For professional investors - Marketing Communication - November 2021

ASSET ALLOCATION MONTHLY - NOVEMBER 2021

Long Covid

KEY MARKET DRIVERS

In the short term, we are concerned that confidence in the growth outlook will wane, particularly given the recently weaker data in China, 'stagflation risk', and an earnings season dominated by the 'margins squeeze' story.

VIEWS & ASSET ALLOCATION

Visibility on the outlook has deteriorated and selected risks have increased. We believe, however, in the supportive base case that continues to favour equities over government bonds. Growth should strengthen as Delta infections and inflationary pressures wane, while central bank support should recede only slowly.

At the beginning of the third quarter, the hope was that the Delta wave would eventually subside and the economic recovery could resume. These hopes have been largely unfulfilled as worsening supply chain and labour market bottlenecks have hindered the recovery and the impact of the virus has lingered. Consequently, market expectations for third-quarter eurozone and US GDP growth have fallen over the last several months (see Exhibit 1).

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BNP PARIBAS ASSET MANAGEMENT

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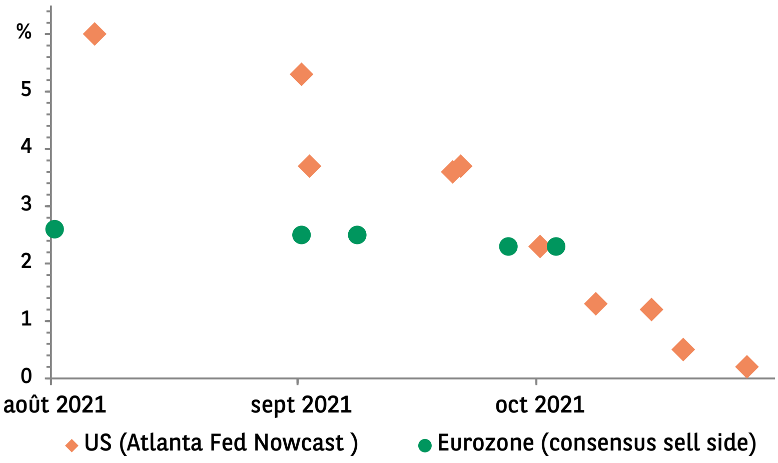
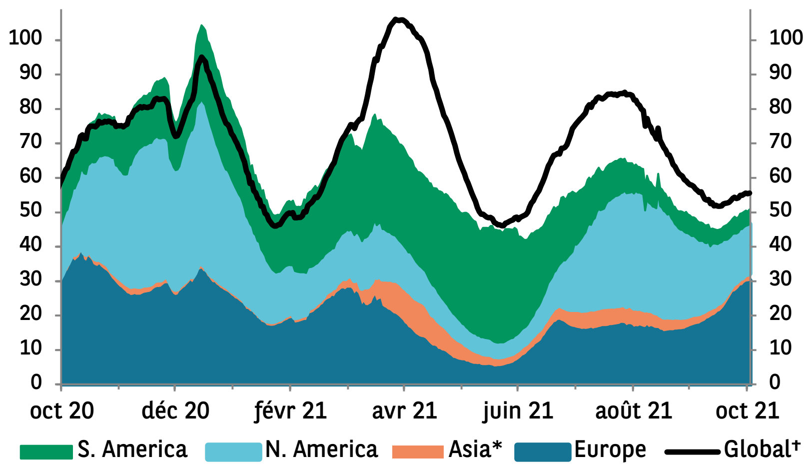
Exhibit 1: Change in 3q 2021 GDP growth forecasts



Data as at 1 November 2021. Sources: Atlanta Federal Reserve, BNP Paribas Asset Management.

The declines were mainly driven by negative surprises from retail and consumption data as consumer activity slowed. More recently, manufacturing and housing data has disappointed.
As we are all aware, the virus is still with us. Infection rates have been rising globally, with Europe in the lead (see Exhibit 2).

Exhibit 2: Daily new Covid-19 cases



Data as at 1 November 2021. Sources: Our World in Data, BNP Paribas Asset Management.

The resurgence is likely due to colder weather, the rising risk of breakthrough infections as vaccine efficacy declines over time, and the potential effect of a new variant. Infection rates started to rise in eastern Europe as vaccination rates are lower, but infections are now also up in western Europe despite a larger number of people having received two doses of vaccine.

The UK may be Europe's bellwether. Its high level of infections since this summer compared to the rest of Europe is likely due to factors specific to the UK, namely the delay in child vaccinations, the lack of social distancing measures since 'Freedom' day on 19 July, and its reliance on a vaccine that is proving to be slightly less efficient than two rival products.

