

Asset Allocation Monthly

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The 'four horsemen' of 2023

- There are a handful of key judgements that matter for the year ahead. We identify four: Probability and depth of economic recessions; the near-term path and expected terminal rate of inflation; central bank reactions to that; and the prospects of desynchronised global growth.
- We 'dislike' overall risk-taking in our multi-asset portfolios and are in the cautious quintile of the ranges for our risk budgets and the maximum tracking error. We are neutral on equities – long China and the US against a short in Europe. We are maintaining our long position in EU investment-grade corporate bonds and in commodities where risk-reward remains attractive, in our view.
- Equity market valuations have deteriorated after the rally in the fourth quarter of 2022, but earnings expectations are likely still too high in some areas, notably Europe.
- We favour US technology stocks where expected earnings and valuations have fallen a long way. We also like Asian equities, both emerging Asia broadly and China specifically.
- Bond markets are signalling mounting recession risks, with a steep inversion of nominal bond yield curves; in contrast, a more "Goldilocks"-like outcome is discounted by the gently upward sloping breakeven curves. Overall, we are neutral on government bonds, including US Treasuries.



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A clean slate as we enter 2023. One would be tempted to wish for that as we briefly look back at 2022, the worst year since 1937 for a portfolio with 60% equities and 40% bonds. Losses were 17% in US dollar terms, compared with average gains of 12% since the mid-1980s. Importantly, these unusually weak returns were driven more by bonds than equities.

Where does that leave us for 2023, and how does that stack up against this time in 2022?

Early last year, the tail risk of sharply higher real bond yields was a particular focus and our most successful asset market call. At the start of 2023, we see four key judgements that will be central to market behaviour and investment opportunities for the next 12 months. These are:

- 1) **The probability, sequencing and depth of an economic recession.** With the largest consensus ever calling for a deep recession in 2023, we note private sector balance sheet strength and signs of tentative stability in leading data. There is thus a possibility that a recession will be softer than predicted. We highlight that labour market data is backward-looking, that is, this market typically weakens last.
- 2) **The path and final expected landing point of inflation.** Different data sources have been giving conflicting signals. Global headline inflation halved towards year-end with significant sequential declines. Each of the five sources of inflation – margins, wages, oil, food and rent – are coming off the boil, so the risks here appear to be skewed towards the dovish side.
- 3) **Central bank reaction functions.** Central banks are seeking to adjust monetary policy to be more forward-looking rather than backward-looking at a time when many leading and lagging data points are sending different messages. While sharply inverted bond yield curves and an abrupt reversal of tightening at the front end may reflect a central bank policy mistake, breakevens are arguably at more “Goldilocks”-like levels. We note that markets never ‘bought into’ the terminal rate predicted by US central bankers.
- 4) **Potential for desynchronised growth in different parts of the world.** This could favour China over the US. We note that measures such as dual production lines (based on whether or not an employee is infected with Covid) have lowered the impact of higher infections on supply chains. China may be one of the few regions where growth is higher this year than in 2022.

Overall, we ‘dislike’ risk taking. We are cautiously neutral on equities, balanced by a long position in EU investment-grade corporate bonds and commodities (see asset class overview below). Regionally, we prefer Asian equities, both emerging Asia broadly and China specifically, on the momentum created by the reopening of the Chinese economy. We are keeping a close eye on areas such as South Korea and Taiwan, which are often seen as bellwethers of turns in the cycle and where too much bad news may be ‘baked in’.

Equities – Seeking value

Not all equity markets are created equal nor have they performed equally. As such, in our view, they are not universally cheap or rich. The rally so far in 2023 has been almost entirely valuation driven, making many markets more expensive. But under the bonnet, US tech, Chinese and emerging Asian stocks look relatively attractive to us, while European equities look richer; fairly high earnings expectations make standard price/earnings metrics only optically cheap. Indeed, scanning across markets, Europe stands out for still optimistic expectations for 2023 earnings.

