

EQUITY OUTLOOK 1Q 2021



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Equity investors, rightly, remain focused on the positive, medium-term outlook for corporate profits rather than the near-term economic challenges with vaccine rollouts, virus mutations, and extended lockdowns.

The economic recovery, monetary policy support and a rebound in inflation will fuel value and small-cap stocks. While value can recover some of its underperformance of the last several years, we expect quality/growth to retain its dominance in the future.

Investor sentiment has swung from excessive despair to enthused optimism and valuations for some sectors and markets have become extended. This will likely limit returns this year, but we would view any pullbacks as an opportunity to add risk.

THE NOT-SO-GREAT ROTATION

Equity investors began 2021 focused on the expected level of earnings at the end of the year rather than on the inevitable challenges in generating them. With economies globally in a synchronised recovery, higher earnings are almost assured; the worry is rather whether the currently expected level turns out to be too optimistic and whether the market multiple placed on those earnings is unsustainably high.

While most markets ultimately posted gains in 2020, we expect the order of the winners in 2021 to be somewhat different. Instead of primarily the growth, technology and internet-leveraged sectors, we see small caps and value as contributing a larger share to positive returns this year. Similar to 2020, the US should outpace Europe and emerging markets can be expected to outperform developed markets. We believe value's gains will be sustained as inflation expectations and bond yields rise modestly, but we do not see the style's multi-year underperformance fully reversing and we believe that in the medium-term, quality/growth stocks will remain dominant.

One thing that has perplexed many investors is the seeming disconnect between the biggest decline in gross domestic product since World War II and equity markets gains of 18% last year (the Wile E. Coyote phenomenon¹). It is exactly the focus on GDP rather than household income, however, which has created the confusion. The institutional response to the recession has been radically different from the past, just as the recessions themselves were different, being caused by government-imposed lockdowns as opposed to an external shock.

The fall in US household incomes due to unemployment was replaced by government support and personal incomes rose rather than fell over the course of the year. (In Europe, household income is always more resilient thanks to existing welfare support programmes.) Government fiscal aid amounted to as much as 12% of GDP and the US is on track to add perhaps another 6% in 2021. This helps explain why corporate revenues fell by far less than GDP.



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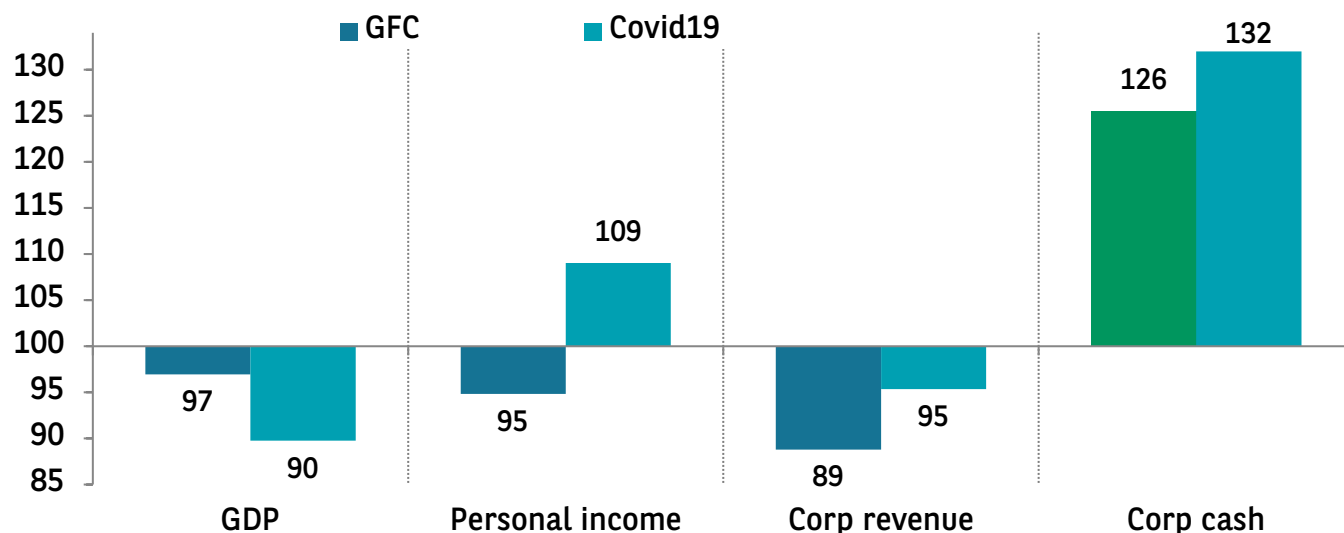


"THE RESPONSE OF CENTRAL GOVERNMENTS TO THE PANDEMIC WAS UNPRECEDENTED."

