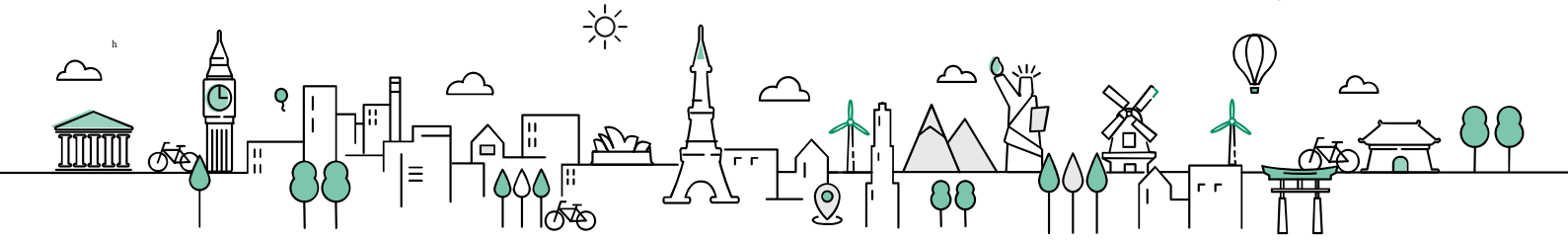

Asset Allocation Monthly • May 21

Christophe Moulin
Head of multi-asset

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Chief market strategist

KEY MARKET DRIVERS

- US stimulus funding moving from debt issuance to tax hikes. Corporate profits will depend on the balance between spending and the degree/ composition of tax increases.
- Real interest rates moderated in April due to dovish Fed messaging, but inflation pressures are building and real rates are likely to rise again.

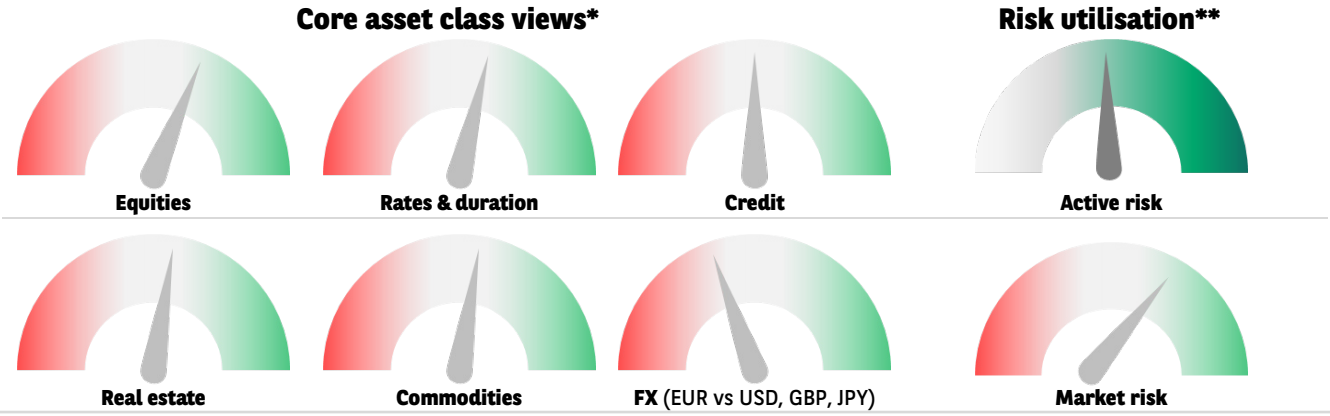
VIEWS & ASSET ALLOCATION

- Our medium-term scenario continues to favour risk and equities, given the fundamental factors and economic policy support.

PASSING THE BATON

Equity and fixed-income markets have benefited over the last year not only from stepped-up central bank support, but also from a clear abandonment of 'austerity' as a response to economic shocks. Instead of regaining investors' trust through budget discipline, governments have taken advantage of the fiscal space given them by central banks to increase budget deficits significantly. This money was used initially to offset the collapse in demand from the lockdown recessions, and now in the US to promote green investments and bolster parts of society that had not shared in the gains from prior economic and stock market growth.

