For professional investors - Marketing Communication - October 2021

EQUITY OUTLOOK
OCTOBER 2021

Daniel Morris
Chief market strategist

A tricky transition

Equity markets are finding the transition to the post-pandemic landscape more challenging than one might have expected. While the Covid-19 pandemic is certainly not over, infection rates have been falling in most countries and high vaccination rates (at least in the developed world) should minimise the impact of any winter wave in the northern hemisphere. As restrictions fall away and confidence improves, the economic recovery from earlier this year can resume.

The recovery has in a sense become the problem. The surge in demand has not been met by a surge in supply thanks to supply-chain and labour market bottlenecks. Prices have inevitably risen to bring supply and demand back into balance. While the persistence of the resulting 'temporary' inflation has been surprising, we still believe the current disruptions will fade over time, production will recover, and we will revert to the same 'low-flation' world we were in prior to the pandemic.

BNP PARIBAS ASSET MANAGEMENT

The sustainable investor for a changing world

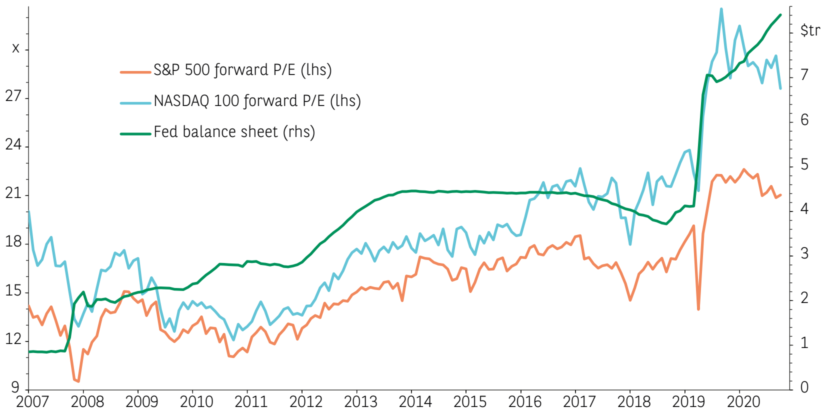
"One key challenge for investors today is assessing market valuations."

Valuations

One key challenge for investors today is assessing market valuations. By most any metric – price-earnings, price-book, price-sales – equity markets look expensive. To cite just one example, the forward P/E of the S&P 500 index at the end of the third quarter was 21x. The only other period with comparable multiples was the tech bubble at the end of the 1990s. The average forward P/E since 1985 for the index has been just 15.5x, meaning anyone anticipating a reversion to the mean would foresee a 27% decline in the market.

This analysis is perhaps flawed, or at least irrelevant, however. One hesitates to say it, but things really are different this time. A 21x multiple in 1998 reflected overoptimistic earnings growth expectations, whereas today they reflect quantitative easing (QE). As the US Federal Reserve and other central banks have purchased bonds and driven down interest rates (particularly real rates), multiples have expanded (see Exhibit 1).

Exhibit 1: US Federal Reserve balance sheet and US equity market multiples

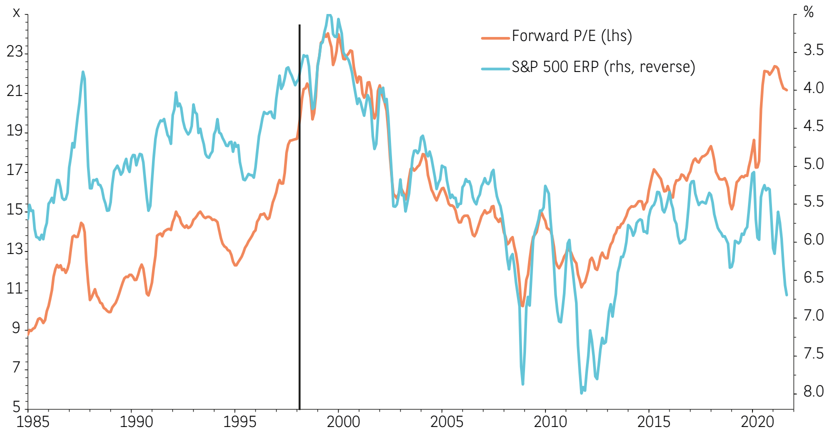


Data as at 30 September 2021. Sources: Bloomberg, BNP Paribas Asset Management.

