

# Asset allocation monthly September 2022



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## Sanguine for now

- The market reaction to Jackson Hole has been fairly sanguine: 10y yields are a bit above where they were pre-JH, and while equities have been weak, they have held on to a decent chunk of their gains since June. We took profit on half our sovereign duration shorts, closing our European short entirely but sticking with a lighter US position.
- The Fed failed to deliver the hoped for 'pivot', and in referencing the need for a 'sustained period' of below trend growth, raised the bar for so doing. Service inflation — both wages and shelter — will be key to watch and tend to be sticky.
- Analyst equity earnings forecasts meanwhile remain much too high, which is not necessarily unusual but is striking given growth concerns. Revisions are rolling over though, and adjusting for these, earnings expectations are negative. Europe is the clear weak spot, vulnerable to further downgrades and our chief short.
- European investment grade credit by contrast continues to look appealing at current valuations, as do commodities.



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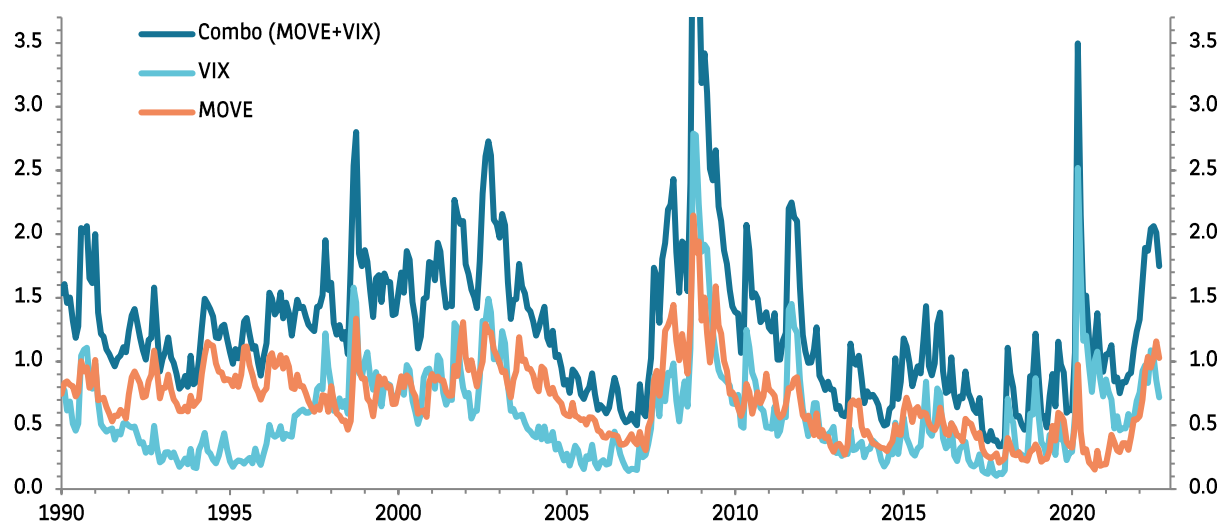
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## Attention deficit disorder

The combination of the end of a 40+ year fixed income bull market, the transition from quantitative easing to quantitative tightening, pandemic fallout, and now the conflict in the Ukraine, has led to the highest level of sustained fixed income and equity market volatility since the Global Financial Crisis (see Exhibit 1). This volatility has also been driven by distracted investors, whose focus has swung from inflation fears to growth worries depending on the latest data print. Moreover, the focus of equity investors has frequently been the opposite of fixed income (inflation vs. growth).