Moreover, thanks to central bank policies, companies were able to raise even more cash than during the global financial crisis (GFC) and at very low interest rates to tide them over through the slowdown in activity (see Exhibit 1).

Exhibit 1: Nominal US GDP, personal and corporate income

Change from pre-recession level to respective peak or trough

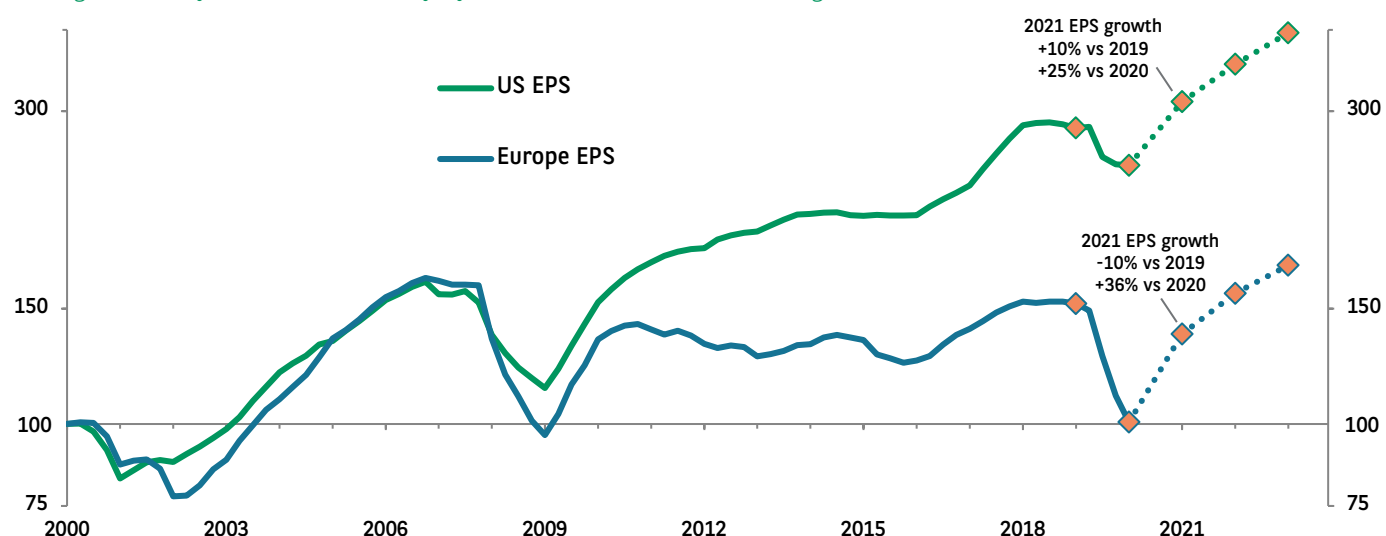


Data as at 9 February 2021. Source: FactSet, BNP Paribas Asset Management

Corporate profits are expected to recover more quickly than they did after the GFC, rebounding this year in the US by a forecast 25% and by 36% in Europe. Earnings will nonetheless be only marginally above pre-pandemic levels for US companies and actually still down by 10% for Europe, suggesting that market expectations are not wildly optimistic (see Exhibit 2).

Exhibit 2: Earnings per share level

Trailing 12-month for actuals, consensus for forecasts; MSCI standard indices; log scale



Data as at 9 February 2021. Note: Europe EPS in euro. Source: FactSet, BNP Paribas Asset Management

Numerous market observers are concerned about excessive investor enthusiasm and, ultimately, valuations. While some indicators of market sentiment are indeed high, we believe there is no major risk of a greater-than-normal correction. For example, the CBOE put-call options ratio is low, but this is because there is an unusually large number of calls on individual equities (perhaps reflecting the recent popularity of commission-free brokerage sites), rather than an unusually low number of puts. The ratio for indices is in fact above average. Bulls-to-bears indicators give mixed readings, institutional investor allocation to equities is only average, and net fund flows into equities from retail and institutional investors are near zero.

