ASSET ALLOCATION MONTHLY - SEPTEMBER 2023

Complacent? Not us.

- Markets have been volatile since our last monthly, buffeted by the much-anticipated gathering of leading central bankers at Jackson Hole, poor macroeconomic data from the US, a focus on China's weak economy and hopes for firmer stimulus from Beijing.
- The current economic and market narrative is one of 'Goldilocks' in developed markets (DM), a scenario typically characterised by rising or firm economic growth and falling inflation, particularly in the US. However, in our view, risks are skewed toward weaker economies and earnings, chiefly in DM. We see the US labour market softening, and in its wake consumption – just as the 'offset' to tighter monetary policy from easy fiscal policy and excess COVID savings dissipates. The European and UK economies look markedly weaker already. We are at or close to peak policy rates, in our view.
- In this context, and with bond premia meaningfully above equity premia for the first time in 15 years, being long duration remains our largest risk position, and we have increased it over the month. We have also added a position in emerging market local currency debt, seeking to benefit from August's sell-off.
- We remain cautious on equities, chiefly in Europe. Since our last monthly, our equity short overall has increased as we reduced our long in EM equities on China concerns.

Maya Bhandari
Global Head of Multi-Asset

Daniel Morris
Chief Market Strategist

BNP PARIBAS ASSET MANAGEMENT

The sustainable investor for a changing world

Macroeconomics – Goldilocks or not?

Recent data have challenged the consensus narrative for a 'Goldilocks' outcome of improving economic growth and lower inflation, initially in the US and then in Europe. The latest data on US payrolls, real incomes, JOLTS (Job Openings and Labor Turnover Survey) and quit rates all signal weakening labour market conditions. The sharp slowdown in hours worked, household jobs, and temporary employment in recent months point in a similar direction, as does the Conference Board jobs differential reading, which is now consistent with a marked rise in the unemployment rate.

Importantly, this comes just as excess household savings built up on the back of COVID stimulus are close to being fully spent, and fiscal policy is poised to tighten, starting with the resumption of student loan repayments in October), and a government shutdown looms. This removes the economic cushion against the impact of higher interest rates. Consumer surveys, including the most recent one from the New York Federal Reserve, also point to a less rosy outlook for consumption.

In the eurozone, monetary tightening has not been offset by fiscal easing, and credit conditions have tightened meaningfully in recent months. While the ECB's strong focus on real-time inflation outcomes increases the risk of over-tightening as credit conditions worsen, we expect the central bank to stand pat for now. The first cut in policy rates is unlikely to come before the middle of 2024.

To us, these developments argue firmly against a 'Goldilocks' narrative. With attractive risk premia in bonds, we added to our long-duration positions over the month and remain cautious on equities — see more below.

New cracks and action in China

Stresses have again become visible in the Chinese economy, notably in the already weak property and trust sectors. Beijing has reacted, perhaps more readily and faster than in the past, but we find the measures taken so far underwhelming. For instance, a 200bp fall in the inflation rate has been met with only 50bp in official rate cuts so far.

A lot of bad news is already reflected in the price of Chinese assets. But in view of the recent developments in China, and concern over Beijing's willingness to stimulate the economy more broadly, we lowered our allocations to China-focused emerging market equities.

Pricing risk – The time for bonds

Every risk has a price, and in our view, different markets are currently priced for different outcomes. Strikingly, bond premia now exceed equity premia for the first time since the Great Financial Crisis (see Exhibit 1). The gap has been this wide only twice in the last century — during the Great Depression and the Nasdaq bubble. The current differential has been driven by higher long-term rates (inflation breakevens and real yields have risen), and lower earnings yields as analysts have turned more bullish on expected earnings.

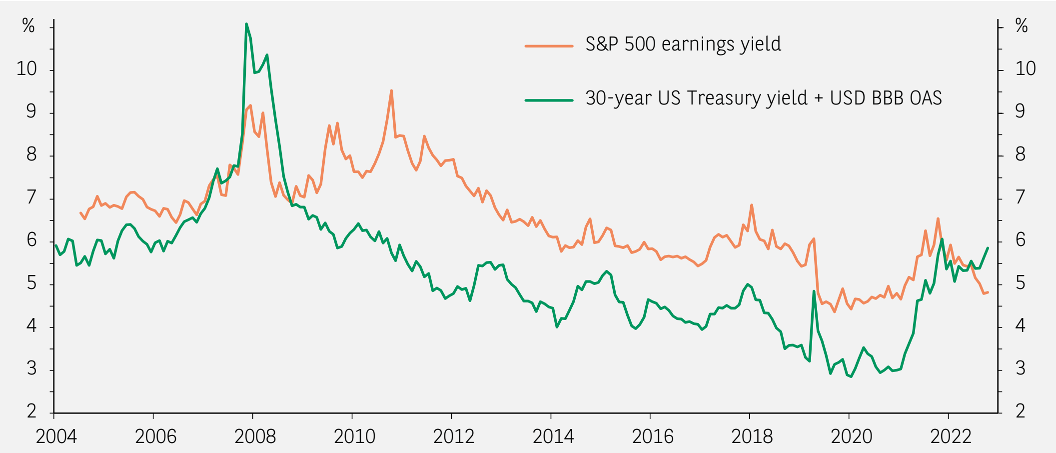
Relative valuations look extreme to us, presenting attractive opportunities for active asset allocation. Our key risk positions are now a long in sovereign bonds, chiefly in the US, and a modest short in equities, concentrated in Europe.

