

# ASSET ALLOCATION MONTHLY - NOVEMBER 2022



## Pivot is here, adding to EU credit and US equities

Policy rates are priced to reach 5.0-5.5% in the US and 2.75% in Europe by mid-2023. Forward real rates are at post-Global Financial Crisis (GFC) highs in both, approaching the 'old normal' of the noughties. With downside risks to both growth and inflation mounting, the rates backdrop is increasingly restrictive and the need for policy making to 'pivot' forward is clear.

We deepen our long towards European investment grade credit, without increasing our duration hedge in tandem, thereby taking a more positive stance on duration.

We establish a small long towards US equities, in particular tech stocks where valuations are increasingly attractive. Tech stocks are more defensive by nature and an important beneficiary of the 'pivot'; seasonality is favourable, too, for this tactical position.

This allocation replaces our long-standing preference for Japanese equities, which we now close. Japan Inc has smartly outperformed Europe ex UK (our chief short) this year, but the outlook is darkening and Japanese companies are highly operationally levered to the global cycle. Given increasingly challenged policy making and fuller relative valuations, the supports for our long equity position have weakened considerably.



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Underscoring the still heightened market volatility, fixed income premia moved notably higher over the past month, led by real yields. Many in the market, including leading central banks, focus on 5-year/5-year forward real yields as a long-term indicator of the 'neutral' level of policy rates. This year, they have risen from the lows of the last 50 years<sup>1</sup> to levels last seen before the Great Financial Crisis. Effective policy rates have also moved significantly.

According to market prices, policy rates should reach 5.0-5.5% in the US and 2.25% in Europe by mid-2023. At those levels, policy rates are not neutral, rather they are restrictive. In other words, economic growth is squeezed at such levels. The spike in expected rates comes just as the effects of central bank measures taken so far are feeding through in the economy in the form of weaker growth and inflation; the tough policy tightening is starting to bite.

Overall, we remain neutral on government bonds, but continue to deepen our long positions in European investment-grade credit.

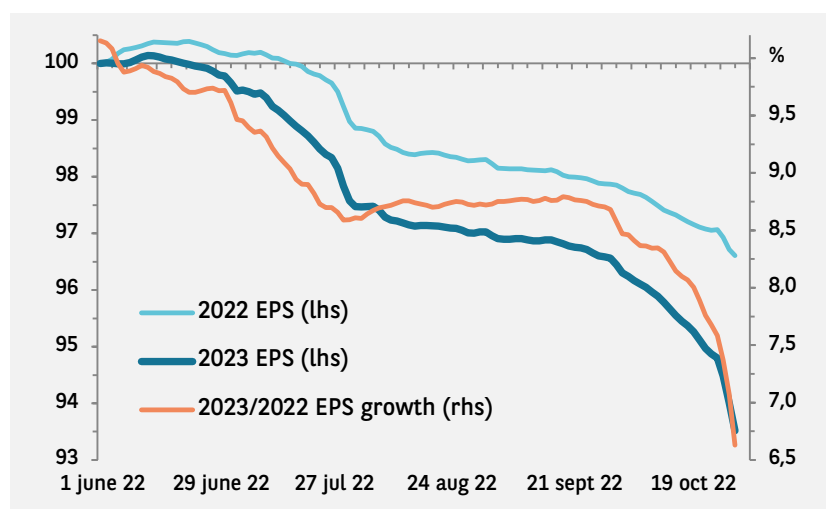
## Earnings season

Investors have eagerly awaited the 3q 2022 earnings season to see if fears of cascading profit warnings would materialise. Declines in US equities so far this year have been driven more by rising real yields/discount rates than falling earnings expectations, while in Europe growth worries have predominated. While we believe there is room for earnings expectations to correct lower in Europe, these have fallen a long way in the US, especially for tech names.

### Exhibit 1

#### Negative earnings revisions are accelerating

Next-twelve-month consensus earnings estimates and growth rate



Data as at 30 Oct. 2022. Sources: FactSet, BNP Paribas Asset Management.

The S&P 500 was only forecast to generate 1.5% earnings growth this quarter versus 3q 2021, and 75% of the increase was solely due to the energy sector. Excluding energy, EPS was expected to drop by 6%. Europe was forecast to see 20% earnings growth at the index level, but just 5%

