For professional investors - Marketing Communication - June 2024

MONTHLY MARKET VIEWPOINT

GOLDILOCKS, FOR NOW

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- The US economy has recently experienced the benign combination of steady growth and slowing inflation; a sort of renewed 'Goldilocks'.

- The volatility in economic data since the pandemic, however, suggests the situation is unlikely to last. We anticipate growth will slow modestly in the quarters ahead, while core inflation remains comparatively high.

- Multi-asset portfolios remain overweight equities, which continue to be the largest driver of risk in portfolios. Interest rate risk accounts for around one-third of active asset allocation risk. Duration is at median levels. Excluding a short position in Japanese government bonds, active duration is close to one year, coming from long positions in emerging market local currency debt, European investment grade credit and Treasury Inflation-Protected Securities (TIPS).

The latest US Consumer Price Index (CPI) inflation data was welcome news for investors and the US Federal Reserve (Fed). After unexpectedly strong inflation in the first part of the year, CPI inflation dropped to 0.2% on a monthly basis in May (2% annualised) from 0.3% in the prior month. The consensus forecast for May had been 0.3%.

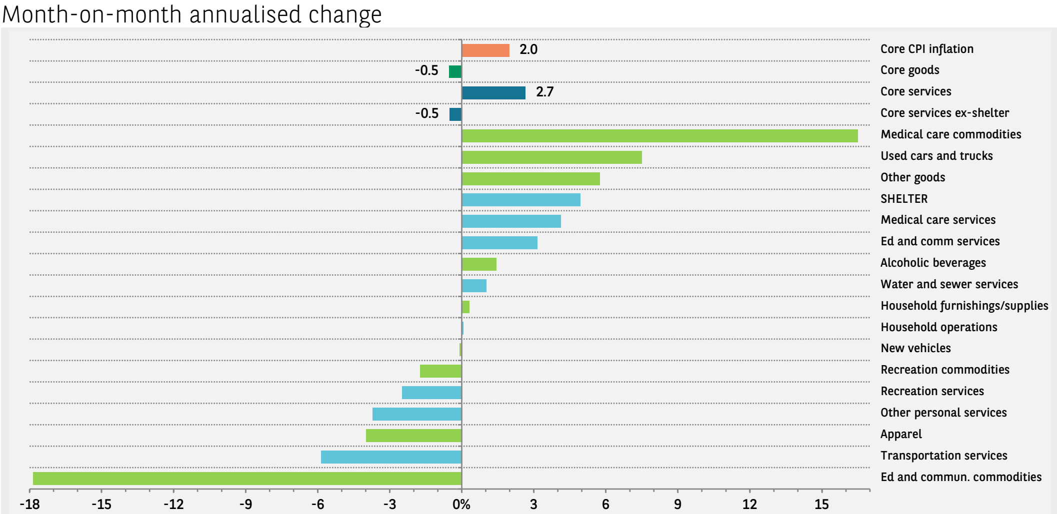
Encouragingly, this was not due to extreme weakness in one particular category but was more broad based. Core goods inflation was negative, but the big improvement was in core services inflation excluding shelter (often referred to as 'supercore'), which was also negative (see Exhibit 1).

Given the lower weight of shelter in the Fed's preferred inflation gauge, the Personal Consumption Expenditures (PCE) index, this suggests that the May value for PCE will also be low.

Exhibit 1

Core services inflation (excluding shelter) was negative in May

Month-on-month annualised change



Data as at 13 June 2024. Note: light green bars represent goods sub-indices; light blue are core services sub-indices. Sources: FactSet, BNP Paribas Asset Management.

Complementing this deceleration in inflation has been broadly positive economic growth data over the last several weeks. The S&P Global services sector Purchasing Managers' Index (PMI) jumped sharply in May, as did the PMI from the Institute for Supply Management.

US private non-farm payrolls data also came in above forecasts, with the seasonally adjusted monthly figure rising to 229,000 versus an expected 165,000 and just 158,000 in the preceding month.

Even with the soft CPI inflation data in May, the Fed reduced the number of expected cuts for this year

The high inflation during the first part of 2024, however, led the Fed to reduce the number of cuts it anticipates this year from three to one, in line with market estimates. It is worth recalling that at the beginning of the year, risk assets were supposed to be propelled by the 'pivot' from the Fed towards lower rates; markets at one point anticipated nearly seven cuts. The unwinding of those expectations has had little equity market impact, however. This is because the reason for the smaller number of cuts is stronger growth, and equities at least are happy with the boost to the earnings outlook, even if it is at the expense of a higher discount rate.

