

ASSET ALLOCATION MONTHLY - MAY 2023



Different phases

- We see the three major regions at quite different phases of the business cycle: US is close to the end, Europe 8-12 months behind, but still in late cycle, and emerging markets close to the start of a new business cycle.
- From an investment perspective, the US and Europe are decoupling. While the US economy is moving towards a recession as growth and inflation fall, European inflation is slowing without a material softening in growth. Emerging market growth prospects are improving even as those for developed markets weaken.
- This broadly favourable *current* macroeconomic setting notwithstanding, we note that high European company earnings expectations are skewed by the prospects for specific sectors and their weight in benchmark indices.



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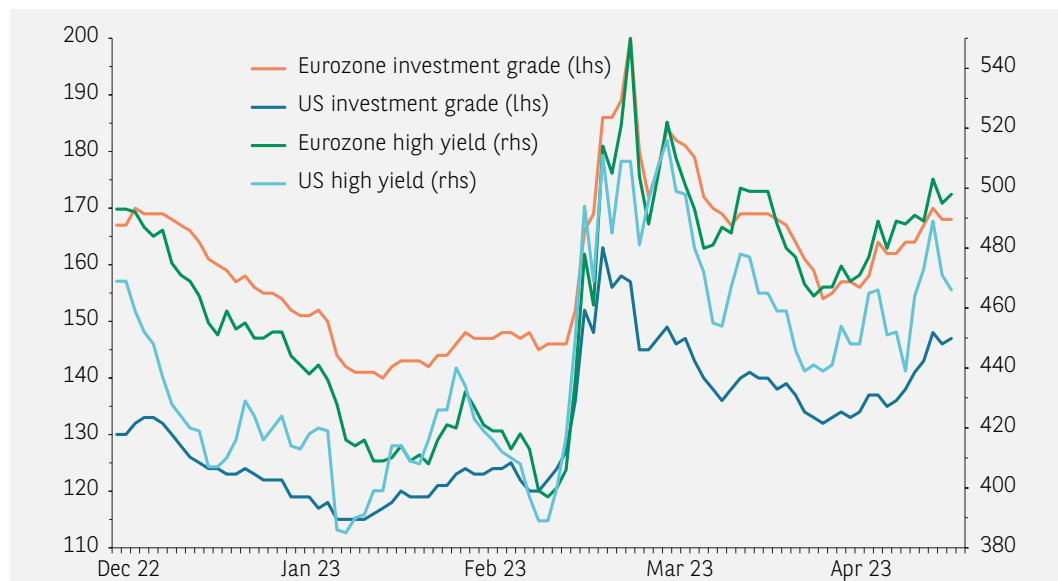
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Bonds and investment-grade credit

Corporate bond credit spreads have rallied from the banking-turmoil-induced widening (see Exhibit 1). We took advantage of the moves to reduce the exposure of multi-asset portfolios to European investment grade corporate bonds. Positions are now at about one third of what they were earlier this year. Our overall view remains 'favour' (see table on page 5) since the compensation from the spread relative to likely defaults remains well above the historical range.

Exhibit 1

Credit spreads have recovered from banking sector turmoil
Credit spreads (bps)



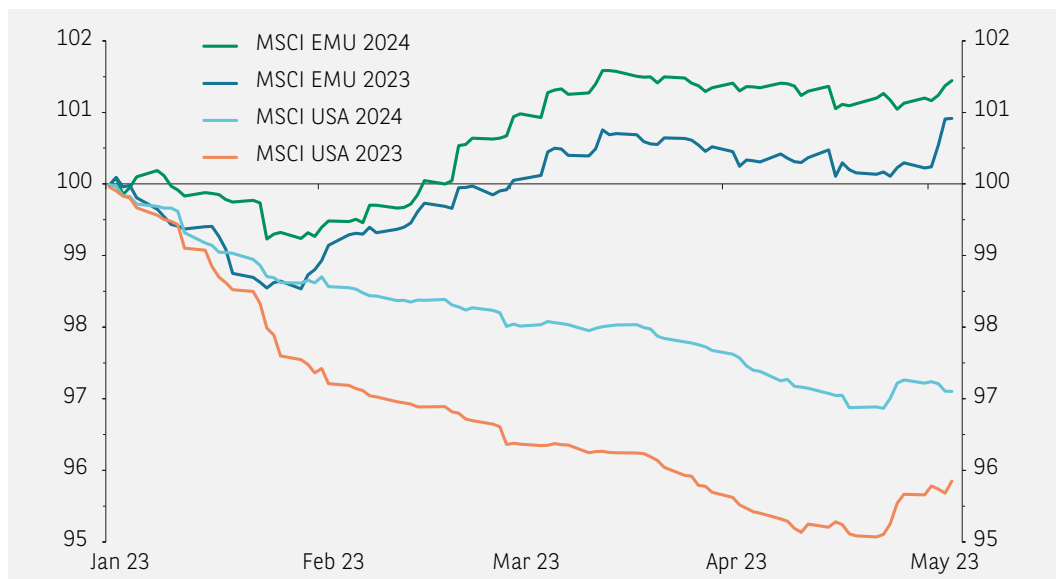
Data as at 8 May 2023. Sources: FactSet, BNP Paribas Asset Management.

