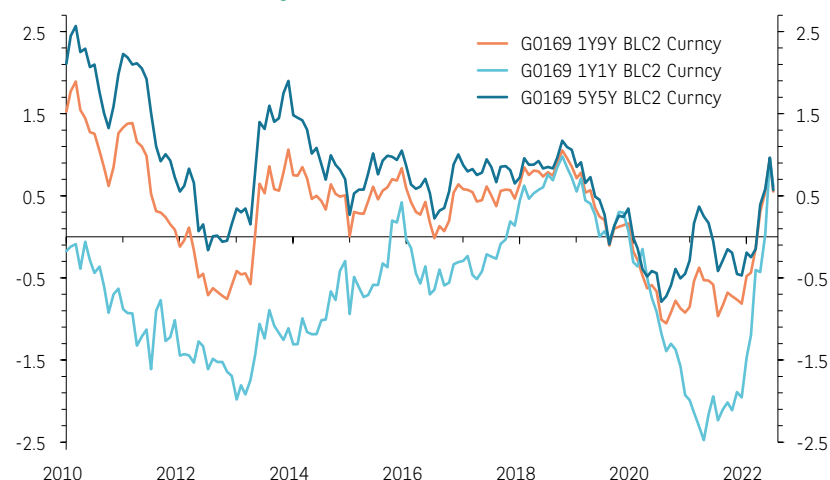
The question of how restrictive policy must get and how high rates need to go is a difficult one. To be clear, our view is that the Federal Reserve’s objective should be to soften the labour market to dampen wage pressures. An immaculate disinflation, whereby excess job openings are removed but no job losses occur and wage pressures normalise, is wishful thinking. A period of below-trend, possibly negative, growth will be required to drive the unemployment rate higher. How tight financial conditions need to get – in combination with fiscal drag – to achieve this, is difficult to say. Nevertheless, our working assumption is that real yields need to be driven higher than was the case at the end of the last hiking cycle in late 2018, when policy rates reached 2.75% but core PCE inflation was barely 2.1% (versus 4.7% currently).

For some context, we can refer to Exhibit 2, which shows 1-year/1-year, 1-year/9-year and 5-year/5-year real yields. We use forward yields to remove distortions from inflation accretion due to the indexation lag.



"We think the FOMC will have to deliver more than the 3.35% peak rate currently priced into markets. Inflation is more entrenched and structural."

Exhibit 2: Forward real yields



Data as at 21 July 2022. Sources: Bloomberg, BNP Paribas Asset Management.

One can see that all these real yield measures are approaching, but have yet to surpass, levels reached in late 2018. As our fixed income strategist put it, "perhaps that is really all it took" for the market to be comfortable that inflation will come back to target – and indeed breakevens are now at levels consistent with the Fed's inflation target.

However, we remain sceptical, and we think the FOMC will have to deliver more than the 3.35% peak rate currently priced into markets. Why? Because the risk is that inflation is more entrenched and structural than is widely appreciated, and that a modest slowdown is not going to be sufficient to vanquish it.

The recent rally from 3.48% to 2.75% on 10-year Treasuries caught many off-guard. In a sense, it should not have, since a decline in consumer confidence and ISM readings in response to tightening financial conditions – classic leading indicators of economic slowdown – are typically accompanied by investor purchases of Treasuries.

However, the simultaneous pullback in Fed rate hike expectations, in our view, is entirely unjustified, and reveals a misunderstanding of the Fed's reaction function in the current context. Put crudely, generating a recession is the whole point. The Fed wants to see output weaken and unemployment rise, in order to moderate wage demands and reduce inflation pressures. The idea that the Fed would stay its hand at the first whiff of slowdown or slide in equity markets is deeply misguided, in our view. With unemployment 0.4% below the Fed's assessment of full employment and core and headline PCE inflation at 4.7% and 6.3%, respectively, the Fed's objective is clear – to bring down inflation, even if jobs have to be sacrificed.

