

MID-YEAR INVESTMENT UPDATE

JULY 2023

Getting the yield curve wrong

- Many investors have been puzzled (and consequently wrongly positioned) by an inverted yield curve signalling a recession, while equity markets rise and analysts forecast positive earnings growth.
- While one market could simply be wrong, the puzzlement is not the result of contradictory markets but from a mistaken interpretation of the yield curve.
- While an inverted yield has historically often been followed by a recession, it does not have to be. Higher interest rates today and lower rates in the future simply reflect central banks attempting to slow growth and inflation. If economic growth merely decelerates but does not turn negative, positive equity returns and rising earnings are perfectly reasonable.
- This is not to say current market pricing excludes the chance of a recession, just that it reflects a scenario where the probability of a slowdown is greater than the probability of a recession.



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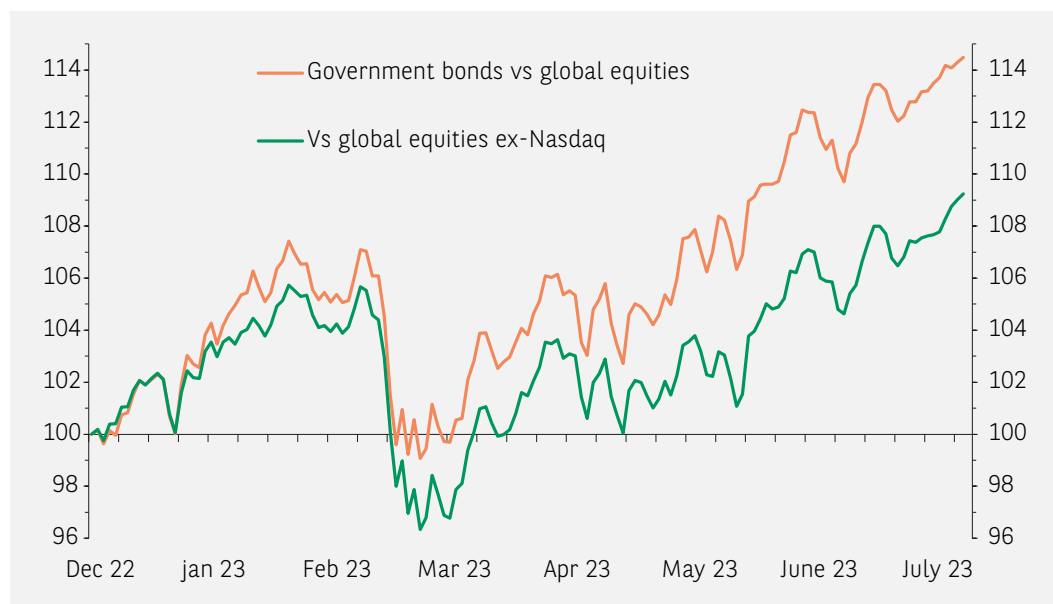
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Investors have been puzzled this year as an inverted US yield curve (alongside economist forecasts and CEO surveys) signalled an impending recession, while the outperformance of risk assets (equities, high yield debt), suggested a much brighter outlook (see Exhibit 1). Consensus earnings forecasts project rising profits instead of the declines one typically sees in a recession.

Exhibit 1

Equities have outperformed government bonds despite inverted yield curve

Bloomberg Global Treasuries Aggregate vs. MSCI ACWI, total return in USD



Data as at 25 July 2023. Sources: Bloomberg, FactSet, BNP Paribas Asset Management.

One possible explanation for the apparent divergence in views between the markets could be simply that one market is right and the other wrong and that eventually they will converge (assumedly equities fall once the market 'realises' a recession is actually in store). While this is possible, it seems unlikely that markets could sustain such a schizophrenic view for so long.

Assuming the current yield curve inversion implies a recession as it has done in the past could also be mistaken due to quantitative easing. That is, perhaps the yield curve would not be as inverted, or inverted for as long a time, if the Federal Reserve had not accumulated USD 7.5 trillion in Treasuries and mortgage-backed securities?

There is another explanation which reconciles the apparent contradiction in the markets: that the interpretation of the inverted yield curve as a recession signal is mistaken. While it is true that historically an inverted curve has very often been followed by a recession, it is not inevitable that it does. The inverted yield curve simply reflects high interest rates today as central banks aim to slow economic growth and hence inflation, and lower interest rates in the future once growth and inflation decline. That is, the inverted yield curve (accurately) forecasts a slowdown in growth, but that slowdown does not have to end in recession. This is not to say current bond market pricing excludes the chance of a recession, just that the markets reflect a scenario where the probability of a slowdown is greater than the probability of a recession.