Equity markets have gained from the fall in interest rates but now the baton must be passed to earnings growth. Equity index valuations are at 20-year highs and the market anticipates strongly rising profits. This may be justified given the multi-trillion dollar stimulus in the US, but higher corporate taxes may limit earnings growth, while increases in personal taxes reduce the amount of capital for those sectors not targeted by the government.



BNP PARIBAS
ASSET MANAGEMENT

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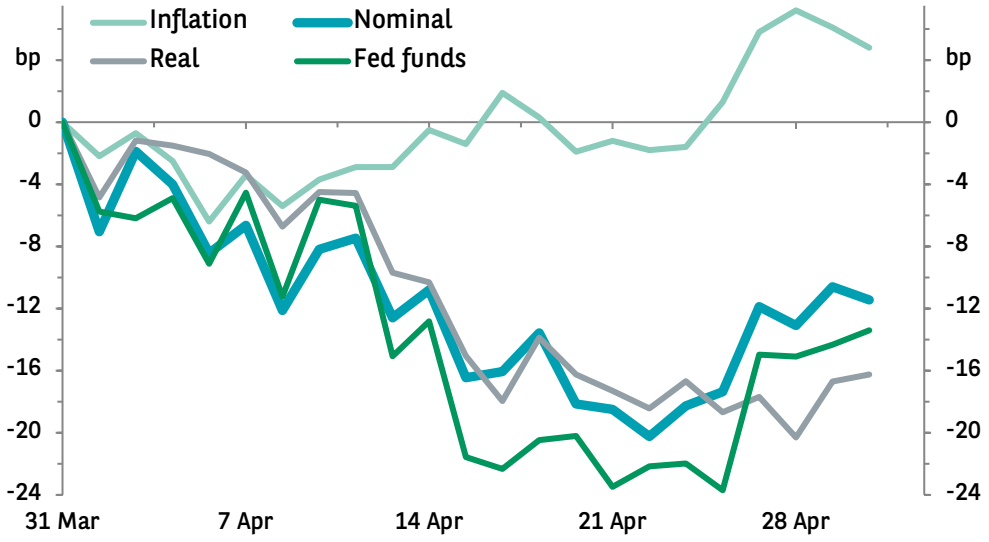
FIXED INCOME

The initial euphoria about the impact of US stimulus on Treasury yields, inflation and policy rate expectations was tempered over the past month as the market's focus shifted to the prospect of tax increases. The passage of subsequent stimulus packages will be far slower and more fraught as different constituencies lobby to protect their privileges. The US Federal Reserve (Fed) has reiterated that a near-term rise in inflation is not a concern, even though we believe the year-on-year increase in the consumer price index could hit nearly 4% over the summer. The central bank has made it clear it will not taper quantitative easing (QE) purchases or raise policy rates as soon as the market seems to expect. As a result, 10-year Treasury yields dropped in April, driven primarily by falling real yields (see Exhibit 1).

Exhibit 1: Change in 10-year US yields since 31 March 2021



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

The Fed is assuming, perhaps reasonably, that consumer prices will rise only temporarily due to the short-term surge in demand. It believes that the Phillips curve will remain flat and that even once the unemployment rate falls to 3.5% from the current 6.0%, wages will not rise meaningfully. Anecdotal evidence, however, suggests some employers are already struggling to find workers at current wage levels, particularly as income support payments will continue through the summer, which reduces the pressure on the unemployed to find work. Ongoing demands for an increase in the minimum wage also point to the risk of positive inflation surprises. President Biden recently signed an executive order forcing federal contractors to pay a USD 15/hour minimum wage, up from USD 10.95.