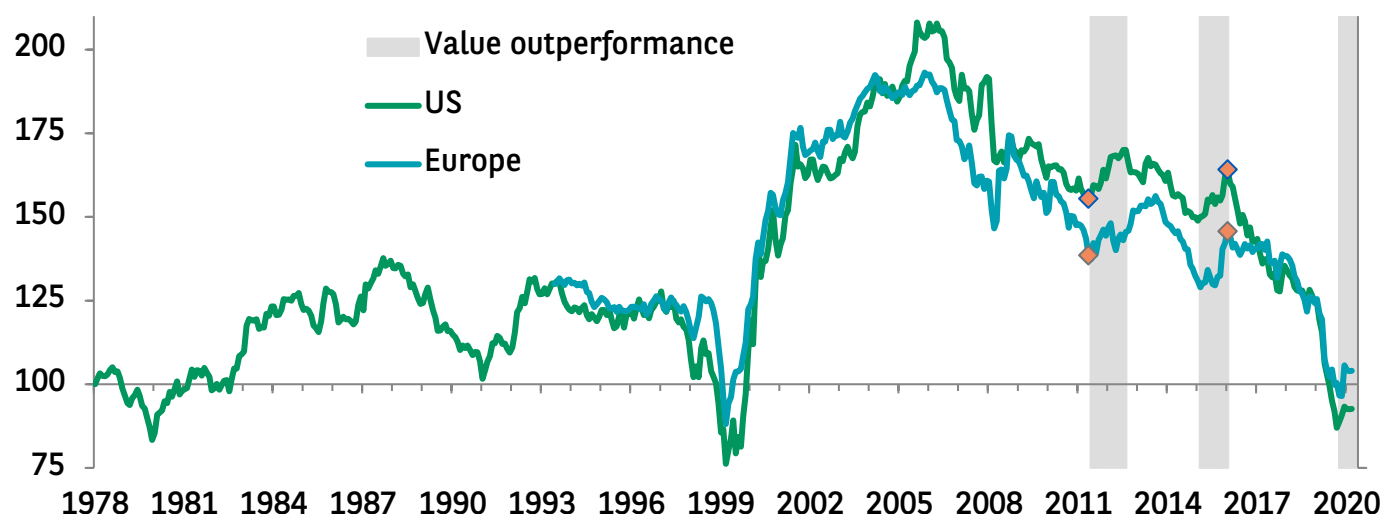
Price-earnings ratios are a concern. US large-cap equity index multiples, even on a 24-month-forward (STM) basis, are not far below the peaks of the tech bubble: they are at 23 times expected earnings today compared to 24 times in 1999. There is some justification for higher multiples given low interest rates, but we would expect P/E ratios to contract over the course of the year. How resilient total returns turn out to be will depend on the rate of earnings growth. Forward earnings estimates have risen by 16% over the last six months (32% annualised). Even if the growth rate halves and P/E's decline by 10%, investors would still achieve a 6% total return for the year.

VALUE VS. GROWTH

Waiting for an upturn in value stocks has required significant patience over the years, although, arguably, the style held up well during the post-GFC recovery through to Donald Trump's election as US president. With Trump's tax cuts, however, growth again bested value, at least partly because of the beneficial effects of the cuts in particular for tech companies. Then with the pandemic and lockdowns, which boosted internet-leveraged companies, the trend of value underperforming growth accelerated until last autumn and the announcement of the first vaccine trial results. Since then value has begun to make up some of the ground lost over the last several years (see Exhibit 3).

Exhibit 3: The performance of value relative to growth

Russell 3000 and MSCI Europe indices; total return in local currency



Data as at 9 February 2021. Source: FactSet, BNP Paribas Asset Management

There have been other periods of value index outperformance since the GFC, notably 2012-2013 and 2016. The question facing investors today is how long the current value rally can last; we expect that it may well be as brief as the other ones over the last decade.

It is not accidental that previous rebounds in value have coincided with a sell-off in US Treasuries and a rise in oil prices. The financial sector, which benefits from higher rates, has by far the largest weight in the value indices, and volatility in energy prices leads to an outsized contribution to value's performance when commodity prices are rising. That dynamic of rising bond yields and commodity prices to persist. Europe is likely to produce more robust relative returns. The broad European indices often lag the US due to the small size of the European technology sector, but here it is an advantage as European value stocks faces less 'competition' from growth.

