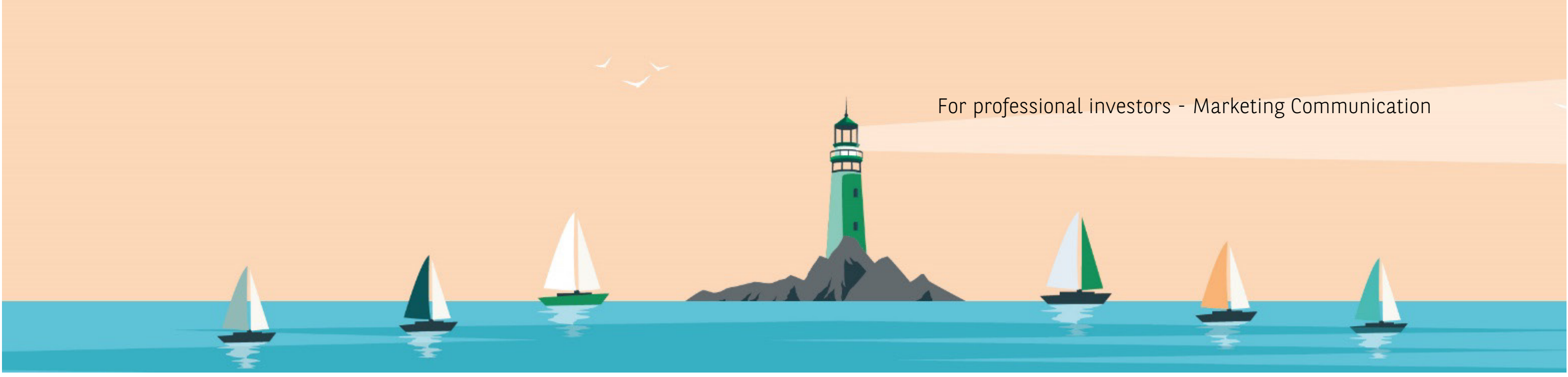
For professional investors - Marketing Communication



Asset Allocation Monthly July 2022

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Rates roller coaster

- The US Federal Reserve's (Fed) decision at its latest meeting to raise the fed funds rate by 75bp pushed expectations for the peak level next year to more than 4%. Simultaneously, fears that economic growth is slowing more quickly than expected has renewed recession worries, and rate expectations have dropped back sharply. Equity markets are 'pricing in' 80% odds of recession; rates markets aren't pricing in a recession – yet.

- BNPP AM's central research is crystallising on a 'hard landing' call, pointing to risks of a technical recession (already underway in the US), with a 'proper' labour market recession now the base case for the middle of next year. Europe is expected to see stagflation.

- Multi-asset portfolios at BNPP AM have been turning more cautious since late February, with equity risk-taking today 75% lower than it was in January; US/European rates (short) positions are also lighter, as we have taken profit on around 40% of positions. Overall risk-taking is cautious, with around 30% of risk/TE budgets being consumed, vs. 50% in January.

- We maintain our positive stance on Asian (Japan and China) equities against deep caution in Europe, which leaves equities overall a whisker away from neutral, and should be seen in conjunction with much lighter overall risk taking.

- Our portfolios also remain long on commodities, where the geopolitical risk premium and demand/supply imbalances should support higher prices.

BNP PARIBAS ASSET MANAGEMENT

The sustainable investor for a changing world

Portfolio perspectives

- Multi-asset portfolios at BNPP AM have been turning steadily more cautious since late February, with equity risk-taking today 75% lower than it was in January; US/European rates (short) positions are also lighter, as we have taken profit on around 40% of positions. All in, portfolios are consuming roughly 30% of maximum risk (or tracking error ranges) vs. just north of 50% at the start of the year.

- This positioning has been progressively at odds with forecasts of a 'soft landing', so the crystallisation of hard landing forecasts from BNPP AM's central research better aligns portfolios with research-based views. Although weak, equity total returns have been propped *up* by expectations of rising earnings, which would seem unlikely in the more challenged macroeconomic environment ahead. We maintain our positive stance on Asian (Japan and China) equities against deep caution in Europe, which leaves equities overall a whisker away from neutral, and should be seen in conjunction with much lighter overall risk taking. Europe continues to be our preferred short, judged to be in the cross-fire of geopolitical risks, inflation/supply chain challenges, policy pressures and growth/earnings challenges. Our portfolios also remain short on duration and long on commodities.