While five-year five-year inflation expectations have returned to pre-pandemic levels, they are still more than 50bp below what was seen between 2010 and 2014. During this period, the economy was growing more slowly, the output gap was larger and the economy did not face surging demand alongside supply constraints. Real interest rates are, for the time being, contained, thanks to the Fed's go-slow messaging. Real rates are nonetheless still well below historical averages and we expect tapering to begin by the first quarter of next year, with policy rate increases following by 2024. As the market anticipates the tightening, we should also see real rates increase. Hence, we remain cautious on the outlook for duration.

The recent sell-off in Italian government bond (BTP) spreads should remind investors not to become complacent about risks in the eurozone. On the one hand, the Italian government's proposal to use the Next Generation EU funds to promote competition and improve infrastructure is welcome, but it has been accompanied by a plan for fiscal stimulus. Unlike in the US, this fiscal push may not meet a willing or able central bank. There still appears to be dissention within the ECB's governing council about how long asset buying under the current Pandemic Emergency Purchase Programme should go on, and at what pace. Without the ECB's support to keep peripheral bond spreads low, Italy may struggle to recover from the pandemic lockdowns.

"The Fed has reiterated that a near-term rise in inflation is not a concern, though the CPI could rise nearly 4% YoY over the summer."

Another notable move in eurozone fixed-income markets has been inflation expectations. Five year five-year inflation has risen by nearly as much as in the US – perhaps too much, given the divergence in both fiscal and monetary policy between the two regions. While the eurozone is set to see a boost to demand from the removal of lockdown restrictions later this year, this will not be accompanied by the same level of fiscal support as in the US. As a result, we are now less optimistic on the outlook for eurozone inflation.

EQUITY VALUATIONS AND EARNINGS

By almost any measure, most equity markets are highly valued; it's not just the US any more. The current forward price/earnings ratio for the S&P 500 at 21.7x is nearly two standard deviations above the long-run average. The z-score for the MSCI Europe Index is 'only' 0.8x, and 0.9x for the price-to-book ratio of the MSCI Emerging Markets Index (see Exhibit 2). While still-low interest rates and inflation warrant a premium versus historical averages, we believe some normalisation is inevitable.

Exhibit 2: Region, country and sector relative valuation z-scores

Market	P/E	P/B	P/S	EV/S	P/CE	PEG	DY	EV/EBITDA
US vs Europe	2.1	3.6	2.5	1.9	2.6	-0.8	-0.2	2.3
United States	1.8	2.2	2.8	2.9	3.3	-0.1	1.2	2.8
Japan	1.8	1.7	1.9	2.1	2.9	-0.4	0.3	2.1
US broad tech	1.6	2.2	3.1	2.8	1.8	0.6	0.6	2.8
US ex-broad tech	1.5	1.5	2.2	2.7	2.8	-0.9	1.1	2.5
DM	1.2	1.7	3.0	3.2	3.0	-0.5	1.2	2.7
EM	0.8	0.9	1.8	2.0	4.0	-0.2	1.4	2.7
Europe	0.7	0.5	1.7	2.7	1.7	0.3	1.3	2.0

Below average | Average | Above average

Data through 30 April 2021. Note: P = Price, E = Earnings (next-twelve-month), B = Book, S = Sales, EV/S = Enterprise value-sales, CE = Cash earnings, PEG = PE-EPS growth, DY = Dividend yield. For PB, multiple based on IMI indices from 1974, except EM which is from 1995. Colours reflect z-score, with threshold at +/- 1 and +/- 0.5. Sources: IBES, MSCI, FactSet, BNP Paribas Asset Management.

The question is how, and when, that normalisation occurs. There are two scenarios as to the how: either a steep fall in the price or a more rapid increase in earnings than in prices (that is, the stock 'grows into' the multiple). We believe the latter scenario is more likely even if it promises below-average returns for equities from current levels. During the Trump presidency, the average annual increase in earnings until the pandemic was 10% (recently it's been 30%). If we assume a similar 10% gain during the Biden presidency in the belief that the negative effect of tax increases will be offset by fiscal stimulus, and that equities rise by just 5% per year, it would still take three years before the forward P/E ratio of the S&P 500 dropped below 20x.

