

Asset Allocation Monthly

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Not so fast

- The surge in equities and fall in long-term bond yields so far this year suggest investors have been buying into the idea of 'immaculate disinflation' — that easing inflation would be painless for growth in 2023. Such market moves could also reflect the notion that it is 'job done' for central banks in their fight against inflation. Our base case is more cautious.
- We are neutral on equities, where 'immaculate disinflation' could become a problem for margins if the cost of goods sold does not slow as fast as sales (or rises faster than revenues). That could mean further downside for earnings estimates, particularly in Europe where estimates appear overly optimistic relative to the latest macroeconomic data.
- We are broadly neutral in our multi-asset portfolios. European equities are our main (and meaningful) short position, against which we are long US and emerging market stocks.
- China's reopening has led us to increase our allocation to emerging market equities. Valuations look attractive now and after a long period of negative earnings revisions, we anticipate more positive momentum from here on. EM Asia and commodity exporting countries should benefit in particular from the reopening.
- We have added a modest long position in the Japanese yen against the euro. The trade should benefit from the Bank of Japan seeking to abandon yield curve control. We believe the yen is attractively valued and can hedge current portfolio positioning.
- We continue to favour European investment-grade credit, where spreads have tightened further from when we were building positions (to 141bp today from 228bp). We also favour commodities.



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A (too) good start

Markets had a generally good January, continuing the bounce that started late last year. Equities closed sharply higher on the last day of the month, extending the rally ahead of the latest monetary policy update from the US Federal Reserve and capping a month of solid gains.

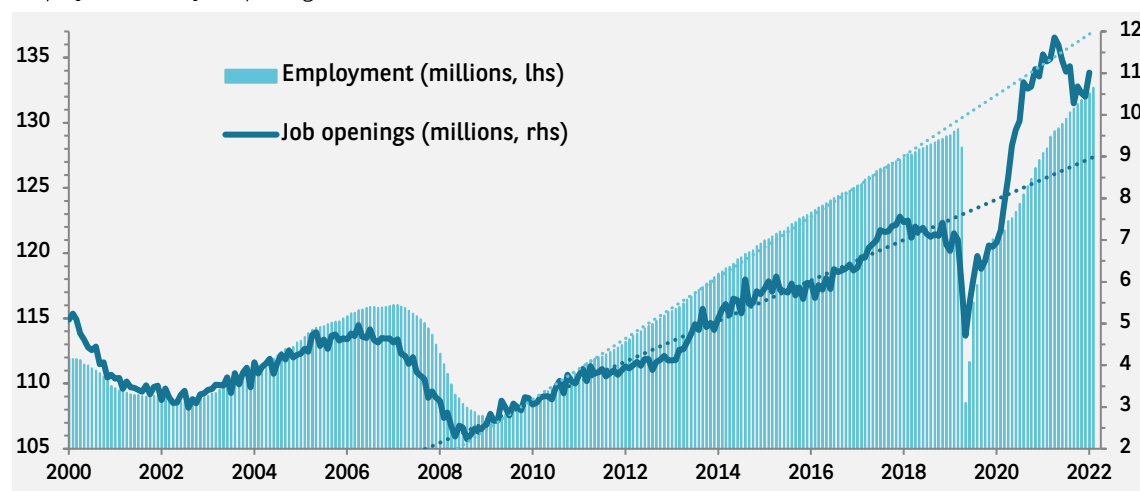
Europe in particular had the best start to the year since 2015, with mid and small-capitalisation stocks outperforming large caps. All sectors and factors ended January in the black, with consumer discretionary being the brightest spot among the sectors, and value among the factors. European fixed income also started 2023 on the front foot, with many fixed income indices gaining.

The surge in equities and fall in long-term bond yields suggests investors have been buying into the idea of ‘immaculate disinflation’ — that easing inflation would be painless for growth in 2023. Such market moves could also reflect the notion that it is ‘job done’ for central banks in their fight against inflation. In our view, this narrative is particularly challenged in Europe, where analyst earnings expectations are still in ‘suspended animation’ – i.e., cash flow projections appear much too high – at the same time as expectations for the level of discount rates may be too low. Both cash flows and discount rates are posed to pull in opposite directions, in our view.

Exhibit 1

The US labour market has recovered pre-pandemic job losses, but is still well below trend

Employment and job openings



Data as at 7 February 2023. Sources: BLS, BNP Paribas Asset Management.