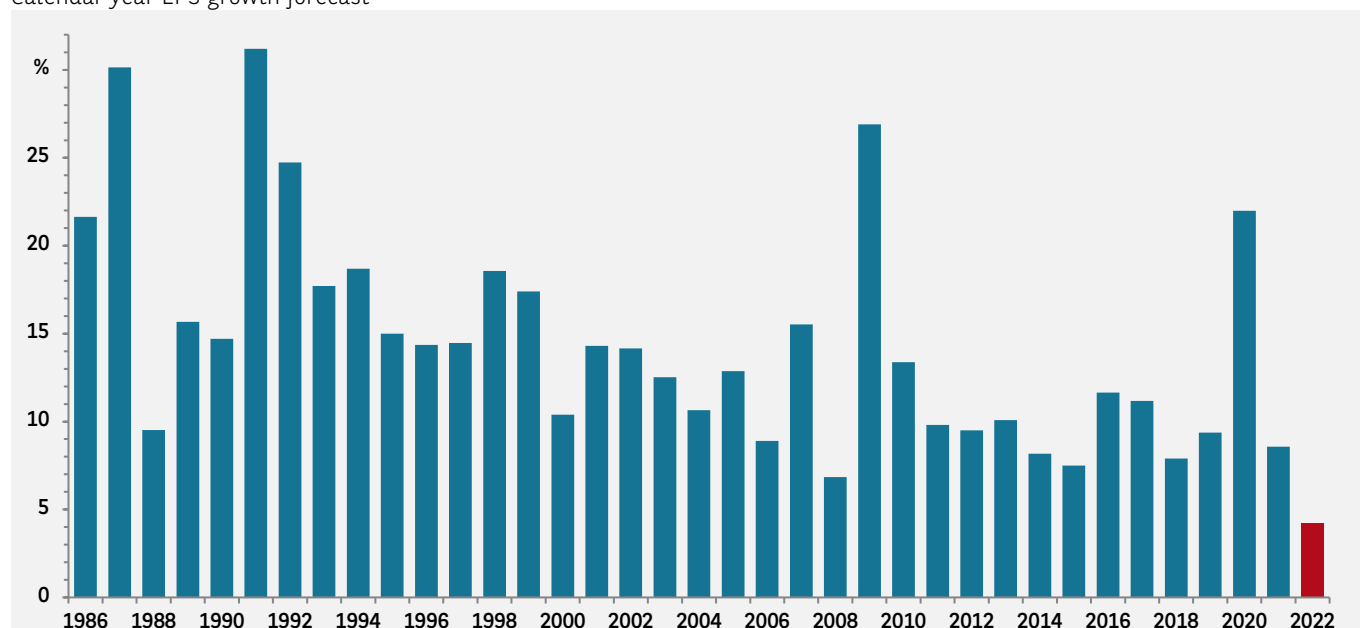
To be sure, earnings expectations in the US have fallen to their lowest for a December since 1986 (see Exhibit 1) and earnings revisions are near recessionary levels (we ‘favour’ US equities; see table below). By contrast, expectations for European earnings have moved by much less and support from a weak euro and the heavyweight financials sector may not last.

Our positioning reflects these differences – we are long US and Chinese equities against a short in Europe.

Exhibit 1

Expected US earnings per share year-ahead growth at a record low for a December

Calendar year EPS growth forecast



Data as at 16 January 2023. Sources: IBES, BNP Paribas Asset Management.

Bonds – What's baked in?

Bond premia have pulled back to below equity premia again. Real yields have been the chief driver. However, we are struck by the flatness of breakeven yield curves, which point to "Goldilocks"-like conditions, in contrast to nominal yield curves – 80% of the US curve is now inverted, signalling recession (see Exhibit 2). In Europe, too, concerns over a central bank policy 'mistake' have crept into valuations, with an abrupt easing expected to follow (over)tightening in the first half.

