ASSET ALLOCATION MONTHLY - DECEMBER 2023

Bonds rally, still cautious on equities

- Bond markets rallied strongly in November on the back of falling inflation and weak economic data
- The rally markedly benefited BNP Paribas Asset Management's active asset allocation portfolios, where being long duration is our largest risk position
- We continue to judge risks to consensus economic growth forecasts for 2024 to be to the downside, notably in the US and Europe
- Asset valuations, meanwhile, continue to point to the attractiveness of fixed income over other assets. We think equity market valuations are rich, particularly when a more cautious earnings outlook from the season just passed is factored in
- We booked profit on our long Gilts vs. Bunds trade. Key long duration positions remain in long-dated US real yields, European investment grade (IG) credit, emerging market local currency bonds and a modest long towards US nominal yields in the belly of the curve. More on Euro IG below.
- Against this, we stay cautious on equities, chiefly in Europe, with modest longs in more defensive markets in the US and UK. We have broadly halved our equity underweights in recent months.

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BNP PARIBAS
ASSET MANAGEMENT

The sustainable investor for a changing world

The current narrative

Desynchronisation continues to be a feature of the post-covid period. The third quarter of 2023 has witnessed extreme volatility in the macroeconomic narrative. We have moved from recession to 'soft landing' to overheating and back again and again.

Currently the median consensus view is for a 'Goldilocks' scenario — moderate growth, low inflation — in the US. However, with an unusually wide dispersion of views across sectors, the reliability of such a benign scenario is not entirely obvious to us. By comparison, growth and inflation expectations are more cautious and less dispersed in Europe and the UK.

We see risks as being quite easily skewed towards weaker growth outcomes relative to median expectations. In our view, the cumulative 525bp of rate hikes in the US will work their way through the economy in 2024 without the two chief drivers that offset tightening this year:

i) The doubling of the US fiscal deficit, something unprecedented outside a major recession or wartime; it is unlikely to be repeated in 2024

ii) Surplus savings, which are now broadly depleted, particularly for lower income groups.

We also see downside risks to an already struggling Europe (although the UK may be at the bottom and recovering), and Japan on its own track.

Q3 earnings season takeaways

The third quarter earnings season revealed strong earnings in the US and weak earnings (against weak expectations) in Europe. In the US, earnings were 7% higher than expected, more than twice the typical earnings excess in magnitude and also with more breadth than normal. The weak expectations in Europe were missed by 1%. At the sector level, US and European earnings were weighed down differently by the significant impact of commodity sectors. Importantly, US earnings were bolstered by the 'magnificent seven' tech giants.

Projected earnings were nonetheless perceptibly lower in both regions. For example, the 4% drop in expected fourth quarter earnings per share (EPS) for S&P 500 companies would be the biggest since 2020. The current run rate for analyst downgrades to upgrades is 2:1 for quarter four, climbing to 6:1 for companies that missed on earnings.

Insofar as our macroeconomic research points to downside growth risks in 2024, and our valuation research reveals still-rich forward valuations, these lower expectations bear watching, particularly given weakness in earnings for consumer sectors and the threat to margins flagged by large-cap retailers.

Caution from analysts has been pronounced in US consumer related sectors this season, with earnings projections for construction, consumer durables and employment companies all softening. The combination of weaker demand and consumers having to be more price conscious appear to be the common thread. In contrast, restaurants look healthier.

In Europe, meanwhile, the end of destocking could support earnings in the quarters ahead, but companies have suffered from cyclical debt. Relative to the US, the region is hobbled by the weight of the manufacturing sector, the impact of energy costs, and the lack of major tech companies. Although European companies are taking advantage of artificial intelligence, there appears to be limited scope for a local 'magnificent seven'.

Regional growth outlook

US: Despite fiscal easing and (some remaining) excess household savings, we anticipate further weakness in the more cyclical areas of the economy as months of monetary policy tightening feed through. The large increases in mortgage, credit card and car loan rates are starting to show up in rising delinquencies, while purchasing intentions have tapered off. Survey data signals that inventories could contract markedly. Our wage tracker, meanwhile, points to wage growth below 3%.

EU: We see yet further downside risks to growth. Survey expectations for manufacturing employment have turned negative for the first time since the pandemic, which is significant given the weight of this sector in the eurozone economy. Data has pointed to weak new orders, poorer sentiment and high inventories. Although wages are still rising, consumption and retail sales have been weak. Precipitous falls in money and credit indicators are a concern. Business margins, though, have been more resilient in Europe to date than in the US.

UK: Growth has been slow, with the housing market in particular suffering from tighter monetary policy. The labour market is softening despite high nominal wage growth. Corporate balance sheets are worse off compared to the US or Europe. However, recent data has shown signs of stability. Broad money supply growth is low, but we have seen an improvement in broader credit conditions on the demand side.

