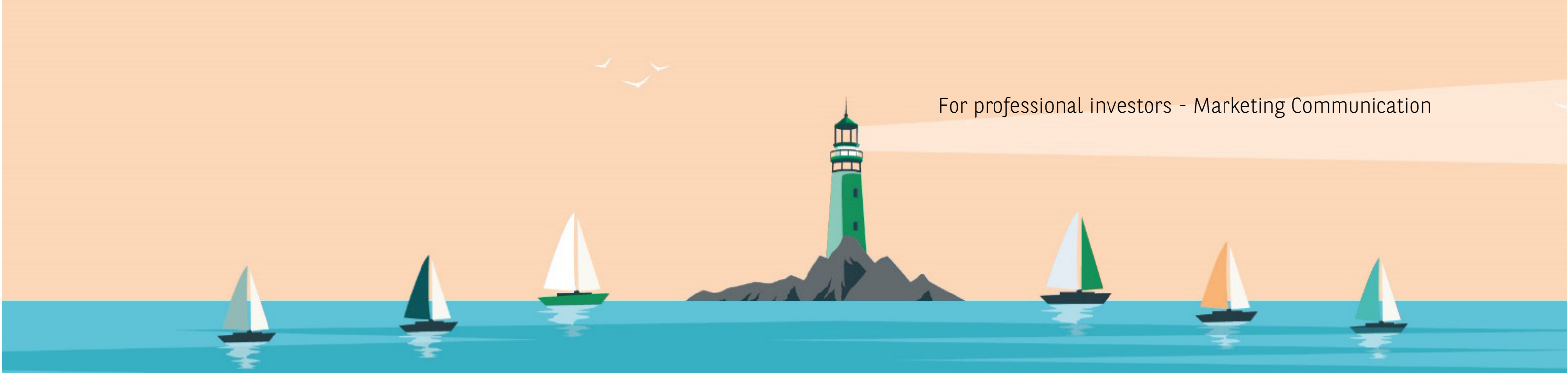

Asset Allocation Monthly June 2022

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Mounting stagflation fears

- Financial markets are increasingly pricing in 'stagflation' – an unfriendly mix of soggy growth and rising inflation.
- Over the course of the month, expectations of the level that the fed funds rate will reach in a year have dropped by about 30bp, driven by signs of weakening economic growth and worries about a recession. The belief is that the fed funds rate need not rise as high as originally thought in order to slow inflation.
- Growth, however, needs to weaken if inflation is to move back towards the Fed's long-run inflation target. Equity investors are now trying to determine how much corporate profits may drop due to slower growth rather than calculating how much valuations could fall due to higher discount rates.
- So far, earnings estimates have been surprisingly resilient, particularly for continental Europe. We believe, however, that forecasts for Europe ex-UK are overly optimistic and foresee more meaningful downgrades ahead.
- In contrast, the drivers for our decision to go overweight Chinese equities in late March have been reinforced, in our view.

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Portfolio perspectives

- Looking back over 30 years, broad asset market returns have rarely been weaker. So far this year, an investor in a 60:40 portfolio of equities and bonds would have lost around 12%, akin to losses incurred during the global financial crisis in 2008. Financial markets are increasingly pricing in 'stagflation' – an unfriendly mix of soggy growth and rising inflation.
- The Investment Committee has made two chief shifts over this period.
- First, with the violent sell-off in core duration, we decided to clip back shorts to the US and Europe soon after the May US consumer price index (CPI) release; we are maintaining our short in Japanese sovereign bonds alongside this, where the asymmetry remains appealing. This a valuation-led move, rather than an altered fundamental view: we remain cautious on long duration assets; looking ahead 12 months, government bonds remain marked at -1 on our risk-adjusted grid. Including moves in late April, multi-asset portfolios have taken profit on around 40% of US/European duration shorts, remaining conservative on risk taking overall.
- Sovereign bond yields moved violently higher at the beginning of May, with US 10-year T-note yields crossing the psychological threshold of 3% for the first time since 2018; real five year-five year forward yields also turned positive again. Being short on duration, concentrated in the US, Europe and to a lesser extent, Japan, remains one of our core asset allocation views.
- Second, after a period of strong outperformance of European equities vs. the rest of the world – around 11% since the lows of March – we deepened our short to similar levels to those where we first established an underweight position in late April. Cyclically geared European equities face headwinds from a variety of fronts: slowing growth and rising inflation (aka stagflation), with an ECB that is clearly focused on risks from the latter; continued geopolitical risks, with a disproportionate impact on the region; and over-optimistic analyst earnings forecasts. When we pen in a more credible 'E', forward price-earnings (P/E) ratios are not cheap.
- Our long equity exposures are focused in Asia (Japan, EM and China), against this deeper short toward Europe that has both cash flows and discount rates moving against it. We see Japan as offering quality value, with a very supportive domestic policy backdrop: this is the only area where internal research points to upside risks to consensus earnings forecasts. In China, policy is following through from the Politburo's latest meeting, with deeply attractive valuations, particularly in the tech sector.