Different this time

There are two reasons why things may be 'different this time', with the inverted yield curve not being followed by a recession. Previous recessions have arguably been caused by central bank policy mistakes, that is, raising rates too high or for too long. The US Federal Reserve (Fed) is clearly aiming today for a soft landing, however, and may err on the side of letting inflation stay higher for longer (as long as it is declining) rather than raising rates more aggressively in order to get inflation back to target quickly. It is worth noting that at the June FOMC meeting, not only did the Fed pause its rate hikes, it also raised its inflation projection for 2023.

The other key difference is that the US economy is in a different state than during previous slowdowns. Thanks to fiscal stimulus, consumer demand remains very strong. Personal consumption expenditures rose by 4.2% (SAAR) in the first quarter. The headline 2% GDP growth rate was lower due to the drawdown in inventories, but the drawdown was itself a reflection of the very strong consumption. Retail sales over the last few months show US consumers still motoring along.

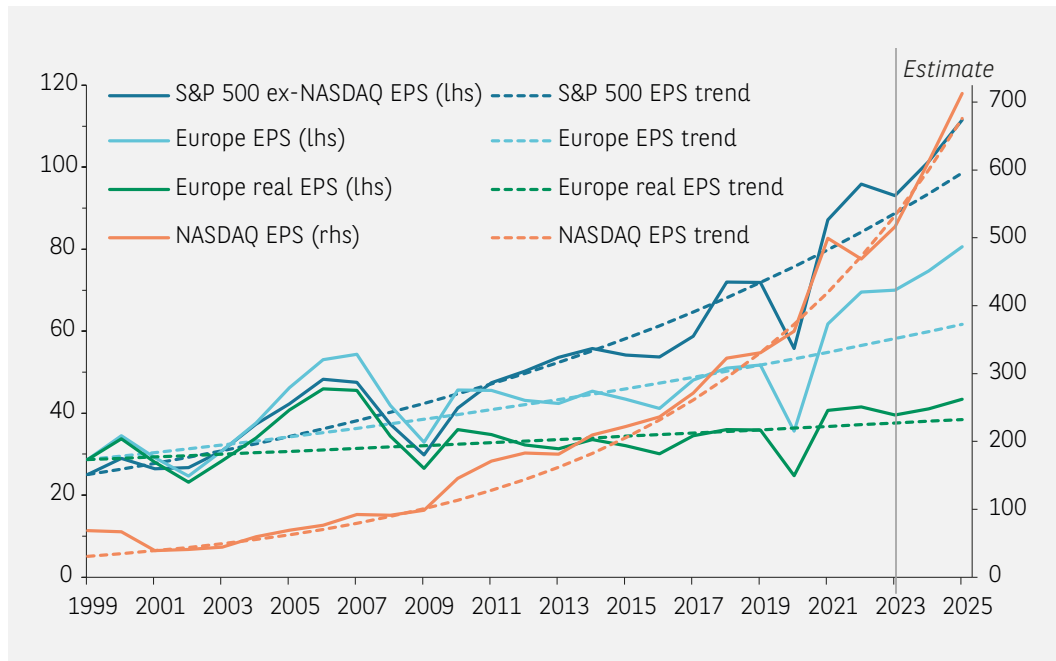
If GDP growth is merely expected to slow to a below-trend rate (say, 1.75% in real terms for the US), it is perfectly reasonable that equities would rise. Following the very negative market returns last year, a recovery in equity indices in 2023 was anyway to be expected. Analyst forecasts for positive earnings growth in the quarters ahead should also not be surprising. Remember that as inflation is falling only slowly, even factoring in consensus economic forecasts of a recession this year, the US economy is still expected to grow by 3% in nominal terms over the next year.

As we enter the second quarter earnings season, US consensus earnings estimates have already been revised down and earnings growth (ex-energy) is expected to be around zero this quarter. For the rest of the year and into 2024, however, expectations are much higher: 6% for the third quarter, 14% for the fourth, and a similar rate in 2024. These forecasts are likely too optimistic, though year-ahead forecasts almost always are.

Exhibit 2

Index earnings per share

Trend based on CAGR from 1999 to 2019



Data as at 25 July 2023. Sources: FactSet, Bloomberg, BNP Paribas Asset Management.

