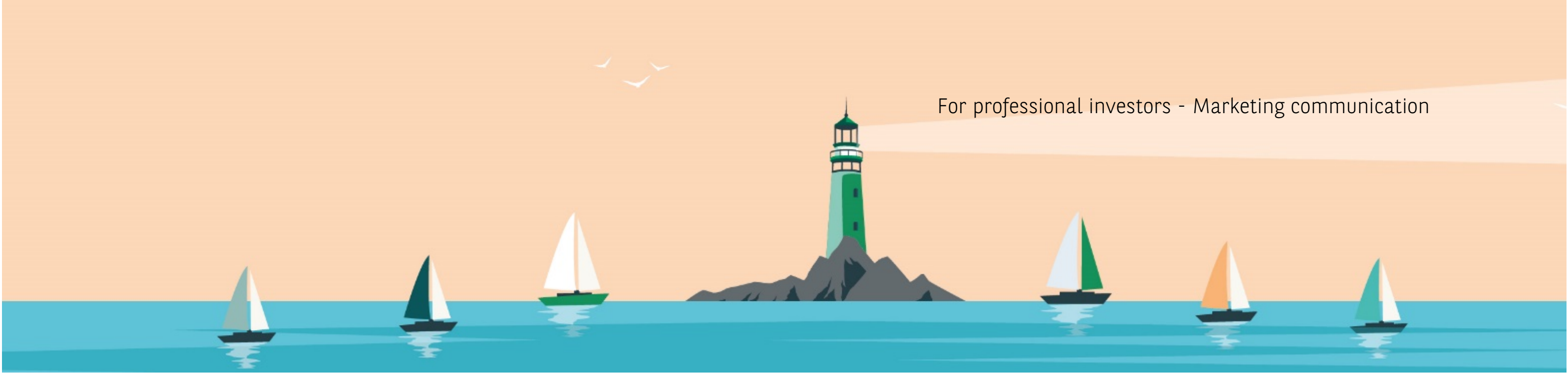

Asset allocation monthly

May 2022


Maya Bhandari
Head of multi-asset

Daniel Morris
Chief market strategist

Downside risks to earnings – especially in Europe

- After a bounce of 10% or more from this year's lows, we have downgraded European equities to underweight, thereby also reducing our overall directional equity risk and risk taking overall.

- We remain long Japanese and emerging market stocks. With both European company cash flows (i.e., earnings) and discount rates moving in an increasingly unfavourable direction, the recent rally feels more like a 'dead cat' bounce than a durable upturn.

- We have lowered Japanese sovereign bonds to 'dislike' and moved to a short position as we seek to capture an asymmetric return profile. The Bank of Japan is lagging other major central banks on tackling domestic price pressures, which are rising sharply. A policy move would benefit a weaker yen.

- We have re-instated our 'favourable' position in commodities. On top of the persistent fundamental supports (deep demand-supply imbalances and geopolitical tensions), our market dynamics/timing tools are pointing to a break higher from here.