Furthermore, if current inflation has structural elements to it (as a result of protectionism, the rebuilding of supply chains, and an upward reset of inflation expectations), then lowering it could take some time, suggesting policy rates could stay elevated for far longer than markets are currently pricing in. Investors, we believe, have yet to fully comprehend this new reality.



"Inflation is unlikely to turn around anytime soon. We expect headline to peak in September at around 9%, with risks remaining to the upside."

Eurozone

In the near term, energy remains the main focus for both growth and inflation given the ongoing conflict between Russia and Ukraine. Natural gas prices saw another sharp increase in recent months, as Russia reduced gas deliveries to the eurozone.

We have seen estimates which suggest that a 10% cut in gas supply would reduce eurozone growth by 0.7%. Should there be a sudden and complete shutdown of gas imports from Russia, a severe recession amid high inflation would be an inevitable outcome.

Looking ahead, with natural gas prices skyrocketing since early June on the back of rising concerns of disruptions in Russian gas supply, and food inflation still in the pipeline, the risk for energy and food inflation in the near term is still skewed to the upside.

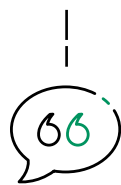
The risks around core inflation, however, appear more mixed. On the one hand, the momentum in non-energy industrial goods inflation has slowed somewhat, as Covid restrictions in Asia have eased, and business inventories have started to build while consumer demand slows.

On the other hand, services inflation will likely remain well supported in the near term as the travel, recreation and hospitality sectors benefit from seasonal strength and pent-up demand. In addition, the pass-through from high commodity prices and input prices will likely remain supportive to core inflation in the coming months.

Labour shortages due to disruptions from the pandemic are boosting wages, and the high realised inflation recently may also lift wages if pay settlements are tied to cost-of-living adjustments. While the economy is already slowing, the lagging nature of the labour market means that the employment outlook will likely remain rosy over the near term.

Taking all of this into consideration, it is clear that inflation is unlikely to turn around anytime soon. We expect headline inflation to peak in September at around 9%, with risks remaining to the upside.

The evolution of inflation longer term will be determined by developments in wages. In the tradable sector, faced with higher energy input costs and global competition, manufacturers will likely be under pressure to keep labour costs low. In the services sector, employment growth will likely start to slow once the post-pandemic reopening effects fade and higher living costs cut into consumption, which in turn could help contain wage growth.



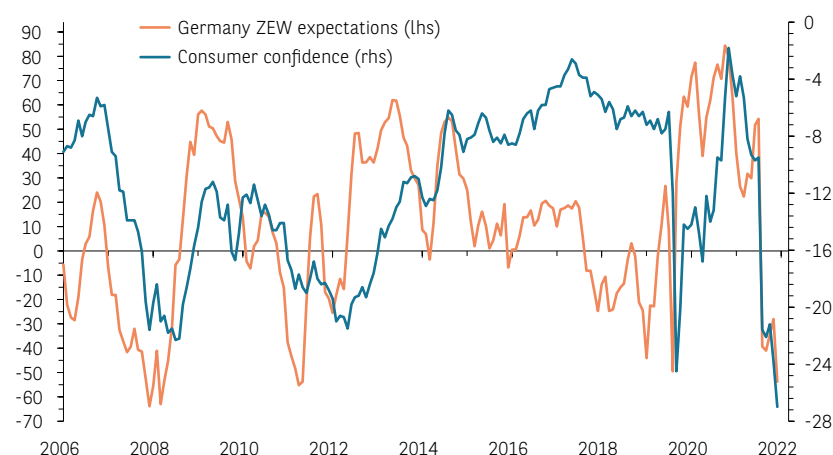
"Recent PMI data suggest that the negative impact on growth associated with the geopolitical conflict was delayed rather than avoided."

Implications of the Russia-Ukraine conflict

Economic activity in the eurozone has remained remarkably resilient in the immediate aftermath of the Russia-Ukraine conflict. However, the sub-50 July PMI data (to the lowest level in 17 months) suggests that the negative impact on growth associated with the geopolitical conflict was delayed rather than avoided. The decline was broad-based across sectors and countries, but of most concern was manufacturing, with some indicators falling well into recessionary levels.