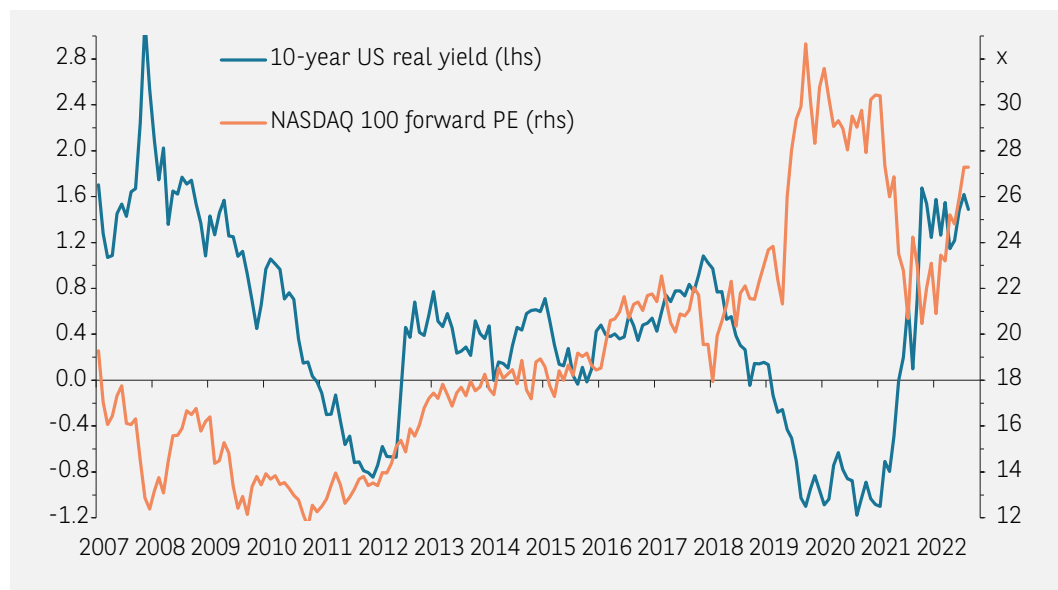
The 2024 US forecast of 14% growth seems particularly high given that historically realised earnings growth has been closer to 9%. Underneath the headline estimate, there is an important divergence between the expectations for non-tech stocks, whose earnings are expected to rise by 10% in 2024, versus 19% for the technology sector. While the growth rate for tech stocks is elevated, it results in an expected level of EPS that is not far off the projected level for the sector (see Exhibit 2). Optimistic projections mean that earnings revisions are likely to be negative, but still-positive earnings growth should support prices over the medium term.

The market vulnerability lies more in valuations for tech stocks than in earnings. The current forward multiple on the NASDAQ 100 is 27x earnings, well above the average of 19x, while for the 'non-NASDAQ' parts of the S&P 500, the multiple is 15.7x, only slightly above the long-run average of 14.5. The NASDAQ price-earnings (P/E) ratio has notably increased since the banking sector turmoil in March, even as real yields have risen by 50bp (see Exhibit 3). Normally the correlation between growth stock valuations and real yields is negative, but because of enthusiasm around artificial intelligence (AI), valuations have continued to rise. To normalise the multiple, equity prices will either have to appreciate at a lower rate than earnings, or prices will need to fall.

Exhibit 3

Tech stock valuations have risen even as real rates have climbed

Forward price-earnings ratio and US real yields



Data as at 25 July 2023. Sources: Bloomberg, FactSet, BNP Paribas Asset Management.

Europe

The outperformance of European equities over US equities since the start of the Ukraine war is unlikely to be repeated over the next year. While we also expect a slowdown in Europe (core inflation rates are at similar levels to those in the US and the European Central Bank is arguably more hawkish than the Fed), consumers are in a less strong position to drive GDP growth. In addition to US fiscal stimulus boosting consumer spending, American businesses are benefitting from the Inflation Reduction Act.

European equities have outperformed US equities in just four years since the Global Financial Crisis (GFC). Last year was exceptional, with Russia's invasion of Ukraine souring initially positive investor sentiment towards Europe. With the outbreak of the war and the surge in energy prices, most investors assumed the impact on the economy and markets was going to be similar to the OPEC oil shocks. Fortunately this pessimistic view proved to be mistaken and the market recovered as sentiment improved.

It is worth recalling, however, that optimistic sentiment towards Europe that existed prior to the war; 2022 was going to be the year that Europe fully reopened and corporate profits were expected to surge. In the end, despite the shock from the war, that profit surge largely occurred. Earnings in 2022 rose by 14% in Europe vs. 4.7% in the US. Now, however, earnings trends are expected to revert to normal, with superior profit gains in the US.