There are, however, common factors with the rest of Europe: waning vaccine-induced immunity and the emergence of a new variant. The UK's early vaccine rollout means that more people may now be at risk of breakthrough infections than in other European countries. Delta-plus (a sub-lineage of Delta) could be 10-15% more transmissible than Delta. This variant represents 6-10% of cases and is becoming more prevalent. It is nonetheless unlikely to be a game changer like the Alpha or Delta variants. These variants were each 50% more transmissible than the previous strain and, according to experts, Delta-plus is unlikely to escape current vaccines. More evidence is needed to fully understand the risk and whether the variant is behind the recent surge in UK cases.

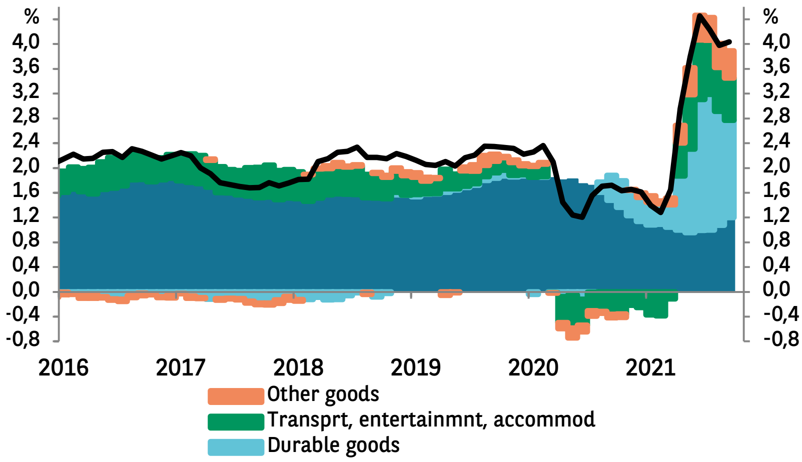
The main worry is the pressure on hospitals due to staff shortages as Covid infections and other respiratory illnesses rise during the winter. In western Europe, where vaccination rates are high at around 70% of the population, hospitalisations are much lower than during previous waves, but there is still a correlation between cases and ICU hospitalisation. Some UK hospitals are under rising pressure: operations have been cancelled as staff shortages prevent the use of the available ICU beds. In central and eastern Europe, where vaccination rates are lower, health systems are already under significant pressure.

Governments as well as citizens are eager to avoid lockdowns this winter. Some restrictions will likely be necessary, however, such as mask wearing, vaccine passports for mass events, and guidance to work from home. An alternative may be an accelerated booster programme. Some UK government models predict falling infections without the need to implement restrictions as the virus reaches 'endemic equilibrium'. One concern is that the booster rollout is too slow; people are eligible for a booster dose six months after the second dose in view of evidence of a significant drop in vaccine efficacy over time.

US macro

Behind the falling expectations for economic growth is the realisation that supply chain bottlenecks and inflation will be greater and last longer than originally thought. The semiconductor shortage crimping car production may take several quarters to resolve. While demand for cars is high, there is limited supply. This has had an unsurprising effect on prices. Monthly sales are still 27% below pre-pandemic levels, while used car and truck prices are 40% higher. Other sectors have seen large price gains, particularly in goods. This has absorbed much of the displaced demand over the last 18 months from services. Consequently, we expect the year-on-year change in core prices (as measured by the Personal Consumption Expenditure index) to continue to rise for another year and to peak at around 4.4% before falling back to 2% in 2023 (see Exhibit 3).

Exhibit 3: Core personal consumption expenditure (PCE) inflation breakdown



Data as at 1 November 2021. Sources: BEA, BNP Paribas Asset Management.

"While central banks focus on core prices, consumers pay headline."

While central banks are focused on core prices, consumers are paying headline prices and the increase in the cost of energy in particular will further erode household disposable income. These costs are coming just as stimulus cheques and other government fiscal transfers end, suggesting households will likely draw down some of the savings they accumulated during the pandemic.

The US Federal Reserve has acknowledged the higher-for-longer inflationary pressures. This already led Federal Open Market Committee members to increase their projections of the future level of the fed funds rate at the last two quarterly meetings. We are likely to see a further upward shift in the 'dot plot' in December. We believe Chair Powell is preparing the market so that the change does not come as a surprise.