BNP PARIBAS
ASSET MANAGEMENT

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Portfolio perspectives

- At our 27 April investment committee meeting, we **reduced European equities and Japanese government bonds** (JGBs) to -1. As a result, our overall risk-taking moves down by one quintile to -1.
- The short position in European equities allows for a reduction in overall directional equity risk after a 10% (dead cat?) bounce in European equities from the lows this year. There are four main rationales to this:
    - Significant downside to earnings (where expectations have risen this year), pointing to less 'true' valuation support once you put the right 'E' into price/earnings (P/E) multiples
    - Likely continued pressure on growth and inflation from the Ukraine conflict and China supply chain issues
    - An expectation that, on balance, the conflict is more likely than not to be an extended one
    - A shift in the ECB's reaction function, which is becoming more focused on inflation than other central banks are; this is leading to policy tightening as growth weakens.
    - All in all, both cash flows (i.e., earnings) and discount rates are moving in an unfavourable direction for EMU equities and we would seek to deepen our short should markets rally.
- The **short to JGBs** seeks to capture an asymmetric return profile: The Bank of Japan (BoJ) is meaningfully behind – or even an outlier – versus other developed market central banks. With both inflation jolting higher and a weaker yen, the BoJ will likely need to widen the bands around Yield Curve Control (YCC), perhaps to 50bp (from the current 25bp). There are questions around timing given governor Koruda's posturing, but Japan's monetary policy moves have tended to surprise markets, and the case seems clear that the bands should be widened. That 10-year JGBs would move much lower from here seems unlikely.
- Our view at our 20 April 2022 investment committee meeting was that core government bonds had sold off violently in the recent weeks, with US 10-year yields a whisker away from 3%, steeper curves, and positive real rates. We **reduced** the additional **short exposure to government bonds** we had taken on 2 March 2021, when yields dropped to 1.75%. This decision was led by valuation signals as captured in our quant 'toolkit', with both market dynamics and market temperature strongly supporting some reduction after the speed of the move. In the medium term, we expected to see yields moving higher, supported by both real rates that are still meaningfully below levels associated with secular stagnation, and term premia (ditto). We maintain a sizeable short position reflecting this.
- We **upgraded commodities to 'favour'**, reversing the downgrade of 9 March 2022. Fundamental supports remain as before, including the stage in the economic cycle and demand-supply imbalances, in addition to continuing, heightened geopolitical risk. The allocation shift was spurred by our market dynamics/timing tools, which no longer pointed to a fall in the commodity index we track (BCOMXALT), but rather to a break higher.

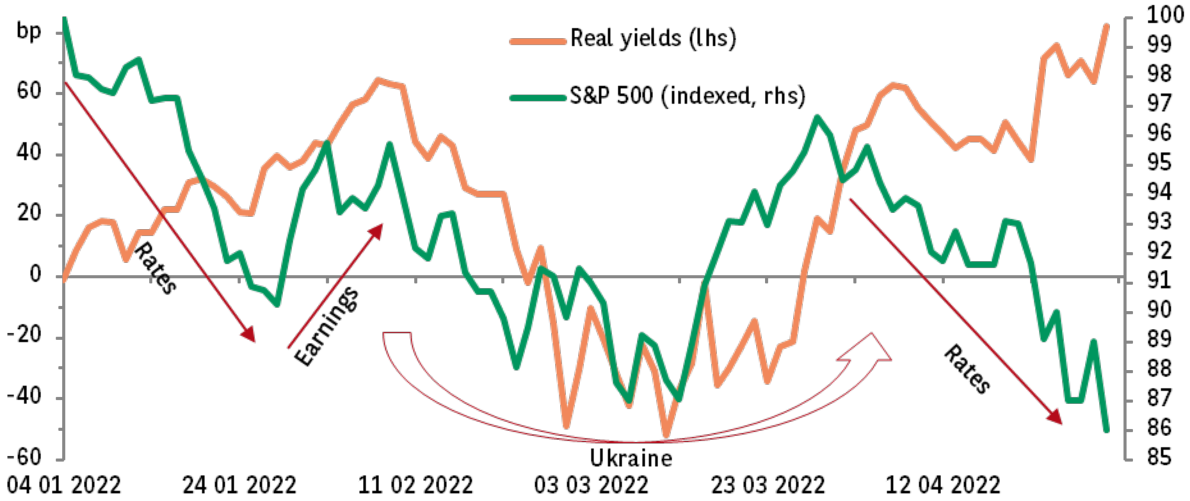
Tug of war

The tug of war between real yields and earnings growth continues in US equity markets, while Ukraine and Covid hang over European and Chinese equities, respectively (see Exhibit 1). The two key questions for global equities are:

1) How much higher can expectations for discount rates (and real yields) go?

2) Where will cash flows land; i.e., wiill results from the current earnings season be good enough to drive a rebound in equities?