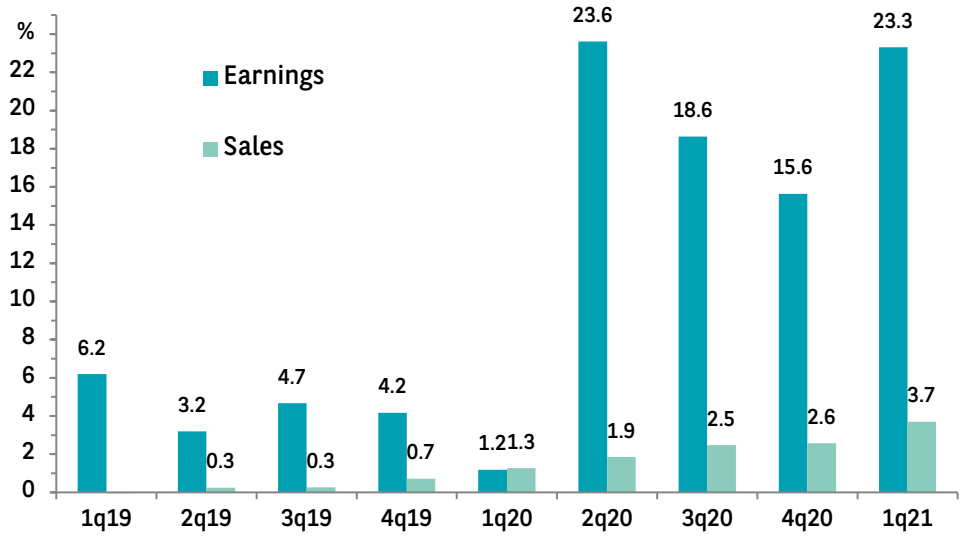
Typical market volatility should provide a better entry point for investors in the future, and our market temperature indicators indicate that time may not be far off. Market timing aside, we believe the risk is not high valuations *per se*, but rather a larger decline in the market *because of* high valuations in the event of a negative catalyst. The difficulty is imagining what that catalyst would be, given not only the monetary support from central banks, which we have had since the global financial crisis, but also the more recent fiscal support from governments.

One potential catalyst could be the US economy overheating as a flood of stimulus coincides with a smaller output gap and inflation expectations become unanchored. This could force the Fed to raise policy rates sharply. Another possibility is that tax increases become a larger part of the proposals by the Biden administration, dampening investor sentiment and corporate profit growth.

"A premium versus historical averages is warranted but we believe some normalisation in valuations is inevitable."

Given the high market pricing, earnings will need to at least match market expectations to support current multiples. So far, that has been the case. Continuing the pattern we have seen since the recession last year, companies have handily beaten both earnings and sales forecasts at a rate much higher than the historical average. To date in the latest earnings season, results have surpassed estimates by 8.6% and sales by 3.4% (see Exhibit 3). This bodes well for the market as vaccination rates rise, more and more countries come out of lockdowns, and pent-up demand is fulfilled.

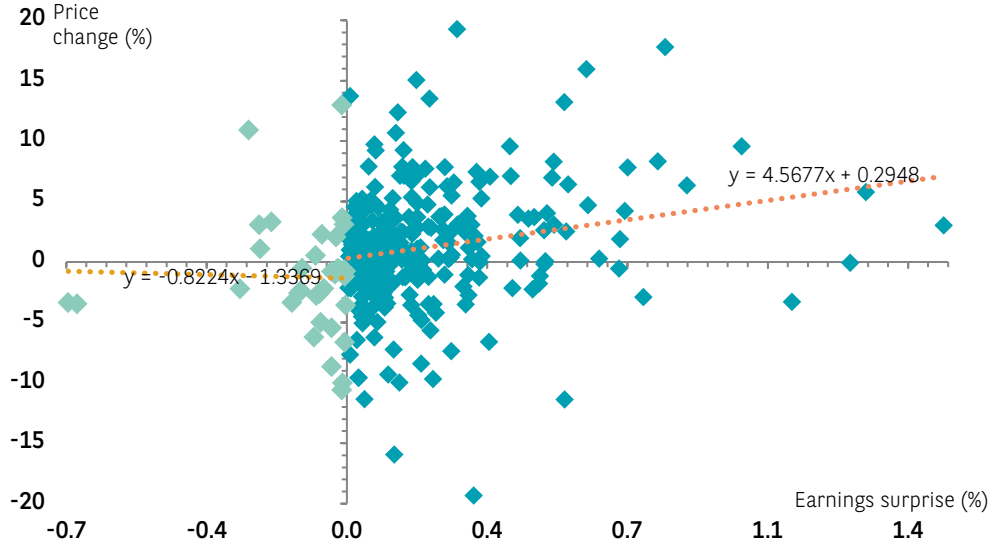
Exhibit 3: S&P 500 Q1 2021 earnings and sales surprises