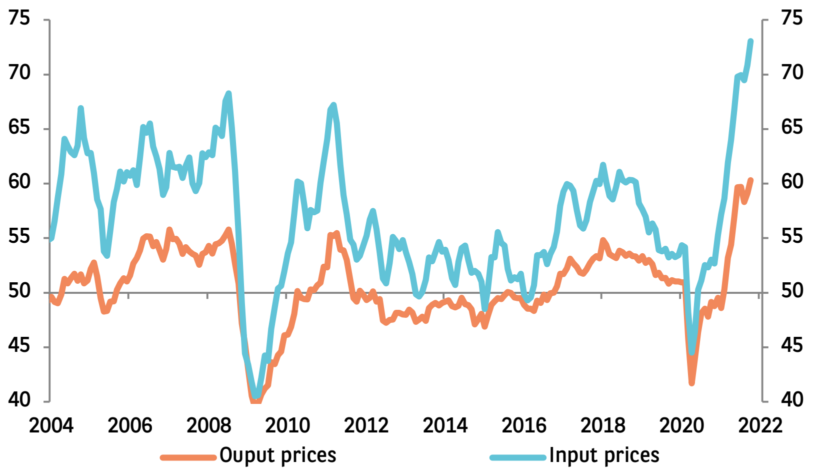
Meanwhile, the Biden administration is still trying to pass its Build Back Better spending packages. We won't comment on the details as they are changing daily, but it is important to remember that the impact on 2022 growth and inflation is likely minor, regardless of the final configuration.

Europe macro

If anything, Europe is more vulnerable to the disruptions from the post-lockdown reopening than the US. The increase in natural gas prices is more damaging as it is a much more important energy source for the region, and the car industry is a larger part of the economy, particularly in Germany. Despite worries in the near term, the outlook further ahead is still positive. Supply and energy issues should abate, the Next Generation EU grants will be disbursed, labour market dynamics remain favourable, excess savings are high, and the easing of travel rules should boost tourism further.

Recent purchasing managers' indices indicate activity has continued to slow at the same time that prices have risen to record highs. Importantly, the increase in input prices has been partly matched by higher output prices.

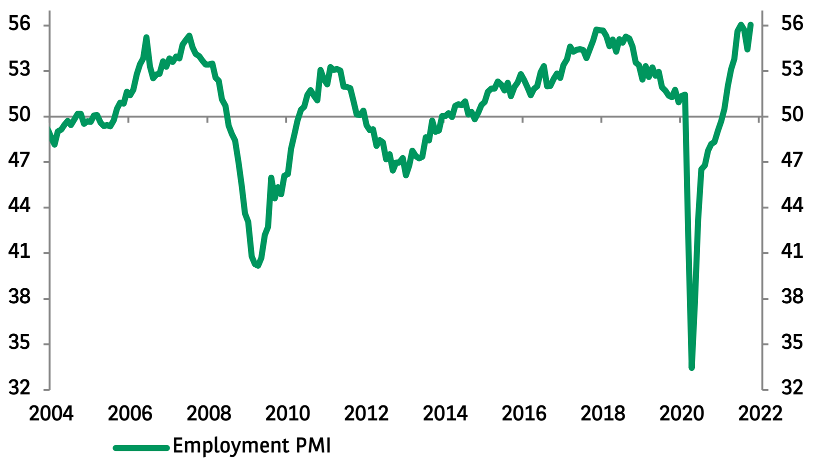
Exhibit 4: Input and output prices rising



Data as at 1 November 2021. Sources: Markit, BNP Paribas Asset Management.

The constraints on manufacturing are particularly notable in Germany, although the services sector has also lost momentum, in part as supply issues spill over and as Covid cases rise. Offsetting these factors is the pace of job creation: This has increased to its highest level in 21 years (see Exhibit 5).

Exhibit 5: Employment activity



Data as at 1 November 2021. Sources: Markit, BNP Paribas Asset Management.

Consumer confidence has held up despite lingering worries about Covid and higher prices. So far, the surge in energy prices has not derailed spending. One might expect higher inflation to encourage consumers to bring forward major purchases rather than postpone them, but the most recent data does not bear this out. The increase in households postponing major purchases may simply reflect the problems in obtaining the goods they want to buy, such as cars.

As in the US, headline and core inflation are on the rise. The pattern is somewhat different, however, as in Europe, goods inflation has waned while services inflation has waxed. Energy inflation has been a major contributor to the gains in headline data, with year-on-year changes reaching 24%, although by next year, the rate will likely turn negative.