A price-earnings or price-book ratio does not capture this dynamic and so gives a false impression of market valuations. This is not to suggest that such high multiples are sustainable indefinitely. They are underpinned by QE and when (if ever) central banks allow their balance sheets to shrink, equity markets would be at risk. We just think that is a distant prospect.

An alternative way to evaluate how expensive markets are is to look at the equity risk premium (ERP). There are numerous ways to construct an ERP model. We have discounted consensus earnings forecasts by the Treasury yield curve (see Exhibit 2). You will note that the last time P/Es were at today's level in 1998, the ERP was low, meaning that both metrics indicated high valuations. In contrast today, the ERP is above the average of 5.2%, suggesting S&P 500 valuations are at least fair value if not better.

Exhibit 2: S&P 500 forward P/E and equity risk premium



Data as at 30 September 2021. Note: Three-month moving average. Sources: IBES, Bloomberg, BNP Paribas Asset Management.

Ideally, one could calculate an ERP for every market, assuming you had sufficient history for earnings forecasts and the yield curve. It becomes more problematic with regional indices, however, given different benchmark interest rates. One way around this constraint is to consider relative P/Es, that is, the multiple of a market versus the global (ACWI) market multiple.

If P/Es are inflated equally by QE, then by taking the ratio, QE should drop out as a factor. This assumption is not entirely valid — the impact of QE has been larger on developed market equities than on emerging market and larger on some sectors more than others — but looking at the current valuation ratio compared to the long-run average should at least mitigate some of the distortions created by QE.

On a relative multiple basis, US equities (and in particular US growth stocks) are still more expensive than other key equity markets. The z-score for every metric (price-earnings, price-sales, etc.) is near or above one standard deviation for the US, while Japan and Europe are comparatively the least expensive markets (see Exhibit 3).

"On a relative multiple basis, US equities are more expensive than other key equity markets."

Exhibit 3: Relative valuation z-scores
Country/region vs MSCI All Country World

Market vs ACWI: z-score	Price-earnings	Price-book	Price-sales	Enterprise value-sales	Price-cash earnings	P/E-growth	Dividend yield	**Average**
United States	1.6	2.1	1.0	0.7	1.8	0.8	0.8	**1.2**
Russell Growth	0.5	2.9	2.0	2.3	1.2	2.6	-0.4	**1.6**
Russell Value	-0.2	-0.8	-0.6	-1.9	0.7	-0.5	-1.0	**-0.6**
Russell 2000	-0.1	0.2	-1.6	-0.2	0.0	1.4	-3.1	**-0.5**
Europe	-0.2	-2.1	-2.2	-0.8	-1.1	-0.5	0.3	**-0.9**
Japan	-1.4	-1.8	-0.4	-1.3	-1.0	-0.6	-1.6	**-1.2**
Emerging Mkts	-0.6	-0.7	-0.9	-0.8	-0.8	-0.1	-0.7	**-0.7**

Data through 20 October 2021. Note: Time period depends on market and metric. Sources: IBES, MSCI, FactSet, BNP Paribas Asset Management.