### Exhibit 1

#### VIX and MOVE index z-scores

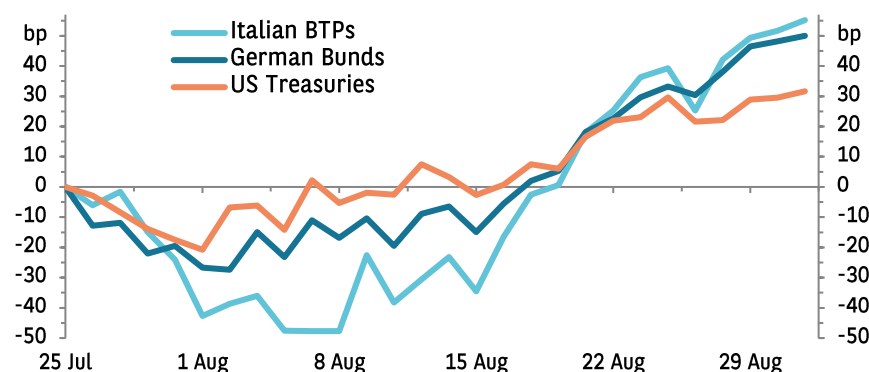


Sources: Bloomberg, BNP Paribas Asset Management, as at 31 August 2022.

Government bonds saw sharp sell-offs late in August, encouraging us to raise European bonds from underweight to neutral on a risk-adjusted basis and close our short position. With sizeable moves in US bonds too, we took profits on the shorts we had built early in August, while remaining strategically cautious. Overall, our short government bond positions have now been broadly halved on the back of valuation-led moves.

### Exhibit 2

#### Large and swift moves in yields



Data as at 31 August 2022. Sources: FactSet, BNP Paribas Asset Management.

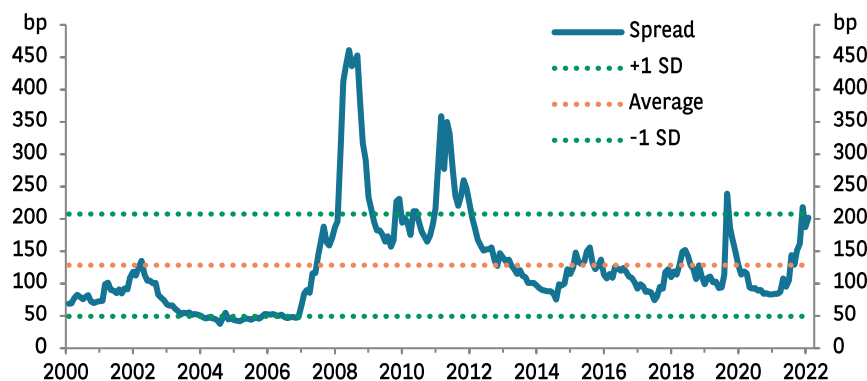
We have also upgraded Japanese government bonds to neutral, chiefly for technical reasons: we felt JGB shorts were at risk of a costly squeeze on the contract roll.

Amid wider European investment-grade bond spreads, we built on the constructive positions we held. Spreads are now compensating investors for what we see as exaggerated default outcomes, despite many IG companies boasting solid balance

sheets and being long cash. Overall, our risk-taking has moved a bit lower, staying within the 'dislike' quintile, as a result of these moves.

### Exhibit 3

#### EUR IG spreads are wide, 9% defaults expected



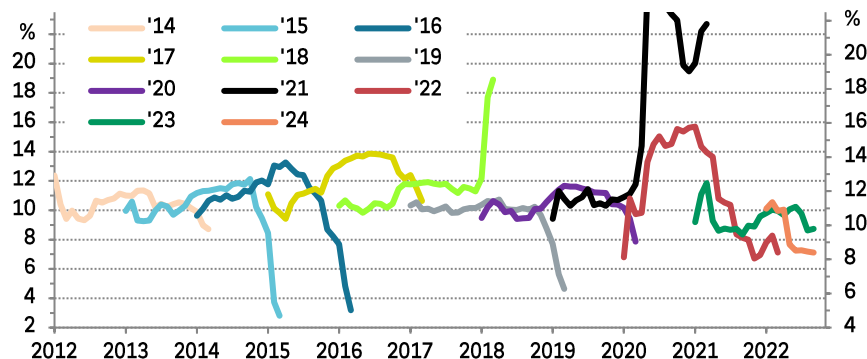
Data as at 31 August 2022. Sources: FactSet, BNP Paribas Asset Management.