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

The corollary of the need to beat earnings forecasts is that stocks are more harshly punished if company results fall short of expectations. The (comparatively few) companies that have disappointed analysts so far have seen a greater fall in their stock price relative to the earnings surprise than the gain in price for those companies whose earnings beat estimates (see Exhibit 4).

Exhibit 4: Earnings surprises and 1-day price change

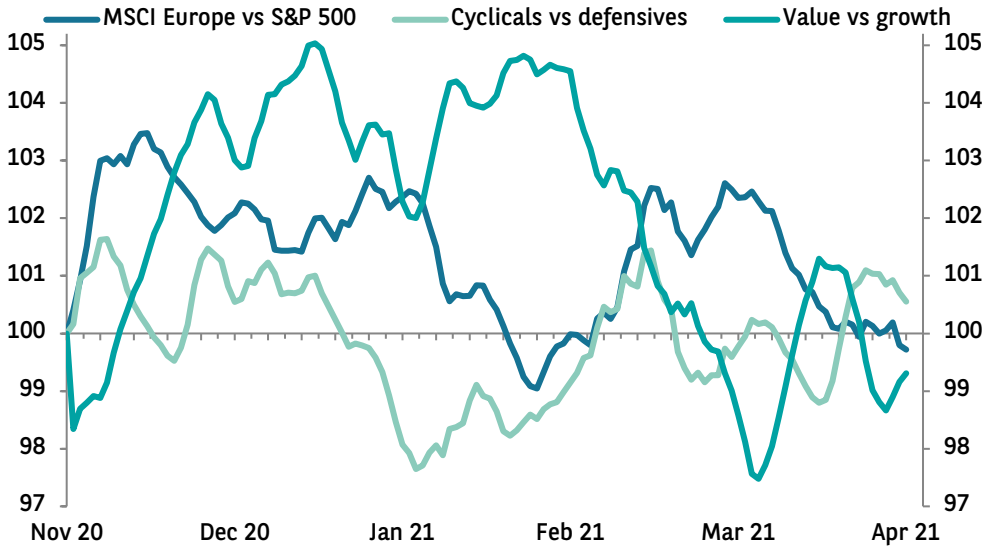


Data as at 30 April 2021. Sources: Bloomberg, BNP Paribas Asset Management.

EUROPEAN EQUITIES

The strong performance and high valuations of US equities have prompted some investors to consider a move into European equities to capture the next leg of the re-opening trade. Since last November, however, European equities have performed in line with the US, so it is not clear that there is a gap to be closed (see Exhibit 5).

Exhibit 5: European vs. US equity indices' relative performance



Data as at 30 April 2021. Total return in local currency. Sources: FactSet, BNP Paribas Asset Management.

The relative performance of cyclicals and defensives has been similar in both regions, as has that of value versus growth, although the underlying dynamics for value and growth are different. European value stocks have underperformed US value by about the same amount as European growth has outperformed US growth, with the net effect being slightly lower returns for Europe. European equities are more cyclical and value-oriented than US equities, but that bias seems to have only offset the benefit to US equities from fiscal stimulus as opposed to driving an outperformance of European equities. We are currently overweight US (value) 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.