The outlook for the services sector is not rosy, either. Consumer confidence has fallen meaningfully in response to higher inflation, and household discretionary spending will likely suffer on the back of negative real wage growth. There is some evidence that the heightened uncertainty and weak consumer confidence are starting to weigh on business sentiment (see Exhibit 3).

Exhibit 3: Confidence measures



Data as at 21 July 2022. Sources: ZEW, European Commission, BNP Paribas Asset Management.

Monetary policy

Despite the recent upward adjustments in inflation forecasts, they are still too optimistic when compared with the recent developments in realised inflation (see Exhibit 4). This means the ECB will likely have to revise its inflation projections higher again in September. Indeed, with price increases becoming more widespread across sectors, wage growth starting to pick up, and tentative signs of rising inflation expectations, the cumulative 125bp of rate hikes signalled so far look more like the lower bound within the ECB's policy guidance.



"High inflation alongside slowing growth or a recession puts the ECB in a complicated situation."

Exhibit 4: ECB growth and inflation projections for the eurozone

Annual percentage changes

	June 2022				March 2022			
	2021	2022	2023	2024	2021	2022	2023	2024
Real GDP	5.4	2.8	2.1	2.1	5.4	3.7	2.8	1.6
HICP	2.6	6.8	3.5	2.1	2.6	5.1	2.1	1.9

Source: ECB, 9 June 2022.

The outlook for eurozone interest rates remains highly uncertain, as high inflation alongside slowing growth or a recession puts the ECB in a complicated situation. A sudden and complete shutdown of gas imports from Russia will likely push the eurozone into a severe recession. In such a scenario, the fiscal response will likely be large.

Sectors subject to energy rationing will likely receive support, such as liquidity schemes through state-backed loans and guarantees, similar to the ones seen during the pandemic. Lower-income households will also likely receive large energy subsidies. Germany is unlikely to return to its 'black zero' fiscal balance.

Moreover, given the nature of the common external shock from the Russia-Ukraine crisis with asymmetric impacts across national economies, the EU may deploy a fiscal response that entails some burden sharing.

In terms of a monetary policy response, if the recession is sufficiently serious to slow underlying inflation, the ECB will not have to move policy rates into restrictive territory. However, it is equally likely that, despite a significant hit to growth, the current bad inflation may transform into ugly inflation, whereby the ECB may feel compelled to continue raising interest rates instead of looking through another round of supply disruption.

Given the recent developments in inflation, the current strong labour market backdrop, as well as the ECB's singular focus on delivering price stability, we believe the risks around monetary policy are skewed to the ECB over-delivering rate hikes versus current market expectations.

Over the medium term, however, our view remains that higher inflation caused by exogenous shocks will eventually lead to a deterioration in consumer purchasing power and slow consumption. For export-oriented economies, such as Germany's, the terms-of-trade shock would eventually hurt businesses' competitiveness, leaving employers little room to raise wages.

EQUITIES

The future's so bright, I gotta wear shades

United States

One of the few “easy” equity market calls at the beginning of the year was the likelihood that US equities would underperform the rest of the world. The US had already outperformed for four years in a row, and since 1970 the US had never beaten non-US equities for longer than that. The primary reason to expect US equities to lag was the outlook for monetary policy. At the time, the fed funds rate was forecast to rise about 150 bp over the next two years as the bank tried to bring inflation (then nearly 5% for core Personal Consumption Expenditure (PCE)), back down to the Fed’s 2% target. Since then, fed funds expectations have risen a further 200 bp while inflation has remained high. This increase in policy rate expectations has been enough to deliver the expected underperformance in US equities despite the Russia-Ukraine conflict in Europe and Covid still forcing lockdowns in China.