As for European high-yield bonds, companies are generally (far) less protected from the deepening economic and energy-related woes, so we have neutralised our positive position versus euro aggregate bonds.

Global equities rallied by 13% between the June low point and mid-August, with the US S&P 500 index up by 17%. This caused investors to wonder whether we were in a bear market rally, or if the moves could indeed have 'legs'. Historically, the moves in the S&P have been around the median of around 20 bear market bounces since 1929. This leaves us cautious. Growth and earnings look unlikely to improve from here – Exhibit 3 shows the relative resilience already baked in. High inflation should ultimately eat into margins, particularly in Europe, while rising interest rates are increasing the cost of capital. Finally, while forward equity valuations are cheaper now, many are still at or above the 15-year median.

### Exhibit 4

#### Year-on-year earnings growth forecasts still resilient



Data as at 31 August 2022. Sources: FactSet, BNP Paribas Asset Management.

#### Quant signals: Balanced

Taking a closer look at quantitative equity market signals, the equity bottom-up element offsets fairly cautious messages from the other three pillars, particularly macro. Valuation and behaviour were more mixed across the regions.

Variables captured by the 'momentum' category, such as operating income and revenues per share, are holding up (earnings per share have started to soften, but it is early days).

The 'quality' component that reflects moves in return on equity, operating margins and net debt has also been relatively firm, although less so in Japan. Japanese valuations – and, to a lesser extent, behaviour – are offsetting the positives.

## Disparate pricing

Moves in fixed income markets have been intense in recent weeks. At this point, roughly half of the US yield curve is inverted. This is consistent with mounting recession risk – this now at roughly twice the level it was at in the summer (see Exhibit 4). We are not quite at the 80% levels historically associated with recessions. Meanwhile, a super-simple measure of what equities are pricing based on their behaviour over the past 11 cycles has also increased recently.

This disparate pricing likely reflects the distinct probabilities of how successful central banks and economies will be in traversing a narrow path of taming inflation without cratering growth. For the US, this involves:

- Slowing growth to below potential, allowing supply to catch up with demand
- Rebalancing in the labour market (and relatedly wages)
- Stickier shelter inflation.

Success in each area so far appears mixed. As economic research colleagues have emphasised, the question is whether US growth and consumption have slowed sufficiently, especially with fiscal tightening fading and financial conditions easing back. In the labour market, job openings are down by 600 000 since the peak. However, monthly payroll gains are still five times more than would be needed to stabilise unemployment. Three years of above-target inflation seem to be 'baking' into wages. Notwithstanding the inventory-led technical recession, the US labour market is, on many metrics, hotter than in boom times, presenting a clear challenge to the Fed's dual mandate.

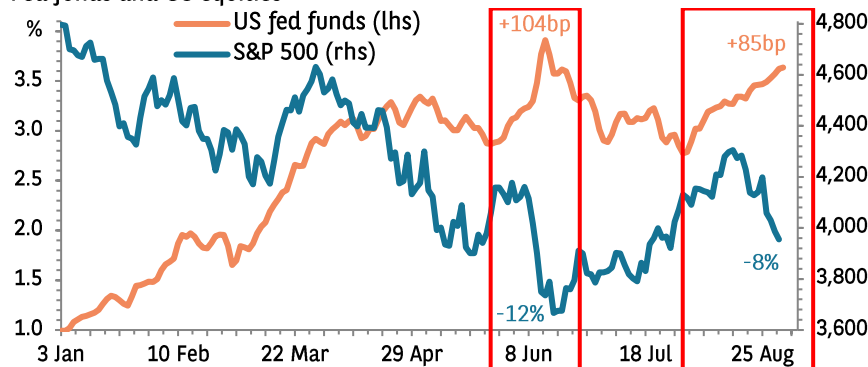
With business inflation expectations sticky, and rental inflation high, the outlook for prices is now far from clear. It is notable that the interest rate expectations of the investment community more broadly have – unusually – lagged behind inflation expectations in recent months.

