

# EQUITY OUTLOOK

## APRIL 2022



**Daniel Morris**  
Chief market strategist

## One step back, two steps forward

**So far this year, two main factors have driven equity market volatility: A reassessment of the policy rate outlook in the US, and the conflict in Ukraine.**

Initially, the compression of multiples driven by rising real yields offset a positive earnings outlook. Once the Q4 2020 earnings season began, however, the positive growth outlook led equity markets to rebound. This recovery would likely have continued if not for the outbreak of hostilities in Ukraine. Real yields then fell well below where they had started the year and equities followed suit.

From mid-March, concerns about the impact of the war on economic growth (if not on inflation) eased somewhat and the odds of a negotiated end to the conflict rose. Investors have also become more confident that Russian oil and natural gas will continue to flow to Europe: Europe needs Russian gas as much as Russia needs European cash.

Meanwhile, central banks have signalled that they are more concerned about the inflation outlook than any risks to growth from the conflict. As a result, monetary policy will tighten more – and sooner – than previously expected.

As attention has returned to the interest rate outlook, we have seen a partial replay of what occurred in January. Real yields have jumped and growth stock valuations have fallen (one step back) — see Exhibit 1. We believe, however, that the earnings growth outlook is good enough that markets will soon recover again (two steps forward).

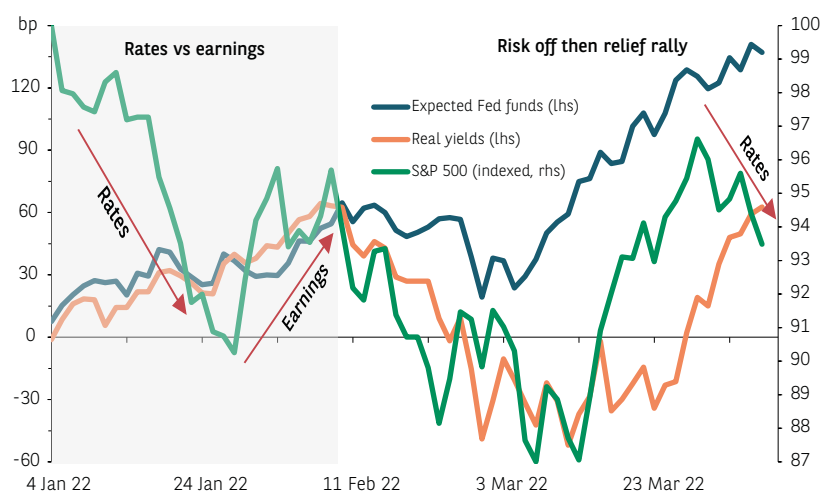


**BNP PARIBAS**  
**ASSET MANAGEMENT**

**The sustainable  
investor for a  
changing world**

**Exhibit 1****Change in real yields, policy rate expectations, and US equities**

2 January 2022 = 0 (yields) or 100 (equities)



Note: 2-year yields. Sources: Bloomberg, BNP Paribas Asset Management, as at 6 April 2022.

Moreover, financial conditions are still very loose. The US Federal Reserve (Fed) has belatedly acknowledged that they are in fact far too loose given the level of inflation and US economic capacity, but there's a limit to how fast the bank can normalise.

To judge by the most recent Fed 'dot plot', policy rates will have returned to neutral within a year. The risk to equities (alongside the risk of recession), should only really arise if the Fed needs to move further into restrictive territory in order to return inflation to its target.

If, as one hopes, the Ukraine conflict is resolved sooner rather than later, will the jump in policy rate forecasts lead to a replay of the beginning of the year, with equity markets falling? We do not believe so.

It was inevitable that as markets priced in higher policy rates and anticipated quantitative tightening, valuations would begin to revert to pre-QE (quantitative easing) levels. The only real question was how quickly this normalisation would happen and how far it would go. If it was swift, equity prices would fall as multiples compressed, even though earnings were rising. That is exactly what happened.