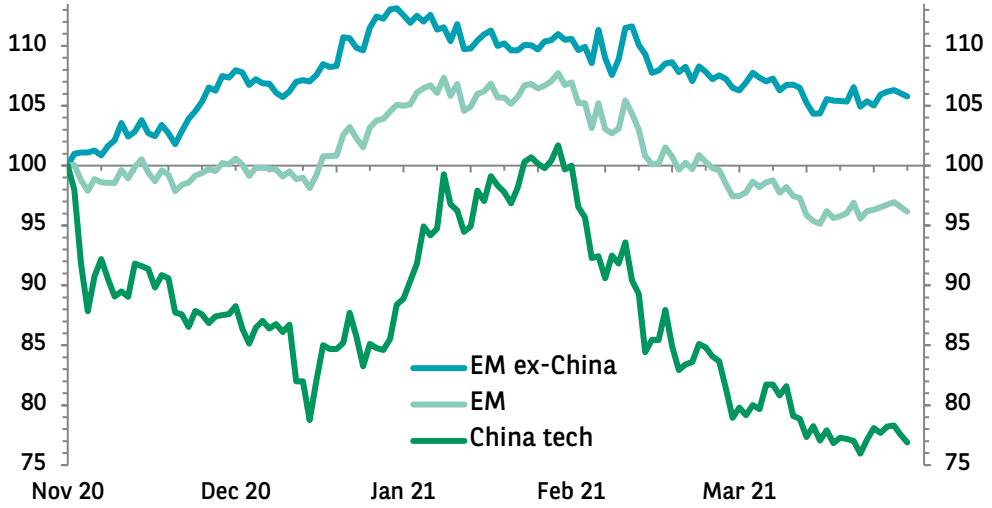
EMERGING MARKETS

Emerging market (EM) equities outperformed on last November's 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 6). 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 that of the MSCI World index. The Chinese equity market, however, is much less cyclical. In fact, since November, the correlation between the relative performance of Chinese equities and that of cyclicals has been negative. This is one reason we have begun to consider our China and emerging market allocations separately, with a focus particularly on the opportunities (and risks) of the Chinese technology sector.

"The composition of the Chinese equity market is different from the rest of emerging markets, meaning a separate allocation is needed."

Exhibit 6: Emerging market (EM) equity index returns relative to MSCI World



Data as at 30 April 2021. Sources: FactSet, BNP Paribas Asset Management.

We expect EM ex-China to outperform developed markets given EM's cyclical nature, the benefit from reduced trade tensions between the US and China and a weakening US dollar. The risks are that rising US interest rates make EM investments relatively less attractive, but foreign portfolio inflows have been strong.

While Asia saw significant initial success in containing the pandemic, the pace of vaccinations in the region has fallen behind. 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 3.2x for the MSCI World index and 1.9x for the MSCI World ex-US.

Chinese GDP growth, which is a key determinant of emerging market growth, may be high, but fall short of expectations. In the first quarter, the economy expanded by a disappointing 2.4% compared to the last quarter of 2020, whereas economists had forecast 5.6% growth. This disappointment reflects the challenges the government faces as it tries to drive growth while simultaneously seeking to reduce debt in the economy.

MARKET DYNAMICS INPUTS

In the short run, our indicators suggest that the trend in global equities is now complete and that we are entering a risky period again. This trend exhaustion signal could pave the way to a new corrective setback, which we continue to consider as an opportunity given the long-term bullish trend.

Furthermore, since March, we have had the indication that the rise in yields should pause for few weeks/months before resuming its trend higher.

