

# ASSET ALLOCATION MONTHLY - OCTOBER 2023

## All that glitters is not gold(ilocks)

- The market's view on the US economy has shifted from expectations of a recession to a Goldilocks or soft landing. We are less confident things go so well. The strength of the labour market has been the key pillar of the macroeconomic narrative. We expect this to fade away into year-end.
- Inflation has slowed materially in recent months, boosting real disposable incomes. That tailwind could wane, though, if commodity prices renew their uptrend.
- The medium-term outlook for inflation is more uncertain. Re-shoring of supply chains, energy transition subsidies, and rising wages due to labour shortages are all inflationary.
- Corporate profits have been buoyed by the "money illusion": in a period of high inflation nominal profits rise as companies raise prices, but underlying volume growth is lacklustre. As inflation abates, profitability may come under strain. Issuers will also have to refinance debt at much higher rates, eating into profits. Hence our continued cautious stance on equities.
- We believe there is a limit to the recent sell-off in fixed income. Bonds look attractive, especially if we are correct that rates have peaked and growth starts to weaken.



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**The market has traded many different macro narratives in the last 12 months. The view has shifted from a near unanimous belief a US recession was coming, to an almost as solid conviction that a soft landing was possible, despite a record pace of monetary tightening. Of course, focusing only on monetary policy is very 'pre-covid'; fiscal policy has become increasingly important. It has sustained growth in recent quarters, and has also led to higher bond yields as concerns mount about elevated deficit spending and debt sustainability.**

## **Growth – we expect some softening in Q4**

Desynchronisation continues to be a feature of the post-covid period. In the third quarter of 2023, global growth momentum was buffeted by weakness in China and the EU, but supported by strength in the US. While China policy is becoming more supportive, the measures taken so far have not been enough to change the trajectory of growth. Europe remains in the slow lane.

In the US, various elements of the economy have been moving in different directions. Housing, the most interest-rate-sensitive part of the economy, had a difficult 2022 but bottomed at the start of 2023. The recovery was dominated by the new home sales market, however, while existing home sales remain weak. Recent housing data has been disappointing relative to consensus expectations and the sector has started to underperform the broad equity market.

In contrast, manufacturing looks to be improving. The gap between new orders and inventories has improved as inventories have fallen. It is possible that firms over-ordered in 2022 with China still closed. Now that those inventories have been worked off, the outlook for production should improve. The latest manufacturing ISM survey seems to support this view. Some industrials have also been supported by the secular trend of companies re-shoring production back to the US, and by the US Inflation Reduction Act (IRA) subsidising green investment.

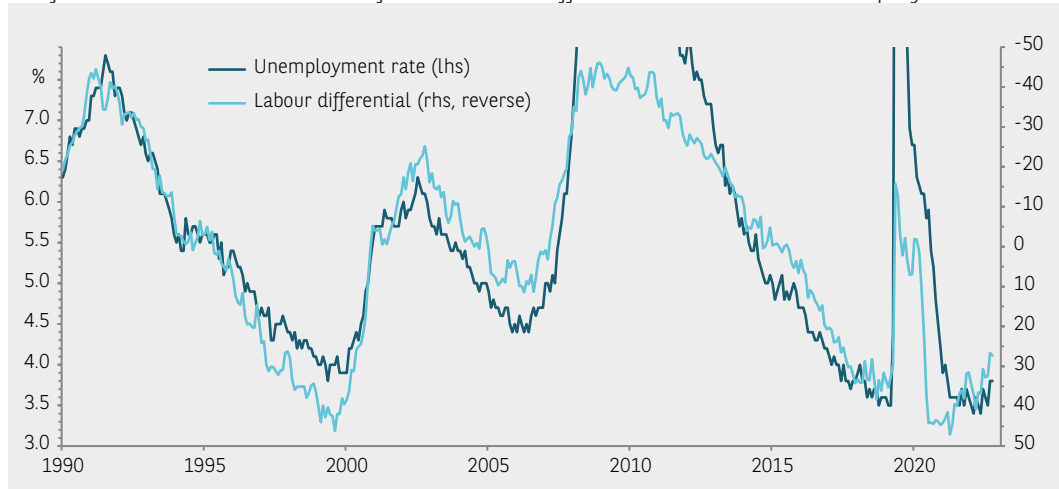
Over the last several quarters, earnings growth has surprised positively, but we are sceptical that this can be sustained. There may be pockets of strength in artificial intelligence (AI)-related sectors, which would support profits for some of the mega-cap tech companies. Much of the rest of the market, however, has been buoyed by the “money illusion”, that is, in a period of high inflation nominal profits rise as companies raise prices, but underlying volume growth is lacklustre. As inflation abates, profitability may come under strain.