In the eurozone, unemployment is at historic lows and wages are picking up

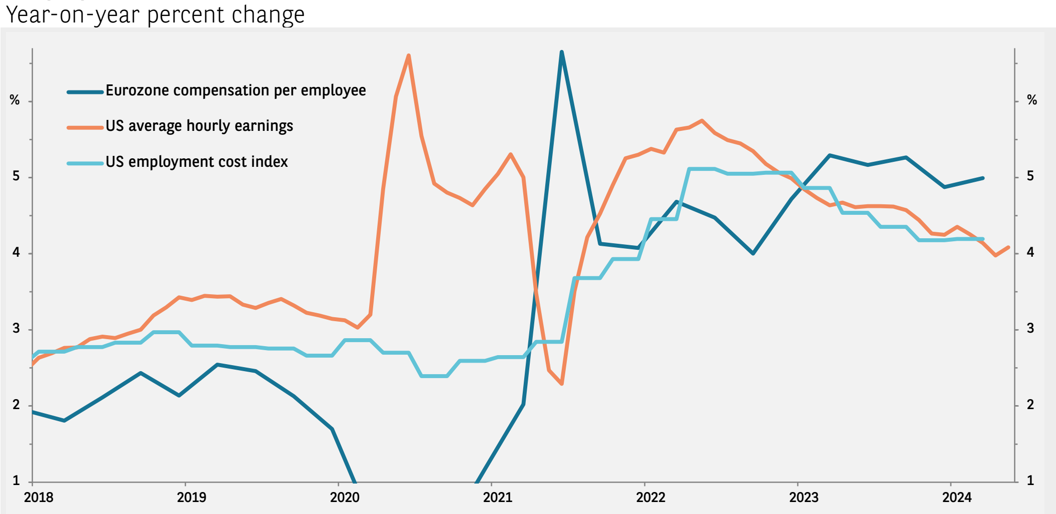
A key risk to the outlook for a continued decline in inflation is the labour market. The unemployment rate in the US did move up slightly to 4.0% in May from 3.9%, but this is still below the long-run equilibrium rate of 4.2%. Notably, average hourly earnings rose from 4.0% to 4.1%, breaking a three-month streak of declines.

In the eurozone, unemployment is at historical lows, while the growth rate in compensation per employee has also picked up (see Exhibit 2). With strong wage growth impacting services inflation, higher unemployment rates may be needed before inflation moves back down.

Exhibit 2

Wage gains have picked back up

Year-on-year percent change



Data as at 13 June 2024. Sources: FactSet, BNP Paribas Asset Management.

The reduction in the number of planned cuts in the fed funds rate from three to one in the recent 'dot plot' suggests that the latest CPI data did not significantly change the Fed's view that inflation will decrease only slowly towards target.

A key decision will come in September, when a first cut could be warranted if inflation stays low or declines. By then, however, political considerations may become paramount. Reducing rates so close to the US presidential election could be viewed in some quarters as interference, and in any event, a Trump victory in November could necessitate its reversal.

Growth dynamics in the eurozone are similar to those in the US, with PMIs pointing to continued strength in the services sector and an improving outlook for manufacturing. In contrast to the drop in US core inflation, however, eurozone inflation rose from 2.7% to 2.9% (driven by services).

The European Central Bank (ECB) nonetheless went ahead with its planned 25bp cut in the deposit rate at its most recent meeting. It was viewed as a 'hawkish' cut as President Christine Lagarde refrained from committing to further reductions. The ECB remains very much 'data dependent.

Equities

A bit more growth and a bit more inflation have certainly not troubled equity markets. Most major indices continue to rise and the macroeconomic environment remains supportive.

The markets are continuing to assess when and by how much the Fed cuts this year, and there is as yet little prospect of an increase in policy rates. With steady (as opposed to rising) real rates, equities (and growth stocks in particular) will depend more on the outlook for earnings. Analysts' forecasts reflect an optimistic view.