From the frying pan into the fire

Over the course of the month, expectations of the level that the fed funds rate will reach in a year have dropped by about 40bp, driven by signs of weakening economic growth and worries about a recession. The belief is that the fed funds rate need not rise as high as originally thought in order to slow inflation.

Equity investors are now trying to determine how much corporate profits may drop due to slower growth rather than calculating how much valuations could fall due to higher discount rates. A rise in interest rates may prompt a sharp fall in price-earnings (P/E) ratios, but once valuations have reset, equity markets tend to rebound in line with earnings. This is arguably all that has happened this year: real yields have jumped by more than 100 basis points since the end of 2021 and the forward P/E ratio on the Nasdaq has commensurately declined from 33x to 23x. The whole time, however, earnings expectations *rose*.

Growth in any event needs to slow if inflation is to move back towards the Fed's long-run inflation target. The key lesson from the first quarter US GDP release was that demand was far too strong relative to the productive capacity of the US economy. Hence the surge in imports and resulting negative GDP growth. Fortunately, retail sales growth is slowing and purchasing managers' indices (PMIs) are falling.

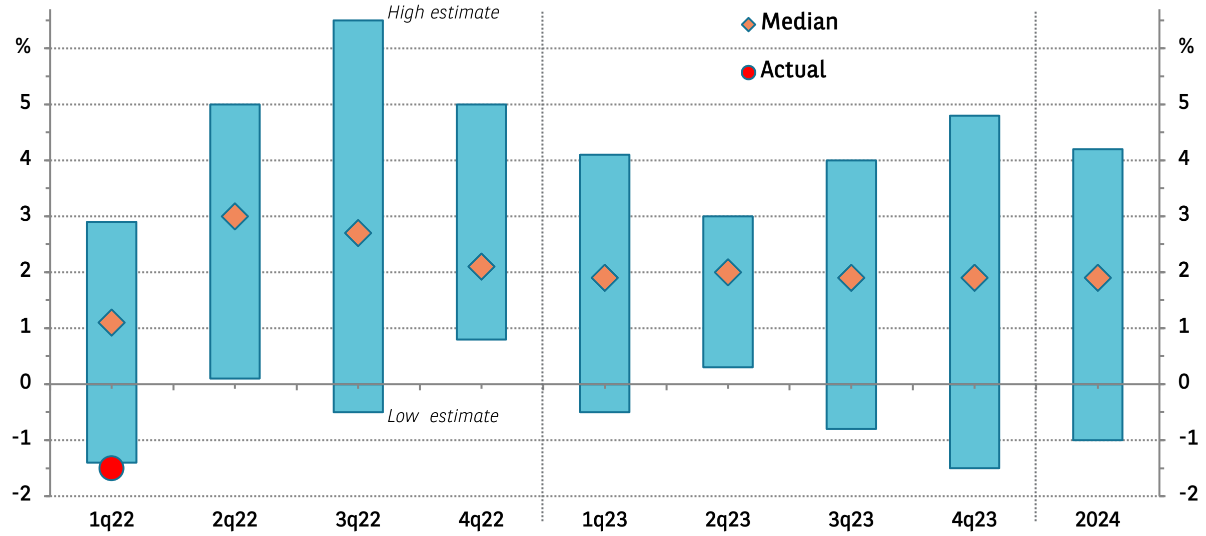
Investors are inevitably nervous that the deceleration in demand will go too far. The Fed projects that GDP growth will decline to 2.2% by the end of next year, with unemployment rising only modestly from 3.5% to 3.6% and the fed funds rate at 2.8%. More persistent or stronger inflation would necessitate a higher fed funds rate and a bigger increase in unemployment to achieve the inflation objective of 2.7% core PCE (Personal Consumption Expenditures).