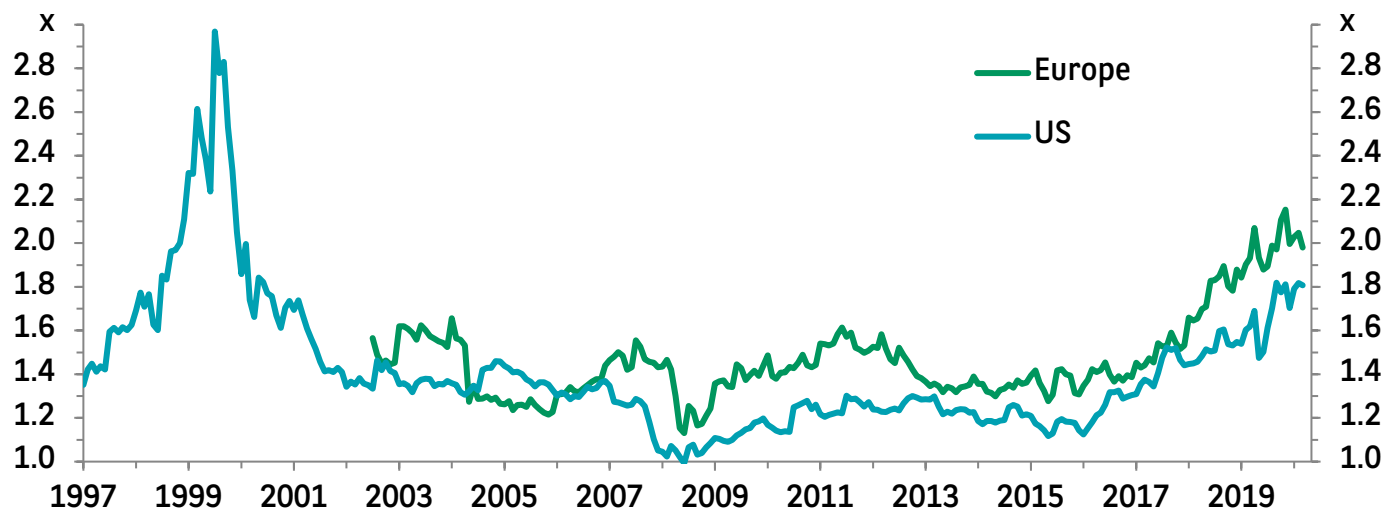
With Democratic control of the US Congress, the outlook is for yet more government spending to offset the effects of the lockdown. New green energy, healthcare and infrastructure initiatives will all be financed primarily by increased Treasury issuance rather than tax increases. Economies globally are expected to recover strongly in the second half of 2021 as vaccinations increase and pent-up

demand is satisfied. Higher commodity prices, which typically rise at the beginning of a recovery, will feed through to headline inflation, aided by the resumption of travel and commuting. Central banks will likely not react pre-emptively to an above-trend rate of inflation, which in any case should not rise too far thanks to persistent long-term, structural disinflationary factors (demographics, productivity, etc.). Central bank asset purchase programmes will moderate any increase in nominal yields. This will keep real rates low. Hence, we see potential for bond yields to rise further this year, but do not anticipate a dramatic sell-off in prices.

Beyond the support for value from higher interest rates and oil prices, we see scope for a further, partial normalisation of relative valuations. The forward multiple of the MSCI Europe growth index relative to value has fallen slightly but is still near historic highs, while in the US the ratio is still at levels last seen in 2001 (see Exhibit 4). Once relative multiples normalise, however, the combination of persistently low interest rates (which put a premium on growth), and the ability of the technology sector to make the most of economic disruption and drive earnings higher should allow the longer-term outperformance of growth stocks to resume.

Exhibit 4: Growth valuation vs. value

Relative price to next-twelve-month earnings; Russell and MSCI indices



Data as at 9 February 2021. Source: FactSet, BNP Paribas Asset Management

REGIONAL ALLOCATIONS

Despite the high valuations of some US technology stocks, we expect US large caps to outperform their European counterparts. The key driver is the divergence opening up between the two regions on both the pandemic front and the response by governments and central banks to the crisis.