Now that valuations have improved, however, we believe the adjustment from here on will be smoother. Though the recent inversion of the US yield curve has raised worries about an imminent recession, we feel this remains a reasonably distant prospect. Even with the drag on consumption from higher inflation, the reopening of the economy following pandemic lockdowns means GDP is still forecast to expand by over 3% both in the US and Europe this year.

## Earnings

In the meantime, corporate earnings will continue to rise, which is always the fundamental driver of equity prices. Despite a poorer economic growth environment than a month ago, aggregate earnings growth forecasts have not fallen. This is because negative revisions in many sectors have been offset by positive ones in commodity sectors (see Exhibit 2).



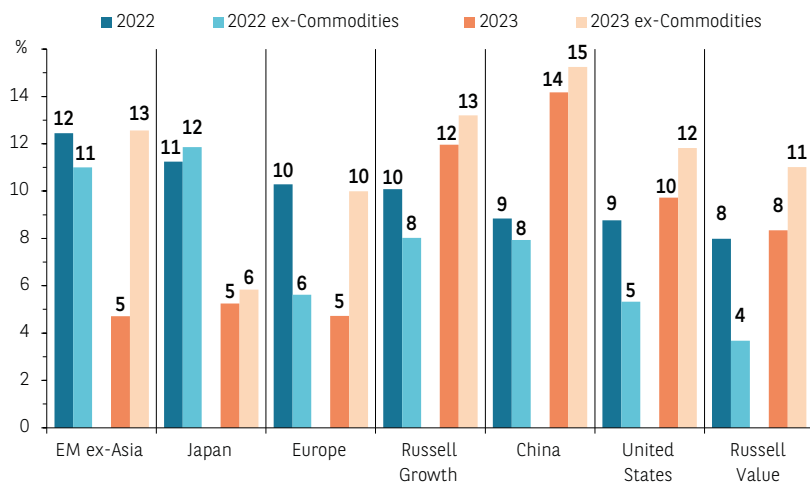
**"Financial conditions are still very loose, which supports equities."**

**Exhibit 2****Change in 2022 earnings-per-share (EPS) estimates since 18 February 2022**

	ACWI	Developed			Emerging		
		US	Europe	Japan	Asia	LatAm	EMEA*
<b>Index</b>	<b>1.8</b>	<b>1.4</b>	<b>3.0</b>	<b>2.3</b>	<b>-1.4</b>	<b>10.3</b>	<b>3.4</b>
<b>Ex-Commodities</b>	<b>-0.7</b>	<b>-0.6</b>	<b>-1.5</b>	<b>2.1</b>	<b>-2.0</b>	<b>2.1</b>	<b>1.6</b>
Energy	26.4	30.8	28.5	11.0	7.5	31.6	14.4
Materials	8.6	5.8	13.7	2.7	-0.3	13.9	7.2
Industrials	2.0	-0.5	-1.5	11.4	5.6	0.0	19.1
Consumer Discretionary	-3.0	-2.9	-0.9	-3.0	-6.7	-0.8	-10.0
Consumer Staples	-1.0	-0.4	-1.6	-5.1	-3.1	1.9	-0.9
Health Care	-0.1	0.1	-0.4	0.7	-7.8	-1.6	0.2
Financials	-1.0	-1.3	-2.6	0.3	-0.2	2.2	1.1
Information Technology	0.3	0.3	-0.5	1.6	0.4	1.4	
Communication Services	-1.9	-1.6	-1.7	-0.1	-4.3	2.3	-0.3
Utilities	-2.8	-0.3	-0.7	-11.0	-4.3	2.3	-0.3
Real Estate	-3.1	0.6	-3.0	0.6	-12.0		12.7

Note: Commodities includes energy, fertilisers and agricultural chemicals, metals & mining, and agricultural products. \*Excludes Russia. Sources: FactSet, BNP Paribas Asset Management, as at 6 April 2022.