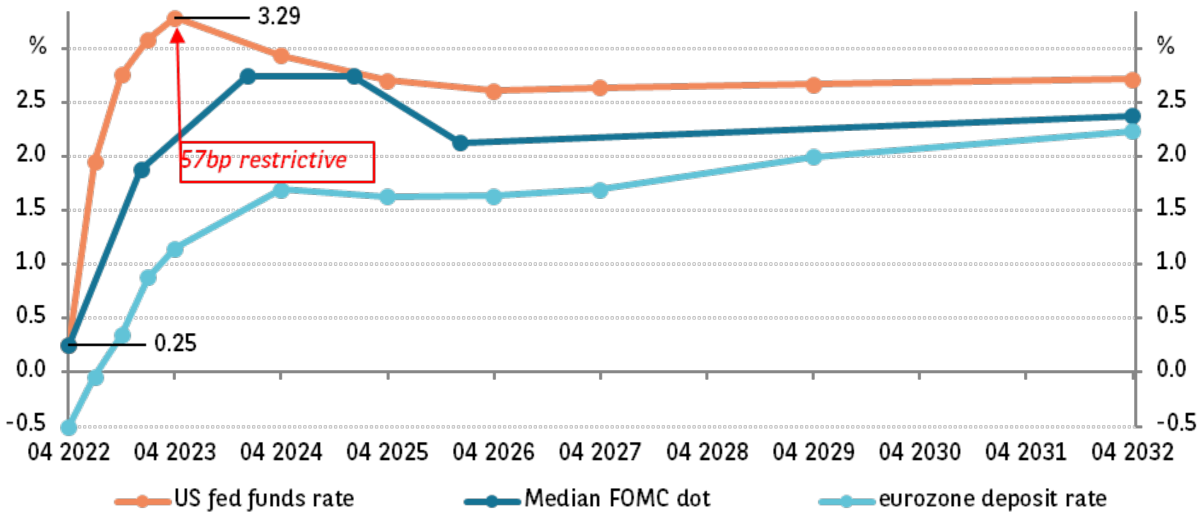
Exhibit 1
Change in real yields and US equities
2 January 2022 = 0 (yields) or 100 (equities)



Note: 2-year yields. Sources: Bloomberg, BNP Paribas Asset Management, as at 29 April 2022.

As at the end of April, the market expects the fed funds rate to peak at 3.3%, nearly 60bp above the neutral rate. The Fed indicated a slightly smaller move into restrictive territory in its latest 'dot plot' (see Exhibit 2). We believe more tightening may be necessary to bring inflation back towards the Fed's 2% (PCE) inflation target. Many of the transitory inflation factors, such as high energy prices and supply chain bottlenecks, will fade, and we expect inflation to peak soon. Yet wage gains at 5%-6% per year in the US are too high relative to the Fed's inflation target, hence a period with rates in restrictive territory will be necessary – a point Fed chair Jerome Powell has emphasised. In Europe, the UK and even Australia, central banks are tilting more towards tackling inflation pressures than supporting growth.

Exhibit 2
Expected level of leading central bank policy rates



Sources: Bloomberg, BNP Paribas Asset Management, as at 29 April 2022.

And, if inflation proves more obstinate there is the risk that policy rate expectations move higher – further dampening (growth) stock valuations – and that ultimately the Fed would be required to induce a recession to sufficiently dampen wage pressures.

In the meantime, results from the ongoing Q1 2022 US earnings season are encouraging. Underlying earnings growth — i.e., excluding energy (which will post unusually high growth rates), and financials (which were expected to show negative year-on-year comparatives) — is running at 17%, with results beating expectations by 6%. Corporate guidance has been in line with previous quarters and slightly above the long-run average. If this pattern continues, and policy rate expectations stabilise, markets should recover, just as they did in the first quarter.

Equities and rising interest rates

A rising rate environment is typically not positive for equities. Since 1970, the average (annualised) monthly total return for the US S&P 500 index has been 12.4%, while during periods when the Fed is raising the fed funds rate, it drops to just 5.2%. The performance of different indices depends, however, on the broader trends in growth and inflation, whether they are high or low, rising or falling. The grey-shaded columns in the table below correspond with the scenario we feel is most likely in the months ahead, that is, decelerating growth, high but falling inflation (falling if not immediately, then soon), and loose financial conditions, corresponding to the beginning of a rate rising cycle (see Table 1).