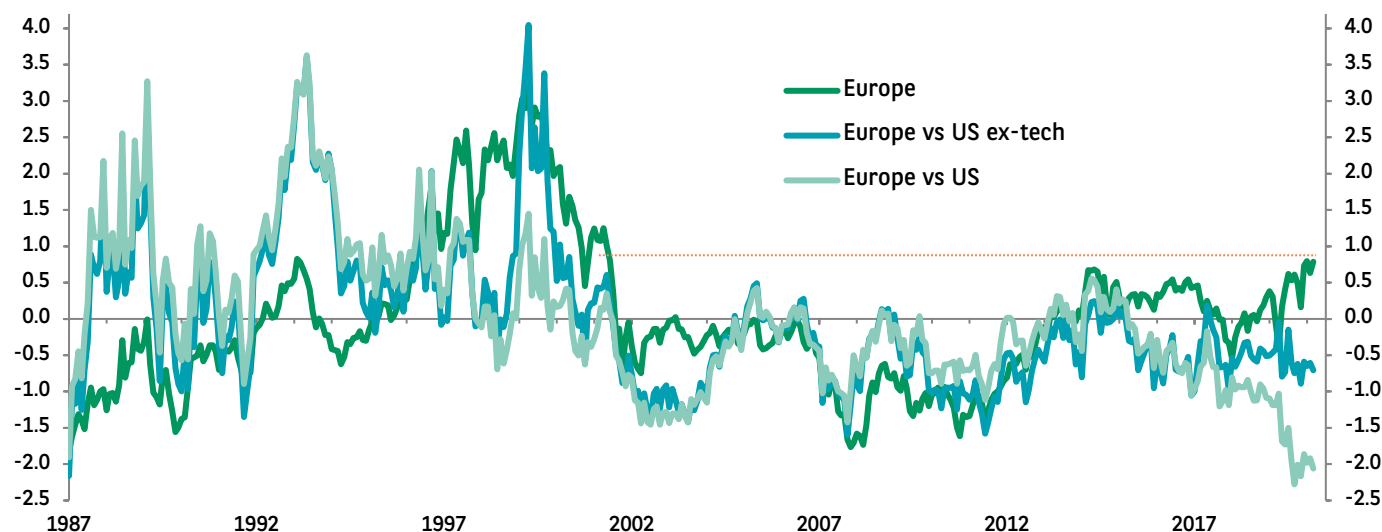
Few countries have escaped the worse-than-expected winter waves of the coronavirus. While the US has inevitably had more infections and deaths than countries in Europe due to its larger size, both regions have had similar outcomes on a per-capita basis. The government response, however, has been significantly different. While most European countries have deepened and extended their lockdowns, restrictions in the US have remained broadly low. There are few cities or states with stay-at-home orders and most businesses are open. Consequently, US purchasing managers indices have remained high and are rising, while in many parts of Europe they are indicating contraction at below 50 – and they are falling. Retail sales have similarly been far more robust in the US. The delays in rolling out vaccinations in continental Europe are only further widening the gap with the US.

Even as Europe locks down more stringently and for longer, the region has less capacity to offset the economic impact. The US is looking at a third fiscal support package, while the EU has yet to distribute the funds from its initial package from last spring. In any case, this money is to be focused on improving infrastructure and climate resiliency rather than supporting demand. The ECB seems disinclined to increase its monetary support (perhaps validly given how low interest rates already are), while the US Federal Reserve still has options such as reorienting its bond purchases towards the long end of the curve to suppress interest rates if needed.

While European equity markets have long struggled under the region's comparatively weak growth outlook, one justification for an overweight allocation to European equities has often been valuations. Even that support has now waned. European equities are still trading at a larger-than-average discount to the US, but they are no longer at a discount relative to their own history. The current forward multiple of around 14.7x for the MSCI Europe index is as high as it has been since 2002. By contrast, relative to the US, the P/E ratio is near all-time lows, but this stems largely from high valuations in the US tech sector. Relative to the rest of the market, Europe's P/E ratio is near its average over the last few years (see Exhibit 5).