The lack of earnings momentum is a near-term challenge to the markets, but the medium-term outlook is still good as earnings continue to recover from last year's lockdowns. The surge in commodity prices is helping year-on-year EPS comparisons, but the gains this year are expected to be reversed next year. For example, the forecasted 9% earnings growth for the MSCI US index in 2022 drops to just 5% if one excludes commodity sectors, but for 2023 the growth rate increases from 10% to 12%. Japan and China suffer less of a swing (see Exhibit 3).

**Exhibit 3****Year-on-year earnings growth rates forecasts**

Note: Commodities includes energy, fertilisers and agricultural chemicals, metals & mining, and agricultural products. Sources: FactSet, BNP Paribas Asset Management, as at 6 April 2022.

## Europe vs US Equities

Earnings growth expectations for Europe are still robust, averaging 8% over the next two years. Valuations, however, are not compelling. Although the Fed will certainly be more aggressive than the ECB and the Bank of England, rates will still be rising in the eurozone and quantitative tightening is imminent.

We thus see little reason to be overweight European equities currently, in contrast to the beginning of the year when we anticipated that economic reopening and attractive valuations would lead the market to outperform (which it did).

The US market will benefit, as it most often does, from higher earnings growth. That was also true at the beginning of the year, however, and it did not prevent US equities from underperforming the rest of the world. The drag from rising policy rate expectations proved to be too much. The US market became a safe haven once the war broke out, but the focus is returning again to the rising policy rate outlook.

How should equity investors position themselves as the Fed hikes rates?

What is unusual about the coming cycle is that it will be the first time since 2005 that the Fed has begun to raise rates when inflation was high. Previously, the Fed was pre-emptive, but fiscal stimulus and now the Ukraine conflict have left the central bank well behind the curve.

Investors are right to be worried about equity returns during a hiking cycle. Since 1970, the average (annualised) monthly total return of the S&P 500 has been 12.4%, whereas during periods when the fed funds rate is rising, it has been just 5.2% (see Exhibit 3).

How robust returns are depends on whether economic growth is accelerating or slowing, whether inflation is rising or falling, high or low, and whether it is early or late in the cycle (which should align with financial conditions being loose or tight).

In Exhibit 4, we have shaded those columns in grey which we believe most closely fit the environment we anticipate in the year ahead. It is worth noting that a stagflationary environment (decelerating growth and high inflation), while rare, corresponds with negative returns for almost every index.



