

EQUITY OUTLOOK



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- Equity market beta should remain favourable, even if less so than over the last year
- We are transitioning from a period when returns were driven by multiple expansion, thanks to central bank support, to one where earnings per share growth becomes the principal driver
- This transition should lead to more alpha opportunities such as value versus growth, small caps and selected emerging markets

A TEMPORARY REVERSAL

The simple reflation trades – value versus growth, cyclicals versus defensives, small caps versus large caps – that had performed well following the news of positive vaccine trial results last November reversed in April (see Exhibit 1). The most straightforward explanation for this turnaround was that the reflation bubble itself began to deflate: After peaking at 1.74% at the end of March, US 10-year Treasury yields were down by 20bp at the time of writing. Medium-term inflation expectations are unchanged. Is the reflation trade already over?

We do not believe so, at least not quite yet. Various factors can explain the underperformance of the indices, but we believe most of the factors that turned against the reflation trades will again revert. The broad macroeconomic environment remains supportive of equities, particularly growth and inflation, while valuations for growth stocks still look stretched.

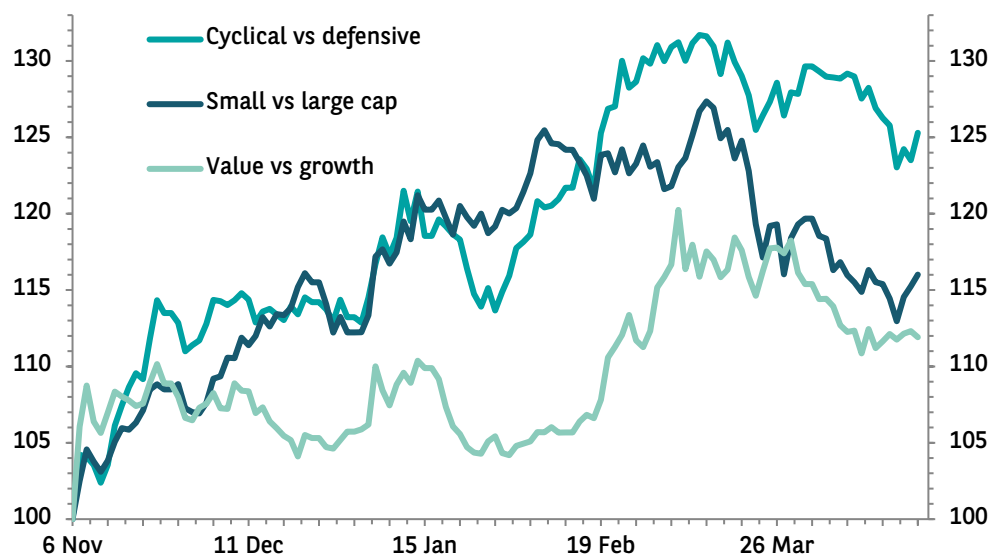
Worries about valuation persist, but it is not high valuations *per se* that pose a risk to equities, but rather their vulnerability to a larger-than-average sell-off *because of high valuations* in the event of a negative catalyst. The difficulty is imagining what that catalyst would be given not only continued central bank support in many economies, which we have had since the global financial crisis, but supportive governments now as well. Instead of austerity, Keynesian stimulus is seen as the solution to weak growth. The tail risk is that there is too much stimulus in the US and inflation expectations become unanchored, forcing the US Federal Reserve to raise policy rates sharply.

The markets currently do not reflect such a scenario. While near-term inflation expectations are 100bp above the 2019 average, this increase is not expected to persist. Five-year five-year inflation expectations have risen by just 30bp, but are arguably still below the level commensurate with the Fed achieving its 2% inflation target. High valuations for equities mean that returns from today will likely be below long-run averages. Normal volatility will provide a better entry point in the future, but our medium-term view remains positive.



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Exhibit 1: US indices' relative returns

Data as at 23 April 2021. Sources: Barclays, Russell, S&P, MSCI, BNP Paribas Asset Management.

The recent decline in yields may be the result of better messaging from the Fed. When yields began rising in February, the market expected the Fed to push back against the increase, fearing the impact of higher rates on economic growth. The Fed only did so partially. It did not view the increase in 10-year T-note yields as particularly worrisome since this reflected higher growth and inflation, and financial conditions were still very accommodative.

The central bank did, however, communicate that it felt the increase in market expectations of the future level of policy rates was mistaken. It emphasised that it would not

begin tapering its asset purchases until the labour market had recovered and realised inflation was sustainably above the 2% target. Only once any tapering had been finished, which might take a year, would the Fed contemplate raising interest rates. This would not happen until 2023 and would certainly not lead to a 50bp increase in the fed funds rate in two years, as priced in the market. The 'dot plot' of forecasts from the last Federal Open Market Committee (FOMC) meeting showed only eight out of 17 members expecting an increase in rates within two years.