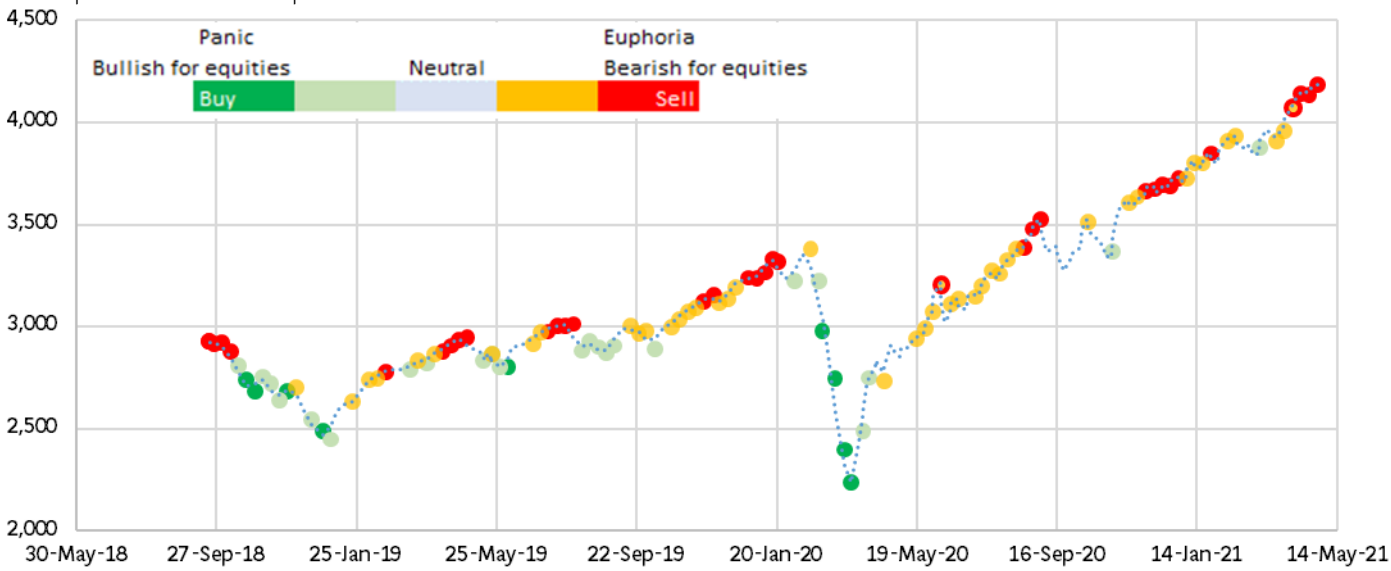
Finally, for the US dollar, we see its recent strength as a corrective bounce in a long-term bearish trend. This trend could resume shortly. The medium-to-long-term signals are still bearish, consistent with further USD weakness.

Our blended 'market temperature' indicator turned red hot in late April, pointing to cautiousness in the short term (see Exhibit 7). For example, in our 'market temperature' pillar, sentiment inputs were as stretched as they were before the equity market corrections in 2020. As a result, the current equity 'market temperature' is hot, dampening risk/reward attractiveness in the short term.

In recent weeks, our proprietary 'market dynamics' tool box – consisting of 'market technicals' and 'market temperature' signals – has suggested that there is a risk of a pullback in the short run. In this light, we will be closely monitoring any potential correction in equity markets.

Exhibit 7: Evolution of market temperature since July 2018 (S&P 500)

All temperatures shown except neutral



Data as at 27 April 2021. Sources: Bloomberg, BNP Paribas Asset Management.

ASSET ALLOCATION

The near-term outlook for risky assets still reflects the tension between strong growth expectations and the prospect of higher US yields. Ultimately, we see a strong global growth recovery anchored by progress on vaccine rollouts/re-openings, a large US fiscal expansion, and easy monetary policy supporting risky assets over the medium term.

We expect the cyclical recovery to gain further traction later this year. So far, the recovery has been led by the US, given its progress on vaccinations, aggressive fiscal stimulus and pent-up demand. Growth in other major economies that have been hit by COVID-19 (e.g. Europe and EM ex Asia) should accelerate as vaccinations lead to re-openings. Our medium-term scenario continues to favour risk and equities given the fundamental factors and economic policy support.