Table 1
Equity returns when the US Federal Reserve is raising interest rates
Total returns in USD

		When Fed funds rises														
Index	**All months since 1970**	**All periods**	Accelerating growth	Decelerating growth	Rising inflation	Falling inflation	Top quartile inflation	Middle quartile inflation	Bottom quartile inflation	Loose financial conditions	Tight financial conditions	Steepening yield curve	Flattening yield curve	**Stagflation**	**Score**
Months	614	104	45	58	53	51	42	56	6	55	49	21	83	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**	**-3.7**	**7.6**	**-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	0.3	13.3	-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	-7.0	12.5	-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	-0.2	7.5	-16.8	1
High dividend	13.2	4.7	-6.2	9.4	3.6	5.9	22.1	6.9	-19.2	4.8	3.3	4.3	4.9		2
NASDAQ 100	15.3	6.6	22.5	-5.1	-3.1	17.6	1.4	11.9	-3.7	16.5	-3.6	-11.6	11.7	-25.2	2
Energy	11.3	21.7	34.8	10.6	29.6	13.9	25.5	25.8	-29.4	29.5	13.4	17.3	22.8	-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	1.9	10.1	-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	0.4	7.3	-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	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	-1.5	3.7	-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	8.5	9.8	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	-5.1	0.5	-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	-3.3	19.9	-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	-15.2	-5.4	-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	-25.2	-1.7	-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	-15.7	5.5	-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	-2.8	19.6	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	23.9	17.8	40.7	4

Note: Stagflation defined as decelerating growth and high inflation. *Excludes Amazon. Sources: FactSet, Bloomberg, BNP Paribas Asset Management, as at 29 April 2022.

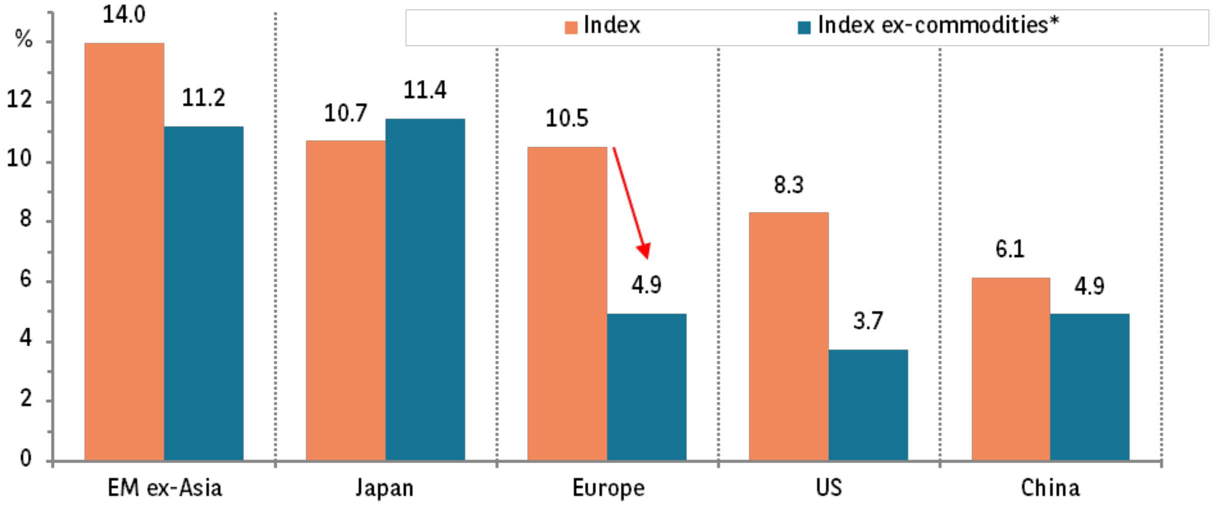
Under these scenarios, the relative performance of the different indices vs. the S&P 500 is tallied in the last column. The most consistent outperformers historically have been small caps, growth stocks, energy and healthcare. That said, perhaps most notable is the outperformance of non-US markets, both developed and emerging. As the ECB, too, moves towards raising rates, investors may wish to anticipate the performance of these same indices within Europe.

European equities

While European equities, for the moment at least, are benefiting from a comparatively more accommodative monetary policy, there are few other arguments in their favour. As described above, we have recently moved to an underweight position. Analysts' earnings estimates have risen modestly for the MSCI Europe index since Russia's invasion of Ukraine. Higher earnings look unlikely to us even factoring in the impact of higher commodity prices. Our strategy team, for example, points to forward European equity multiples appearing rich to history, once the right 'E' is plugged into ratios – more on this below.