Our long in developed market sovereign bonds is our highest conviction view, expressed chiefly via long-dated US Treasury inflation protected bonds (20-year TIPS), alongside a modest long in nominal Treasuries, a long position in EU investment-grade (unhedged recently), and long UK gilts versus German Bunds. Last week, we added to our positive duration positions, starting to build an (unhedged) long towards EM local currency sovereign bonds. At current yields, we believe bonds 'lock in' increasingly attractive diversification benefits to multi-asset portfolios.

Exhibit 1

Fixed income risk premia exceed those for equities

Equity earnings yield (next-twelve-month) vs bond proxy



Data as at 15 September. Sources: Bloomberg, BNP Paribas Asset Management.

The appeal of EM local debt

We turned more constructive on emerging market local currency debt over the month on the back of three chief supports:

- **Diversifying positive duration:** We turned incrementally more positive on duration over the summer. EM local, with a 6.4% carry yield, is a diversified way to play this, capturing carry both in EM currencies and yields. A softer economic landing would provide a particularly beneficial setting for this asset class, while our existing developed market bond positions would likely do better in a sharper slowdown.

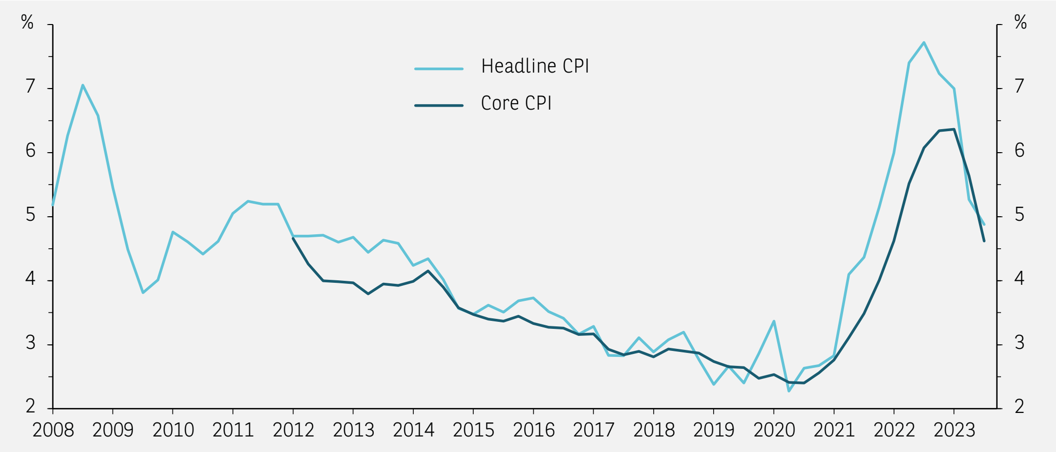
- **Favourable EM macro set-up:** Inflation has fallen sharply in almost all emerging markets in recent months (see Exhibit 2), ahead of most expectations and in contrast to stickier inflation in developed markets. Real policy rates (see Exhibit 3) are relatively high (1.5%), with 100bp downside to the historical average (50bp). We believe this provides scope for both front-end and long-end rates in EM to start falling, particularly given EM central banks' more credible inflation targeting, better external balances, and big declines in currency volatility. Should larger EM central banks be cautious in cutting rates too quickly, EM currencies stand to benefit from a tailwind.

- **Positioning:** In our view, EM local debt is fairly underinvested, with current foreign ownership of major EMs a fraction of what it was pre-COVID.

