

# ASSET ALLOCATION MONTHLY - DECEMBER 2022



## Relief rally faces big test

- Multi-asset portfolios benefited from an upturn in risk appetite – in particular via our long positions in US and Chinese equities and European investment-grade corporate bonds. Risk premia remain attractive in the US and China, in sharp contrast to Europe where more caution is warranted given the generally still optimistic earnings expectations.
- The low valuation of small caps relative to large caps reflects the negative forward EPS estimates for many small caps. Looking at price-to-book or price-to-sales ratios, the small-cap discount is not so large. On sectors, the cheapest area is financials.
- Earnings in emerging markets, and emerging Asia in particular, have outpaced developed markets. Chinese equities are trading at the lower end of their historical price-to-book ranges, but putting the 'right' risk premium on segments can be tricky.
- Fixed income premia have been slightly above those on equities for the first time since 2008. European investment-grade bonds are the standout from a valuation and quality standpoint.



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Multi-asset portfolios benefited from an upturn in risk appetite – in particular via our long positions in US and Chinese equities and European investment-grade (IG) corporate bonds. In terms of valuations, risk premia remain attractive in the US and China, in sharp contrast to Europe where more caution is warranted given the generally still optimistic earnings expectations.

With investors generally having opted for extremely cautious positioning, the release of softer US macroeconomic data allowed for some investor relief (notable in US technology stocks, an area where we are positive, as positioning showed the deepest underweight since 2006, according to data from BAML).

Softer US inflation data underscored the view that we are past peak hawkishness in terms of the Federal Reserve's tone and policy stance, even if US policy rates can still be expected to rise slightly. The upside from being bearish on asset markets is less clear to us now than it was earlier in the year.

Rising layoffs in some sectors of the US economy could be an early sign of a softening labour market.

In Europe, it is not clear that macroeconomic weakness has been fully reflected in analyst earnings estimates, although we note that to date, earnings have been boosted by weaker European currencies as foreign sales are converted into local currency.

## Equities

Earnings forecasts for 2023/2024 have started to tick down. Aside from US technology and Chinese stocks, where we have already seen corrections, there is probably room for further adjustments elsewhere given that earnings per share (EPS) expectations are still at or near levels suited to the top of the cycle. We believe price/earnings ratios (P/Es) are not sufficiently low to reflect a return to trend, especially after the latest P/E-led rally in equity markets.

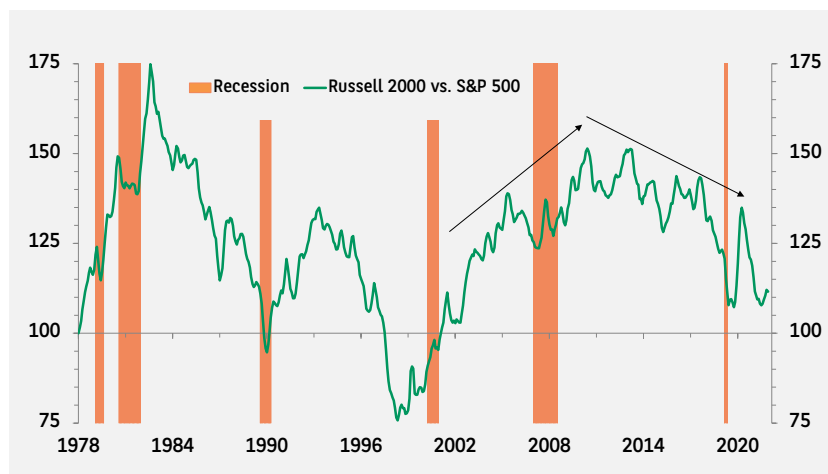
Market sentiment on US equities is off the lows. The VIX volatility index is lower, but put/call ratios are higher, reflecting market concerns. The overall picture, in other words, is mixed.

In the US, there may be more earnings downside to come. Third-quarter earnings growth excluding energy companies was down by just 4.5% from a year ago. It fell by 11.5% for growth-focused index aggregates, however. Technology stocks in particular lagged analysts' estimates. A below-average number of Q3 results beat analyst expectations. The negative stock price reaction to such misses was the largest since 2000. To us, this suggests some investors are capitulating.