The view on peak policy rates in the US and the eurozone has shifted notably. Immediately before the banking sector turmoil, US central bank rates were forecast to reach 5.5-6.0%. Pricing has now moved to imply almost 150bp of cuts within the next year. In Europe, the moves have been less dramatic, but the ECB's peak rate is now expected at around 3.75%, with one or two rate cuts in the following six months. We believe such excessive optimism is supportive of short positions.

US and European equities

We currently see downside risks to the outlook for the US economy and company earnings. Moreover, our market temperature framework is now flashing 'red' for the first time since 2021. As a result, we have nudged down our US equities exposures albeit remaining in the broadly 'neutral' zone.

While analysts have already cut their estimates for US earnings, we regard even the lower level of expected earnings as still too high given a weak macroeconomic outlook (see Exhibit 2). Anecdotal evidence from cyclical and consumer staples companies has fanned our concerns over the downside risks: many staples companies have passed on price rises of 10% or more in the first quarter alone, which could cloud their outlook. Further declines in analyst earnings expectations would reduce the attractiveness of US equities by raising price-earnings multiples.

Exhibit 2**Earnings estimates for the eurozone have risen while those for the US fall
Consensus earnings per share estimates**

Data as at 5 May 2023. Sources: FactSet, BNP Paribas Asset Management.

In Europe, however, our optimism around the case for European banks relative to US banks has grown. Accordingly, we have added a modest position in European banks relative to broader European indices. European banks have recently posted earnings showing better-than-expected bad debt provisioning and firm net interest income. Additionally, many banks are exposed to the positive interest income trends in Latin America.

Macroeconomic fundamentals are also supportive with sticky inflation, which favours higher-for-longer interest rates and hence the prospect for further (net interest) margin expansion. European banks have well-capitalised balance sheets with large liquidity portfolios, and a diversified deposit base which continues to grow. Furthermore, the regulatory framework has been far more rigorous than for their US counterparts.

Valuations are attractive, with the 12-month forward price-earnings ratio at a 23-year low. In relative terms, the price of the broad STOXX Europe 600 index is nearing its 2023 peak level, while the narrower SX7E banks index is still 14% below.

For eurozone equities more generally, earnings forecasts have held up much better than elsewhere (see Exhibit 2). Negative earnings revisions continue for the US, with evidence of margin compression across the board. Overall, we are neutral on equities.

Emerging market equities

With expectations for a recession in the US and stability in Europe, the forecasted expansion of the Chinese economy stands in stark contrast. Given the size of the Chinese economy, growth there should benefit emerging Asian countries more broadly. Chinese inflation remains very low (year-on-year core inflation currently stands at 0.5%), meaning the People's Bank of China has scope to lower policy rates to support growth if needed. Beyond the diverging macroeconomic outlook, emerging market earnings expectations have fallen sharply over the last two years, widening the gap with developed markets. Consequently, we see from current levels more potential for gains in emerging market equity earnings and declines in developed market earnings. As a result of EM equity underperformance over the last couple of years, valuations based on forward price-earnings multiples are relatively low versus developed markets.

A compelling case, one would think, for the outperformance of emerging market versus developed market equities. Year-to-date, however, emerging market equities have underperformed by about 5%. What might explain the divergence, and more importantly, will it persist?