## **Growth and inflation**

The strength of the labour market has been the key pillar of the macroeconomic narrative. We expect this to fade away into year-end; a leading indicator of the labour market suggests the unemployment rate will rise (see Exhibit 1). The latest-well-above expectations private non-farms payroll data for September might seem to be pointing in the opposite direction.

**Exhibit 1****Labour differential index points to rising unemployment**

Conference Board Consumer Confidence Labor Differential and US U-3 Unemployment Rate



Data as at 11 October 2023. Sources: Bloomberg, BNP Paribas Asset Management.

Both wage inflation and Consumer Price Index (CPI) inflation have slowed materially in recent months, boosting real disposable incomes. That tailwind could be fading, though, especially as commodity prices appear to be on a renewed uptrend.

The medium-term outlook for inflation is more uncertain. The global economy has changed in a material way since Covid. Supply chains are being rebuilt to improve domestic resilience to external shocks. Governments are providing large subsidies to drive the energy transition. Labour is gaining at the expense of capital as wages rise. All three of these factors are fundamentally inflationary and add to an already large fiscal burden.

**Policy-tightening cycle almost complete, but lagged impacts not fully felt**

The transition from a goldilocks to a potentially stagflationary environment poses a challenge for the US Federal Reserve (Fed). For now nominal growth remains strong, but given our concerns about the housing and labour markets, this may not persist. The tone of September's Federal Open Market Committee (FOMC) meeting was hawkish, prompting the market to price out expected cuts in 2024. Higher for longer rates will slow the economy. Good nominal GDP growth has helped contain corporate credit spreads, but issuers face a large maturity wall in 2024 and 2025 when they will have to refinance at much higher rates, eating into profits.

To an extent, central banks risk losing control of interest rate policy with bond markets selling off globally, partly driven by fears of debt sustainability. Recent Fed comments have expressed some concern about the tightening in financial conditions leading to calmer bond markets.

In our view, there is a limit to the recent sell-off in fixed income. We think bonds look attractive, especially if we are correct that rates have peaked and growth starts to weaken.

## Déjà sort of vu

The most significant market development over the last two months has been the big increase in US Treasury (and subsequently global) yields. These two months have been an (unpleasant) reminder of what occurred in 2022, that is, rising real yields leading to a compression of (growth) equity multiples. The sell-off began in August with Fitch's downgrade of the US long-term debt rating and resumed at the last Fed meeting when the committee's "dot plot", which laid out their forecasts for the level of fed funds in the years ahead, showed a bigger increase than the markets expected in 2024. Technical factors (positioning, overseas sellers), have also likely contributed to the rapid move in Treasury yields.

While the reasons for the sell-off in interest rates are debatable, the impact on equity markets is not. Equity indices have declined globally due to a compression in valuations. The impact on earnings will likely be seen in the weeks and months ahead.

At the same, the impact has been far less dramatic and in some ways quite different than in 2022. In that year, 10-year Treasury yields rose by 270 bps, and the Russell 1000 Growth Index underperformed the Russell 1000 Value index by 14 percentage points (growth -28%, value -14%). Since 31 July this year, yields have increased by a further 65 bps, but growth has outperformed by 4 percentage points (growth -3%, value -7%; see Exhibit 2).