China

The performance of Chinese equities this year has disappointed many investors. The initial bounce in the market following the end of zero-Covid policies was expected to continue, following the pattern of US and European equities when those regions reopened. Investor disappointment, however, is somewhat unwarranted, as the high expectations did not take into account the difference in the support provided by the Chinese governments to households during lockdowns compared to what happened in Europe and the US. The USD 1.9 trillion fiscal stimulus provided at the beginning of the Biden administration is still fuelling consumer demand today. While there was no commensurate support in Europe, most people were furloughed during lockdowns, meaning they did not lose their job and were still paid. As there was little one could do in lockdown, savings inevitably rose, which has supported demand subsequently. In China, by contrast, government support was directed to industry, not households, so many people had to rely on their savings to get through the period of restrictions. Once reopening came, confidence remained weak.

There is more to the underwhelming performance of the market, however, than just the current cyclical growth worries. It appears there has been a broader reassessment of the prospects for Chinese equity returns. This is partly a function of the increasing decoupling of China and the US (and to some degree Europe) that has continued during the Biden administration. Though the domestic Chinese economy is certainly large enough to generate significant future profit growth for domestic companies, foreign investors worry about their ability to capture it.

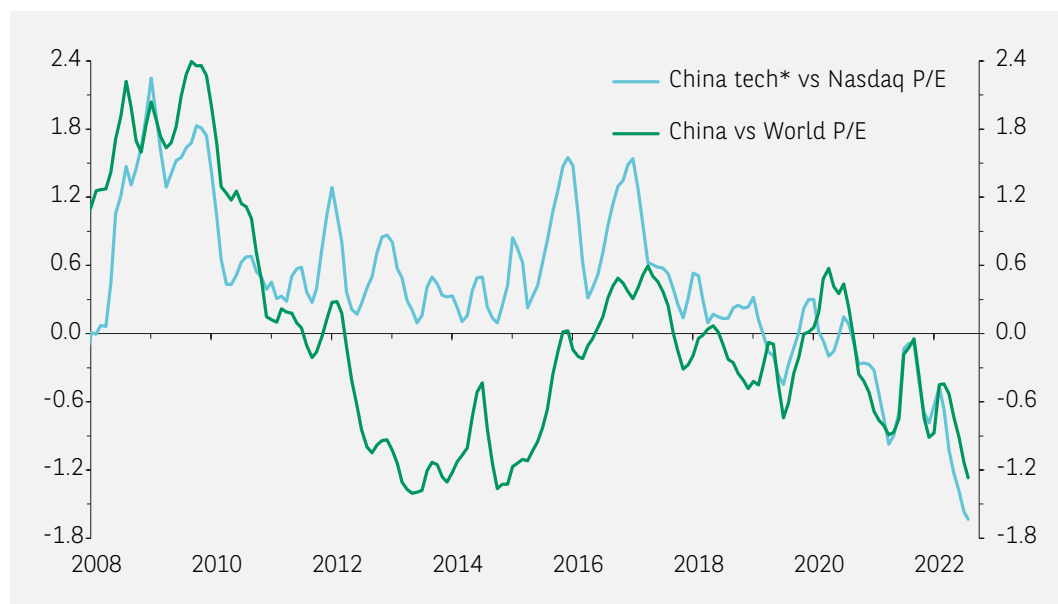
One major challenge that remains – with no easy solutions available – is to reduce indebtedness in the property market without unduly slowing economic growth. While Taiwan is discussed as another potential worry, that has not prevented Taiwan's equity market from being the best performing emerging market so far this year.

As a result of this reassessment, relative valuations for Chinese equities have dropped and are now as low as they have been since the GFC (see Exhibit 4). In contrast to the period of low valuations from 2014-2015, however, multiples may not recover to their historical average. Investors seem less inclined to assume China risk now with GDP growth slowing, particularly as Chinese equities did not outperform global equities even when GDP growth rates were far higher.

Exhibit 4

Valuation discount may be permanent

Relative forward price-earnings ratios



Data as at 25 July 2023. *Includes technology, internet retail, broadband retail, media & entertainment, interactive media & services, automobiles. Sources: FactSet, BNP Paribas Asset Management.

Despite this, we believe Chinese equities should recover in the months ahead. After the recent weak second quarter GDP figures, the government is likely to provide further stimulus to boost growth. These measures could include further policy rate cuts, more forceful measures to support the property sector, and additional (quasi) fiscal support.

We anticipate that at least some of the higher earnings growth rates expected for Chinese equities will be realised and will outpace that in the US or Europe. The growth is driven primarily by rising earnings for consumer discretionary stocks, financials and technology, which after three years of lockdowns should materialise.