Exhibit 5: Forward multiples

Z-score



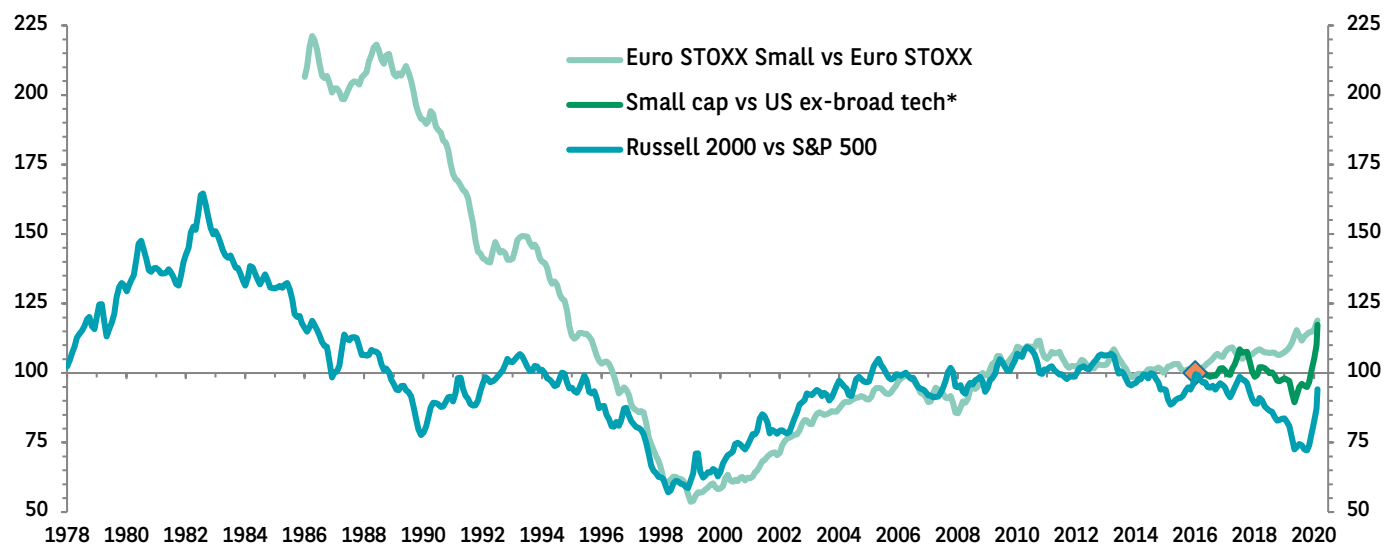
Data as at 9 February 2021. Source: FactSet, BNP Paribas Asset Management

SMALL CAPS

One of the mysteries over the last several years has been the underperformance of US small-cap stocks versus large caps when European small caps have outperformed. The explanation for the breakdown in the correlation between the two markets is — as it is for so many things — the US technology sector. Mega-tech stocks have overshadowed the returns of small caps, while the rest of the large-cap market has performed roughly in line with small caps. With the announcement of vaccines against the coronavirus, however, the technology sector has begun to lag and small caps have recaptured much of the lost ground. November 2020 saw the best monthly returns for the Russell 2000 (+18%) since the index's inception in 1978 (see Exhibit 6).

Exhibit 6: Relative performance of small caps

100 = December 2016



Data as at 9 February 2021. *MSCI USA indices. Broad tech includes information technology, internet & direct marketing retail, movies & entertainment, and interactive media & services. Source: FactSet, BNP Paribas Asset Management

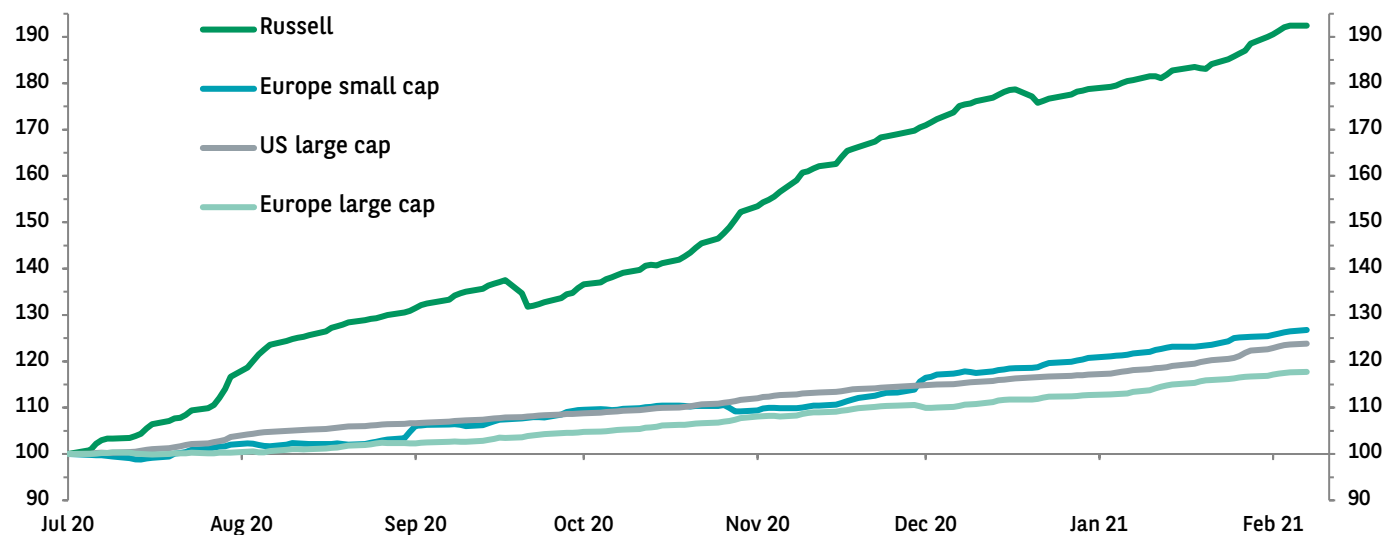
We believe this outperformance can last, although there are reasons for caution. Valuations have already risen significantly compared to pre-pandemic levels. The premium of US small caps over large caps is now average compared to a 10% discount early in 2020. Excluding tech, small caps are at a 20% premium. In Europe, small-cap valuations are now 10% above average.