The underperformance of US small-capitalisation stocks has been striking. The Russell 2000 index has dropped by 33% from its peak in October. Forward P/Es fell by 40% (peak to trough, with the peak in February 2021). That is more than the typical recession 'average' of 33%. As a result, forward valuations are now the cheapest since 1991 in absolute terms and the lowest since 1999 in relative terms; in other words, small caps are priced for a quite bad outcome.

A catalyst for a bounce may be in sight: recession alongside inflation has marked the beginning of each of the three periods of extended outperformance since the 1970s (see Exhibit 1). Seasonality and market temperature should provide additional support, and over the long term, small caps should also benefit from more on-shoring. Nonetheless, we urge caution. The reason for small caps outperforming in a recession is less clear to us: larger companies tend to have more pricing power, while small caps tend to be more domestically focused and prone to greater cyclicality. Importantly, we question the veracity of earnings estimates for smaller companies, and by association, the view that a recession is already reflected in the recent poor performance. Finally, we view a commitment to small caps as indicative of a constructive stance toward equities, with a value tilt. This does not gel with our generally cautious view on equities.

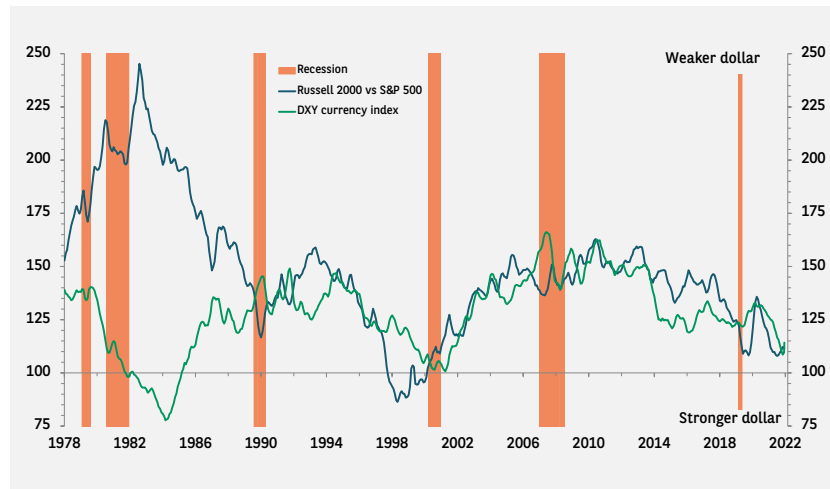
**Exhibit 1**  
**Relative performance of US small-cap stocks**



Data as at 6 December 2022. Sources: Bloomberg, BNP Paribas Asset Management.

One should not expect domestic macro factors (growth, inflation) to have demonstrably different impacts on small and large-cap stocks, though the currency factor might be the exception. A weaker US dollar should benefit large caps at the expense of small caps as large-cap companies are typically more export focused. The data suggests the relationship is not so clear-cut (see Exhibit 2).

**Exhibit 2**  
**Relative performance of small-cap stocks and the US dollar**

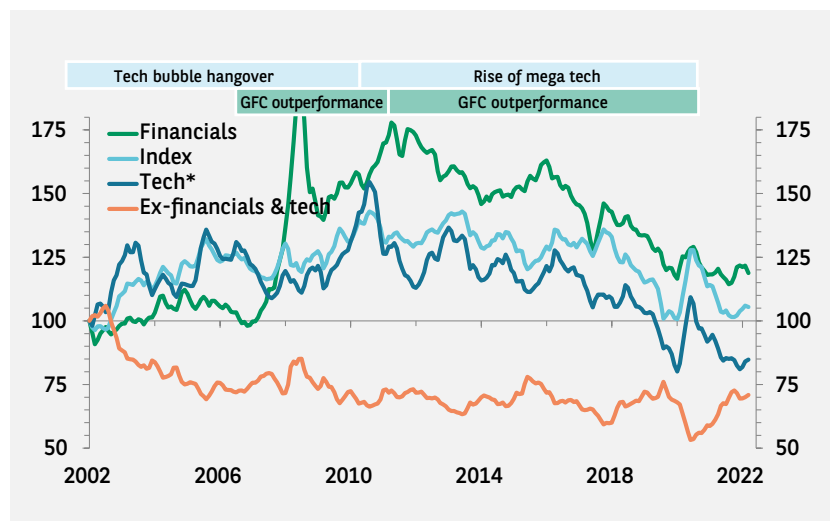


Data as at 6 December 2022. Sources: Bloomberg, BNP Paribas Asset Management.