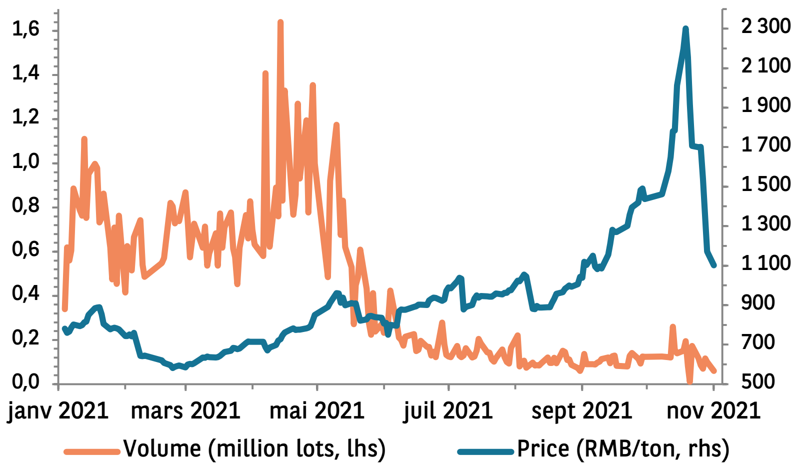
For the first time in a long time, core inflation is now at around the ECB's target. The year-on-year comparison is currently distorted by the transitory decline in VAT last year in Germany, and durable goods prices are also a factor, although not on the same scale as in the US. There has been a contribution from package holidays and flights, but this reflects changes to their weights in the index composition. Encouragingly, our calculation of the seasonally adjusted monthly changes in core inflation components shows cooling pressures, even if they are still at above the recent trend. As the base effects drop out of the calculation in the months ahead, we expect core inflation to fall to below the 2% target by the end of next year. There are upside risks, however, notably second-round effects (and minimum wage hikes). Easing supply chain stress might contain the upside pressure.

"China has been facing numerous challenges recently."

China macro

China has been facing numerous challenges recently: debt-laden property developers, Covid infection outbreaks, flooding, and now power shortages. The power crunch has primarily been driven by a mismatch between supply and demand, with at least 20 of China's 31 provinces experiencing either power cuts or power rationing in late September. The government has ramped up its policy response. Initially, the focus was on increasing coal and gas supplies, while raising electricity prices, to boost supply and damp demand. More recently, government agencies have proposed prohibiting the sporadic shutdown of local mines, instructed exchanges to curb 'excessive speculation', and targeted hoarding and price gouging. As a result, coal prices have dropped sharply, although they remain high (see Exhibit 6).

Exhibit 6: Coal prices and volumes



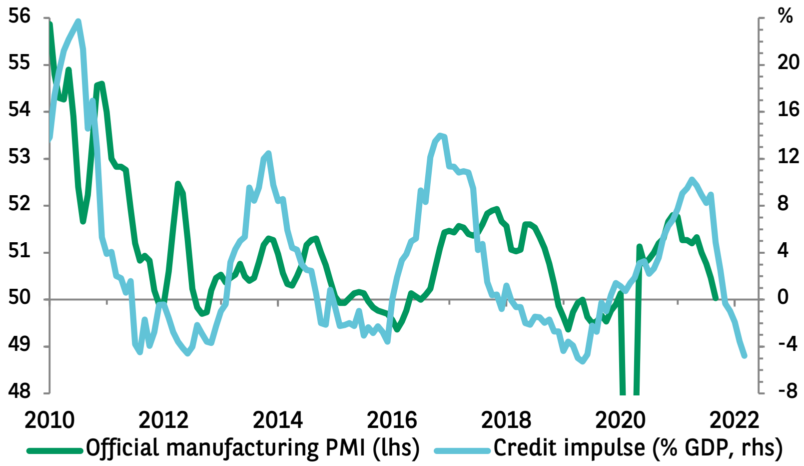
Data as at 1 November 2021. Sources: CEIC, BNP Paribas Asset Management.

Prices could fall further in the coming weeks as increased imports add to coal and gas supplies.

The fundamental problem of the supply-demand mismatch remains unresolved, however. On the one hand, the gap was somewhat smaller in October thanks to a seasonal drop in demand, and local governments have rationed power use. Coal inventories have increased, but not significantly so. The increased policy response suggests officials are still worried and we expect power rationing through the winter, although perhaps not as severe as many had feared.

As Chinese growth slows, many observers anticipate renewed measures from the government to spur a rebound. Historically, this has taken the form of increased credit. The change in new credit as a share of GDP often shows turning points earlier than the change in the stock of credit. Specifically, the credit impulse normally leads economic growth in China by around six months (see Exhibit 7).