Initially, this explanation did not convince the market and the expected level of rates rose further. This reaction may have come about because market participants anticipated that the increase in inflation over the next two years would be so substantial that the Fed would be forced to raise rates despite its assurances to the contrary.

The Fed has continued to stress it was comfortable with the anticipated increase in inflation (headline consumer price index (CPI) inflation could reach nearly 4% this summer) and was in no hurry to raise rates. Over the last few weeks, the message seems have sunk in. Fed fund futures have fallen from their highs, which has in turn led to a decline in real rates. Near-term inflation expectations have declined slightly, perhaps reflecting the impact of the coming increase in taxes on growth after the initial debt-fuelled stimulus.

We expect Treasury yields to resume their rise. There is scope for medium-term inflation expectations to move higher, particularly if we see further surprises in inflation, as we did in the latest report on consumer prices. Real rates may be contained in the near term as the Fed sticks to its message, but they are very low relative to history and we expect further normalisation. The details of the Biden administration's broadly defined 'infrastructure' packages will be crucial. By how much spending actually increases and the degree to which it is paid for by higher corporate and personal taxes or further debt issuance will drive the moves in real and nominal yields.

"The recent decline in Treasury yields may simply be the result of better messaging from the Fed. The market seems to have finally listened."

VALUE vs. GROWTH

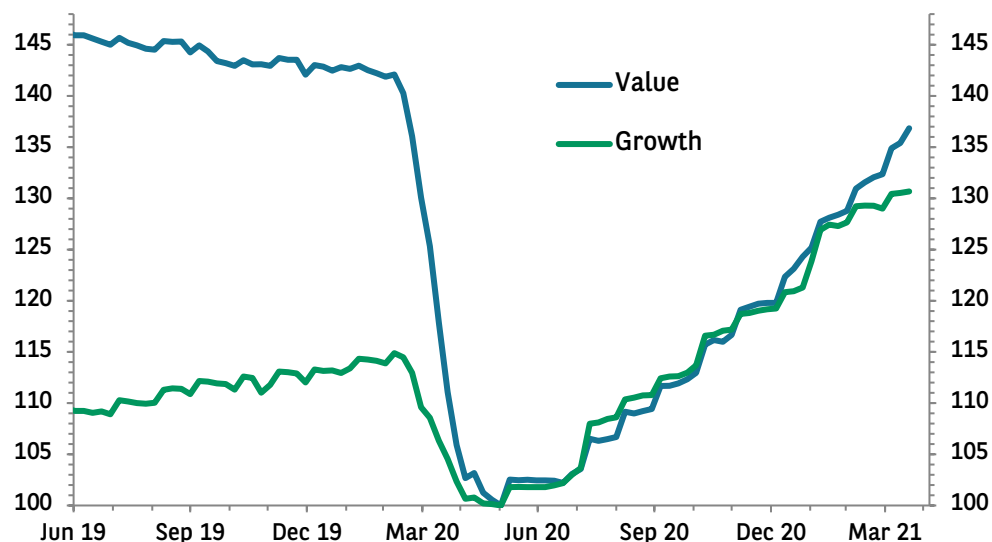
Rising bond yields, however, are neither a necessary nor a sufficient condition for the outperformance of value over growth. For example, from 2016 to 2018, US 10-year yield rose by 170bp, but the Russell 1000 Value index underperformed its growth counterpart by 20%. Rising yields nonetheless do benefit financial stocks, which have a large weight in the index. They penalise growth stocks, whose earnings are further out in the future and more sensitive to a higher discount rate.

Other factors support value stocks. Apart from rising interest rates, value outperformance tends to occur when oil prices are rising, reflecting the bigger weight of the energy sector in the value indices. Crude oil prices have risen to pre-pandemic levels, even though global demand remains low given that travel and local mobility remain limited. Prices are still 16% below their 2018 highs. As the US and Europe loosen restrictions further and borders reopen, we expect rising demand to drive oil prices higher.



The rotation to value (and cyclical) stocks reflects the rotation in demand away from lockdown beneficiaries, such as technology, to 'reopening winners' such as transportation. This shift can be seen in analyst estimates. Earnings expectations for value had been falling before the pandemic, while they were rising for growth. Once governments imposed lockdowns, expectations collapsed far more for value, but now they are rising faster (see Exhibit 2). One sign that the value rotation is nearing its end will be when the earnings trends revert to the historical pattern of much higher expectations for growth stocks.