The increase in commodity earnings estimates is an important factor, however. Consensus year-on-year estimates for 2022 for MSCI Europe appear quite strong at nearly 10%, higher in fact than that for the US at 9.4%. But exclude commodities and the earnings growth rate drops to 4.7%, less than the growth rate for the US at 5.1% (see Exhibit 3). In asset allocation portfolios, we are capturing this by being long commodities more broadly rather than commodity companies per se.

Exhibit 3
Consensus 2022 earnings growth expectations



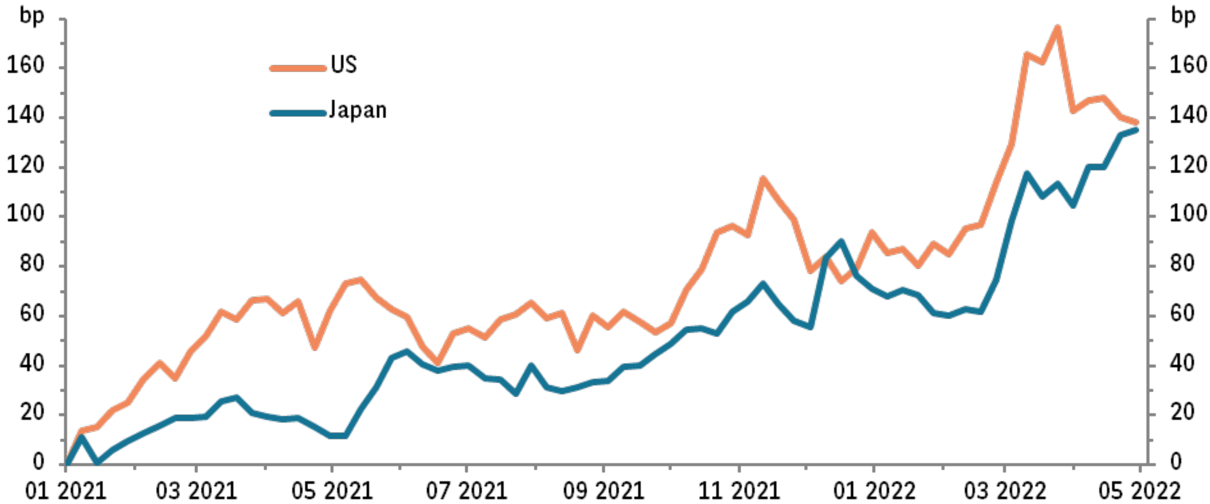
*Excludes energy, fertilisers & agricultural chemicals, metals & mining, and agricultural products. Sources: FactSet, BNP Paribas Asset Management, as at 29 April 2022.

The partial rebound from the low in early March means that equity valuations more broadly are not clearly compelling yet. And while what has happened so far in the Ukraine conflict is reflected in current market prices (if not earnings estimates), we see a greater likelihood that the situation will stay challenging in the near term, rather than dramatically improve. Finally, part of the apparent valuation discount at the index level is driven by commodities; the z-score for the index P/E ratio ex commodities is closer to zero.

Japanese government bonds

As 10-year US Treasury yields have risen, recently to 3%, we have trimmed our underweight, recently supplementing this with a short in Japanese government bonds. Japanese yield moves have been remarkably contained as the BoJ's Yield Curve Control policy caps the 10-year yield at 0.25%. Inflation expectations, however, have risen almost as much in Japan as they have in the US (see Exhibit 4).

Exhibit 4
Change in 5-year breakeven inflation
1 January 2021 = 0



Source: Bloomberg, as at 29 April 2022.

We believe the BoJ will be obliged to widen the band around JGBs, perhaps to 50bp from the current 25bp, particularly given the recent sharp decline in the yen. When this might happen is unclear. The bank has often surprised markets - as it did when it announced the YCC policy, for example – and with yields unlikely to move lower from here, the asymmetric return profile looks attractive to us.

Asset class views

	Strongly dislike	Dislike	Neutral	Favour	Strongly favour
Risk appetite*		X			
Asset allocation		Government bonds	Credit Real estate Cash	Equities Commodities	
Equity regions		Europe ex-UK	US UK	Japan GEM	
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 EMD	EU IG EU HY	
Commodities			Precious metals	Energy Base metals	
FX			USD, AUD, GBP, EUR, EM currencies	JPY	

* Prospective returns to risk/tracking error. Data as at 29 April 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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