

# EQUITY OUTLOOK

## APRIL 2023



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Chief market strategist

## A fragile rally

- Some equity market observers have taken heart from the impending end of the Fed's hiking cycle. The focus on policy rates somewhat misses the point, however. The Fed is hiking because economic growth is too strong for the bank to meet its inflation target. Recent equity market gains reflect the near-term benefit to profits from the expansion. It is only once the economy starts to slow more significantly and the recession we anticipate approaches that the Fed will begin cutting rates. That slowdown will dent corporate profits, and hence equity markets.
- We see US and European equity indices underperforming those for emerging markets given still tightening monetary policy from the Fed and ECB. Emerging markets by contrast will benefit from China's reopening. Earnings expectations have already reset lower in emerging markets, while forecasts are unrealistically high in developed.
- The coming decline in interest rates should boost growth stocks versus value, and hence the US relative to Europe. Europe has benefited more than the US from higher commodity prices and the normalisation of interest rates. These tailwinds will turn to headwinds as the year progresses.

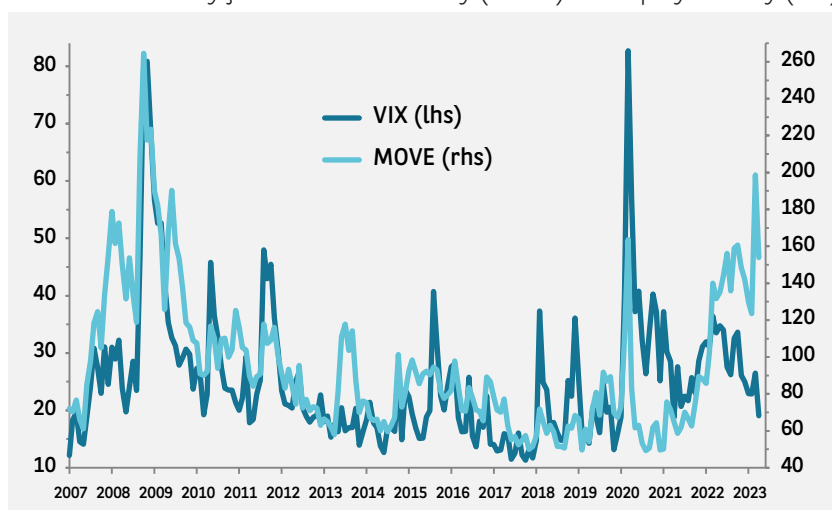


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**Exhibit 1****Unusually high fixed-income volatility recently relative to equity volatility**

Maximum monthly fixed income volatility (MOVE) and equity volatility (VIX)



Data as at 24 April 2023. Sources: Bloomberg, BNP Paribas Asset Management.

Alongside high market volatility over the last year (see Exhibit 1), investors have had to grapple with 'narrative' volatility. The unprecedented and lingering disruptions of Covid lockdowns and re-openings have made it challenging for investors to construct a narrative that explains — at times contradictory — economic data and market moves. Over just the last few months, we have swung from anticipating an economic soft landing to renewed overheating to stagflation to a hard landing.

One reason for the lack of narrative longevity has been the inability to 'believe' the data. Government statistical agencies have struggled to apply seasonal adjustment factors to normalise data when these times are anything but normal. Revisions have been unusually large.

These problems, which also impact central bank policy, are the result of the violent economic shock of the pandemic. Moreover, the return of inflation ended the 50+ year bull market in fixed income, meaning many post-1980 historical correlations are suspect.

The resulting uncertainty can be seen in the dispersion of S&P 500 companies' earnings-per-share (EPS) estimates, which has surpassed the levels seen in the Global Financial Crisis (GFC) and Covid lockdown periods (see Exhibit 2).