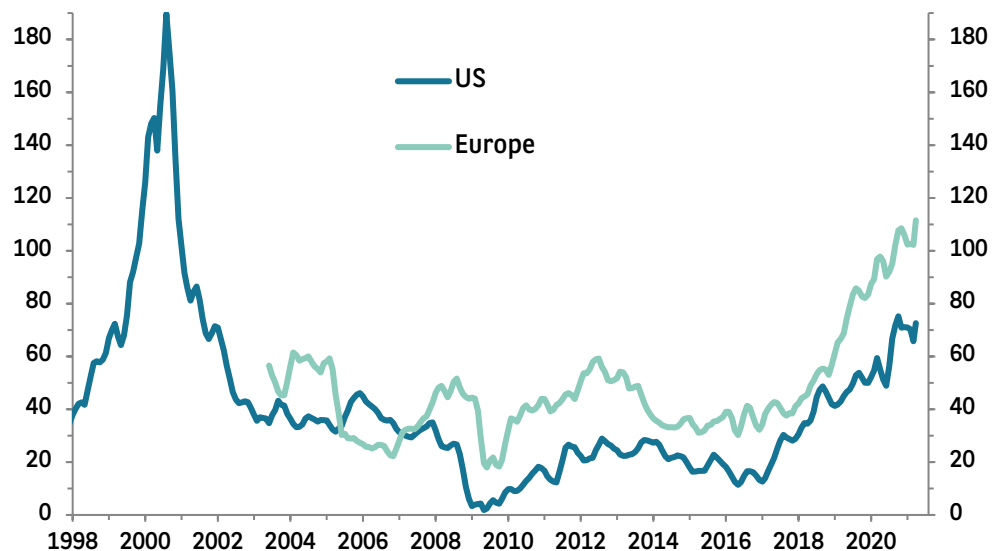
Exhibit 2: Forward earnings estimates for Russell indices



Data as at 22 April 2021. Sources: IBES, FactSet, BNP Paribas Asset Management.

hit and lockdowns began, the demand for technology infrastructure rose to support home working and home entertainment. This boosted the growth premium to nearly 80%. Even after the recent underperformance of growth, the premium is still 70% (and is even higher in Europe; see Exhibit 3).

Exhibit 3: Valuation premium, growth versus value, based on forward P/E



Data as at 22 April 2021. Sources: IBES, FactSet, BNP Paribas Asset Management.

The greater earnings momentum for value is accompanied by far lower multiples. The price-earnings growth (PEG) ratio for the growth index has fallen only slightly, from 1.9x to 1.8x, from the end of 2019 as both the forecast long-run earnings growth rate and the price-earnings (P/E) ratio have increased. For the value index, by contrast, the PEG ratio has dropped from 2.6x to 1.6x.

Looked at another way, the premium that growth stocks command over value stocks is still high despite the rotation we have had since last November.

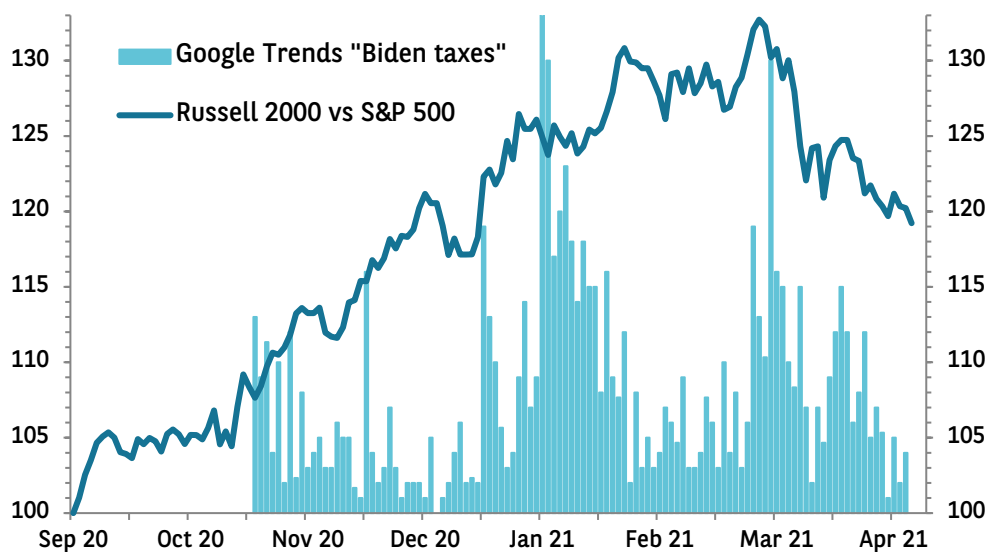
Before Donald Trump's election, the premium based on forward P/E's was 20%. It rose to 60% after his election. Once the pandemic

Between strong earnings momentum, attractive valuations, rising energy prices and interest rates, we believe there is still room for value to outperform growth.