A key indicator to watch will be US wage growth. The Atlanta Fed's wage growth tracker showed median wages rising at 6% year-on-year at the end of April. While of little comfort to workers when headline CPI is over 8%, this pace of wage growth is clearly incompatible with the Fed's long-run inflation target. The wage growth figure will need to begin falling by autumn for the markets to continue to believe that 200bp of additional tightening (as currently priced in), will be enough to manage inflation.

One can take little comfort from consensus estimates that so far suggest GDP growth will remain steady at around 2% each quarter (on an annualised basis) through next year (see Exhibit 1). The shock negative GDP print in the first quarter came when the median estimate was for growth of 1.1%. If the most negative forecast turns out to be right again, a recession seems most likely towards the end of next year. While our view is somewhat more pessimistic than the consensus, we nonetheless anticipate a recession will be avoided.

Exhibit 1

Consensus real GDP growth forecasts: range high to low, median and actual



Sources: Bloomberg, BNP Paribas Asset Management, as at 31 May 2022.

Commodities and the rest

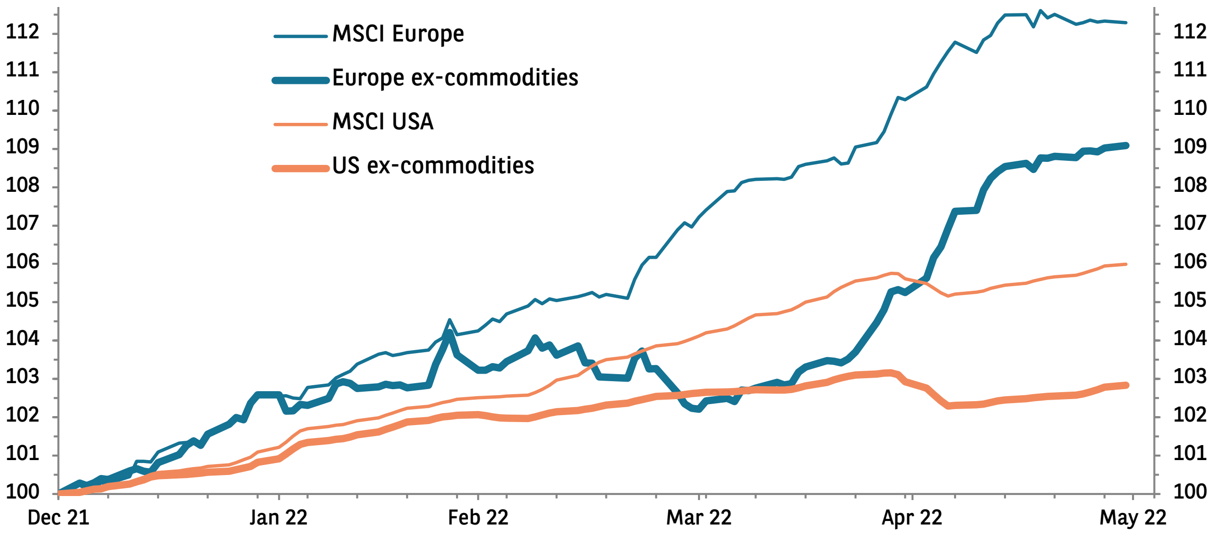
For all the headwinds equity markets have faced since mid-February, earnings estimates have been surprisingly resilient. The average forward earnings-per-share (EPS) for European equities has risen by 8% since February, more than twice the increase seen in the US. This has been almost entirely due to higher forecasts for commodity sectors, however. Earnings forecasts have mostly flatlined now, as analysts factor in waning demand due to inflation and lower margins from higher input costs and wages (see Exhibit 2). Even so, we believe the forecast for Europe ex-UK is overly optimistic and foresee more meaningful downgrades ahead. Even the boost to earnings growth from commodities is likely only temporary. While European energy sector earnings are expected to almost double in 2022 versus a year ago, they are projected to fall for the next two years.