The outlook for the rest of the year depends on whether a recession ultimately materialises in the US in the second half of next year. Reading newspaper articles or surveys might lead one to believe a recession was almost certain. For example, nearly 60% of those queried for the latest BofA Global Fund Manager Survey expect a recession. This result is particularly notable as the percentage is quite high so far ahead of when the recession is expected to occur. During the Global Financial Crisis (GFC), the percentage did not reach that level until November 2008, **after** the recession had actually started.

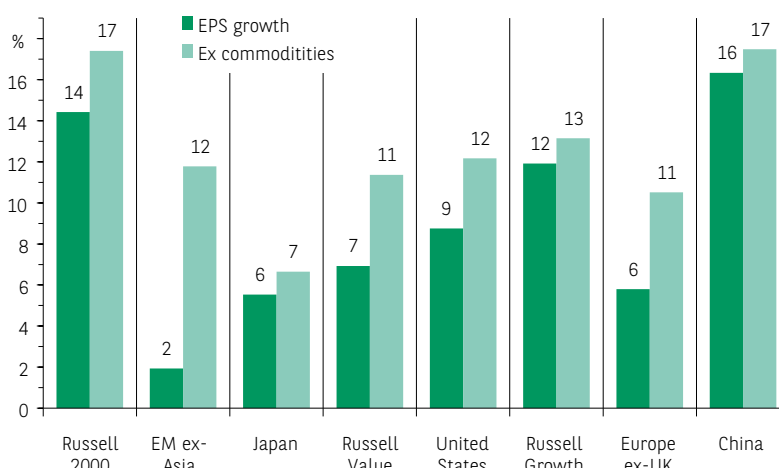
While many expect a recession, and are positioned accordingly (the percentage of fund managers taking lower-than-normal risk is at an all-time high), to the markets and economists the future is still reasonably bright. To start with fixed income, while the 2 year-10 year US Treasury spread is negative, other yield curve models are not inverted to the degree that in the past has signalled a recession. Looking at economist estimates, the median estimate from the most recent Bloomberg survey has growth bottoming at just 1.1% (QoQ SAAR) in the first quarter of 2023 before rebounding to 1.6% by the end of the year.

Nor do equity analyst forecasts reflect a contraction in US GDP next year. Based on historical patterns, the increase in fed funds, and decrease in the rate of inflation, that markets have currently priced in would suggest a 20-30% decline in earnings is ahead. While earnings **revisions** have indeed been negative since Russia’s invasion of Ukraine, consensus estimates still point to 9% **earnings growth** next year. Excluding commodities, the forecast is 12%. Other markets are similar (see Exhibit 5).



"The decline in US equities this year is not a recession signal; earnings expectations have not fallen. Rather it has been valuations."

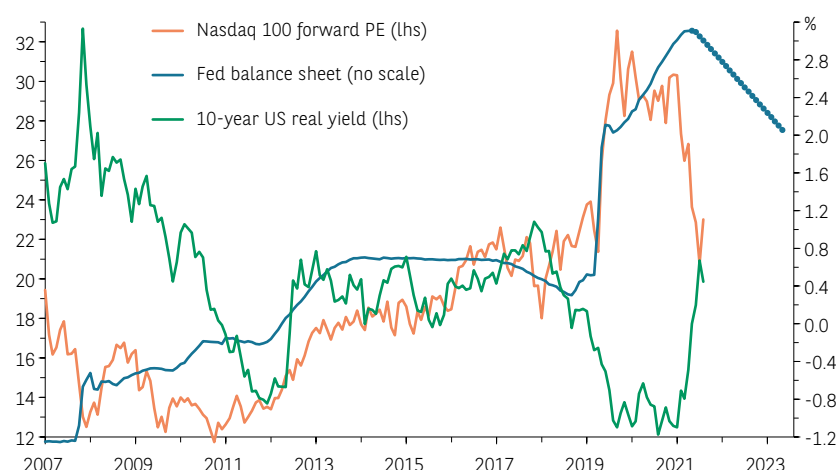
Exhibit 5: Consensus year-on-year index EPS growth for 2023



Data as at 21 July 2022. Sources: FactSet, BNP Paribas Asset Management.