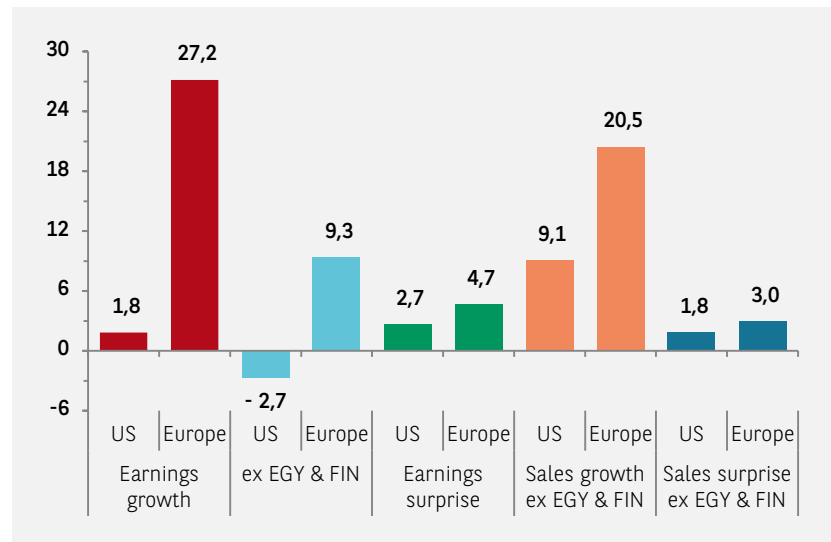
<sup>1</sup> From -85bp in the US and -1.4% in Europe around this time in 2021 to 1.25% and 1.50% in Europe and the US, respectively.

ex-commodities. With that backdrop, the fact that US earnings growth ex commodities so far is negative is not surprising (see Exhibit 2). Most sectors have nonetheless beaten estimates, with the notable exception of the interactive media industry, where several large companies disappointed. Europe has bested the US again as reopening profits come through.

### Exhibit 2

#### Earnings growth negative in US but surprises positive

3Q 2022 earnings season results, year-on-year growth rates



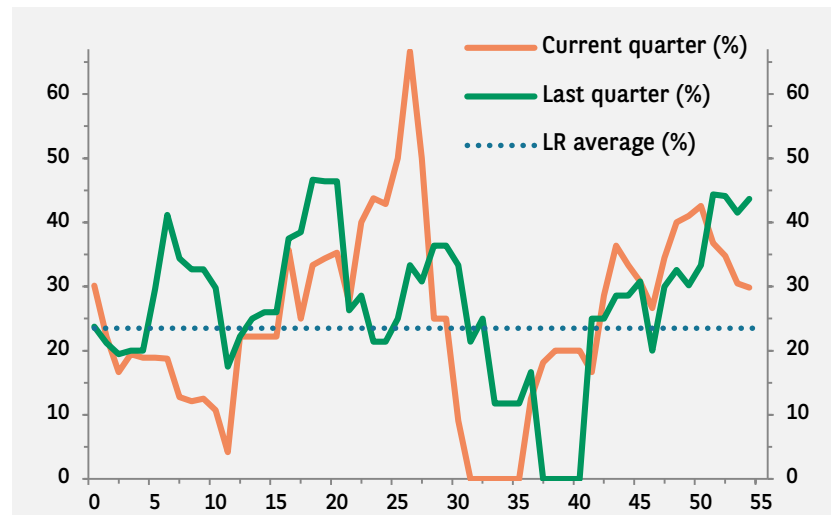
Data as at 28 Oct. 2022. Sources: Bloomberg, BNP Paribas Asset Management.

As always, though, it's the future that matters to equity investors and a key driver of the recent bounce in US equity markets has been better than average guidance when investor sentiment towards equities was extremely poor. Though there were some notable profit warnings over the last few weeks, many of them were in industries that had benefited previously from lockdowns but were now seeing earnings revert to pre-pandemic trends. Across the index, however, guidance has so far been in line with that of last quarter and above the long-run average rate of just 23% (see Exhibit 3).

### Exhibit 3

#### Earnings guidance above average like last quarter

Positive guidance as % of total, 5-day MA; number of companies reporting



Data as at 28 Oct. 22. Sources: Bloomberg, BNP Paribas Asset Management.

## Interest rates

Aside from falling earnings expectations, the key negative factor for equity markets (particularly growth stocks) has been rising real interest rates. We believe expected real yields have largely normalised, however, meaning they should be less of a risk for equity markets from here. Once the Fed pivots to lowering policy rates, they could even become a tailwind.

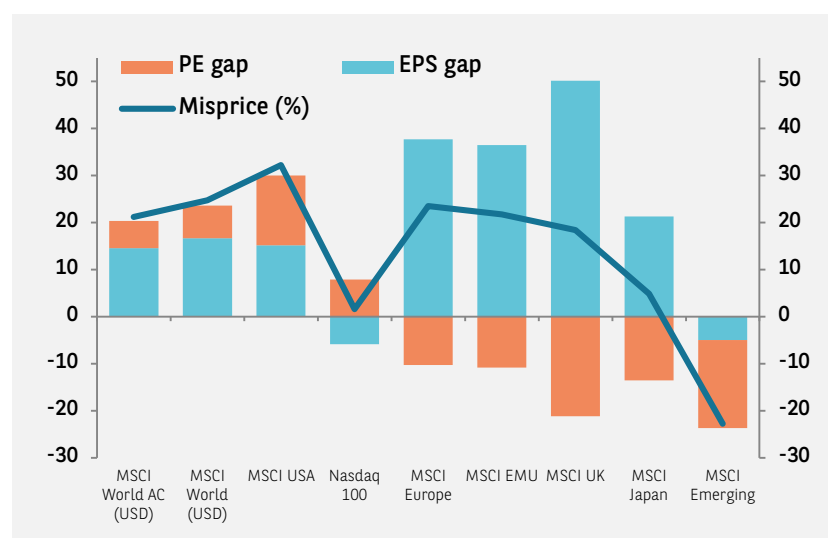
The impact of higher policy/discount rates has been most keenly felt in multiples of long-earnings-duration growth stocks. When real yields plummeted during lockdowns, as the Fed embarked on its biggest yet round of quantitative easing, valuations soared to levels not seen since the tech bubble era of the late 1990s. That policy accommodation is being painfully reversed now. Five-year five-year real yields have risen nearly 200 bps this year. The good news is that real yields and growth stock valuations have largely normalised (or at least normalised for the post-Global Financial Crisis era), and now the NASDAQ 100 looks to be one of the more attractively priced markets (see Exhibit 4). As a result, we have rotated our Japanese equity market exposure towards US equities, in particular US tech stocks.