If prices do not rise in line with earnings, that means valuations are continuing to fall. The market is currently trading on 10.2x forward earnings when the low since the GFC has been 7.7x, so there is indeed scope for valuations to fall further. But we believe pessimism has gone too far and that the growth in corporate profits will eventually be rewarded by the markets.

Fixed Income

The key question for the outlook of US policy rates is whether core inflation can decelerate without a meaningful rise in recession-induced unemployment. Inflation data over the last two months suggests that it indeed may be possible to see inflation fall even as the labour market remains relatively strong.

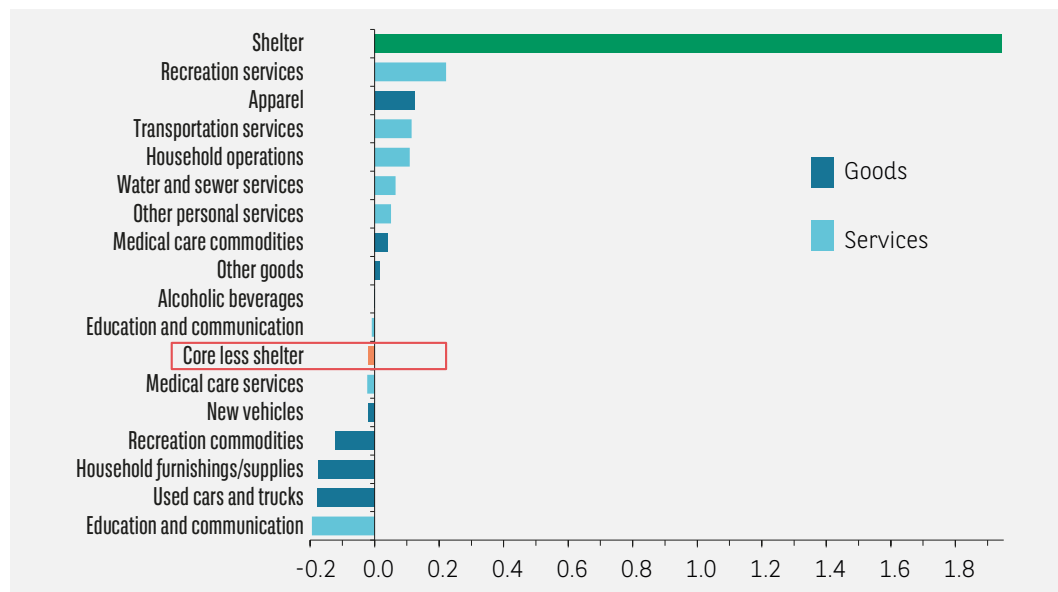
Job growth has surpassed most economists' projections this year. The view had been that once the employment level returned to where it was pre-pandemic, job creation would slow. In fact, the current level of employment in many industries is still below where it would theoretically be today if the pandemic had not occurred, suggesting there is still room for employment to increase. It is not surprising, then, that the last job openings data showed an increase in available positions.

The constraint to US economic growth is not labour demand but supply. Participation rates for prime age workers has surpassed pre-pandemic levels so there may be little scope for more workers to enter the labour force. For older cohorts (65+), there appears to be a permanent shortfall as health concerns and healthy pension pots have convinced many people to retire.

The latest consumer price index (CPI) inflation release showed monthly core inflation rising by just 1.9% (annualised) in June, and the bulk of that increase stemming from shelter costs. The remaining categories showed modest increases or even declines (see Exhibit 5). Encouragingly, core services inflation, which is assumed to be sensitive to wage gains, is slowing more quickly than the rate of wage growth. This data may help explain why markets forecast a decline in CPI inflation to just 2.4% in a year.

Exhibit 5**US core inflation ex shelter costs was very low in June**

Contribution to monthly change in sub-index, seasonally adjusted, annualised rate



Data as at 25 July 2023. Sources: FactSet, BNP Paribas Asset Management.

If a recession does begin to materialise, US Treasury yields would likely drop sharply, perhaps as low as 3%, and the markets' forecast of just one cut in the fed funds rate by the first quarter of next year may be too pessimistic. Alternatively, if inflation and growth continue to moderate, the Fed may be able to cut policy rates more than suggested in the 'dot plot', as it will have achieved its desired soft landing. If inflation remains stubborn, the Fed's projection that policy rates only drop by 100bp next year makes sense. Whatever the case, it remains a positive environment for Treasuries as investors should at least earn the current coupon, with potential for price appreciation under numerous scenarios.

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