To be sure, in asset allocation portfolios, we prefer to simply be long commodities – a position that has worked well for us and in which we maintain a clear overweight, re-established in mid-April.

Exhibit 2

Consensus next-12-month earnings estimates

31-Dec-2021 = 100



Note: Commodities includes energy, fertilizers and agricultural chemicals, metals and mining, and agricultural products. Sources: FactSet, BNP Paribas Asset Management, as at 31 May 2022.

China challenges and opportunities

Despite lockdowns in Shanghai and elsewhere in China lasting far longer than was expected, markets appear to be looking past the near-term challenges. One lesson from the last two years is that lockdowns are eventually lifted and activity recovers. After the initial shock and underperformance of Chinese equities in March, Chinese stocks have kept up with other markets as Beijing has sought to follow through on its promise do 'whatever it takes' to support growth in the face of the lockdowns.

Back in late March, there were three chief supports for building on our EM equity exposure with China (with a ratio of 1:2 in risk terms); on balance, each of these is now tilting in a positive direction. First, valuation, where Chinese equites remain nearly one standard deviation cheaper vs. global equities on forward P/E multiples. The discount is particularly large in the tech sector.

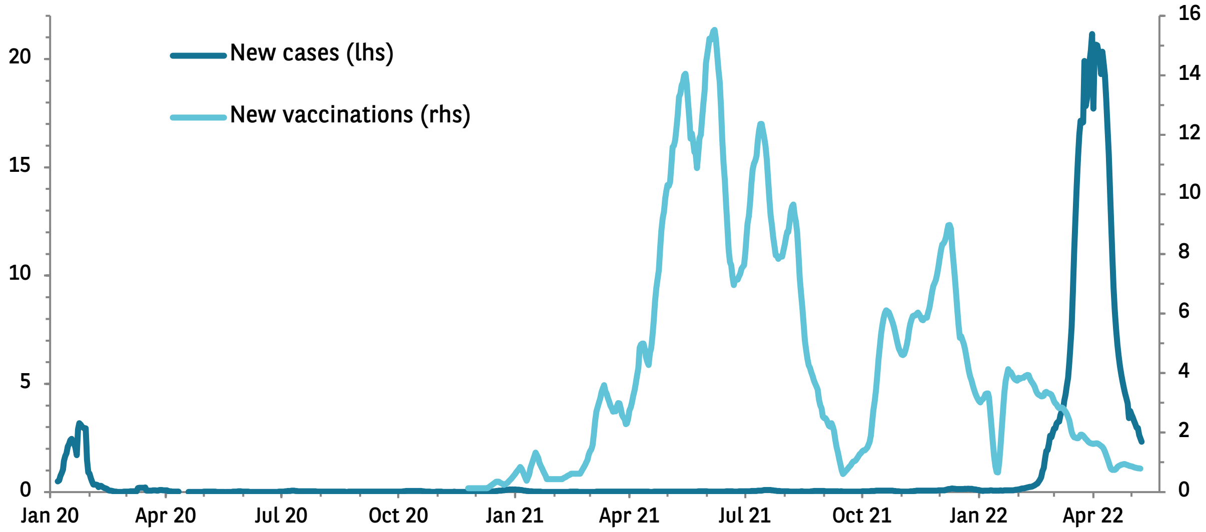
Second, and key to unlocking a meaningful re-rating, a more favourable fundamental outlook following the 'whatever it takes' policy announcement from the Chinese authorities, with good earnings expected in the quarters ahead. Although some segments in consumer discretionary, for instance, have been hit by negative earnings revisions related to lockdowns, the consensus and BNPP AM research see 40% earnings growth for the sector overall. And last but not least, constructive signals from our market timing tool kit, which remain in place.