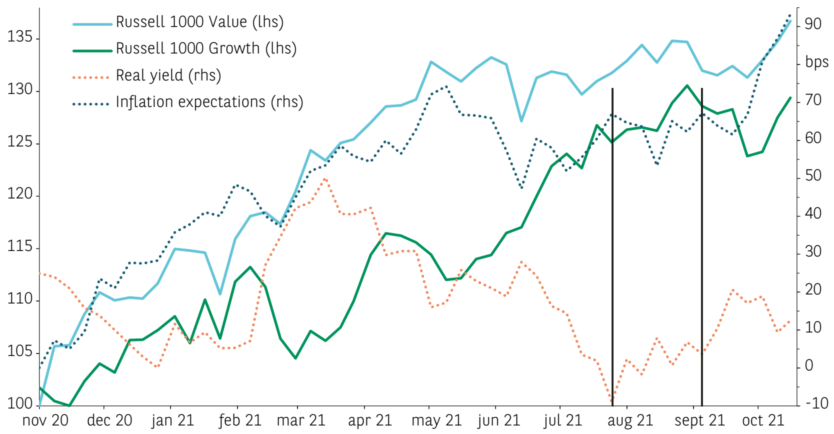
“We believe inflation will be more temporarily persistent than persistently temporary.“

Interest rates

Movements in inflation expectations and real rates remain key drivers of the relative performance of the growth and value equity styles, though perhaps less so than before. Following another hawkish surprise at November’s US Federal Reserve policy meeting, market expectations for the future level of fed funds rose, and real rates alongside.

This move contributed to the recent decline in growth stocks. As we anticipate real rates will climb further, growth stocks could remain under pressure, particularly in the event of a sudden move in yields. It is notable, however, that real rates had been rising since early August and growth stocks initially gained as well (see Exhibit 4).

Exhibit 4: Russell Growth and Value indices and change in 10-year rates



Data as at 20 October 2021. Note: Interest rate change is from low over period. Sources: Bloomberg, BNP Paribas Asset Management.

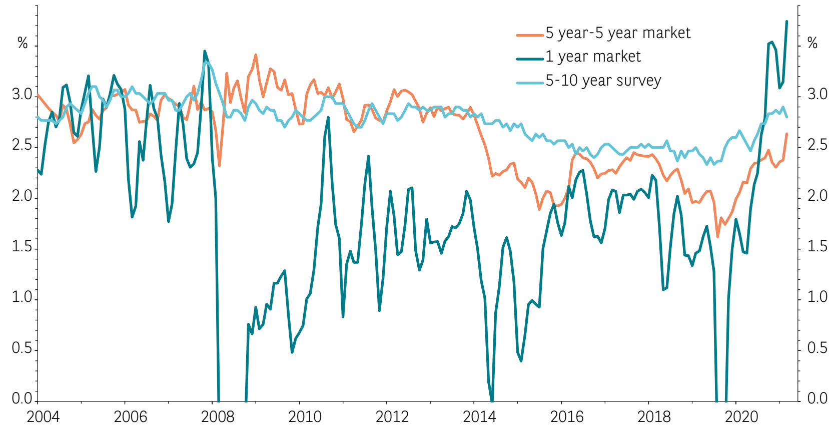
Similarly, the comparatively flat performance of US value stocks over the last several months corresponds with the (until recently) stable outlook for inflation. Now that expectations are picking up again, value stocks may show some gains.

Inflation and margins

One reason for weaker correlation between the style indices and interest rates could the changing inflation dynamic. Part of the initial surge in inflation expectations was simply a rebound from the rally in yields during the lockdowns of early 2020. Even as demand outstripped supply earlier this year, supply was expected to soon catch up, meaning that any inflation would be transitory.

Demand remains robust, but supply-chain and labour market constraints are holding back supply. Consequently, near-term inflation expectations, which had fallen after the initial surge, are rising again. These price pressures are still likely to prove temporary, albeit for a sustained period (that is, more temporarily persistent than persistently temporary). We see tentative signs of easing backlogs in parts of Asia. Crucially for central banks, while longer-term inflation expectations have risen, they are still below the levels last seen in 2014 (see Exhibit 5).

Exhibit 5: Inflation expectations



Data as at 20 October 2021. Sources: Bloomberg, BNP Paribas Asset Management.

This inflation dynamic means that performance between sectors may vary more in the months ahead than between styles. Companies that are able to resist the margin pressures they are facing will likely outperform those companies with thinner margins and/or less pricing power.