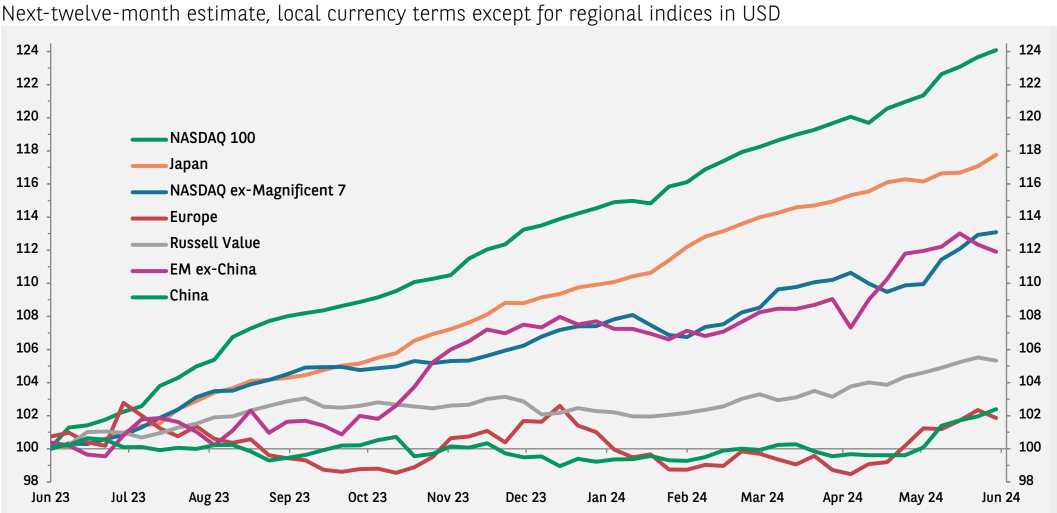
The markets with the most notable change in earnings expectations recently are Europe and China

The markets that have seen the most notable change in forward earnings expectations over the last month have been Europe and China (see Exhibit 3). The rise in earnings in the eurozone is understandable as the region rebounds from the slowdown in 2023 and the ECB cuts policy rates. US growth will pull in European exports, aided by a strong dollar.

Exhibit 3

Earnings expectations finally moving up for Europe and China

Next-twelve-month estimate, local currency terms except for regional indices in USD



Data as at 14 June 2024. Sources: FactSet, BNP Paribas Asset Management.

The primary concern is weak domestic consumer demand. Despite the low unemployment rate and positive wage growth, retail sales growth in the eurozone has been disappointing. Some of the wage gains have come from one-off bonuses (particularly in Germany), and perhaps consumers prefer to save the extra income rather than spend more.

Earnings expectations have also turned up for Chinese equities. One might suppose that the recent gains in the market have been driven by these higher earnings expectations as opposed to simply a rebound in what were very low valuations.

Unfortunately, most of the stocks in the MSCI China index are not seeing an increase in expected earnings per share (EPS). The gains are primarily for just two companies, PDD (the e-commerce holding company that trades as Temu) and Tencent.

As an alternative to China, and as another way to take advantage of spending on artificial intelligence (AI), South Korea and Taiwan stand out. We prefer South Korea as Taiwan has already performed very well both this year and last (and despite persistent geopolitical risk).

Valuations look more attractive for the South Korean market (the z-score for the forward price-earnings ratio is 1.4 for the MSCI Taiwan index vs. just 0.3 for South Korea), and earnings expectations are rising faster.

South Korea is another way to take advantage of the AI boom

South Korea also has greater exposure to memory chip cycle re-rating. The pricing for memory chips has been depressed but is now starting to recover, in large part due to the demand for the DRAM chips used in AI servers.

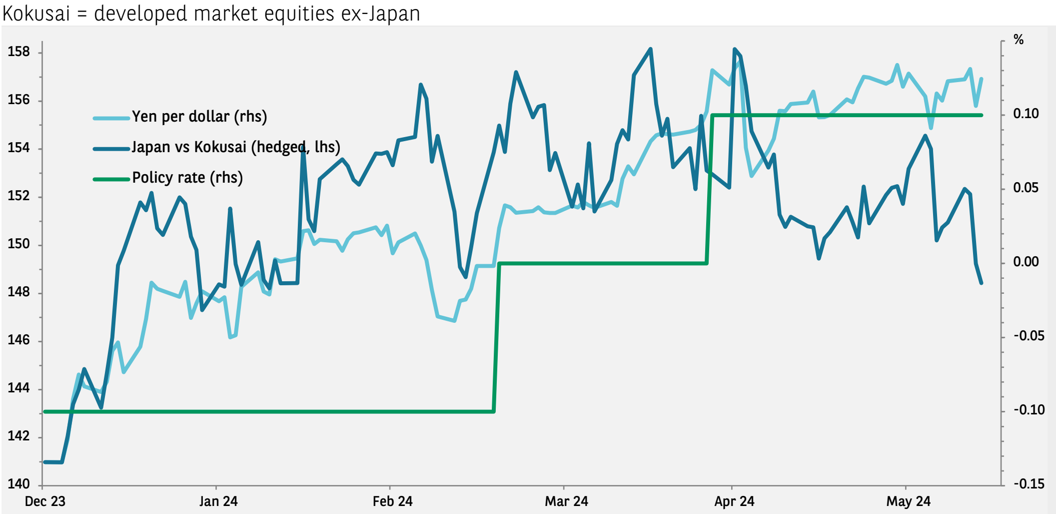
South Korea is also typically a beneficiary of any upturn in the global manufacturing cycle; this could particularly be the case now when inventory levels are low.