Exhibit 7: China credit impulse and economic activity

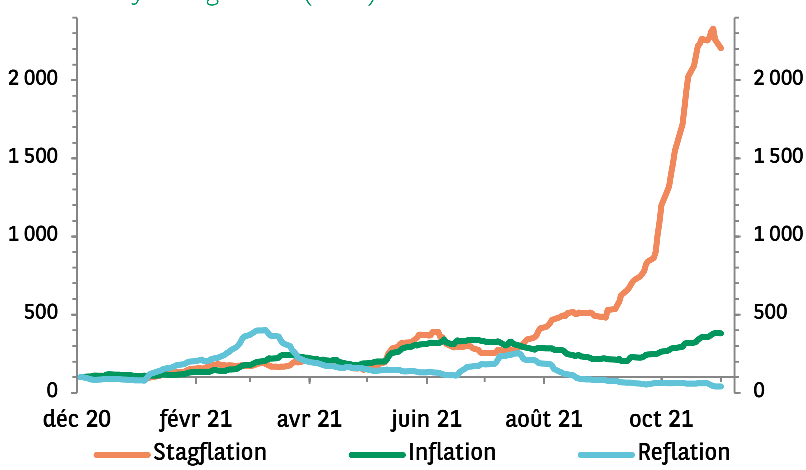


Data as at 1 November 2021. Sources: CEIC, BNP Paribas Asset Management.

Markets

Our medium-term macroeconomic outlook is constructive: solid growth, modest underlying inflationary pressure and loose monetary policy. In the short term, we worry that confidence in the growth outlook will wane, particularly given the weakness in China, 'stagflation risk', and an earnings season dominated by the 'margins squeeze' story. Indeed, stagflation remains one of the key concerns for investors (see Exhibit 8).

Exhibit 8: Change in number of news references to topic
Relative to year-ago level (=100)



Data as at 1 November 2021. Sources: Bloomberg, BNP Paribas Asset Management.

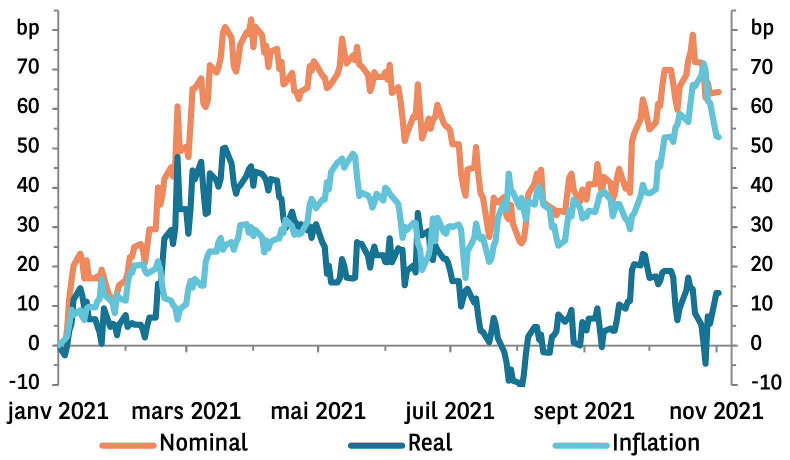
Since markets have now assimilated the news on inflation, and concerns over property developers in China have moderated, earnings have become the key focus. Despite worries that margin pressures would derail the optimism that prevailed over the last few quarters, reported results have been surprisingly strong so far. While banks initially grabbed headlines with returns above expectations, results for other sectors have been almost as good. Year-on-year earnings growth exceeds 40%, well above the low 20% forecast at the beginning of this earnings season. That is to say, surprises have been large. They have been almost as good as they were in the second quarter.

The profit warnings we heard at the beginning of the month have not become a recurrent theme. During the second quarter, positive guidance outpaced negative guidance by 2.2x. This quarter has only been slightly less optimistic, with the ratio falling to 1.8x. While supply chain challenges and labour shortages have certainly weighed on CEOs' minds, the ability of many companies to pass along price increases has so far helped maintain margins.

The current edginess could be heightened by the upcoming debt ceiling debate in the US, but once it has passed, the reflation trade could return. Our analysis of market dynamics indicators shows that technical configurations on many assets already reflect this.