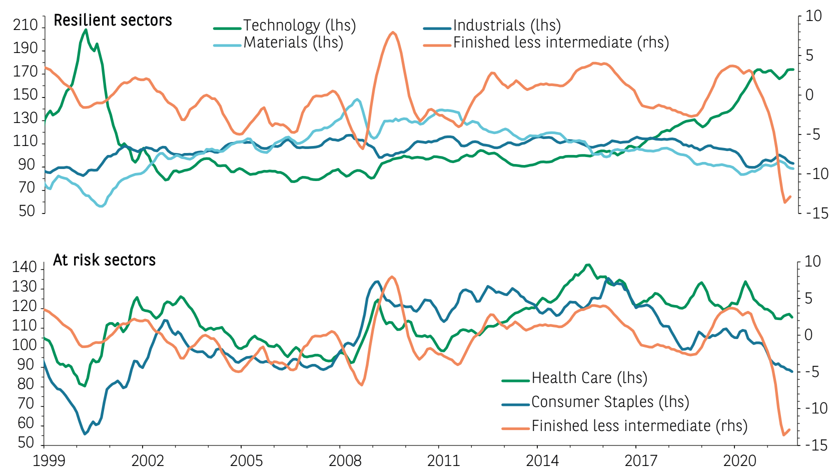
Historically, when crude and intermediate material prices have risen more quickly than finished good selling prices (the orange line in Exhibit 6 below), the information technology, industrials and materials sectors have performed better than others relative to the broad market (top chart below). By contrast, consumer staples and healthcare have generally underperformed (bottom chart).

The IT sector has high margins, so higher input costs are less of a threat to its profits. Materials and industrials companies such as metals and mining, construction materials, and building products companies are better able to pass higher input costs along to customers.

The poor performance of consumer staples is likely because it is both a low margin business and has less pricing power, while prices for many health care companies are often negotiated and so difficult to change at short notice. When the input price pressures reverse, as they did modestly last month, these sectors would be the ones most likely to benefit.

> "In the near term, performance may vary more between sectors than between styles."

Exhibit 6: S&P 500 sector relative performance and relative PPI prices



Data as at 20 October 2021. Sources: Haver, FactSet, BNP Paribas Asset Management.

"Companies no longer have the easy EPS comparisons to the lockdown periods of a year ago."

This sector breakdown helps explain why the performance of growth and value has changed with respect to inflation and real yields. Materials, industrials and consumer staples are all primarily value sectors, so they benefit from rising interest rates, but they respond differently to margin pressures. Similarly, both IT and healthcare are largely growth sectors, but they are in different camps when facing higher input costs.

Earnings

Though every earnings season is important, the upcoming one will be critical as many companies will no longer have the easy EPS comparisons to the lockdown periods of a year ago. Earnings surprises have been exceptionally high recently and it is inevitable that there will be more disappointments in the quarters ahead.

At the beginning of this year, S&P 500 EPS was expected to be nearly 50% higher in the second quarter of 2021 than in the equivalent quarter of 2020. When all the companies had finally reported, the growth rate was 86%. For this quarter, the growth rate is forecast to be 'only' 24%. Full-year profits for 2022 are forecast to rise by 8%.

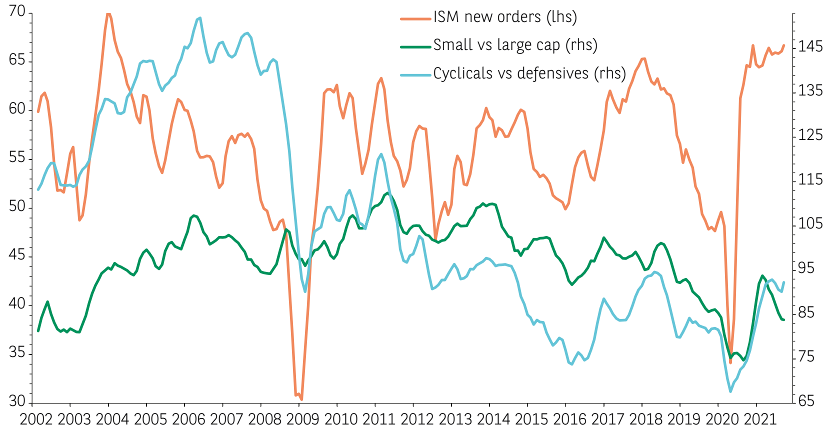
We do anticipate some turbulence ahead for equity markets until more bottlenecks are eliminated. The longer prices rise at a rapid pace the greater the pressure on profits for more companies, but a recovering global economy, reasonable valuations, and solid earnings growth all point to gains for equity markets.