While earnings expectations continue to rise for the MSCI Japan index, the market has lost the support of a weakening currency. With policy rates finally in positive territory, and the Bank of Japan intervening in the market, the USD-JPY exchange rate has been stable at around JPY 156 per USD. The relative performance of Japanese equities (MSCI index) has since suffered (see Exhibit 4).

Exhibit 4

Japenese equity outperformance has waned as yen depreciation stalls

Kokusai = developed market equities ex-Japan



Data as at 14 June 2024. Sources: FactSet, BNP Paribas Asset Management.

Other worries are that wage gains and consumption are pausing, inflation is trending down, consumer confidence has declined, and business confidence is still low. Our multi-asset team has reduced its overweight to the market, but still views the earnings outlook as supportive.

Commodities

Gold prices have moved in a range between USD 2 300 and USD 2 400/ounce since April. We believe there remains significant fundamental support for the asset. There is steady appetite from central banks in an increasingly multi-polar world and investors are seeing ever more value in gold's ability to hedge against geopolitical risk and inflation.

In the near term, a recovery in manufacturing should also be supportive. Our recent article, "Geopolitical risk in a multipolar world leads gold price higher" provides a more detailed discussion.

ASSET CLASS VIEWS

MULTI ASSET

- We remain **overweight equities** despite the slight reduction from historical peaks last month; equities remain the largest driver of risk in portfolios, though interest rate risk still accounts for around one third of active asset allocation risk in portfolios.
- **Duration** is at median levels (approximately zero active duration). Excluding the short position in JGBs, active duration is close to +1yr; this comes, in equal proportions, from long positions in EM Local Debt, European Investment Grade Credit and TIPS.
- **Asset allocation risk** (in particular, from equities) was broadly unchanged over May and remains high – in the top quintile since the start of 2022.
- In early May we removed the outright **short CHF-JPY** position on continued JPY weakness. The **long Japan Equity** position was halved and remains unhedged; the overweight in **US Equity** was doubled in size in our unconstrained model portfolio. In bond portfolios, we added a long position in **Global Convertible Bonds**.
- We increased our positive conviction in **Precious Metals**, doubling the position size in our unconstrained model portfolio. Overweights in **EM Equity** were reduced slightly to maintain a consistent level of market risk.
- We closed the small, tactical overweight in **China Equity** towards the end of May; we replaced this position with **South Korea Equity**.
- We added a relative value position in the **European Energy** sector versus the market; metals have led commodities higher and more recently, gas and oil have also started to rebound. Resource nationalism is intensifying in a multipolar world and energy offers good hedging properties against inflation & international tensions.

FIXED INCOME

- **Rate cuts are on the agenda** in 2024 in the US and the eurozone, but central bankers have tried to push back the assumption of a large cutting cycle. June has seen the start of the first round of cuts for the ECB.
- Following the recent increase in rates, across maturities, **we increased our exposure towards duration** to an overweight. We prefer euro duration to US duration. We still like the 0-3 years segment that could benefit from this environment.
- With a bias towards slightly more growth in the eurozone in the coming months, and technical support for high yield from buyback operations, this should be supportive for credit spreads. We have **increased our beta exposure to Investment Grade and High Yield**.
- The time for reinvesting in **Emerging Market debt** is getting closer and the start of the easing bias would be the signal everyone is waiting for. As always, flows drive this sector and we have freed up some risk budgets in order to be able to invest ahead of the pack.

GLOBAL EQUITIES

- We have a **constructive view on global equities** for 2024 underpinned by strong fundamentals with:
- **Earnings recovery**: earnings growth is set to resume in 2024 with consensus seeing double-digit earnings growth in the US market. This comes after near 0% growth in 2023 and importantly, more sectors are seeing a pick-up in EPS growth versus 2023 leading to a broadening of leadership. Indeed, the post COVID years have been characterised by desynchronisation between goods and services. We saw stark divergences in various end markets with, for instance, a healthy recovery in air travel while rail volumes were still depressed owing in part to inventory normalisation in goods.
- **Stronger economic growth**: US growth strongly surprised on the upside in Q1 prompting upwards revisions to the full year number. Although growth has been slowing since, the economy is still expected to deliver around trend growth in 2024.
- This is constructive for equities but note that while recession risk has been reduced, **geopolitical risk remains**. As such we have been marginally adding to beta in our portfolio and are now slightly greater than one, and are adding to small- and mid-cap stocks, which should benefit from better economic prospects and monetary policy easing. Regionally, we have a preference for the US and Japan where earnings growth is stronger.

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VIEWPOINT

BNP PARIBAS ASSET MANAGEMENT

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