The latest sell-off in 10-year US Treasuries stalled when the yield neared the previous high this year of 1.74%. The increase has been driven almost entirely by inflation expectations, while real yields fell by about 14bp in October (see Exhibit 9). Higher inflation expectations reflect the massive rise in US core inflation since the spring and rising energy prices. Nominal yields are nonetheless still almost 15bp below the peak at the end of March and real yields are some 30bp lower (breakevens are higher).

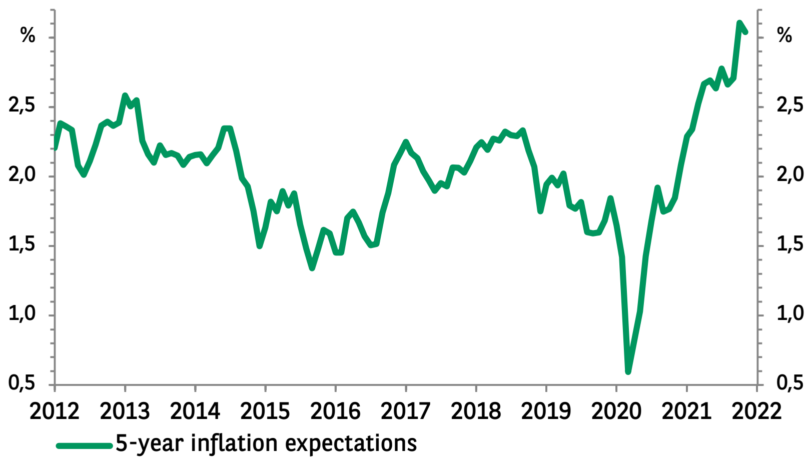
Exhibit 9: Change in components of US 10-year Treasury yield



Data as at 1 November 2021. Sources: Bloomberg, BNP Paribas Asset Management.

The increase in breakevens is no longer simply a recovery from the low levels of the lockdowns. Five-year breakevens in the US are now high in absolute terms (see Exhibit 10). This is not just a US phenomenon: the same shift can be seen in Europe too.

Exhibit 10: Five-year US inflation expectations

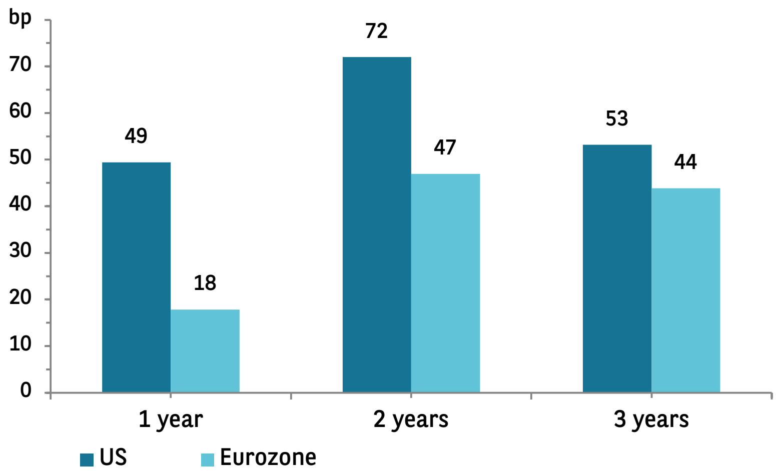


Data as at 1 November 2021. Sources: Bloomberg, BNP Paribas Asset Management.

It is not surprising that breakevens have responded to the realisation that inflation will be high in the near future since Covid disruptions will last for longer, energy prices have surged and now perhaps because rental inflation has rebounded in US. What is more surprising is how much inflation expectations further out have risen. One could say markets are challenging the transitory inflation hypothesis, although inflation risk premia may also play a role.

Given this perceived shift in the market's view on inflation and, in some cases, hawkish commentary from central bankers, market expectations of what central banks will deliver have changed. The FOMC is now expected to execute more rate rises soon after the end of the taper – two increases are priced at the end of 2022. Expectations for ECB policy are also shifting (see Exhibit 11).

Exhibit 11: Change in future policy rate expectations since beginning of August 2021



Data as at 1 November 2021. Sources: Bloomberg, BNP Paribas Asset Management.

> "Markets are challenging the transitory inflation hypothesis."

We have nonetheless seen far less dramatic moves in expectations for the terminal rate. Indeed, in the US, rates further along the curve are still significantly lower than what we saw at the end of March. In the eurozone, we have regained the highs seen in May, but it is still a glacial pace of tightening.

The ECB is faced with a market that is increasingly sceptical of its 'temporary' inflation narrative. Market expectations of the future level of short-term interest rates have jumped higher over the last few months.