**“Investors are  
right to worry  
about returns in a  
hiking cycle.”**



## Exhibit 4

## Annualised monthly total returns

Index	All months since 1970	All periods	When Fed funds rises									Stagflation	Score
			Accelerating growth	Decelerating growth	Rising inflation	Falling inflation	Top quartile inflation	Middle quartile inflation	Bottom quartile inflation	Loose financial conditions	Tight financial conditions		
Months	614	104	45	58	53	51	42	56	6	55	49	18	
S&P 500	12.4	5.2	12.9	-1.1	-1.1	12.1	4.4	6.8	-3.3	8.4	1.7	-14.2	
Small cap	13.6	10.7	17.7	5.7	3.6	17.5	7.1	15.5	-15.5	16.5	3.1	-25.8	4
Growth	13.8	8.6	18.5	0.8	3.2	13.6	16.0	7.2	0.1	10.7	5.6	-14.0	3
Value	13.2	6.0	8.0	3.9	1.7	10.1	4.6	8.5	-9.9	8.4	2.8	-16.8	1
NASDAQ 100	15.3	6.6	22.5	-5.1	3.6	5.9	22.1	6.9	-19.2	4.8	3.3	0.0	2
Energy	11.3	21.7	34.8	10.6	29.6	13.9	25.5	25.8	-29.4	29.5	13.4	-1.5	4
Materials	10.0	8.4	9.4	6.5	7.3	9.6	6.4	12.1	-9.8	11.1	5.5	-1.5	0
Industrials	11.0	5.9	10.0	2.2	0.8	11.4	6.9	7.0	-9.8	10.3	1.2	-13.3	1
Consumer Discretionary*	11.5	4.9	10.4	0.1	-3.8	14.7	0.8	9.4	0.0	0.0	0.0	-14.6	1
Consumer Staples	10.8	2.6	3.8	1.4	4.1	1.1	-0.7	6.9	-11.8	2.4	2.9	-9.1	0
Health Care	12.4	9.5	9.1	8.8	10.5	8.5	12.2	6.9	16.5	13.7	5.1	9.0	3
Financials	9.4	-0.7	-2.0	0.4	-7.1	6.4	-4.4	2.9	-6.9	8.6	-10.2	-12.3	0
Information Technology	12.1	14.8	24.3	7.4	16.6	13.0	6.5	23.0	2.2	19.1	10.2	-7.8	3
Telecommunications	6.6	-7.5	-0.5	-12.4	-12.0	-2.6	-15.0	-0.3	-17.7	1.0	-16.3	-22.6	0
Utilities	6.3	-6.9	-8.0	-8.2	-9.4	-4.2	-10.9	-2.1	-21.2	3.4	-17.4	-26.3	0
REITs	7.4	1.0	5.9	-4.2	-4.4	7.2	-2.5	6.7	-21.6	12.9	-11.4	-17.8	0
World ex-US	10.9	14.7	16.2	13.5	16.4	12.9	11.1	19.6	-3.8	18.6	10.5	6.0	4
Emerging markets	11.7	18.9	7.7	30.0	23.6	14.4	10.0	24.8	21.2	24.2	12.1	40.7	4

Note: Stagflation is combination of decelerating growth and top quartile inflation. Growth based on changes in ISM Manufacturing index. Inflation based on US Consumer Price Index. Small cap = Russell 2000, Growth = Russell 1000 Growth, Value = Russell 1000 Value. Sector indices are for the S&P 500. Ex-US indices are MSCI. \*Excludes Amazon. Source: Bloomberg, Chicago Fed, Standard & Poor's, FactSet, ISM, BLS, BNP Paribas Asset Management as at 31 March 2022.

The last column counts how many times the respective sector, style or size index outperformed the S&P 500. The most consistent outperformers have been small cap stocks, the energy sector, and non-US stocks (outperforming in four out of four periods), followed by growth stocks and the healthcare sector (three out of four). While the information technology GICS sector has also done well, tech stocks more broadly defined (i.e., including Amazon, Meta, Google, etc.), as measured by the Nasdaq 100 index, has a more mixed record.

## Valuations

While the growth and interest rate outlook may have worsened since the beginning of the year, one factor that has improved is valuations. Price-earnings (P/E) ratios had begun to moderate at the end of 2021, but they were still above average in most developed countries. In emerging markets, they were below average, but that seemed to accurately reflect the outstanding concerns about Covid and rising US interest rates.

Given the declines in markets this year — initially due to rising policy rate expectations, then due to the Ukraine war — price-earnings ratios have fallen. There are nonetheless few markets one can argue are cheap in absolute terms. The closest is perhaps China, where the forward P/E z-score relative to the market's own history has dropped to -0.7, the lowest since early 2019.

Once quantitative tightening begins and the Fed increases rates further, real interest rates will likely rise. This will put renewed pressure on

multiples for growth stocks (particularly in the US) as they are still high relative to history. Sub-par returns are likely ahead.

The Fed plans to return its balance sheet to pre-pandemic levels in three years, if not sooner. The average P/E ratio for the Nasdaq 100 index in the 12 months prior to the latest round of quantitative easing was 22x; today it is 26x. If in three years earnings rise as forecasts anticipate, but valuations revert to pre-pandemic levels, one can look forward to just 5% index appreciation each year.