## Earnings outlook and valuations

Equity markets have not been impervious to the deteriorating outlook, with US equities falling by more than 8% from the recent peak, despite a mid-month rally. The declines, for now at least, seem to be driven primarily by the increase in the discount rate rather than falling earnings expectations. The recent moves are commensurate with what occurred in June, when expectations for the level of fed funds in 1 year jumped 100bp (see Exhibit 5).

**Exhibit 5**

Fed funds and US equities

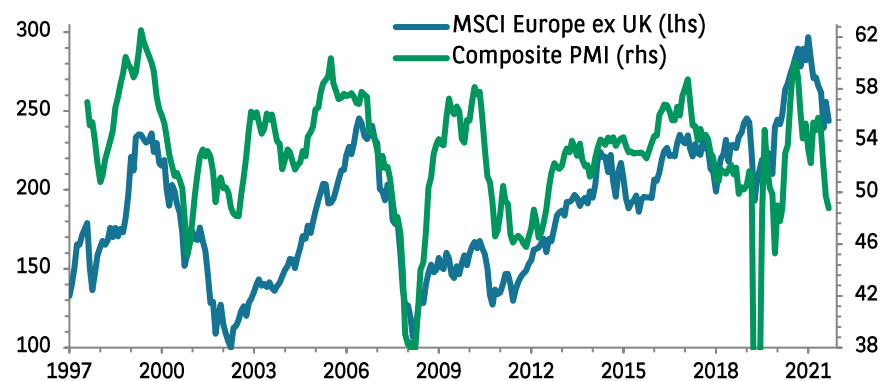


Sources: Bloomberg, BNP Paribas Asset Management, as at 31 August 2022.

European equities, by contrast, appear to be reflecting nearer-term growth worries. While purchasing managers' indices (PMIs) have remained robust in the US, several have dropped below 50 in Europe, indicating contraction. As the growth outlook worsens, markets are pricing in lower earnings (see Exhibit 6). It is worth recalling that during the oil shocks of the 1970s, the US Institute for Supply Management (ISM) manufacturing index fell to 30.

## Exhibit 6

### Europe ex-UK PMI and equity index



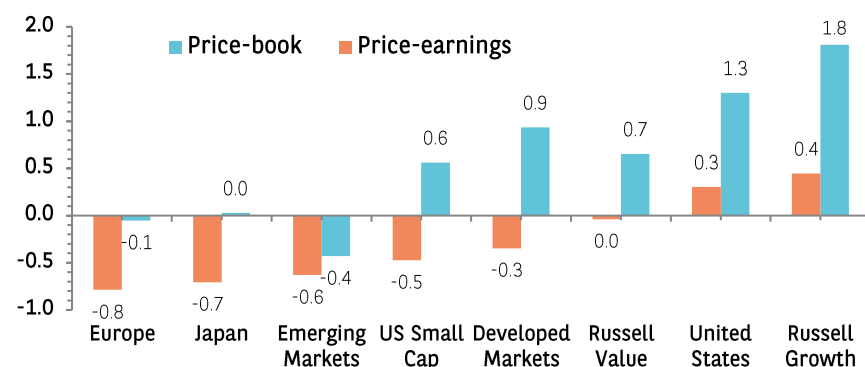
Sources: FactSet, BNP Paribas Asset Management, as at 31 August 2022.

Given the deterioration in growth we anticipate in both regions, determining the current level of valuations becomes more difficult. As noted, analysts' earnings estimates are still quite sanguine about the outlook, but that then inflates price-to-forward-earnings estimates. In this environment, looking at other metrics such as price-book ratios may give a better assessment of the attractiveness of equity indices.

In fact, Europe goes from looking inexpensive, having a nearly one standard deviation below average forward P/E ratio, to having at best an average valuation. Japan is in fact similar, but we have more confidence in the validity of the earnings estimates there, meaning valuations are truly attractive. Emerging markets, notably, look compelling on both measures (see Exhibit 7).

## Exhibit 7

### Price-book and price-earnings ratio z-score



Sources: FactSet, BNP Paribas Asset Management, as at 31 August 2022.

## 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	US UK EM ex-Asia	Japan EM Asia	
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 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 31 August 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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