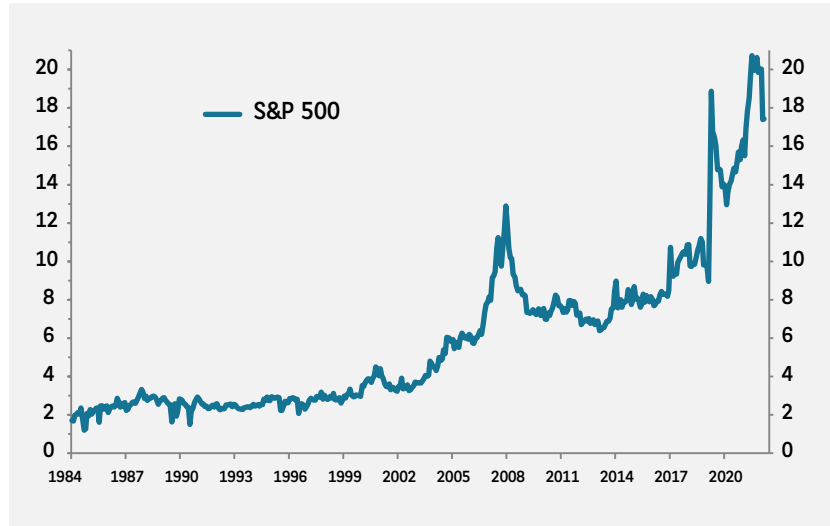
Nonetheless, investors must have an outlook, even if currently the confidence around that view is low and must be continuously validated against the data as it is released.



“Investors have had to grapple with 'narrative' vol along with market vol”

**Exhibit 2****Analyst uncertainty about the outlook is extremely high**

Standard deviation of analyst estimates for 18-month forward earnings



Data as at 24 April 2023. Sources: IBES, BNP Paribas Asset Management.

The key determinant for returns in the US and Europe this year will be if, when, and how deep any recession turns out to be. We believe that without a slowdown — which we see beginning in the second half of the year in the US and eurozone — inflation will not return to central bank targets.

Core inflation remains high and is accelerating in the eurozone and decelerating only slowly in the US. The recent turmoil in the banking sector will aid central banks insofar as it slows growth and hence inflation, but is unlikely to be enough on its own.

Consequently, we anticipate policy rates will rise more than markets expect. Barring a much more significant sell-off in risk assets, the Federal Reserve (Fed) cannot afford to swerve from its focus on inflation. As a result, with interest rates staying higher for longer and liquidity continuing to decline, further surprises for markets are probable.

## US: Has a recession been priced in?

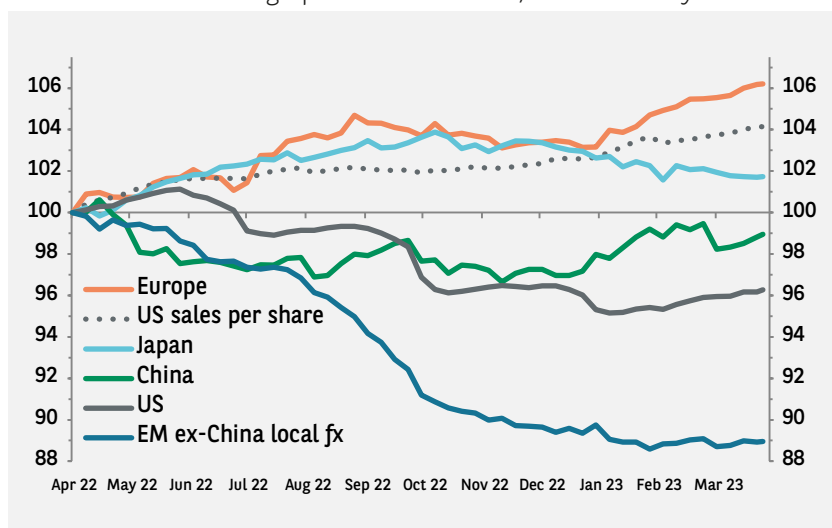
Expectations of a recession is arguably the consensus view. Numerous surveys suggest this, and the US yield curve has been inverted for months. The recent turmoil in the US banking sector has solidified recession expectations, as credit growth is likely to slow. The poor returns for US equities last year and negative earnings revisions (see Exhibit 3), have led some market observers, though, to argue the recession is already priced in.



“The key issue is how deep a recession in the US turns out to be”

**Exhibit 3****US earnings expectations have fallen by more than sales**

Next-12-month earnings-per-share estimate, local currency



Data as at 24 April 2023. Sources: IBES, BNP Paribas Asset Management.

We believe this view is mistaken. While earnings estimates have indeed fallen, this reflects the decline in margins resulting from high input and labour costs more than it does the outright decline in earnings one would anticipate in a recession.

Earnings are forecast to grow by just 0.3% this year, but much of this is due to profit declines in the energy sector as oil prices reset from the post-Ukraine invasion surge, and in the healthcare sector, as vaccine producer earnings normalise post-pandemic. Crucially, sales expectations are still rising (at least partly thanks to inflation).