Recession and decoupling

Unusually mild winter weather and the recent collapse in gas prices have allowed the euro bloc to avoid a terms-of-trade shock, mitigating the effects of the energy crisis. Our macroeconomic research team has revised up their estimates for Q4 2022 and Q1 2023 growth, but also believes recession has only been postponed, not avoided. This is not reflected in bottom-up analyst estimates. These have remained both positive and high in their ranges.

It is striking to us how much further and faster US earnings per share (EPS) expectations have faded vis-à-vis their European counterparts (our view: ‘favour’ US equities; ‘dislike’ Europe). US full-year earnings

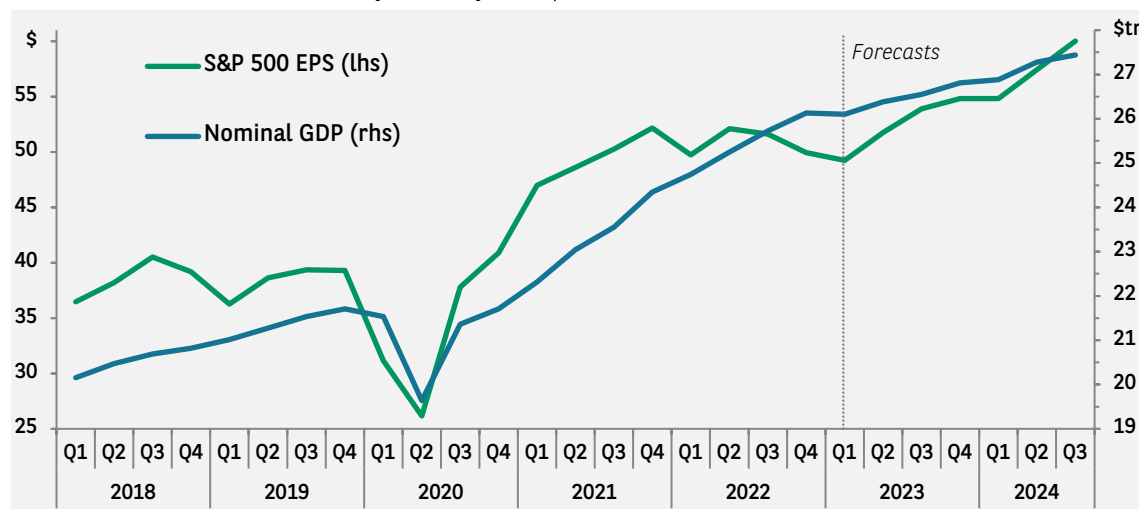
growth estimates have remained low. Analysts have already revised sharply down their quarter-on-quarter expectations. At the end of last September, forecasts were for year-on-year earnings growth in the first half of 2023 of 7%. It is now -1%, in line with consensus expectations for economic growth to troughing the second quarter.

As always, the key judgement for equity investors is whether earnings growth estimates are realistic. Given the negative revisions we have had, they are certainly far more so than they were several months ago in the US (see Exhibit 2). Earnings estimates for Europe appear still overly optimistic relative to the latest macroeconomic data, although the relationship can be patchy (see Exhibit 3). By contrast, EPS estimates for emerging market stocks have now come down meaningfully, albeit in keeping with expectations for low returns on equity (our view: 'favour' emerging Asia).