Given that equity markets typically decline well ahead of the beginning of a recession, the 23% drop through to the low this year has been interpreted by some as the most obvious signal that a recession is likely (supposedly there is an 85% chance). This view misunderstands what has driven the market's decline, however. Earnings may yet fall by 25%, in which case equities would likely do the same, but EPS estimates for 2023, as noted, are higher than those for 2022. The decline in markets has instead been a function of the increase in the fed funds rate, expectations for additional increases, the announced unwind of the Fed's balance sheet, and the resulting increase in real yields, all leading to a decline in equity market valuations. This sequence has (partly) reversed what began in 2008 with the GFC (see Exhibit 6).

Exhibit 6: US real yields, Fed balance sheet, and Nasdaq P/E



Data as at 21 July 2022. Sources: IBES, Bloomberg, BNP Paribas Asset Management.

While fed fund expectations and real yields may rise a bit more, and hence equity market valuations may still be at risk, we believe that valuations have largely normalised and the key driver of equity returns from here will be earnings. Encouragingly, early results from the current reporting season point to an average level of positive guidance and both earnings and sales are coming in ahead of forecast. Sales have actually risen strongly, but earnings less so, illustrating the squeeze on margins from higher input and wage costs. The strong dollar will also be a burden (though a boon to European exporters). Rising inventories may be the next worry.



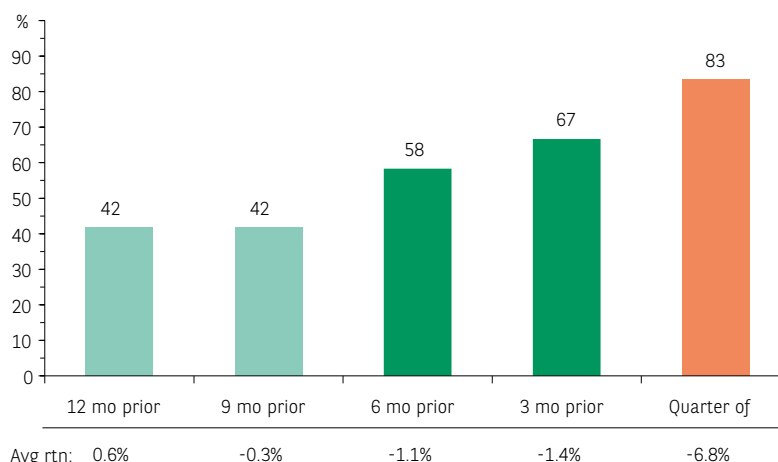
“If a recession does materialise, when should an investor change allocations and which sectors or styles should they prefer?”

When and what

If a recession does ultimately materialise next year, it raises two questions for investors: when should one change allocations and which sectors or styles to prefer? The answer to the latter question might seem trivial as we have already had sufficient experience with markets and recessions over the years, but the combination of a recession and high inflation has not occurred since the early 1980s.

The belief that equity markets anticipate recessions is undoubtedly warranted. Not surprisingly, equity markets decline in the quarter when a recession begins (68% of the time with an average return of -6.8%), but they also generally fall in the three and six months prior to the beginning of a recession, even if the average drop is much less. More than six months prior, however, equity markets generally do not fall and the price return is only slightly negative and the total return is actually positive (see Exhibit 7).

Exhibit 7: S&P 500 price returns prior to recessions



Data as at 21 July 2022. Sources: ECRI, Bloomberg, BNP Paribas Asset Management.

Given how anticipated this recession is, it is conceivable markets will decline further ahead of time than has normally been the case, but it may still only be at the beginning of next year that allocations need to turn more defensive.

Merely looking at the average returns of different sectors and styles during recessions gives an overly rosy picture of how risk assets perform; the average return of the S&P 500 during recessions since 1946 is just -3.0%. This fairly low number is because markets anticipate the recovery after a recession in the same way they anticipate the decline at the beginning. That is, equity returns at the end of a recession are often very good. For example, the US economy was still in recession in the second quarter of 2009 but the market had bottomed in early March and the S&P 500's return in the final quarter of the recession was 15.2%.