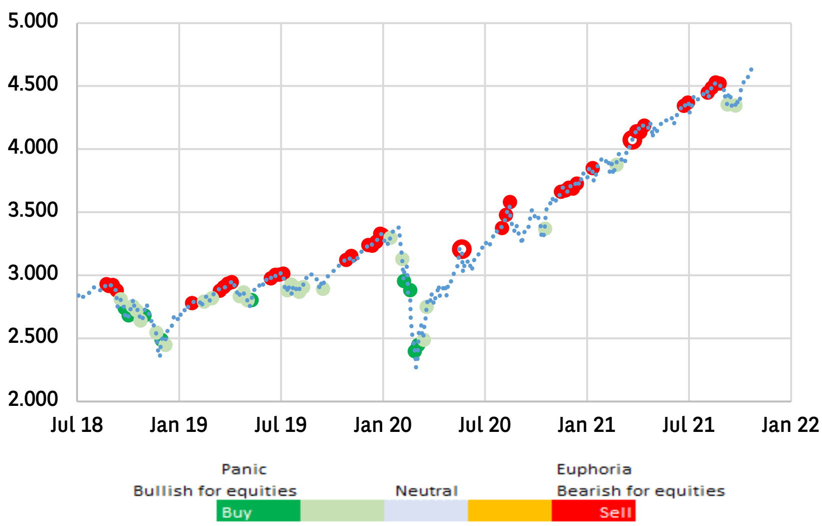
Hawkish comments by some ECB council members have likely contributed to the market's reassessment. We expect the bank to try to push back against this view by stressing that it expects rates to remain at present or lower levels until at least the end of 2023. Given that the planned changes to its asset purchases programmes could be interpreted as hawkish, an emphasis on sustained, low policy rates could make sense. It will be important, however, that the bank's communications emphasise that rate rises are unlikely not only next year, but also in 2023. If not, markets may assume that the rate rises are still coming.

MARKET DYNAMICS INPUTS

In October, both our analysis of the market temperature and price movements indicated the correction was finished, leading to a resumption of the bullish trend. Indeed, even if the market drawdown has been limited, sentiment has dropped sharply, reaching a point where it became a supportive contrarian signal.

Now, the uptrend has resumed and we believe that equities can go higher in the coming months. Seasonality is bullish, companies are leaving the earnings blackout period, and we are not yet seeing any significant excesses or imbalances. Momentum is also improving. In the short term, there could be a pause in the gains in energy prices and sovereign rates. We foresee only a limited setback before the market attempts new highs. We continue to expect the US dollar to weaken in the context of cyclical reflation; investors' positioning is already high.

Exhibit 12: Evolution of Market Temperature for S&P500
All scores except neutral and yellow



Data as at 25 October 2021. Sources: MAQS, BNP Paribas Asset Management.

ASSET ALLOCATION

EQUITIES Overweight

We are long equities: In the short run, investors might focus on the downside risks (global growth, China, US monetary policy), but we believe the medium-term outlook is good thanks to a solid economy and strong earnings growth. What is more, equities still look attractive versus bonds despite their rich multiples.

We are **long US equities**. We kept our long on **Japanese equities**. We are **neutral EMU equities** overall, with a long in small caps and banks. Small caps should benefit from being high beta and their more attractive valuations relative to large caps. Moreover, eurozone fiscal spending (in the form of the Recovery Fund) and ECB support should benefit small caps. We **reduced our overweight** in European banks, but it is still an overweight. Bank results should benefit from the expected rise in long-term yields. Earnings revisions and their relative valuations are also supportive.

We rotated our overweight position in emerging market equities to US equities given the multiple challenges EM equities face, particularly in China.

We added an overweight in US small caps vs. US equity. Cyclicals look clearly extended relative to defensives, while small caps look attractive relative to large caps. A pickup in economic momentum, the return of the reflation trade or a steeper yield curve could all be drivers of small caps.

GOVERNMENT BONDS Underweight

Being underweight duration is a strategic position given the favourable economic outlook, the current low level of yields and the prospects of a normalisation of monetary policies (even if only gradually and cautiously). We see our short position in US government debt as a funding leg for our equity exposure.

We closed our short position in EMU sovereign debt as yields rose to near our target.