US small caps

US small-cap equities have recently underperformed not only relative to US large caps, but also relative to cyclicals (see Exhibit 7). Typically, when survey data on new orders is rising, as it is today, small caps outpace large caps. A pickup in economic momentum, the return of the reflation trade or a steeper yield curve could all be additional drivers of small-cap outperformance.

Small caps also offer exposure to cyclicality for portfolios that have limited positions in other cyclical assets such as emerging market equities.

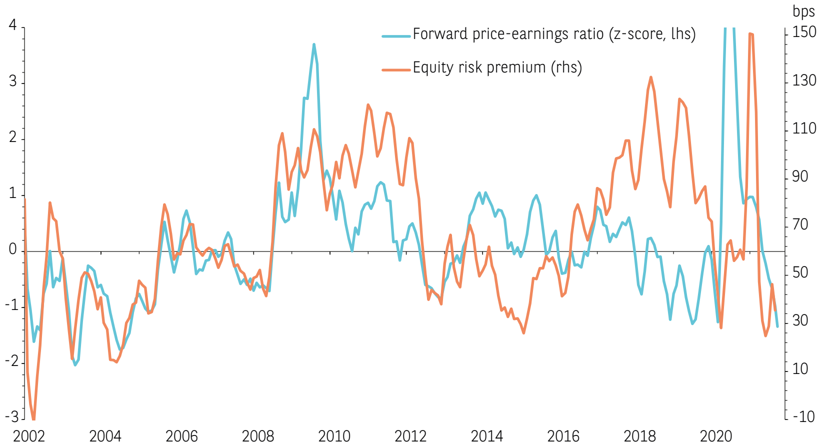
Exhibit 7: US small cap and cyclical relative performance



Data as at 20 October 2021. Sources: Institute for Supply Management, FactSet, Barclays, BNP Paribas Asset Managemen.

We believe small-cap valuations are attractive. Relative to the S&P 500, the forward P/E ratio and equity risk premium are near their lowest levels seen since 2004, driven at least in part by high valuations for mega-cap tech stocks (see Exhibit 8).

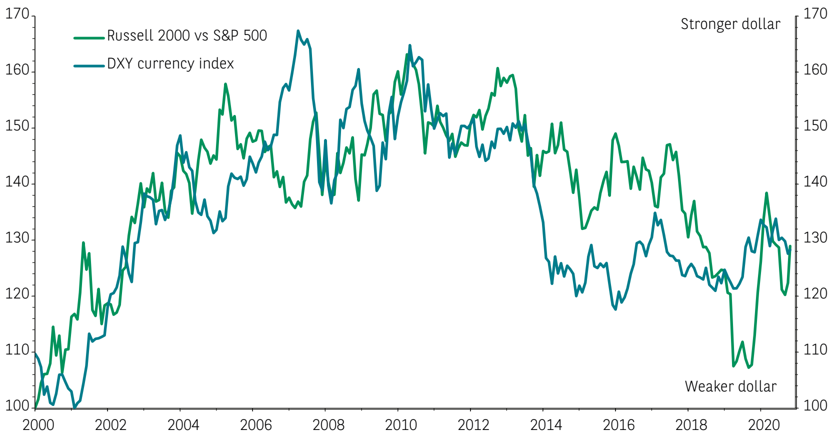
Exhibit 8: Relative valution of Russell 2000 vs S&P 500



Data as at 20 October 2021. Sources: Bloomberg, IMF, IBES, BNP Paribas Asset Management.