- While 10-year Treasuries are currently set for their worst H1 since 1788 according to some Wall Street projections, looking across multiple points along the US yield curve and futures strip and their relationship with each other, 32% of the US yield curve is inverted, with 41% yielding below 10%. Bonds are not yet signalling recession, usually associated with 60% of the curve being inverted; lags are also are long and variable, and taking up to three years. Yet at the same time, markets don't expect the Fed (or the ECB) to be able to hold ground, with a fairly sharp reversal of hikes expected from next year onwards. Meanwhile, equity prices suggest that recession fears are much greater in equities than bonds. But we must remember that: First, markets could fall a lot further – 40% drawdowns are not uncommon and we are 'only' half way there; and second, and pulling in the opposite direction, the stock market has priced nine of the last five recessions. We will closely watch the upcoming results season.

- There is currently a distinct 'Covid feel' to markets, with moves in nominal and real yields and weakness in major equities reminiscent of March 2020. Global growth optimism on key sell-side surveys is at an all-time low, with stagflation fears at June 2008 levels; unsurprisingly, the profit outlook from fund managers is at its worst since September 2008 – although importantly, this is not what the analyst community (whose earnings expectations feed multiples) expect.

- Sharp swings notwithstanding, it is notable that while credit spreads have widened, deeply negative returns across various credit segments have been chiefly duration-led, with option-adjusted spreads (OAS) not at distressed levels across IG, HY or EM indices. Also notable is that while the liquidity premium demanded by investors in corporate bonds – which often contains telling (and leading) information for other asset markets – has increased, moves here have been relatively contained, too. Credit colleagues recently reflected that around 75bp of the current OAS spread is judged to be the liquidity premium delivered to investors in high-yield corporate bonds; we arrive at a similar ball park from looking at the price-to-NAV deviation of the most liquid US HY ETFs. Investors have demanded up to 400bp in periods of stress. Lastly, with defaults/other measures of creditworthiness tending to be both backward-looking and at historically low levels, it is not entirely clear whether current spreads truly compensate investors for a deterioration in underlying credit risk under more challenging macroeconomic circumstances.

- From a relative perspective, though, looking at the equity risk premium against the credit spread, investment grade credit in particular appears attractively valued in both the US and Europe. The Investment Committee are not yet ready to dip in to risk assets, but credit is a clear candidate for adding risk should our appetite for taking more risk increase.

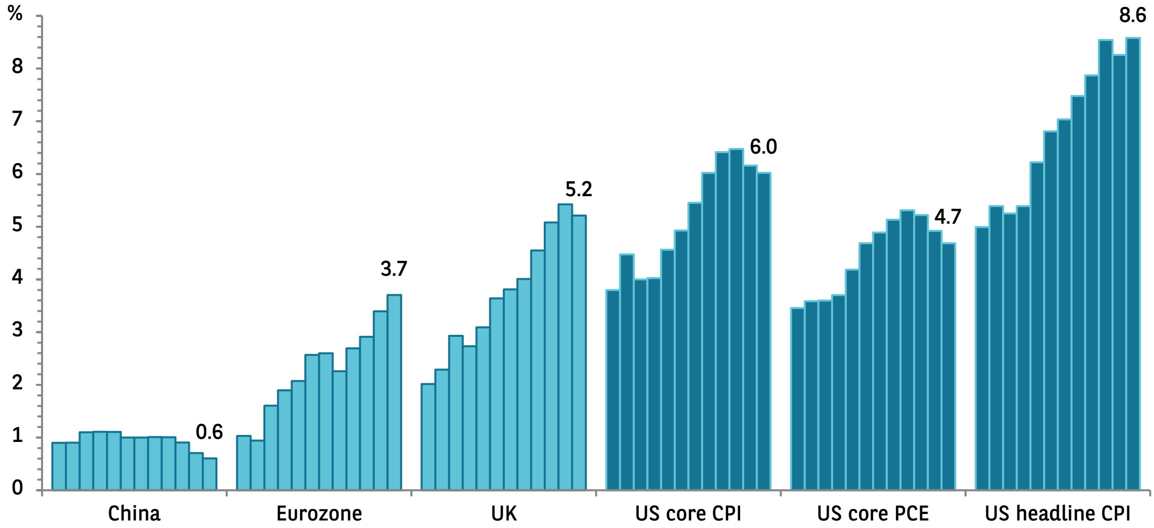
Rates roller coaster

The combination of higher-than-expected US headline inflation, the biggest monthly increase in the rent of shelter component since the early 1990s, and the highest post-Global Financial Crisis (GFC) reading in consumer inflation expecations prompted the Fed to raise interest rates by 75 basis points at its last meeting. Chair Powell had previously said a 75 basis point rate hike was not being 'actively considered', but as Keynes said, 'When the facts change,....'.