In order to capture the anticipatory response of the markets, the calculations in the following table include not only recessionary quarters but also the quarter immediately prior. The last two columns look at just those quarters when equity returns were negative to avoid the distortions of the pre-recovery quarters. The last column takes only those periods when inflation was top quartile to capture stagflation effects. The first column of numbers is for the entire period to serve as a benchmark (see Exhibit 8).

Exhibit 8: Index returns during recessions

Average quarterly total return (annualised, USD)

All periods					Recessions																
					Negative equity return																
					High inflation																
Quarters					304	53	33	17	Quarters					304	53	33	17				
BONDS	Global aggregate	5.0%	7.2%	4.9%	-2.6%	S&P 500	12.6	-3.0	-26.7	-24.9	EQUITIES	Global aggregate	7.0	11.4	2.7	-4.5	World ex-US	10.8	-11.1	-36.2	-33.8
	EMBI	8.2	0.1	-7.5	-18.6	Emerging markets	12.0	-8.2	-32.5	-28.5		TIPS	5.1	7.0	7.9	-13.4	Growth	12.3	-2.8	-28.5	-29.0
	Global IL	5.5	3.3	4.5	-6.3	Value	14.3	-4.5	-28.7	-22.9		Global IL	5.5	3.3	4.5	-6.3	Quality growth	13.8	-2.4	-26.4	-21.1
	EM IL	9.2	7.4	6.1	5.7	Cyclical	10.7	-26.5	-46.9	-18.3		Investment grade	7.5	6.9	-6.1	-11.8	Sensitive	11.6	-24.2	-42.2	-50.0
	High Yield	8.3	0.4	-16.0	-28.0	Defensive	10.3	-11.5	-22.6	-1.0		High Yield	8.3	0.4	-16.0	-28.0	Energy	11.1	-10.2	-27.6	-24.4
	FRNs	1.9	-0.8	-4.6	-22.6	Materials	9.0	-6.8	-27.1	-23.3		Commodities	2.7	-3.0	-4.7	1.9	Industrials	10.7	-10.7	-34.2	-29.3
						Discretionary	11.0	-8.7	-31.1	-26.9		DXY	0.6	-2.3	-7.3	-10.0	Staples	8.8	2.0	-13.1	-15.4
						Health Care	12.6	5.3	-16.9	-17.5		EM fx	-2.9	-10.6	-17.7	-25.3	Financials	9.1	-7.7	-33.9	-30.0
						Technology	15.2	-2.9	-28.9	-29.9							Telecom	5.6	-2.9	-14.8	-17.6
						Utilities	5.9	-2.8	-18.1	-23.1							Financials	9.1	-7.7	-33.9	-30.0
					REITs	7.2	-14.6	-34.5	-25.5												

Data as at 21 July 2022. Note: High inflation is top quartile headline CPI for the period (above 4.4%). Recession quarters include quarter immediately prior to beginning of the recession. Cyclical sectors: Basic Materials, Consumer Cyclical, Financial Services, Real Estate. Defensive sectors: Consumer Defensive, Health Care, Utilities. Sensitive sectors (moderate correlation with business cycles): Communication Services, Energy, Industrials, Technology. Not all indices exist from 1946 so direct comparisons are not always valid. Sources: ECRI, FactSet, Bloomberg, Morningstar, MSCI, FTSE Russell, BNP Paribas Asset Management.

The outperformance of defensives vs. cyclicals (or “moderate” cyclicals, labelled “sensitive” in the table) is what one would expect. By contrast, there was less difference between growth, quality growth, and value. Historical patterns would nonetheless still favour growth as a recession approaches and interest rates and oil prices decline.

Industries that may prove more resilient than they have in the past are those linked to renewable energy. The war has heightened yet further both the need and desire for alternative energy sources and governments are likely to continue to direct investments in this area.