Japanese equities had significantly outperformed Europe ex UK (our chief short) this year, but the economic outlook is now darkening and Japanese companies are highly operationally levered to the global cycle. Given increasingly challenged policy making and fuller relative valuations, the supports for our long Japanese equity position have weakened considerably. Notwithstanding decent corporate fundamentals, and having softened our overweight a few weeks ago, we formally downgrade Japanese equities to neutral, with both valuation and fundamental support.

### Exhibit 4

#### NASDAQ better priced than most other markets

Gap in EPS and PE vs model



Data as at 24 Oct. 2022. Sources: Bloomberg, BNP Paribas Asset Management.

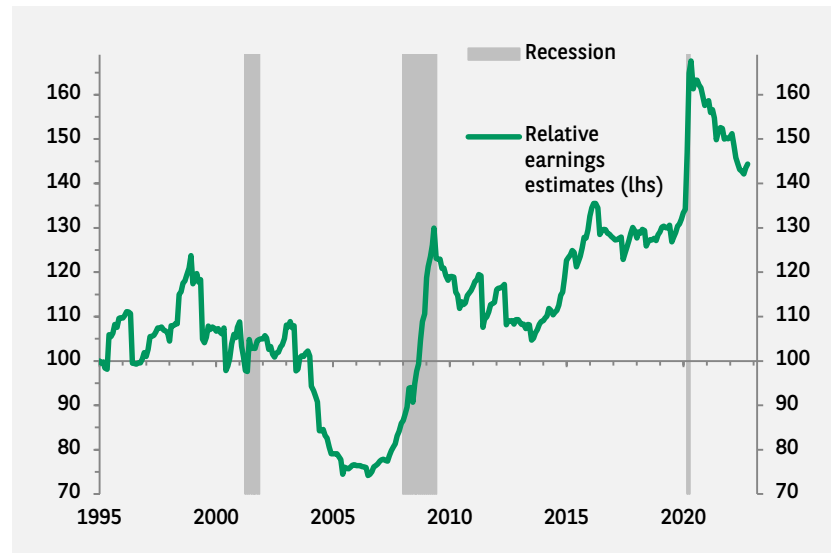
With peak fed funds rate expectations having themselves peaked, the performance of US growth stocks from here should be driven primarily by earnings. These soared during lockdowns but the trend vs value earnings has been reverting since, particularly alongside the gains in commodity prices and financial sector profits (see Exhibit 5). As the economy moves closer to a recession, though, the superior earnings growth from the style

should result in relatively better performance.

### Exhibit 5

#### Growth style earnings should start outpacing value again

Russell 1000 Growth next-twelve-month EPS estimate vs Value



Data as at 28 Oct. 22. Sources: Bloomberg, BNP Paribas Asset Management.

## Commodities and currencies

Commodities have been one of the few assets to deliver positive returns in 2022 to date, although they have now fallen into 'bear market' territory from the peak earlier in the year<sup>2</sup> The asset class remains in our 'favour' bucket. The five key supports for this position all remain in place, recession concerns notwithstanding.

They include

- Strategic developments such as the sustainable transition that are commodity-intensive
- Geopolitics, where commodities are arguably one of the few 'beneficiaries' (for example, from resource nationalism)
- Scarce supply
- Asset allocation/diversification benefits
- China reopening, constraining base metal supplies.

Precious metals, especially gold, may be an attractive inflation hedge, albeit intimately linked to movements in real rates and the US dollar.

Currencies matter for commodity returns. Monetary policy and interest rate differentials have driven exchange rates this year, favouring the US dollar in both real and nominal terms. Recently, these relationships have been challenged, and it is now currency moves driving real rate differentials rather than the other way around.<sup>3</sup> All in, we are neutral on currencies.

<sup>2</sup> The BCOM has fallen 30% from its peak. Bear markets defined as 20%+ falls

<sup>3</sup> Granger causality test on EUR/USD and 2y nominal + real interest rates differential

This report was finalised on 2 November 2022.

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# VIEWPOINT



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