Even if the Fed could have shrugged off one month's data, particularly when core inflation actually declined (see Exhibit 1), the surprising data provided the Fed with cover to bring policy rates up to where they arguably should have been months ago.

Exhibit 1

Annual inflation rates over the last 12 months



Sources: Haver, BNP Paribas Asset Management, as at 30 June 2022.

Since then, some weaker-than-expected growth data (e.g., US manufacturing Purchasing Manager Indices (PMIs)) has refocused concerns about recession and expectations for the year-ahead level of the fed funds rate have returned to where they were at at the end of May (around 3%), down from 3.9%).

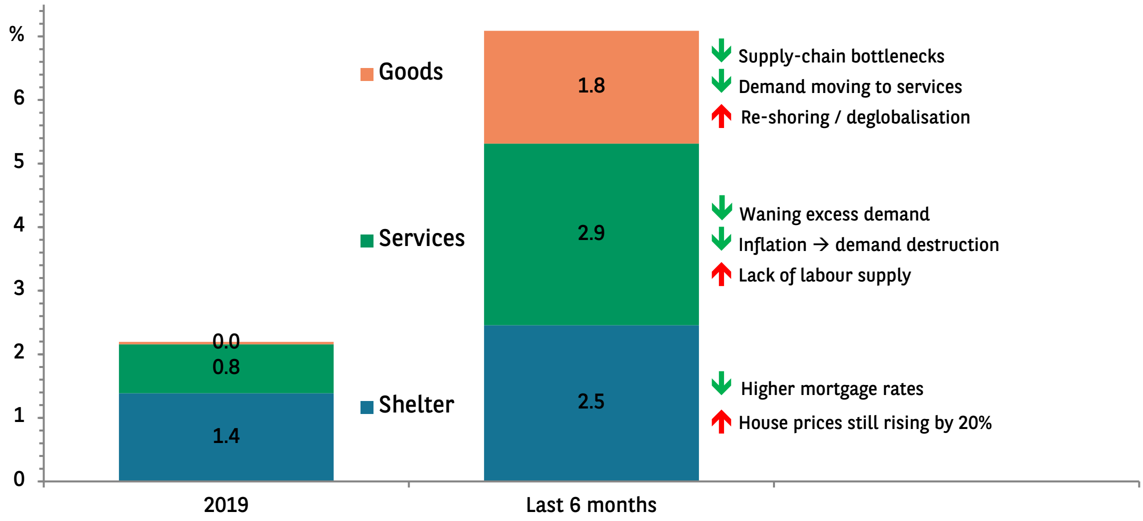
As the Fed itself has acknowledged, the future path of policy rates, and hence recession risks, will depend on how inflation evolves in the months ahead. The latest Summary of Economic Projections shows the Fed expecting headline Personal Consumption Expenditures (PCE) to decline to 5.2% by the end of this year and to 2.6% next year, with core PCE falling to 4.3% then 2.7%.

The long-hoped-for 'transitory' inflationary factors will need to come into play for inflation to meet these projections. All the main components of CPI inflation — goods, services and shelter — are meaningfully higher now than they were prior to the pandemic. While some of the factors driving inflation today, such as supply chain bottlenecks and pent-up demand, should wane, there are longer-lasting structural factors which could keep prices rising at a sustainably faster rate. Re-shoring of production would reverse the costs savings from previous globalisation waves; lower participation rates could limit service sector production; and US house prices are still rising at 20% a year, which will feed through to higher rents.

Exhibit 2

Contribution to core CPI inflation

Average monthly rate of year-on-year inflation



Sources: BLS, BNP Paribas Asset Management, as at 30 June 2022.

Interestingly, the Fed sees inflation slowing to its target 2% target even as GDP growth slows to only very slightly below the long-run forecast of 1.8% (the forecast is for growth at 1.7% this year and next). One might have thought that growth would need to be much lower for inflation to decelerate so sharply. The key question for investors is whether the current amount of tightening anticipated by markets is already enough to drive GDP growth lower. Alternatively, if inflation does not slow sufficiently, will a recession be necessary to lower demand and salary growth enough so that inflation returns to target? This scenario could see policy rates rising sharply to induce the required slowdown.