After increasing its risk exposure over the past few months, the investment committee reduced it in April by lightening up the long equity exposure via a short in Eurozone equities. The net equity exposure remains long via positions in US value, EM equities, Chinese equities and Japanese equities. The regional equity exposure seeks to find a balance between 'growth/quality' and 'value/cyclical' styles that helps provide some insulation against rates volatility while providing a diversified allocation. The current active risk is slightly below half the maximum risk tolerance levels, giving plenty of room to add on dips.

Elsewhere, the investment committee is long other risky assets like commodities and EM local debt, and holds other positions to diversify their portfolios, such as gold and European REITs.

Equities ↑ (new)
Italian equities priced in the good news about Mario Draghi becoming PM quickly in early February. However, growth prospects remain uncertain given political risks, high debt and slow structural growth. Consequently we have closed our overweight position in Italian equities vs EMU equities. At the end of March, we decided to switch our overweight position in US equities to MSCI USA Value.

We are long on equities overall. We are long emerging market equities given our view that China/Asia growth will remain strong. EM ex Asia is cheaper and should benefit from a cyclical recovery and the fact that, in our view, valuations are not onerous. In early March, we profited from the correction to buy Chinese, US and Japanese equities.

The rollout of vaccines, the reduction of lockdown restrictions, expectations of further stimulus in the US and continued ample monetary stimulus should support equities over the medium term. Equity risk premiums are still high relative to real bond yields in the US, so equities remain an attractive option even if absolute valuations (e.g., P/E ratios) appear high.

We remain long EMU small caps versus large caps. Small caps are likely to continue to outperform in an economic recovery. They should benefit from being high beta and from their more attractive valuations relative to large caps.

"Vaccines, lockdown reductions, fiscal stimulus and accommodative monetary policy should support equities."

Government bonds ↑ (new)
In early March, we used the fixed-income capitulation to take profit tactically on our short EMU bonds. In April we closed our long EUR inflation-linked debt position given the rally in European inflation breakevens.

Core yields are still historically low despite their recent rise. Policy rates are at close to the zero bound and central bank asset purchases are containing yields. Term yields are likely to see upside pressure, however, as the economic outlook improves on the back of vaccination campaigns. Bond yields in the eurozone have risen recently in line with the improvement in the outlook for reopening and growth. We still think there is upside potential in yields in a cyclical recovery in the bloc in the medium run. But we would look for better entry levels to re-establish shorts in EMU bonds.

We are long emerging market local currency debt. We see room for further spread compression in the current search for yield. As for currencies, we see plenty of room for appreciation, especially if the US dollar resumes its downtrend.

Credit ⇔ (unchanged)

Currencies € ⇔ (new)
Since late 2020, we have been concerned that the consensus view of a weaker US dollar had become crowded. We believed the news on the fundamentals was contradicting this consensus assessment. Thanks to fiscal stimulus in the US, while in Europe there are extended lockdowns and delayed vaccine rollouts, we expected the US economy to outperform Europe significantly in 2021. Consequently, we turned tactically bullish on the US dollar against the euro, while recognising that in the medium term the US dollar may come under pressure due to its high valuation and the prospect of an acceleration in growth outside the US. We closed the tactical USD long vs. EUR as US yields eased, the European recovery gained traction and bonds yields rose.

Commodities ↑ (unchanged)
We bought back commodities in the March consolidation as we are still bullish in the medium term. We remain long gold but we have cut part of the exposure. Gold should be seen as a currency that cannot be debased by central banks and one that is a good hedge against the risk of inflation.

Thematics ↑ (unchanged)
We have a position in thematic investments: Global environment, energy transition and artificial intelligence. We regard the current investment as a first step and we aim to allocate more to thematic investments, and to broaden the spectrum of themes invested in.

From cover page: *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 and are listed at the end of this publication. ** Risk utilisation/active risk is a measure of the tracking error (as a % of maximum tracking error) of an unconstrained theoretical portfolio, derived from core asset class views and from additional specific/tactical trades.

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