CREDIT Neutral

CURRENCIES € Neutral

COMMODITIES Overweight

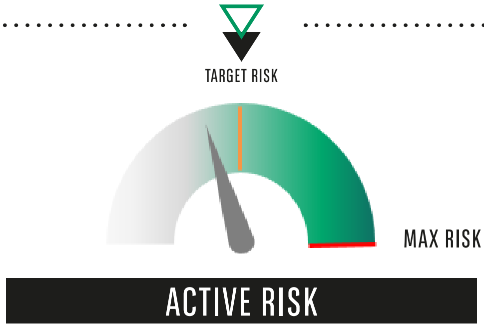
We reduced our overweight in commodities given the strong moves seen already.

We are long gold, which is a currency that cannot be debased by central banks and that can be seen as an attractive hedge against inflation risk.

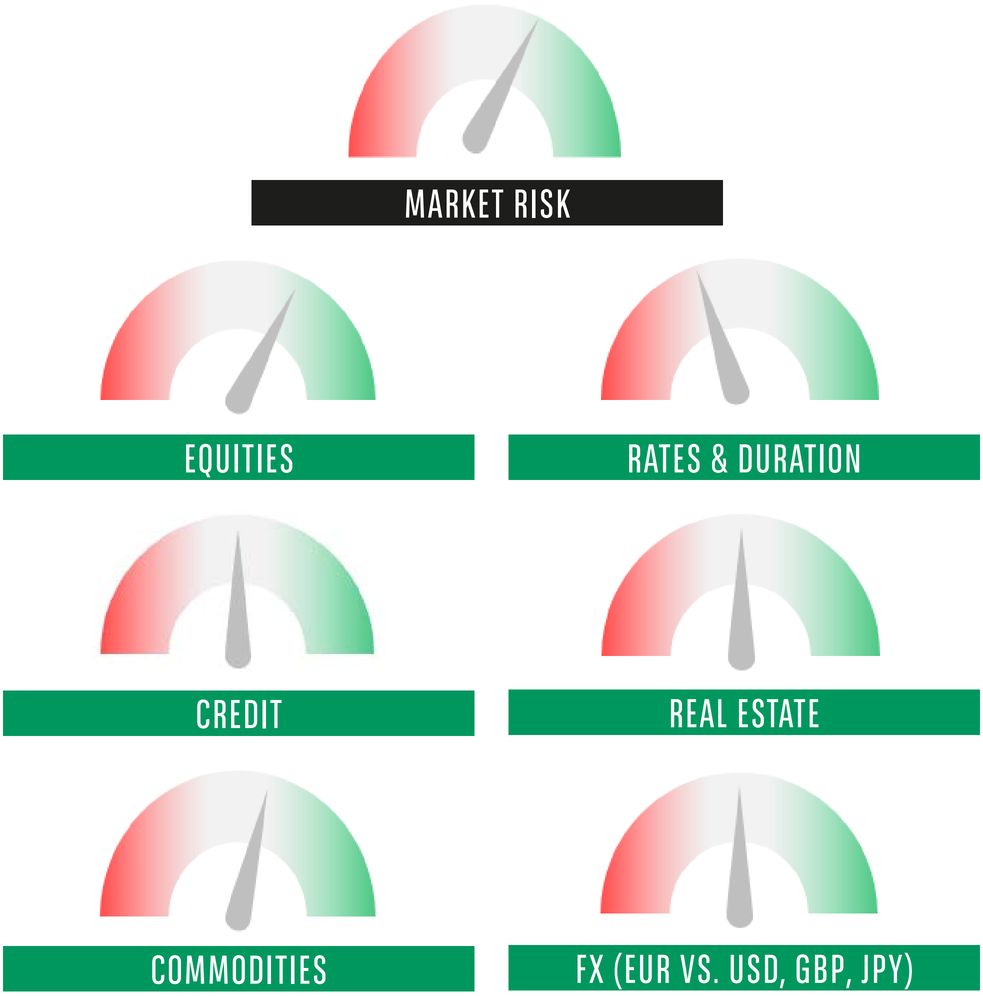
THEMATICS Overweight

We are building positions in various investment themes: Global environmental protection, the energy transition, artificial intelligence and US infrastructure. We introduced this last theme in June to benefit from President Biden’s infrastructure spending plans.

RISK UTILISATION*



CORE ASSET CLASS VIEWS**



* Risk utilisation/active risk is a measure of the tracking error (as a percentage of maximum tracking error) of an unconstrained theoretical portfolio, derived from core asset class views and from additional specific/tactical trades. **The core asset class views dashboard reflects the key views of the Investment Committee of the Multi-Asset team at MAQS. Other specific/tactical trades may be implemented in addition.

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INVESTORS' corner

BNP PARIBAS
ASSET MANAGEMENT

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