Once small caps have made up for their recent underperformance, the outlook may depend on the value of the US dollar. A weaker dollar makes US exports less expensive, which typically benefits large-cap companies more than small caps. The chronic underperformance of small-cap stocks over the last 15 years is at least partly due to the broad weakening of the dollar. Should the dollar weaken further, small caps may resume their underperformance (see Exhibit 9).

Exhibit 9: Russell 2000 relative performance and US dollar



Data as at 20 October 2021. Sources: Bloomberg, FactSet, BNP Paribas Asset Management.

> "The longer-term relative performance of small caps depends partly on the US dollar."

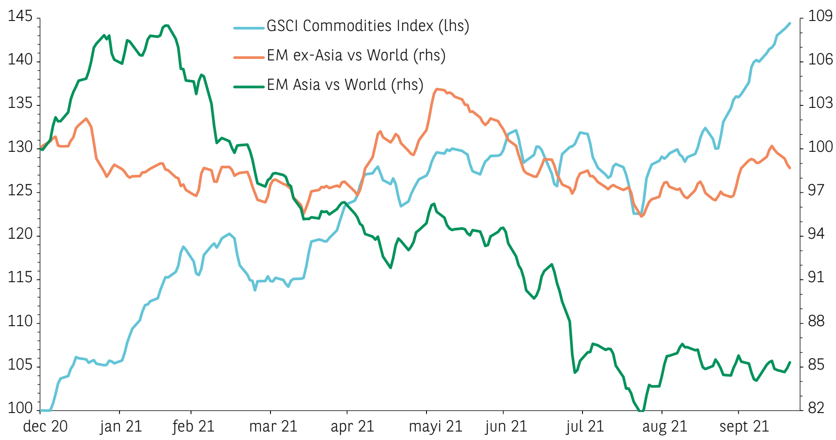
"The list of headwinds facing emerging market equities is unfortunately rather long."

Emerging markets

The list of headwinds facing emerging market equities is unfortunately rather long: a stronger US dollar over the last year, rising US interest rates, lagging Covid vaccinations, regulatory crackdowns and highly indebted property developers in China. These are in addition to the shared global burdens of higher energy prices, supply-chain disruptions and labour shortages. The main factor in EM equities' favour is comparatively low valuations (see Exhibit 3 above).

Emerging markets outperformed initially during the reflation trade at the beginning of the year, but Asia-specific worries began to weigh on returns by the end of February. The sustained rise in commodity prices, however, has benefited commodity exporters, which can be roughly proxied by the MSCI EM ex-Asia index. This index has performed mostly in line with developed market equities this year and has outpaced them over the last two months as the rise in commodity prices accelerated (see Exhibit 10).

Exhibit 10: Emerging market equity relative returns and commodity prices



Data as at 20 October 2021. Note: Total return in USD. Sources: Bloomberg, FactSet, BNP Paribas Asset Management.

Some of the negative factors should fade in the months ahead. While we anticipate further increases in US interest rates, we do not foresee significant or rapid gains. We expect the US dollar will weaken rather than strengthen. While Covid vaccination rates lag those in Europe and the US (the average rate for developed markets is 73% of the population), they are above 50% in most countries in the MSCI EM index and rising.

Developments in China will be critical. While the government is adept in containing financial contagion, the ultimate impact of the latest problems caused by high debt levels on the economy is still unclear. The choice between supporting growth through increased credit and the desire to reduce leverage in the economy is as difficult as ever. For the time being, the "credit impulse" is negative, but the government may be forced to reopen the taps if growth looks to slow too much. The PBoC has already shifted to an easing bias, starting in July with a 50bps cut in the RRR. More calculated easing is in the cards. Trade is one of the few bright spots with exports accelerating last month while imports appear to have plateaued. As global demand shifts further towards services from goods, however, exports may yet slow. The recent regulatory initiatives could continue as the government is aiming to reorient the economy towards high-value added technology hardware rather than software. These initiatives are not meant to rein in the private sector. Rather, they aim at aligning the private sector's interest with Beijing's strategic targets. The manufacturing sector has regained policy favour. The suggests that industrial migration to the interior provinces would likely resume, with high-value-added industries dominating the trend. This could revive the momentum of GDP growth and raise China's productivity in the longer-term.