Overall, it is notable that there is little difference in the equity sector returns between all the “negative equity return” quarters and those with high inflation, except that most returns are somewhat less negative in the high inflation periods. There is a much bigger difference, however, on the fixed income side. While US Treasuries and inflation-linked bonds post positive returns during recessions, when inflation is high the returns are negative. If there is a risk from a stagflationary environment next year, then it is likely greater for fixed income than for equity portfolios.

Whether we actually have such an unpleasant combination is not certain, however. While a recession may well occur next year, inflation may have already fallen. Inflation is forecast to have dropped to 4% a year from now and to decline further after. During the stagflation recessions from 1980-1983, inflation averaged over 10%.

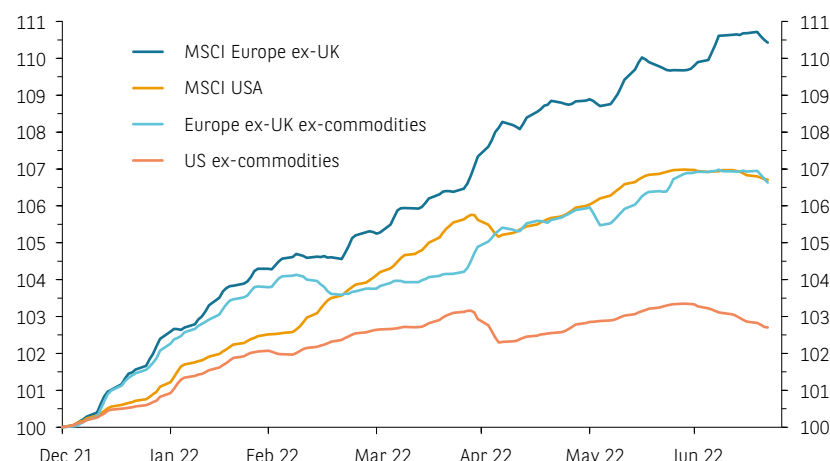
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"There remain significant risks to the region's markets, notably a cut-off of Russian gas exports this winter."

Europe

The expectation at the beginning of the year for US underperformance was partly premised on the view that Europe would be benefiting from the re-opening trade as activity recovered post pandemic lockdowns. This momentum perhaps explains why earnings expectations have continued to rise more quickly than those in the US despite the conflict in Ukraine (see Exhibit 9).

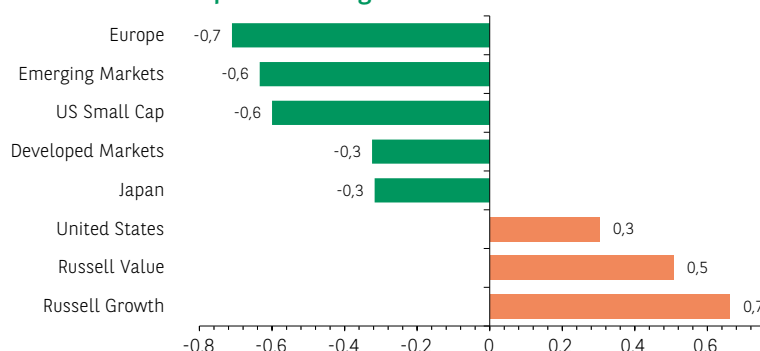
Exhibit 9: Next-twelve-month EPS estimates



Data as at 21 July 2022. Sources: FactSet, BNP Paribas Asset Management.

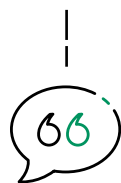
Recession risks from rising policy rates are also lower in the eurozone than in the US given that core CPI inflation at 3.7% is not as elevated as it is in the US at 5.9%. Consequently, policy rates are not forecast to rise as high over the next year even though the change from current levels is similar (about 125 bp both for the ECB's deposit rate and for fed funds). Valuations for eurozone equities are also more attractive relative to those in the US (see Exhibit 10), though that has been true since 2015.