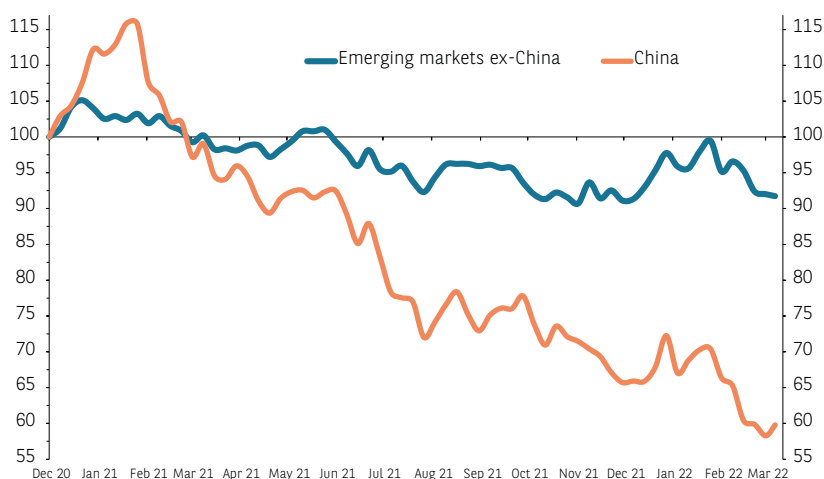
## China equities

The poor returns for Chinese equities over the last year explain almost all of the underperformance of the MSCI Emerging Markets index relative to the MSCI World index (see Exhibit 5). This lag in returns was not without cause. The regulatory crackdown by the government on many sectors of the economy caught investors by surprise, and China's zero Covid strategy, while keeping deaths to a very low level, has had economic consequences. The result was earnings growth last year of just 1% when EPS rose by 50% in the US and 60% in Europe.

### Exhibit 5

#### Index performance relative to MSCI World

Total return in USD



Source: FactSet, BNP Paribas Asset Management, as at 6 April 2022.

After such significant underperformance, the conditions seem good for a turnaround. Earnings growth expectations for the year are comparable to most other regions. Recent government announcements promising support for economic growth, an easing of the regulatory crackdown and aid for the property sector seem to signal a significant change in course.

Relative valuations are also extremely compelling. Compared to the MSCI All Country World index, the forward P/E ratio of the MSCI China index is

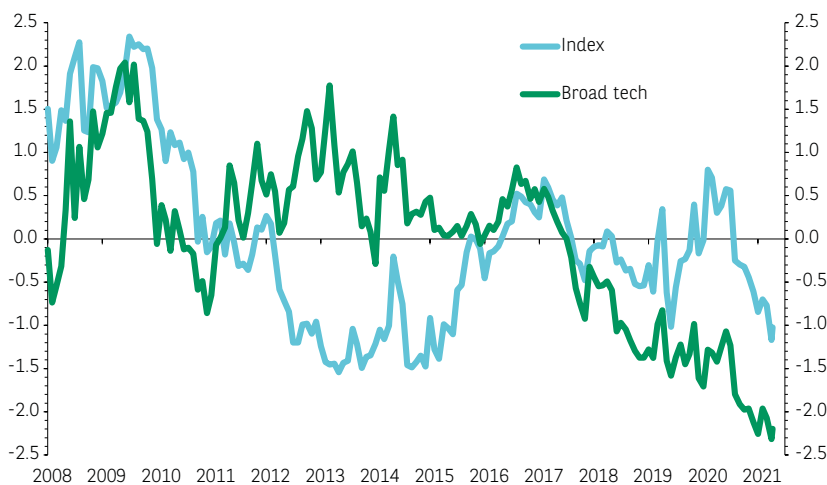


“After lagging significantly, Chinese equities look well set for a rebound.”

one standard deviation below the average since 2008. The z-score has, however, been lower before, from 2014 to 2016 (see Exhibit 6). What is different this time is that the current index discount is driven primarily by the technology sector (where the z-score is nearly -2.5), whereas in the previous period it was more a result of low multiples for the financials sector.