Perhaps more important is the different performance of key sectors, namely technology and financials. As Exhibit 1 shows, small-cap stocks outperformed from 2002 to 2012, but underperformed until the coronavirus broke out. The macroeconomic environment over this period was broadly consistent, with falling interest rates, low inflation, and positive economic growth (leaving the GFC aside).

We believe the explanation for the change from outperformance to underperformance can be found at a sector level. From 2002 through 2012, small caps outperformed primarily because large-cap tech continued to lag post the bubble in the late 1990s. Beginning in 2012, however, with the rise of mega tech, small caps fell behind (see Exhibit 3, dark blue line).

**Exhibit 3**  
**Relative performance of the small-cap Russell 2000 and the large-cap S&P 500**



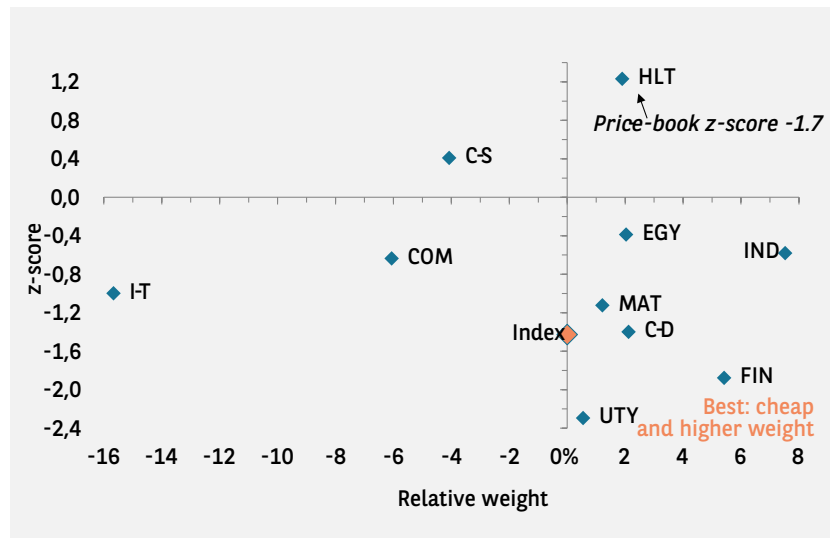
Data as at 6 December 2022. Sources: Bloomberg, BNP Paribas Asset Management.

Meanwhile, financials performed in line until the GFC broke out and massively outperformed as large-cap banks imploded. They have been giving up the outperformance since (green line). The remaining sectors have performed roughly in line (orange line).

The apparent low valuation of small caps relative to large caps should also reflect the robustness of earnings estimates as well as their 'negativity'. That is, many small caps have negative forward EPS estimates. For example, in the small-cap healthcare sector, 75% of the companies do not have a forward PE. Comparing PEs when at a company level, many of the PEs are 'undefined' is problematic. When we look at price-to-book or price-to-sales ratios, the small-cap discount is not so large.

Thinking about potential sector performance in the future, the cheapest sector where there is also a large weight differential in small caps' favour is financials. Tech looks cheapish, but the sector's weight is so much greater in large caps the performance of large-cap tech will dominate.

**Exhibit 4**  
**Russell 2000 vs. S&P 500 sector relative price-to-sales ratio**  
 (z-score)



Data as at 6 December 2022. Sources: Bloomberg, BNP Paribas Asset Management.

Away from the US, in this earnings cycle emerging markets, and emerging Asia in particular, have outpaced developed markets. Europe has been surprisingly resilient, with more companies beating both sales and EPS estimates than average. This is likely because the 'reopening trade' that we anticipated at the beginning of the year materialised. There was simply so much pent-up demand post the lockdowns that companies have generated strong earnings despite all the headwinds from the war in Ukraine. Banks and consumer discretionary/luxury companies have been particularly strong. However, analyst expectations for 2023 and 2024 may still be too optimistic. For UK companies, earnings expectations have already been trimmed significantly.