Japan: Here we see an entirely different picture. Growth is slowly improving, (real) wages are falling and job-to-applicant ratios are on the up. Machinery orders have not been strong and point to downside risks, but the Tankan report and consumer confidence survey point in the other direction. Inflation has proven stickier at a lower level. Money and credit aggregates are levelling off, but have remained positive. Corporate profits are red hot, well above where labour indicators would normally suggest earnings should be. Nominal GDP growth is still rising, which should support sales and earnings, and in turn margins.

A word on corporate credit

Corporate credit stands out as an asset class that is priced for weaker macroeconomic outcomes, with high yields, notably in European investment grade (IG) credit, which remains a favoured asset class (see Exhibit 1 and end table).

Exhibit 1

Euro-aggregate corporate bond metrics

Data as at 30 November 2023. Sources: FactSet, BNP Paribas Asset Management.

Valuations, or yields on offer, are judged to be attractive, notably when set against broadly positive corporate fundamentals, with only a modest impact from higher rates and mildly favourable technicals. Cash is high on IG balance sheets and smoothed coupons are dampening the cost of refinancing from higher interest rates. The maturity wall for EU IG has been pushed out to 2026, with some beginning in 2025. Positive technicals include falling net issuance and favourable rating trends.

Where are valuations heading?

Premia: Fixed-income premia remain meaningfully above equity premia. Real yields are significantly below forward price/earnings ratios.

Fixed income: Rates at the front end of the yield curve have started to price in more central bank rate cuts in 2024 and beyond, notably in the eurozone and the UK. After the pronounced bear steepening of the yield curve, a bull flattening has now led the bond rally, benefiting our positions. Moves in emerging market local currency bonds have been in line with those of US Treasuries.

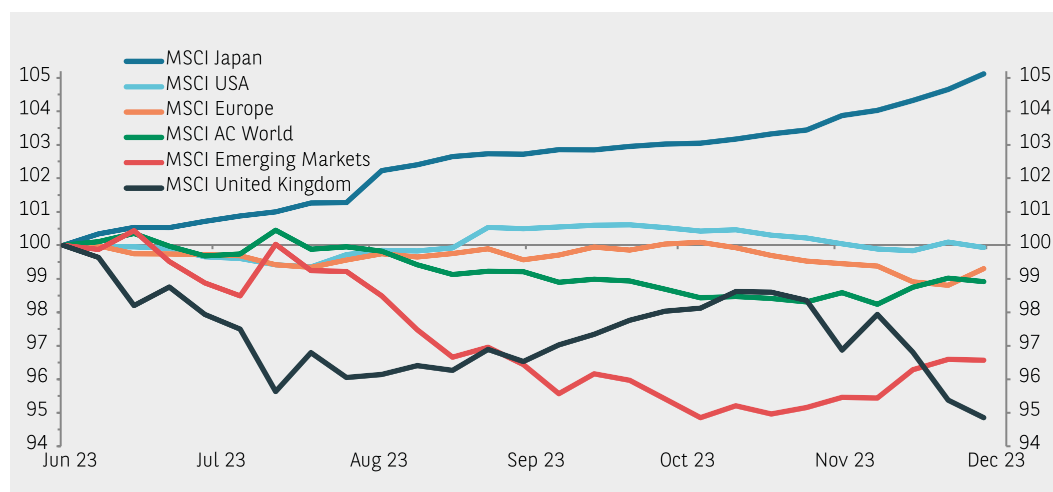
Credit: Spreads have been much less volatile than the underlying risk-free rates, tightening again after a dovish stance by the US Federal Reserve and weaker economic data. We find Euro investment-grade corporate bonds attractive, offering 6% compensation for default risk. The sector also benefits from the decline in asset swap spreads. Spreads on emerging market hard currency bonds are tight for investment-grade but wider for high-yield bonds. We view mortgage-backed bonds as attractive.

Equities: Analyst earnings expectations have started to recede, with 2024 expected EPS for stocks in the MSCI All Country World Index (ACWI) down by 1% over the last six months (see Exhibit 2). Regionally, Japan is outperforming while Europe is weakening ahead of other regions. In the US, forecasts are rising only for the energy and communication services sectors. Emerging markets may be stabilising. Valuations have become more attractive over the last three months and are now average in Europe and above-average in the US. UK valuations look cheap. Longer term, equity valuations remain on the high side, driven by elevated expectations for US earnings.

Exhibit 2

Earnings per share estimates, 2024

Local currency terms except ACWI and Emerging Markets in USD



Data as at 1 December 2023. Sources: FactSet, BNP Paribas Asset Management.

Commodities & currencies: 40% of commodities markets are now in backwardation, pointing to lower prices in the future as demand falls. The market proportion that is in backwardation is down from 50% last month and 65% at the peak earlier in the year, reflecting slower growth expectations. The signficance of interest rate differentials for moves in the US dollar continues to grow for both low and high-beta G9 currencies.

Market temperature: This is now broadly neutral for equities and bonds.

Our asset class views

	Strongly dislike	Dislike	Neutral	Favour	Strongly favour
PRR/risk appetite			X		
Asset allocation		Equities	Real estate Commodities Cash	Government bonds Credit	
Equity regions		Europe ex-UK	US Japan UK EM		
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 FX	

Views as at 30 November 2023

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