Only once we see more significant signs of a slowdown in growth will the market likely begin pricing in a fall in earnings.

**Style performance**

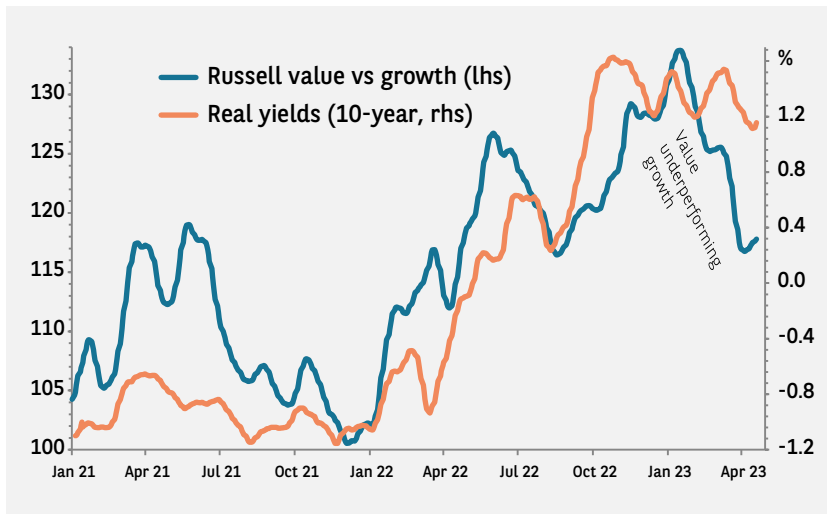
Growth and value stocks have outperformed over the last few weeks (see Exhibit 4) as investors pushed down US fed funds forecasts. This may be a preview of what happens as the recession nears.

The outperformance has been driven by falling real yields reducing the discount rate, which disproportionately benefits technology stocks. This move essentially reverses part of what occurred last year as rates rose. In addition, support has come from declines in energy stocks (on growth worries), and bank shares (due not only to sector stability concerns, but also to lower profits thanks to falling interest rates), weighing on value indices.

While we anticipate a partial reversal of this trend in the near term as fed funds forecasts rise, once the Fed actually does begin cutting policy rates, growth should see sustained outperformance.



“Once growth slows more visibly, equity markets are likely to drop”

**Exhibit 4****Value underperforming as policy rate expectations and real rates decline**

Data as at 24 April 2023. Sources: Bloomberg, BNP Paribas Asset Management.



**"The  
outperformance  
of European  
equities has been  
a surprise"**

## Europe: ECB needs to remain hawkish

The outperformance of European equities last year, and the continued outperformance so far this year, has been one of the bigger surprises given how depressed investor sentiment was following Russia's invasion of Ukraine.

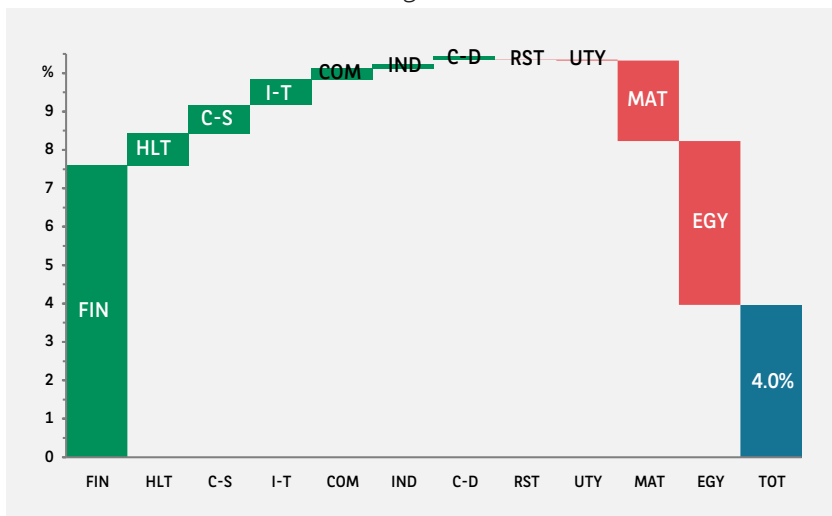
The anticipated energy blackouts, recession, and collapse in profits did not occur thanks to energy conservation, a comparatively mild winter, and the economic momentum from the post-lockdown re-openings.