With the opportunity to gain from normalising multiples already past, small caps will need higher earnings growth for sustained outperformance. There are good reasons to believe this can occur, particularly in the US where significant fiscal stimulus will flow into the economy in 2021. Small-cap companies should benefit disproportionately from higher consumer spending given that 77% of their revenues comes from the US compared to 60% for large caps (domestic revenues in Europe are 67% for small caps versus 46% for large caps). Consumer services, where pent-up demand is highest, are almost by definition non-tradeable and so represent a larger share of small-cap earnings than for large caps. Earnings revisions reflect the expected income (see Exhibit 7).

Exhibit 7: Forward earnings estimates

MSCI indices



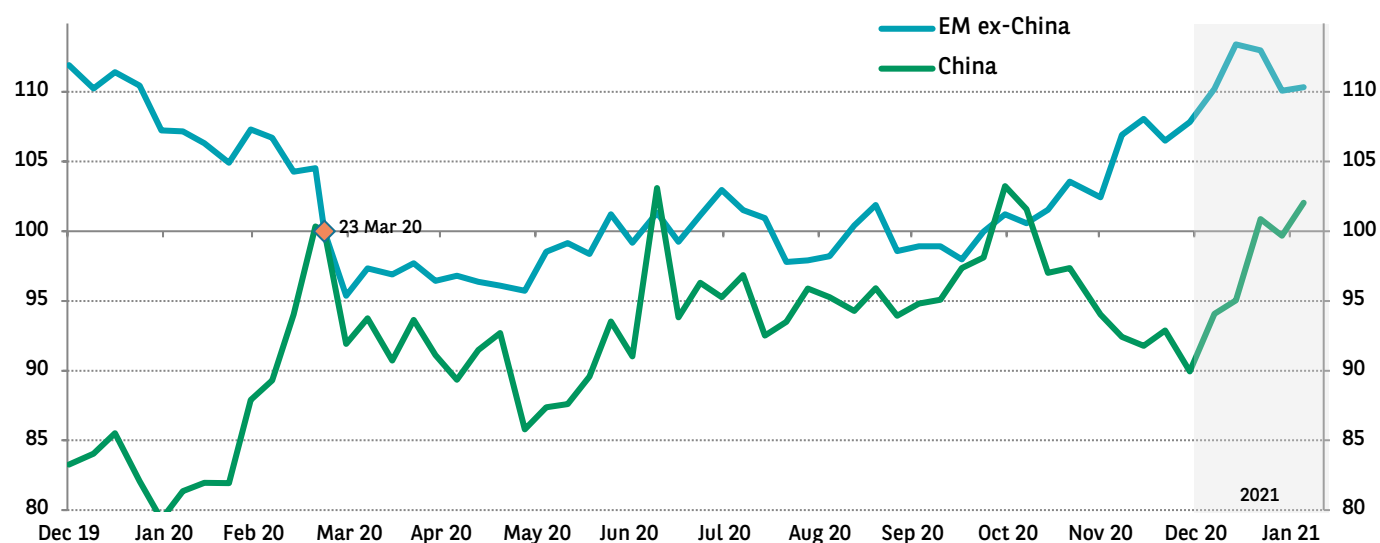
Data as at 9 February 2021. Source: FactSet, BNP Paribas Asset Management

EMERGING MARKETS

While EM equities outperformed developed markets in 2020, this was mostly due to China and occurred only in the first half. When in late September, investors began to anticipate a Biden victory, other emerging markets caught up (see Exhibit 8).

Exhibit 8: Relative returns

Market vs. MSCI World (total return in USD); 23 March 2020 = 100



Data as at 9 February 2021. Source: FactSet, BNP Paribas Asset Management

This coincident move makes it more likely that emerging markets will continue to outperform this year, although as always there are both favourable and unfavourable factors. Reduced US-Sino trade tensions after Biden's victory are supportive. Valuations are comparatively low, although not absolutely cheap. The price-to-book ratio for the MSCI EM index is at 2.1x versus 2.9x for the MSCI World. Forecasts are for strong GDP growth in China with consensus estimates projecting an 8.3% year-on-year expansion in 2021. Finally, investor funds have been returning to emerging markets. The inflows in November and December more than reversed the outflows of the previous 10 months. Strong US growth should pull in EM exports and likely more than compensate for slightly higher bond yields and stronger EM currencies versus the US dollar.