The resilience of Chinese tech names like Alibaba, Baidu and Tencent vs. the broader A shares since the initial March policy proclamation is notable. The drive to regulate tech is judged to be behind us, with an unmistakably dovish stance apparent now. More broadly, the clear turn in China's credit impulse as others tighten policy is striking, and should create a supportive setting for Chinese stocks.

This support, however, is not a panacea: China has clear long-term challenges, and the near-term may continue to be clouded by the latest wave of Covid and any lingering lockdowns. All in all, though, each of the three drivers for a tactical allocation to China have been reinforced, in our view.

Exhibit 3

New China Covid-19 cases and vaccinations per million



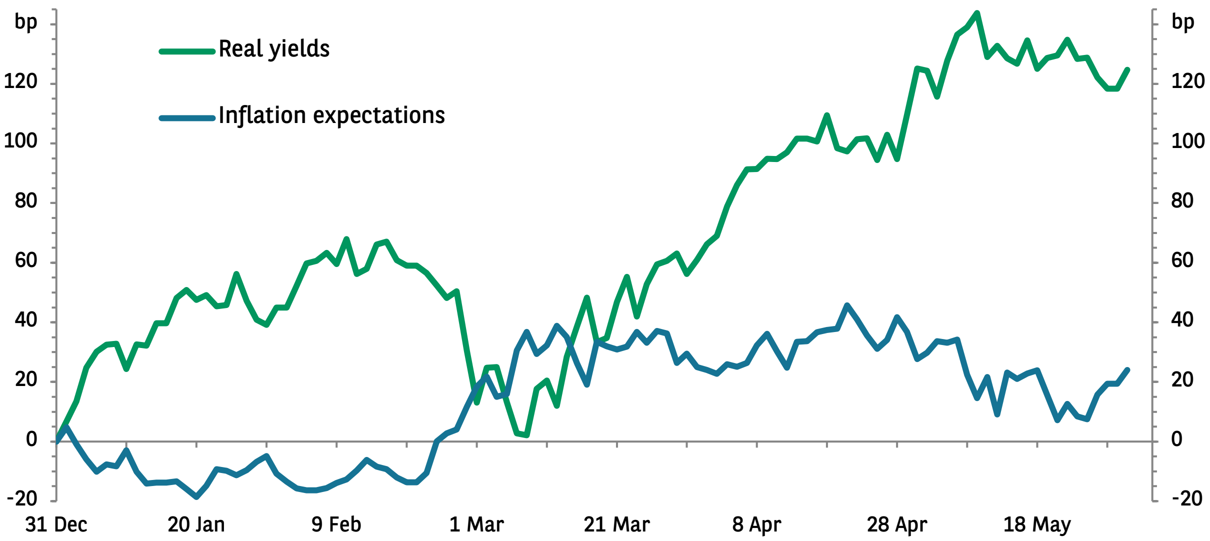
Sources: Our World in Data, BNP Paribas Asset Management, as at 31 May 2022.

The drive for higher yields

Nominal 10-year US Treasury yields breached the significant threshold of 3% in early May, for the first time since July 2018. The increase over the previous month had been driven by sharply rising real yields as expectations of yet more aggressive tightening by the Fed to dampen inflation pressures was priced in (see Exhibit 4). Five year/five year forward real yields jumped sharply higher towards the level associated with secular stagnation, that is, the post GFC 'new normal'.

Exhibit 4

Contribution to change in nominal US Treasury 10-year yield



Sources: Bloomberg, BNP Paribas Asset Management, as at 31 May 2022.

A new regime of higher inflation should bring with it more elevated policy rates and long-dated yields. Volatility has been high and recent market moves have been intense. As nominal yields have risen, we have progressively reduced our underweight in duration, as described earlier. Inflation has already proved to be more resistant than markets anticipated, with room for inflation expectations to rise. It's a long way from 5.2% to 2.7% core PCE (Personal Consumption Expenditures) inflation and the deceleration may not be as swift as markets assume. Term premia moves could also rise further as central banks tighten and quantitative tightening (QT) gathers pace.

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 31 May 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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