Exhibit 10: Forward price-earnings ratio z-score



Data as at 25 July 2022. Sources: FactSet, BNP Paribas Asset Management.

There remain significant risks to the region's markets, however. The most important is that of a cut-off of Russian gas exports this winter. This would almost certainly push the region into a deep recession. Russia has been able to find alternative buyers for its oil exports, which anyway are a much bigger source of the country's revenues than gas. Meanwhile, Russia's imports have dropped sharply, such that the country's need for foreign exchange is low. The financial consequences of a cut-off in gas exports may thus be viewed as manageable by the government, particularly in light of perceived political gains.



"Despite the challenges, we see further upside ahead. The economy will likely rebound quickly once lockdowns are fully lifted."

A smaller risk comes from the region's peripheral bond markets, particularly Italy. The ECB's anti-fragmentation tool (TPI = Transmission Protection Instrument) is designed to prevent Italian government bond yields from rising to a level (generally assumed to be above 4%) where debt sustainability concerns arise. It is worth noting that government debt levels globally have risen post the GFC and post the pandemic, and the burden of that debt becomes more apparent as rates rise. The dilemma for the ECB is that it wants to keep yields low for peripheral markets while at the same time trying to slow growth and lower inflation. There may yet be legal challenges to the programme. We believe, however, that ultimately the ECB will be able to calibrate its response (and the EU may also provide fiscal support), though this does not preclude volatility in markets.

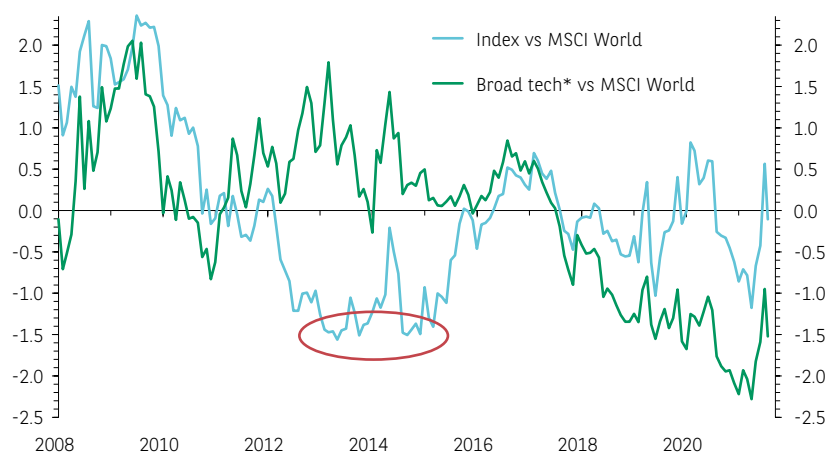
China

Chinese equities have begun to make up some of the ground lost relative to developed market equities last year, though renewed concerns about the country's property market have set back the rebound.

While economic activity has recently been improving (Purchasing Manager Indices have moved back into expansionary territory), property construction is the one area where conditions have worsened. The recent phenomenon of homebuyers refusing to make mortgage payments has increased pressure on the financial sector. Developments on the pandemic front have also been negative, with the highest number of new cases since the end of May and the government imposing sporadic lockdowns wherever outbreaks occur (for a detailed discussion of recent developments in China, please see ["Zero-Covid weighs on China's growth in Q2"](#) and ["China's mortgage 'boycott'"](#) by Chi Lo.).

Despite the challenges, we see further upside ahead. One of the lessons of the last 2 ½ years of the pandemic is that the recovery after lockdowns is swift. Once China is able to fully remove restrictions, the economy and market will rebound. The government may be close to having an effective mRNA vaccine, which would allow an early exit from the zero-Covid regime. Importantly, valuations are still attractive (see Exhibit 11) and we have confidence in the medium-term earnings outlook, particularly for the technology sector.

Exhibit 11: Relative forward price-earnings ratios (z-score)



Data as at 21 July 2022. *Information technology, internet retail, entertainment, and interactive media and services. Sources: FactSet, BNP Paribas Asset Management.

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