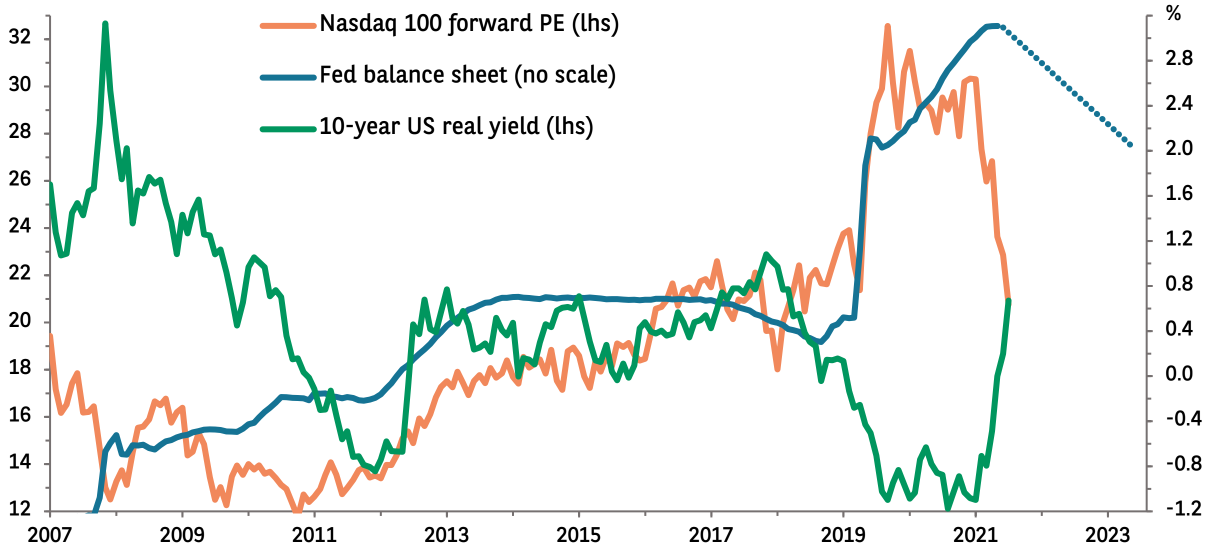
Our view is that a recession (defined as two consecutive quarters of GDP contraction) in the US is possible already, with a negative Q2 possible after a weak Q1. Central research forecasts are for a 'proper' labour market recession to follow next year. We expect non-farm payroll growth to turn negative and the resulting increase in unemployment to drag on wages and ultimately core (services) inflation. Goods prices should rise more slowly (or fall in some cases) as base effects kick in, while higher mortgage rates will dampen house price appreciation.

The first shoe?

The 20%+ decline in major equity indices is a signal to some that equity markets are already pricing in a recession. Based on their behaviour over the past 11 maket cycles, equities in the US and Europe are pricing in around 80% odds of recession in the next 12 months, for example. Yet, while markets have indeed fallen sharply, this has been driven almost entirely by a decline in valuations as central banks begin to unwind the monetary policy stimulus since the GFC. Rising policy rates and expectations of balance sheet run-off have moved 10-year US Treasury real yields from -1.2% to above 0.8%, with a mirror image decline in forward price/earnings ratios from over 30x to as low as 20x (see Figure 3).

Exhibit 3

Fed balance sheet, real yields and equity multiples



Sources: FactSet, Bloomberg, BNP Paribas Asset Management, as at 30 June 2022.

If markets were truly pricing in a recession, one would have anticipated a significant decline in earnings expectations; in fact, they have *risen*. In a recession, earnings typically fall by around 20% and that is what drives stock prices down. Even with the negative revisions, earnings are forecast to grow by 9% over the next two years on average (both including and excluding commodities).

Europe ex-UK earnings have been similarly resilient – and here, we are even more cautious. Europe remains in the cross-fire of geopolitical risks, inflation/supply chain challenges, policy pressures and growth/earnings challenges. A complete halt to Russian gas exports would likely lead to stagflation in the region, with GDP growth turning negative while inflation remains high. To be sure, the balance of risks is sufficiently high that BNPP AM's central research now has stagflation as the base case for Europe.

Asset class views

	Strongly Dislike	Dislike	Neutral	Favour	Strongly Favour
Risk appetite*		X			
Asset allocation		Government bonds	Credit Real Estate Cash	Equities Commodities	
Equity regions		Europe ex-UK	US	Japan GEM	
Equity style/size			EU large cap EU small cap US large cap US small cap		
Sovereign bonds		US Europe Japan	EM local Australia UK Linkers		
Credit			US IG US HY EMD	EU IG EU HY	
Commodities			Precious metals	Energy Base metals	
FX			USD, AUD, GBP, EUR EM FX	JPY	

* Risk appetite/return to risk - Data as at 30 June 2022. The views reflect those of the Investment Committee of the Multi-Asset team at MAQS. Other specific/tactical trades may be implemented in addition.

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