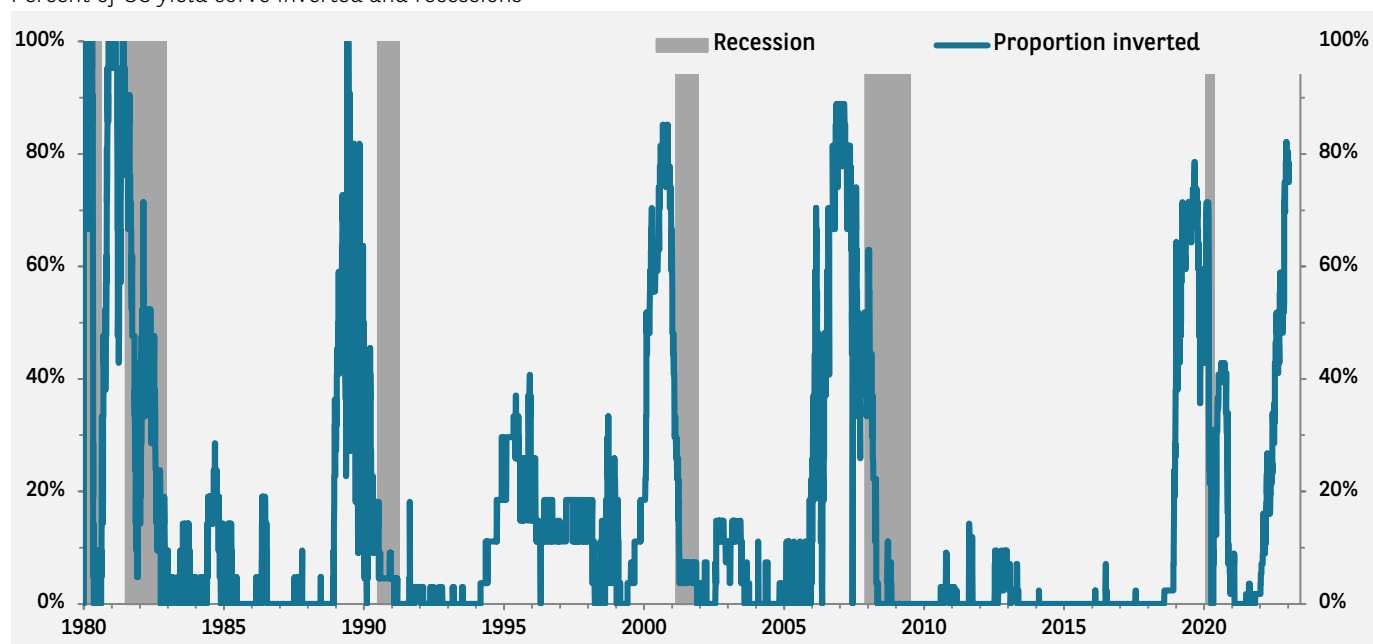
This leaves us cautious on government bonds and inflation-linked bonds.



Exhibit 2

80% of US curve inverted across spot bonds & bond futures curve, pointing to recession

Percent of US yield curve inverted and recessions



Data as at 16 January 2023. Sources: Bloomberg, BNP Paribas Asset Management.

Asset class views

	Strongly dislike	Dislike	Neutral	Favour	Strongly favour
Risk appetite*		X			
Asset allocation			Government bonds Equities Real estate Cash	Credit Commodities	
Equity regions		Europe ex-UK	Japan UK EM ex-Asia	US EM Asia	
Equity style/size			EU large cap EU small cap US large cap US small cap		
Sovereign bonds			US Europe Japan EM local Australia UK Inflation-linked bonds		
Credit			US IG US HY EU HY EM debt	EU IG	
Commodities				Energy Base metals Precious metals	
FX			USD, AUD, GBP, EUR, JPY, EM currencies		

* Risk appetite/return to risk - Data as at 16 January 2023. The views reflect those of the Investment Committee of the Multi-Asset team at MAQS. Other specific/tactical trades may be implemented in addition.

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