Japan

In times of global economic recovery, Japanese equities generally outperform. Through mid-October, however, the MSCI Japan lagged the Kokusai (World ex-Japan) index by more than 6%. Some of the headwinds include:

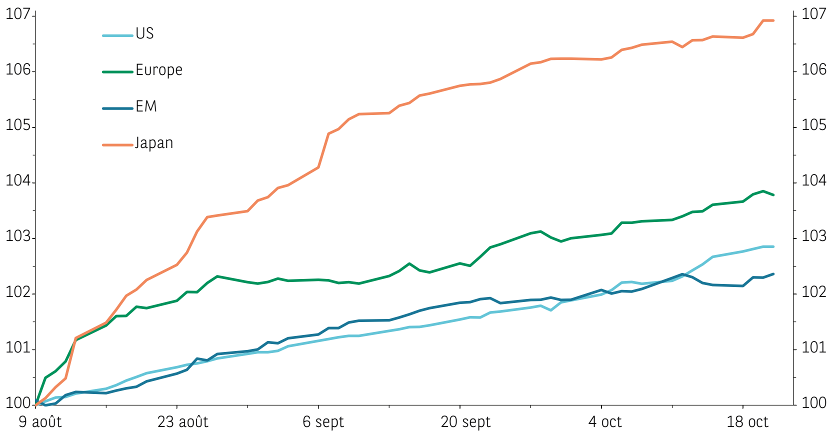
- Waning activity: purchasing manager indices and industrial production data is rolling over
- Rising oil prices (Japan is a net oil importer and its equity market has limited commodity exposure)
- Export exposure to a struggling Chinese economy
- Political uncertainty with a newly elected prime minister.

There is hope, however, for either further fiscal stimulus or reform initiatives, particularly to support domestic consumption and close the country's wealth gap, from the new prime minister.

There are other positive factors:

- Covid cases have fallen sharply and are back to levels not seen in a year; this should spur a faster resumption of economic activity.
- Earnings momentum has been better than in other major markets, particularly in the industrials and consumer discretionary sectors (see Exhibit 11).
- Valuations relative to other markets remain among the most attractive, even accounting for the typical Japanese discount (see Exhibit 3).

Exhibit 11: Next-twelve-month earnings estimates



Data as at 14 October 2021. Sources: FactSet, BNP Paribas Asset Management.

"In times of global economic recovery, Japanese equities generally outperform."

"We may still be in the rapids of the transition, but there is smoother water ahead."

Conclusion

The enthusiasm many investors felt at the start of the year was challenged first by the Delta variant, and then by the less than smooth resumption of global economic activity. Given the depths of the recession last year, and the huge amount of fiscal and monetary stimulus provided to offset it, it should perhaps not be surprising that the adjustment has been difficult and that it is taking longer than expected for activity to normalise.

Managing the lingering price pressures and operational difficulties will challenge company managers. We anticipate greater differentiation in performance between companies, a propitious environment for active portfolio management. To achieve their long-term objectives, investors can also choose from a wide range of equity market permutations: small caps, countries, regions, styles and thematics.

For equity markets broadly, we foresee further gains, particularly compared to most fixed income asset classes. Barring a renewed Covid outbreak, the economic recovery should continue, price increases should bring supply and demand back into balance, jobs should find workers (at some wage), household savings are high, and supply chains should unkink.

We believe inflation will eventually revert to pre-pandemic trends, meaning that monetary policy, while less accommodative than previously, will not tighten so much as to cause economic growth to turn negative. We may still be in the rapids of the transition, but there is smoother water ahead.

This report was finalised on 20 October 2021

October 2021 - Design: Creative Services BNPP AM - P2110047

INVESTORS’ corner

BNP PARIBAS
ASSET MANAGEMENT

The sustainable investor for a changing world