SMALL-CAP STOCKS

Several factors likely explain the reversal in small cap outperformance. In addition to the flattening yield curve, there is a relatively high proportion of biotech and unproven pharma stocks in the small cap index, which together with the index becoming a crowded retail trade, left it vulnerable to momentum reversals. One can add to this the expected increase in taxes following the latest proposals from the Biden administration. Small caps benefited in particular from the Trump tax cuts, with the effective tax rate falling by 10 percentage points from 2015-16 to 2018-19. To the degree that the tax cuts are now reversed, the net present value of small-cap indices should fall. Arguably, that has happened. After the tax cuts in 2017, the small-cap Russell 2000 outperformed the large-cap S&P 500 by about 10% over the course of a few weeks. A mirror image of that happened recently as markets turned their attention from stimulus to tax increases (see Exhibit 4).

Exhibit 4: Small-cap relative performance and mentions of 'tax'



Data as at 20 April 2021. Sources: Google, FactSet, BNP Paribas Asset Management.

Another reason for the underperformance of small caps may be that the companies in the index will not benefit as much as large caps from the increase in infrastructure, welfare and Green New Deal spending. To the degree that a company's taxes increase but sales rise by the same amount thanks to government demand, profits should not suffer. Given the large scale of many of the administration's proposals, large companies are more likely than small companies to capture that incremental demand.

US small caps have also suffered from the same large-cap tech 'curse' as value stocks, notably from Trump's election until the outbreak of the pandemic. Over that period, small caps ex-tech returned 18% against 23% for large caps excluding tech. Small-cap tech returned just 55% against 91%

for large-cap tech, causing the index to underperform by 20%. If large-cap tech suffers from the rotation to value for a while, small caps could resume their outperformance from the newly rebased levels. The potential for gains may be limited, however, due to valuations. Historically, small caps have traded at a 16% premium to large caps (Russell 2000 forward P/E ratio compared to that of the S&P 500). That premium became a 5% discount last autumn. The ratio today has reverted to the long-run average of 16%, so any future performance differential will need to be driven by earnings growth.

COUNTRY-STYLE ALLOCATIONS

Value or cyclical exposure can also be gained by overweighting countries or regions which are more correlated with those factors. Since the vaccine announcements last November, country and region returns relative to the MSCI World index have not matched the outperformance of cyclical stocks over defensives, or value stocks over growth. Of the countries listed in the table below, the ones with the largest outperformance relative to the MSCI World index in US dollar terms include the UK – due to its greater exposure to commodity sectors and underexposure to technology – and the eurozone in local currency terms. The UK market has had the highest historical correlation to value versus growth returns. To capture cyclical outperformance, one might look to Canada and emerging markets as they have had the strongest positive relationship in the past (see Exhibit 5).



Exhibit 5: Country/regional equity index returns and correlations with 'value vs. growth' and 'cyclical vs. defensive'

Index	Return vs MSCI World		Correlation			
	since November 2020		Since November 2020		Since inception	
	US dollar	Local currency	Value vs growth	Cyclical vs defensive	Value vs growth	Cyclical vs defensive
Cyclicals	11.0					
Defensives	-9.5					
Value	6.3					
Growth	-6.6					
Australia	4.1	-2.9	31.2	23.3	4.3	31.9
Brazil	-0.8	-0.4	2.6	10.6	10.0	36.7
Canada	4.1	-0.6	48.7	50.2	-2.0	39.8
China	-18.0	-19.6	-45.9	-6.7	2.1	20.6
Emerging markets	-4.4		-17.3	14.3	-3.4	41.3
Europe	2.8	0.8	48.1	7.7	17.1	14.6
Eurozone	6.0	4.5	46.0	22.4	11.6	25.7
Germany	3.9	2.4	15.9	-6.5	4.4	27.3
Japan	-7.8	-2.3	15.1	5.8	-2.4	-0.9
United Kingdom	5.7	-0.2	65.3	27.7	30.3	5.5
United States	-0.2		-53.5	-17.8	-8.8	-29.6

Data as at 22 April 2021. Note: Relative return calculated from 6 November 2020; total return in local currency except for regional indices that are in USD. All indices are MSCI's. Cyclical index defined as energy, materials, capital goods, transportation, automobiles & components, consumer durables & apparel, banks, diversified financials and semiconductors; Defensive defined as food & staples retailing, food beverage & tobacco, healthcare equipment & services, pharmaceuticals, biotechnology & life sciences, telecommunication services and utilities. Both are based on the underlying MSCI AC World indices. Correlations calculated in local currency total returns where possible, otherwise with US dollar returns, weekly since November 2020 and monthly since index inception. Sources: FactSet, Barclays, BNP Paribas Asset Management.