Exhibit 3

Earnings forecasts broadly in line with economic outlook

S&P 500 EPS and nominal US GDP; forecasts from 1q 2023

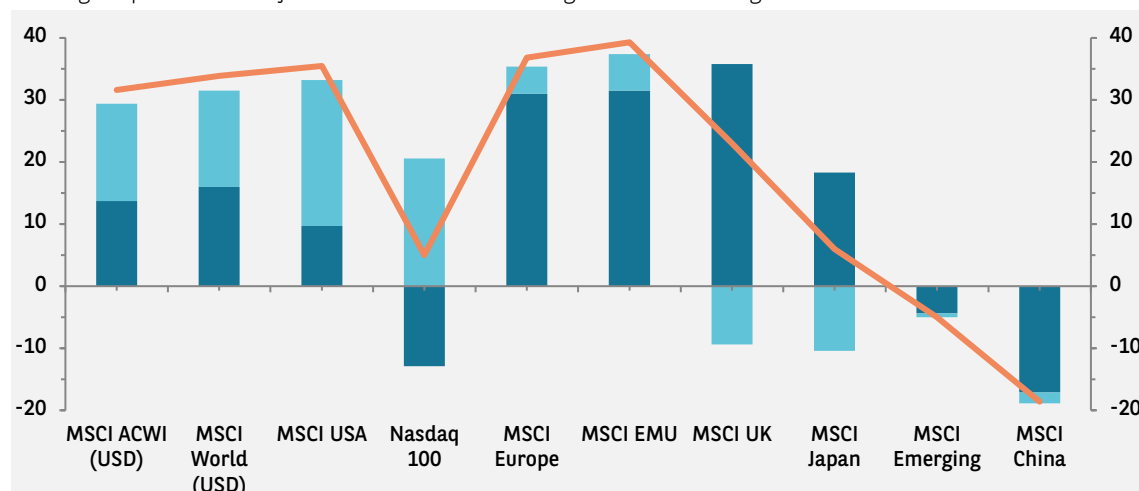


Data as at 7 February 2023. Sources: FactSet, Bloomberg, BEA, BNP Paribas Asset Management.

Exhibit 3

Lofty expected earnings (still) in Europe

Earnings expectation and forward P/Es relative to long-run trend/average



Data as at 31 January 2023. Sources: IBES, BNP Paribas Asset Management.

In Europe, further monetary policy tightening by the ECB remains a significant risk. Our macro research team expects the ECB to follow through on its recent guidance and to take the deposit rate ultimately to 3.5% by the middle of the year. To be sure, there is a notable difference between inflation in the US and the eurozone. Core inflation (which excludes changes in the cost of energy and food) is falling in the US, whereas in the eurozone, it has been rising. This has led members of the ECB's governing council to warn over the risk that high inflation could become entrenched via second-round effects, that is, a resilient job market could lead to higher wages.

The China factor and EM equities

Meanwhile, market expectations for growth in China — a bellwether for the wider Asian region as well as emerging markets generally — have brightened with Beijing's lifting of its tight Covid-related restrictions. The reopening of the economy should boost activity, including travel and consumption, once the pandemic has run its course. Government support for the flagging property market, which fell into a crisis after a Beijing crackdown, should help spur growth as consumer confidence is restored.

There is now a possibility of desynchronised global economic growth. Our macro research team views this as less likely within developed markets, but more so between emerging and developed markets, with China's reopening clearly making a difference. The team notes that most economic models understate the influence of China on other economies, but points out that it has a material impact on financial conditions and business confidence.

The good news coming from China has improved our outlook for emerging market (EM) equities more broadly and we have recently added to our exposure. There are several reasons for this change:

- Evidence of improved growth globally is increasing, which would support EM earnings. Revisions have till now been negative and may have reached a trough. We believe the potential for positive revisions from here on is high, particularly relative to Europe.
- China's reopening momentum should support not only domestic equities, but also those in EM Asia and commodity-exporting Latin American countries.
- The semiconductor cycle looks to be at or close to a trough, which should benefit an industry with a heavy weight in EM equity indices.
- The direction of monetary policy is moving favourably in both developed and emerging markets. The Fed delivered a broadly balanced message at its latest policy meeting. China, meanwhile, continues to shore up the economy. Excess liquidity is improving (when looking at M1-nominal GDP growth, which leads stocks in particular). More broadly, lower real rates in emerging markets relative to those in developed markets, the outsized impact of cheaper food and energy on EM inflation given its weight in baskets of goods, and a weaker US dollar are also supportive.
- EM equity valuations look attractive now and screen positively in our valuation research work – particularly against Europe (which is our short against this position). Even after this year's rally, the 12-month forward price-earnings ratio of an index of Chinese technology and major companies is still at a 16-year low relative to the MSCI ACWI (it would be lower still if earnings estimates for Chinese stocks are currently understated, as we believe). Our aggregate measure of price-earnings, price-book, dividend yield and price-sales ratios is 0.5 standard deviations below that for developed markets over the last 10 years.

Shifting out of neutral on the yen

We shifted to a modest long position in the Japanese yen against the euro (see our asset class views below). The trade should benefit from yen strength as the Bank of Japan seeks to abandon yield curve control. With EUR/JPY at the top of a multi-year range, we see the yen as attractively valued in the longer term.

We expect the market to test the BoJ again on its policy of maintaining a cap on 10-year bond yields, even as inflation in Japan is rising. We see it shifting to a more hawkish stance, which should benefit the yen.

The euro by contrast now appears to be priced for what we see as an unrealistically positive scenario this year (economic stability rather than recession and a problem-free end to the energy crisis, even as the war in Ukraine continues). The market has turned more optimistic, foreseeing less need for higher ECB rates to fight inflation. As said above, we do not share that view. Being long JPY versus the EUR can also be seen as an opportunistic hedge.

Asset class views

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

* Risk appetite/return to risk - Data as at 3 February 2023. 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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