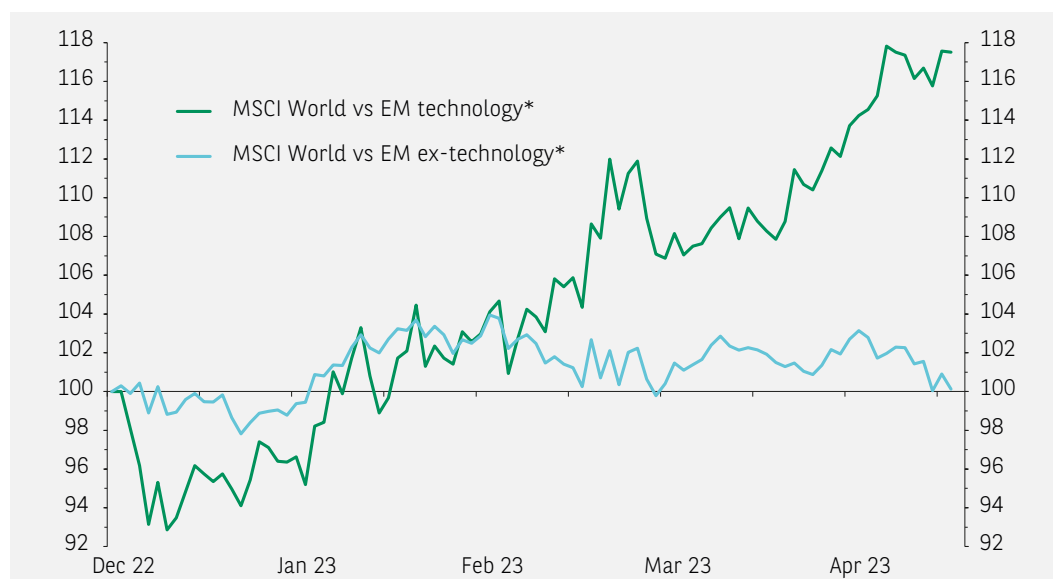
Poor sentiment is one factor. Investors worry about the potential for further decoupling of the US and Chinese economies, with comparatively more damage done to the latter economy than the former. There are lingering concerns about the Chinese government's commitment to developing private sector companies as opposed to state-owned enterprises. The deterioration in sentiment partly explains the lower valuations of EM/Chinese equities described above. Sentiment, however, is unlikely to worsen indefinitely, and could yet rebound.

A second factor has been the strong performance of the (US) technology sector, which has not been shared by the Chinese technology sector, in contrast to the historical relationship where the correlation between the two markets is high. For non-technology sectors, developed and emerging market equity indices have performed roughly in line (though even here, EM has not outperformed as one might hope; see Exhibit 3).

US technology stocks have benefited on two fronts. The market's pricing of a near-term Fed pivot to cutting policy rates has reduced the discount rate for long-duration technology shares. Chinese interest rate expectations by contrast have been largely unchanged. The fall in US discount rates has boosted valuations for technology stocks, reversing the phenomenon of last year when rising rate expectations caused price-earnings ratios to fall sharply.

Exhibit 3

Outperformance of developed market equities primarily driven by technology Total return in USD



Data as at 8 May 2023. *Tech includes broadband retail (Amazon), media & entertainment, and interactive media & services. Sources: IBES, BNP Paribas Asset Management.

Beyond the short-term boost to valuations, tech stocks are also now benefiting from better earnings expectations, also a reversal of a more recent phenomenon. Over the last few earnings seasons, S&P 500 earnings have beaten expectations, with the exception of the tech sector. As tech sector earnings normalised following the pandemic boom, analysts had difficulty determining what the new post-Covid level of earnings should be. This quarter, however, tech sector earnings have beaten expectations by 5%. Results for Chinese companies, by contrast, have disappointed.

These two factors, poor sentiment and strong US technology stock performance, explain why emerging market equities have not outperformed as hoped. Nonetheless, given the fundamental factors described above, we believe sentiment will eventually bottom, and that earnings for emerging market equities more broadly will start to outpace those in developed markets. Index price performance should follow suit.

Our asset class views

	Strong dislike	Dislike	Neutral	Favour	Strongly favour
PRR/risk appetite			X		
Asset allocation		Government bonds	Equities Real Estate Cash	Commodities Credit	
Equity regions		Europe ex-UK	US Japan UK EM ex-Asia	EM Asia	
Equity style/size			EU large cap EU small cap US large cap US small cap		
Sovereign bonds		Europe	US Japan EM local Australia UK Linkers		
Credit			EMD US IG US HY EU HY	EU IG	
Commodities				Energy Base metals Precious metals	
FX		CHF	EUR, USD, AUD, GBP, EM FX	JPY	

Views as at May 2023

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VIEWPOINT



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