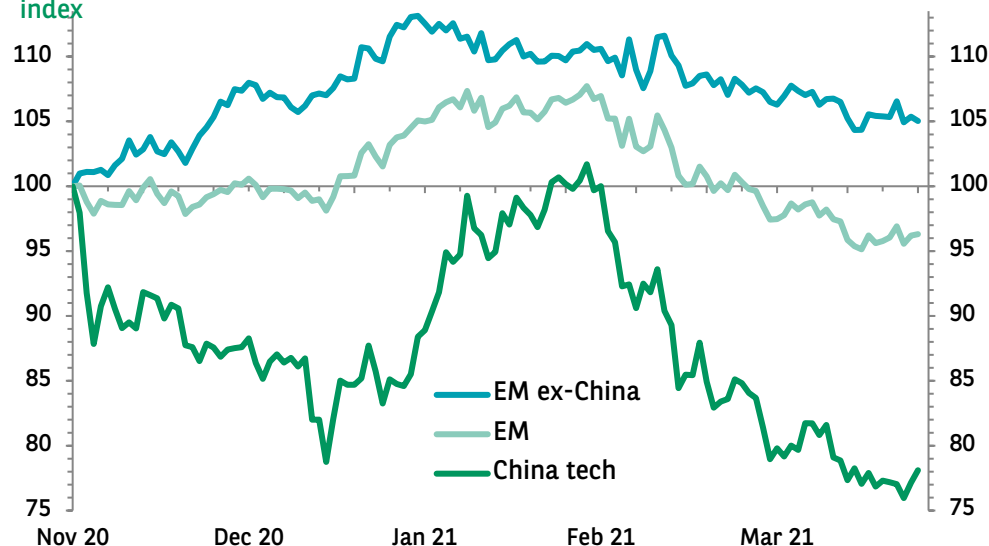
The strong performance and high valuations of US equities has prompted some investors to consider a move into European equities to capture the next leg of the reopening trade. Year-to-date, however, European equities have performed in line with the US, so it is not clear that there is a gap to be closed. Where there has been a divergence in performance is between cyclicals and defensives. As illustrated by the data in Exhibit 5, European equities are more cyclical than US equities. Since last November, European cyclicals have outperformed defensives by 17%, while in the US, the difference is just 6%. That is to say, the market seems to have priced in the recovery already. We are currently overweight US equities, but the prospect of higher interest rates and taxes in the US, when relative valuations remain in Europe's favour, could yet tip the balance.

Emerging market (EM) equities outperformed on the vaccine news, but have since lagged. The performance of the MSCI China index, and particularly the Chinese tech sector, explains much of this underperformance (see Exhibit 5). The rising importance of Chinese equities in the emerging market indices has changed the composition of the index and its dynamics. Historically, EM equities have been cyclical, with the relative performance of cyclicals versus defensives having the highest correlation with the performance of EM equities relative to the MSCI World index (Exhibit 5). The Chinese equity market is much less cyclical. In fact, since November, the correlations have been negative. This is one reason we have begun to consider our China and emerging market allocations separately, with a focus

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particularly on the opportunities (and risks) of the Chinese technology sector.

Exhibit 5: Emerging market equity index returns relative to the MSCI World index



Data as at 22 April 2021. Sources: FactSet, BNP Paribas Asset Management.

We expect EM ex-China to ultimately outperform developed markets given EM's cyclical nature, the benefit from reduced trade tensions between the US and China and a weakening US dollar, but perhaps not immediately. Rising US interest rates will make EM investments relatively less attractive. While Asia saw significant success initially in containing the pandemic, the region has fallen behind in its pace of vaccinations. This means that domestic activity can continue, but the benefits from opening up borders will be delayed. Moreover, valuations are high, with the price-to-book ratio at 2.1x, although this compares to 3.3x for the MSCI World index and 2.0x for the MSCI World ex-US. Chinese growth, which is a key determinant of emerging market growth, may also not meet expectations. In the first quarter of

this year, the Chinese economy expanded by just 2.4% compared to the last quarter of 2020, whereas economists had forecast a 5.6% expansion. This disappointment reflects the challenges the government faces as it tries to drive growth while simultaneously seeking to reduce debt in the economy.



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