The most significant near-term risk is additional outbreaks of Covid-19 infections and the resulting imposition of restrictions. The latest Caixin services PMI reading of 42 shows how large the impact can be. The government is committed to its GDP growth target, however, and will likely provide additional monetary and fiscal support to offset the drag.

**Exhibit 6**  
Relative forward price-earnings ratio z-score, MSCI China vs. MSCI All



Note: Broad tech comprises the Information Technology sector, internet retail, entertainment, and interactive media. Source: FactSet, BNP Paribas Asset Management, as at 25 March 2022.

We also believe Chinese equities will perform better given the significant divergence in monetary policy. Markets anticipate policy rates rising by 240 basis points (bp) in the US, and by 111bp even in the eurozone over the next year. By contrast in China, they should drop by 90bp.

We also favour Japan, where rates could rise by 5bp. A combination of looser monetary policy, currently negative sentiment and a strong earnings recovery could be a powerful driver of returns this year.



**“The Chinese government is committed to its GDP growth target.”**





This report was finalised on 8 April 2022

BNP Paribas Asset Management France, “the investment management company,” is a simplified joint stock company with its registered office at 1 boulevard Haussmann 75009 Paris, France, RCS Paris 319 378 832, registered with the “Autorité des marchés financiers” under number GP 96002.

This material is issued and has been prepared by the investment management company.

This material is produced for information purposes only and does not constitute:

1. an offer to buy nor a solicitation to sell, nor shall it form the basis of or be relied upon in connection with any contract or commitment whatsoever or
2. investment advice.

This material makes reference to certain financial instruments authorised and regulated in their jurisdiction(s) of incorporation.

No action has been taken which would permit the public offering of the financial instrument(s) in any other jurisdiction, except as indicated in the most recent prospectus and the Key Investor Information Document (KIID) of the relevant financial instrument(s) where such action would be required, in particular, in the United States, to US persons (as such term is defined in Regulation S of the United States Securities Act of 1933). Prior to any subscription in a country in which such financial instrument(s) is/are registered, investors should verify any legal constraints or restrictions there may be in connection with the subscription, purchase, possession or sale of the financial instrument(s).

Investors considering subscribing to the financial instrument(s) should read carefully the most recent prospectus and Key Investor Information Document (KIID) and consult the financial instrument(s) most recent financial reports. These documents are available on the website.

Opinions included in this material constitute the judgement of the investment management company at the time specified and may be subject to change without notice. The investment management company is not obliged to update or alter the information or opinions contained within this material. Investors should consult their own legal and tax advisors in respect of legal, accounting, domicile and tax advice prior to investing in the financial instrument(s) in order to make an independent determination of the suitability and consequences of an investment therein, if permitted. Please note that different types of investments, if contained within this material, involve varying degrees of risk and there can be no assurance that any specific investment may either be suitable, appropriate or profitable for an investor’s investment portfolio.

Given the economic and market risks, there can be no assurance that the financial instrument(s) will achieve its/their investment objectives. Returns may be affected by, amongst other things, investment strategies or objectives of the financial instrument(s) and material market and economic conditions, including interest rates, market terms and general market conditions. The different strategies applied to financial instruments may have a significant effect on the results presented in this material. Past performance is not a guide to future performance and the value of the investments in financial instrument(s) may go down as well as up. Investors may not get back the amount they originally invested.

The performance data, as applicable, reflected in this material, do not take into account the commissions, costs incurred on the issue and redemption and taxes.

All information referred to in the present document is available on [www.bnpparibas-am.com](http://www.bnpparibas-am.com)



**BNP PARIBAS**  
**ASSET MANAGEMENT**

**The sustainable  
investor for a  
changing world**