High oil prices benefited European energy companies in 2021, and the change in interest rates from negative to positive has had an outsized impact on corporate profit expectations for banks in 2023. In fact, most of the expected growth in 2023 EPS versus 2022 is expected to come from the financials sector (see Exhibit 5). Similarly, the recent increase in earnings estimates shown in Exhibit 3 is primarily for financials.

**Exhibit 5**

**European EPS growth very reliant on financials**

Contribution to 2023 vs. 2022 EPS growth estimates



Data as at 24 April 2023. FIN=Financials, HLT=Health Care, I-T=Information Technology, C-S=Consumer Staples, COM=Communication Services, RST=Real Estate, UTY=Utilities, C-D=Consumer Discretionary, IND=Industrials, MAT=Materials, EGY=Energy, TOT=Index total. Sources: FactSet, BNP Paribas Asset Management.



“The drag on EM from a strong dollar and rising Treasury yields is reversing”

Whether European equities can continue to outperform will depend on the interplay between interest rates and growth. On one hand, the European Central Bank is now the more hawkish central bank and will need to remain so until inflation finally starts to slow. The Fed will probably be cutting interest rates in the months ahead. The resulting relatively tighter monetary policy argues for European equities lagging those in the US. On the other hand, the reason the Fed will be cutting rates is because the US is moving into a recession.

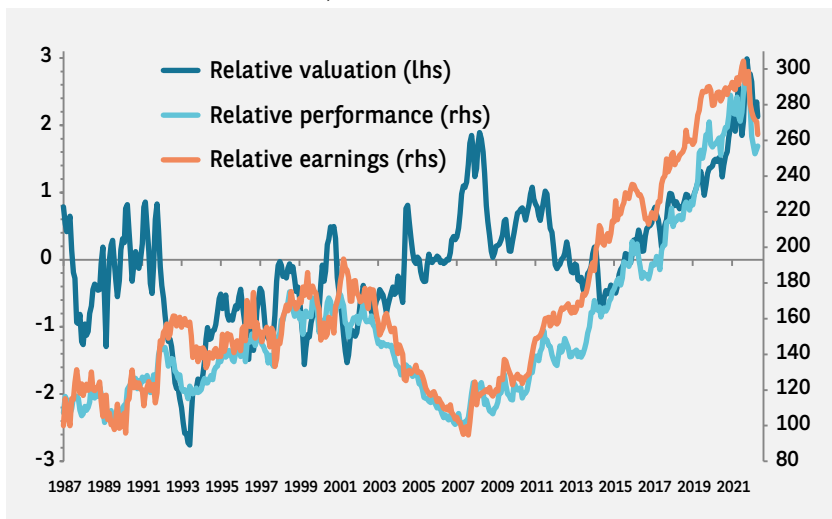
Valuations favour European equities, though that has been the case since 2017. The recent underperformance of US equities has reduced the premium somewhat, but US price-earnings ratios relative to those in Europe are still more than two standard deviations above average (see Exhibit 6).

**Exhibit 6**

**US has underperformed Europe, but valuations are still high**

Relative valuation (z-score), performance, and earnings

MSCI USA versus MSCI Europe



Data as at 24 April 2023. Sources: FactSet, BNP Paribas Asset Management.

Outside of the period from the bursting of the tech bubble through to the GFC, US corporate earnings have consistently outpaced those in Europe, and market performance has followed suit. Though that earnings outperformance has reversed over the last year as abnormal pandemic profits fade, we would count on the US resuming its leadership role.

Even if the US does enter into a recession, it is not clear that US earnings expectations would fall by more than those in Europe given the divergence we have seen over the last year (Exhibit 3). Prices, though, may not appreciate at a faster rate than earnings, reversing the expanded relative valuation we have had since 2015. We believe the proven capability of US corporates to generate superior earnings growth will prevail, particularly as the growth-oriented US market benefits from lower interest rates just as the value-oriented European indices suffer from the same lower rates and falling commodity prices.

## Emerging markets: China spillover

Most emerging markets are in an advantageous position relative to developed ones. Labour markets are not as tight as in Europe and the US and hence wage and service sector inflation is lower and monetary policy less of a risk.