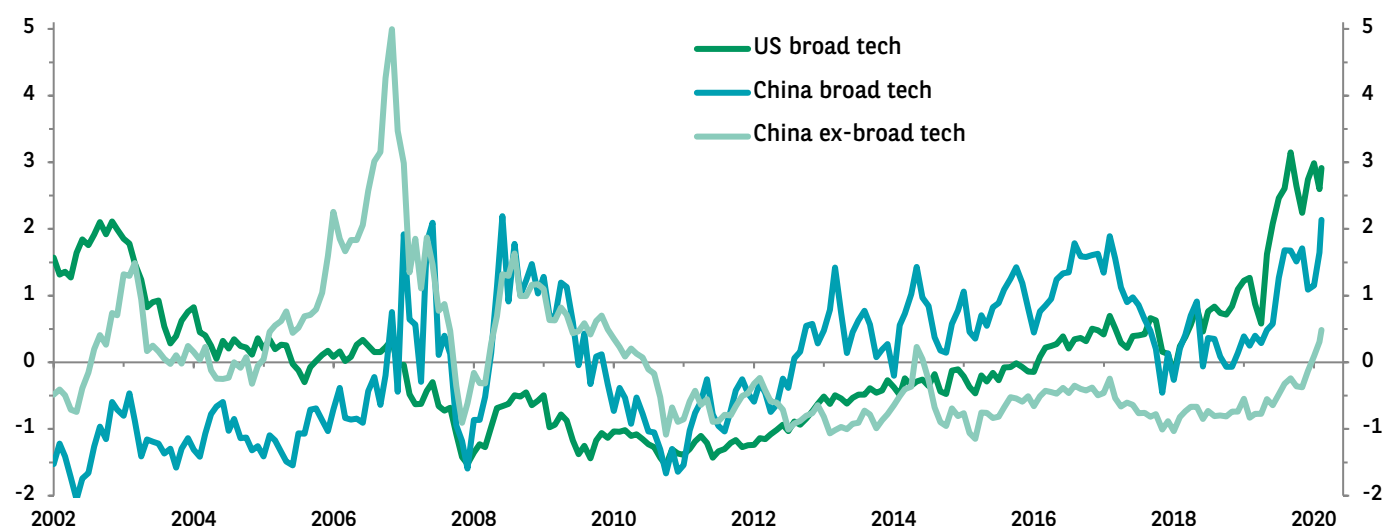
Within emerging markets, commodity exporters should outperform. In the early stages of an economic recovery, which is where many countries currently are, commodity prices tend to recover more quickly. The broad reflation trade that is currently driving markets should boost commodity prices along with inflation. Those countries where the energy and materials sectors represent a high share of the index are Russia, Peru, Saudi Arabia, Brazil and Chile.

We believe there is a particular opportunity in the Chinese technology sector which has come to resemble that of the US. In both countries, this sector dominates the index, accounting for 40-50% of total market cap. Like the US technology sector, the Chinese sector is well diversified. An unfortunate similarity is that valuations are comparatively high in both countries.

While the multiple for the Chinese technology sector is high, it is still lower relative to its history than it is for the US sector: its z-score is at 2.1 versus 2.9 (see Exhibit 9). This comparatively low valuation is all the more attractive given that the expected long-term earnings growth rate for the Chinese technology index is nearly twice as high as it is for the US sector.

Exhibit 9: Forward multiple z-score

Price to next-twelve-month earnings estimates



Data as at 9 February 2021. Source: FactSet, BNP Paribas Asset Management

CONCLUSION

Despite the strong returns for equity markets in 2020, the recovery from the coronavirus lockdowns has some way to go yet. Further fiscal stimulus, low real yields, and an eventual return of economic activity to pre-pandemic levels promise more upside for equities. Any market setbacks on vaccine delays or spreading virus mutations should be seen as opportunities to increase allocations to those markets and sectors benefiting from reflation: value, cyclical, small caps, and US and emerging market equities.

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ⁱ Wile E. Coyote (the market) has run off the cliff (the economy), but he is temporarily suspended in the air before plummeting to the canyon floor.