Exhibit 2

Emerging market ex-China inflation falling sharply

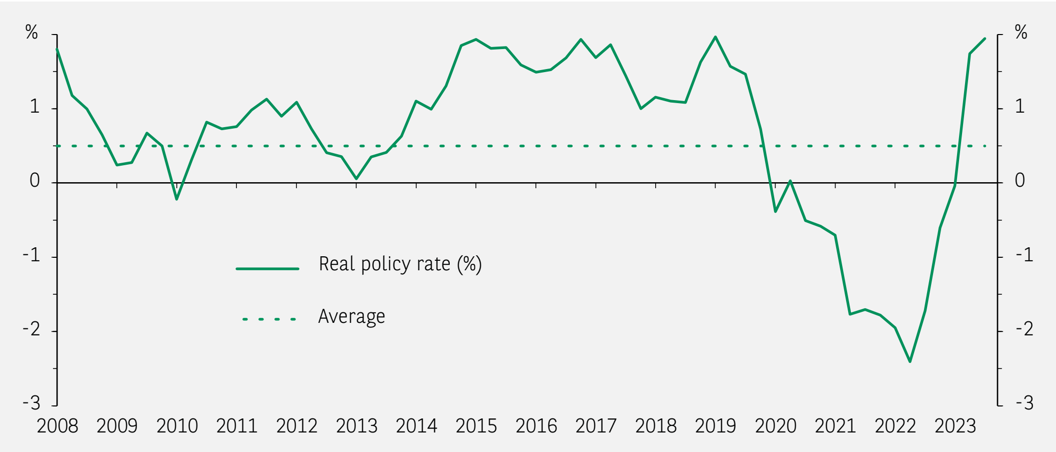
YoY%, GDP-weighted



Data as at 14 September 2023. Sources: Haver, BNP Paribas Asset Management.

Exhibit 3

Emerging market real policy rates are relatively high



Data as at 14 September 2023. Sources: Haver, BNP Paribas Asset Management.

Equities – Still too optimistic in Europe

Against our optimism in bonds, we are cautious on equities, expressed chiefly in Europe where we see downside risks from both a fundamental and valuation standpoint. Fundamentally, European equities are expected to deliver 6% compound annual growth (CAGR) in earnings by 2025, after having risen steadily post-COVID. The increase in earnings expectations for Europe stands in contrast to those in the US, for example (see Exhibit 4). In weaker growth periods, as we are starting to see now, European earnings have tended to fall by 15-30%. In addition, our bottom-up analysts note that while headline earnings and margins were reasonable this reporting season, the outlook from European companies was more cautious, with positive earnings trends chiefly for large-cap value stocks.

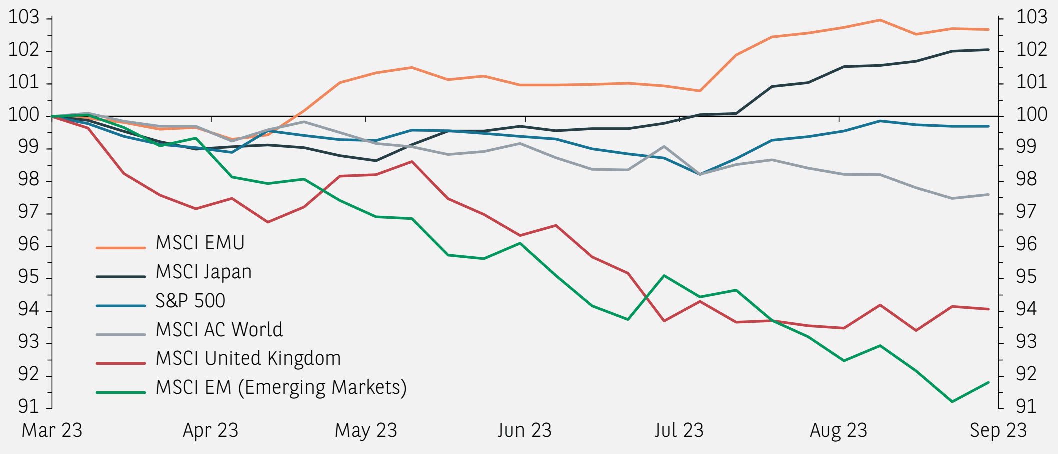
Adjusting for weaker earnings, European valuations look unappealing to us, most notably versus EM equities, hence our long EM versus short Europe. From a cross-asset perspective, our valuation work points to European valuations looking rich versus high-grade and high-yield credit and sovereign bonds.

We have taken profit on our relative-value long position in European banks versus broader European equities as targets were reached. Positioning in banks appears full to us, and macro support for this position is waning.

Exhibit 4

Eurozone earnings forecasts reflect much more optimism

2023 EPS consensus estimate



Data as at 14 September 2023. Note: Local currency except regional indices in USD. Sources: FactSet, BNP Paribas Asset Management.

Aside from being long government and European investment-grade bonds, we are modestly long commodities (ex-agriculture and livestock). The latter offers some diversification to portfolios should economies hold up better than we expect.

We are neutral cash and real estate, and neutral on overall risk consumption, i.e., consuming around half our maximum tracking error ranges.

Our asset class views

	Strongly dislike	Dislike	Neutral	Favour	Strongly favour
PRR/risk appetite			X		
Asset allocation		Equities	Real estate Cash	Government bonds Commodities Credit	
Equity regions		Europe ex-UK US	Japan UK EM ex-Asia	EM Asia	
Equity style/size			EU large cap EU small cap US large cap US small cap		
Sovereign bonds			Japan Europe Australia	US UK Inflation-linked bonds EM local debt	
Credit			EM debt US IG US HY EU HY	EU IG	
Commodities				Energy Base metals Precious metals	
FX			EUR, USD, AUD, GBP, JPY, EM currencies		

Views as at September 2023

September 2023 - Design: Creative Services BNPP AM - P2309031

VIEWPOINT

BNP PARIBAS
ASSET MANAGEMENT

The sustainable investor for a changing world