### Exhibit 2

#### Relative performance of value vs growth and US Treasury yields

Russell 1000 indices and 10-year Treasury yields

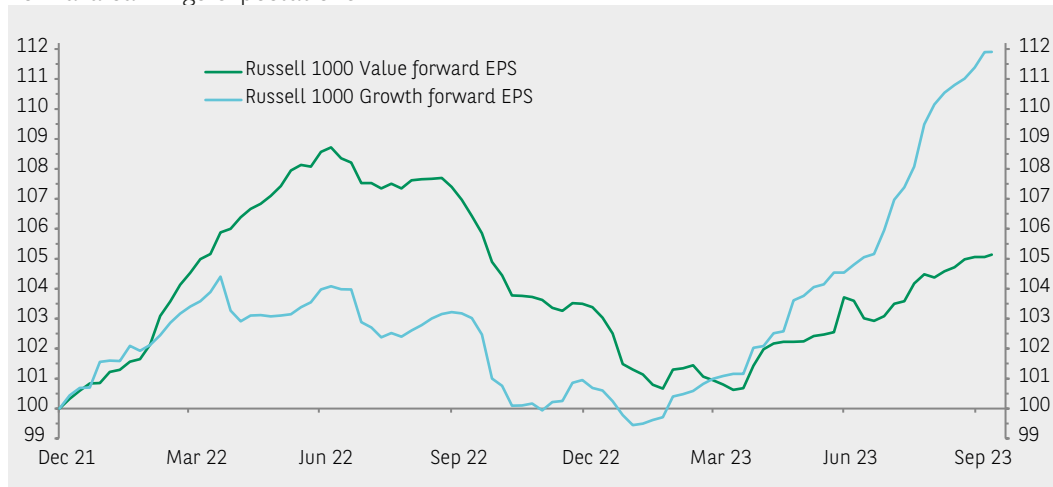


Data as at 11 October 2023. Sources: Bloomberg, BNP Paribas Asset Management.

Valuations have changed as they did in 2022, but earnings expectations have been quite different. The forward price-earnings ratio of the Russell 1000 Growth index has fallen from 27x at the end of July to 24x today, a decline of 9%. The decline in the index, however, has only been -3% because earnings estimates have risen 6%, partly driven by enthusiasm around AI. In 2022, by contrast, earnings expectations for value stocks outpaced those for growth (see Exhibit 3).

**Exhibit 3****Earnings expectations for growth stocks have outpaced those for value this year, unlike in 2022**

Forward earnings expectations



Data as at 11 October 2023. Sources: Bloomberg, BNP Paribas Asset Management.

**Regional equity markets**

Several factors argue for a long position in Japanese equities: positive earnings trends, supportive central bank policy, and neutral equity valuations. We have nonetheless held back chiefly because of the weakening yen, which has fallen to its lowest level in 11 months.

Equally, UK equities arguably look attractive thanks to low valuations. The FTSE 100 is not really influenced by domestic considerations, with over 70% of revenues generated overseas. We find the low beta characteristics attractive (high dividend yields and a sizeable weight in healthcare and consumer staples). We have used recent market weakness to build a position. Our long-term valuation framework points to US and European equities as overvalued. The demanding US valuations are sufficient to hold us back from turning positive, but we have taken advantage of recent softness to close our modest remaining short.

Relative to developed markets, emerging market stocks have been trading at a considerable discount. Within emerging markets, the focus has remained on China. Our macro team is relatively positive on the outlook. They assume that policymakers have the firepower to address the current weaknesses in the economy, including in the housing market and the trust sector. Further stimulus from Beijing is seen as inevitable, even as China's tolerance for economic pain has clearly increased. Geopolitical tensions, in particular with the US, remain a concern given that "getting tough" on China is one of the few areas with bipartisan support as next year's US election approaches.

As for asset allocation, multi-asset portfolios remain exposed to China through both a positive tilt on emerging Asian equities, where China accounts for around a third of the index, and via long positions in emerging market local debt. Positions are, however, lower than they have been for several months. We have been using recent weakness in developed markets to reduce the risk of relative value equity regional positions.

Commodities have been lowered to neutral as we reached our targets.

**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 Japan UK EM		
Equity style/size			EU large cap EU small cap US large cap US small cap		
Sovereign bonds			Japan Europe Australia	US UK Inflation-linked bonds EM local debt	
Credit			EM debt US IG US HY EU HY	EU IG	
Commodities			Energy Base metals Precious metals		
FX			EUR, USD, AUD, GBP, JPY,	EM FX	

Views as at October 2023

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# VIEWPOINT



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