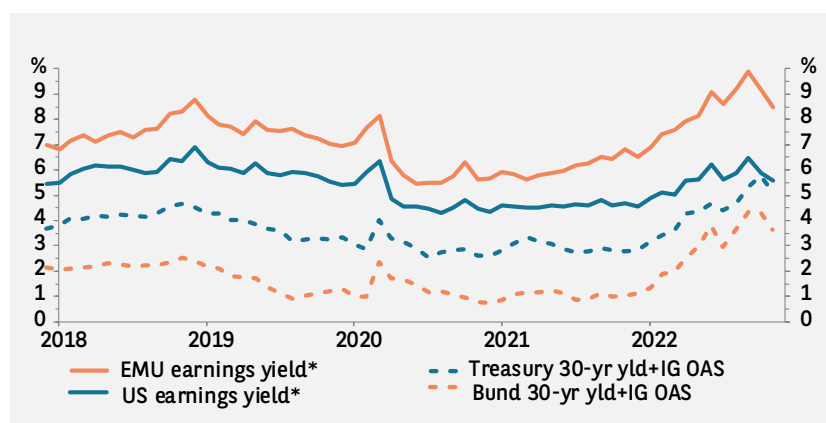
On China, we note that equities are trading at the lower end of their historical price-to-book ranges, with earnings and returns on equity under pressure. Putting the 'right' risk premium on segments such as Chinese tech stocks is tricky given the uncertain regulatory outlook.

## Fixed income

We note that fixed income premia have been slightly above those on equities for the first time since 2008 (see Exhibit 5). As stock-bond correlations have turned meaningfully positive, the relative attractiveness of fixed income over equity premia stands out.

### Exhibit 5

#### US and Europe – equity earnings yield versus bond proxy



Data as at 5 December 2022. \*Next-twelve-month. Sources: FactSet, BNP Paribas Asset Management

European investment-grade (IG) bonds are the standout from a valuation and quality standpoint. We regard the compensation for default risk that the market has priced in as high at 8%. Our fixed-income team favours long duration positions at the front end and belly of the curve, with higher term premia keeping the pressure on long-end rates. The team favours curve steepeners, European IG, and US mortgage-backed securities on both fundamental and valuation grounds.

Looking across US bond yields and futures, 60% of the US curve is now inverted, which is consistent with mounting recession risk. A simple measure of what equities are 'pricing', based on their behaviour over the past 11 cycles, suggests recession concerns may have fallen in the US from the peaks in late September/early October. That is in keeping with other, more sophisticated measures.

The contribution of fiscal support to growth is fading more quickly in the US than in the EU. Liquidity is draining from the US system as the Federal Reserve trims its balance sheet. Is this an opportunity to rotate out of European investment-grade credit (partially hedged) towards a modest long in US bonds? Given the difference between US and EU fiscal support, different drivers of inflation (more cost-push in Europe, but more demand-pull in the US), and the difference in the expected peaks in central bank policy rates in Europe and the US, we stand pat for now.

Most advanced economies appear to be moving towards slower growth and inflation, which tends to favour being long nominal USD rates as well as emerging market local currency bonds. The US economy is seeing slower growth and inflation already; Europe, by contrast, is expected to move to slower growth and higher inflation in 2023. China is expected to move to higher growth and higher inflation next year. We regard the risks of a significant US dollar correction, which would benefit emerging markets (EM), as reasonably high.

## Asset class views

|                   | Strong dislike | Dislike      | Neutral   | Favour                                   | Strongly favour |
|-------------------|----------------|--------------|---|--|-----------------|
| PRR/risk appetite |                | X            |   |  |                 |
| Asset allocation  |                |              | Equities<br>Real estate<br>Cash<br>Government bonds             | Commodities<br>Credit                    |                 |
| Equity regions    |                | Europe ex-UK | Japan<br>UK<br>EM ex-Asia                                       | Emerging Asia<br>US                      |                 |
| Equity style/size |                |              | EU large cap<br>EU small cap<br>US large cap<br>US small cap    |  |                 |
| Sovereign bonds   |                |              | US<br>Europe<br>Japan<br>EM local<br>Australia<br>UK<br>Linkers |  |                 |
| Credit            |                |              | Emerging market debt<br>US IG<br>US high yield<br>EU HY         |  |                 |
| Commodities       |                |              |   | Energy<br>Base metals<br>Precious metals |                 |
| FX                |                |              | USD, AUD, GBP,<br>EUR, JPY, EM, FX                              |  |                 |

Twelve-month, risk-adjusted view; 30 November 2022; source: BNP Paribas Asset Management

This report was finalised on 5 December 2022.

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