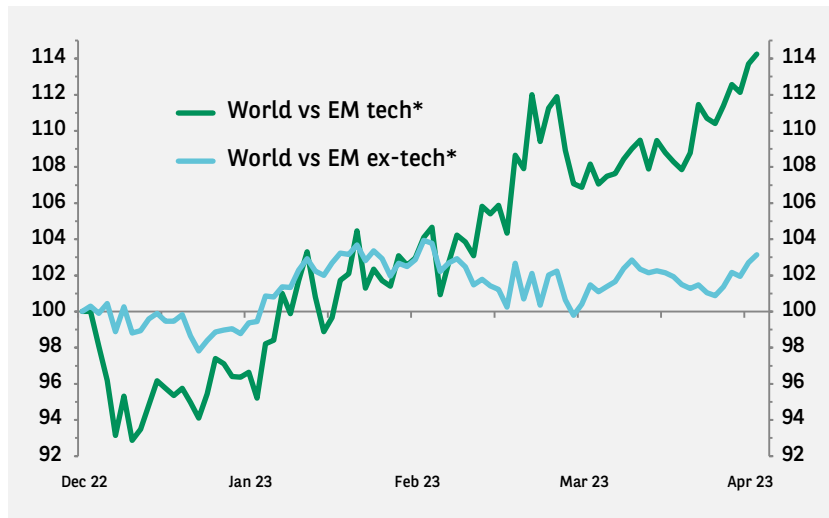
China’s reopening should provide a more prolonged boost to Asia, even if the benefit to commodity exporters and manufacturing is less than during previous China rebounds. Purchasing Managers’ Indices are improving and most countries are in expansionary territory.

That positive outlook, however, has not yet translated into equity market outperformance (see Exhibit 7). The discount rate boost to US growth stocks has dominated and EM earnings expectations have yet to swing decisively higher (Exhibit 3). Geopolitical concerns and US-China decoupling worries have also weighed on sentiment.

### Exhibit 7

#### Emerging market underperformance primarily due to technology

Relative performance MSCI World vs MSCI EM IMI, total return in USD



Data as at 24 April 2023. \*Tech includes internet retail, media & entertainment, and interactive media & services. Sources: IBES, BNP Paribas Asset Management.



“Many emerging markets are in an advantageous position relative to developed

The drag emerging markets felt last year from a rising US dollar and higher Treasury yields should nonetheless reverse this year as the Fed moves to cutting policy rates and US growth slows.

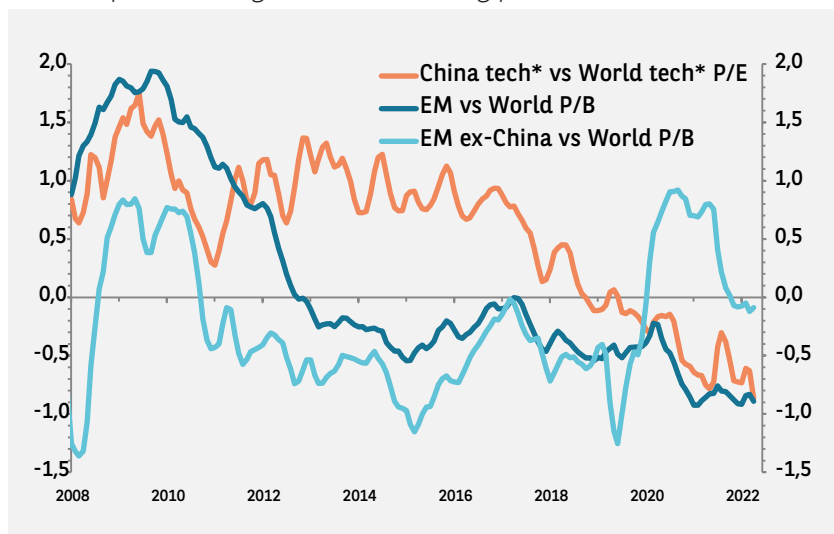
Valuations for emerging markets ex-China are currently average, so any outperformance will need to be driven by superior earnings growth. There is a valuation opportunity, however, in the Chinese technology sector, where relative multiples have fallen to very low levels.

We believe the regulatory pressure Chinese technology companies have been under in the last two years is losing momentum and that valuations will recover, if not necessarily to levels seen previously.

**Exhibit 8**

**Relative valuations favour China's technology sector**

Forward price-earnings ratios and trailing price-book z-scores



Data as at 24 April 2023. \*Tech includes internet retail, media & entertainment, and interactive media & services. Sources: FactSet, BNP Paribas Asset Management.



**“The drag on EM from a strong dollar and rising Treasury yields is reversing”**





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