ASSET ALLOCATION MONTHLY - JUNE 2023

A narrower distribution, skewed to the downside

- Macroeconomic data has been mixed. We judge the risks to growth as being skewed increasingly to the downside, particularly in the US. We see roughly even odds of US recession or stagflation in the next 12 months.
- We made two key changes this month: we lowered US equities to underweight, reducing equities overall in tandem; we neutralised our duration caution and started to build long positions at the long end of US inflation-linked bonds.
- Earnings expectations for S&P500 companies do not reflect the environment we envisage. We expect corporate earnings to fall by double digits as recession unfolds. Relative forward valuations for S&P500 companies look rich to us: they are near the highs of the period after the Great Financial Crisis.
- Similar to our underweight in US equities, our overweight in US 20-year TIPS seeks to capture a valuation opportunity. TIPS offer a real yield near decade highs; they are also a play on stickier inflation and offer attractive carry.
- We took advantage of the rise in German bond yields in late May to take partial profits on our duration underweight.


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BNP PARIBAS ASSET MANAGEMENT

The sustainable investor for a changing world

Asset allocation monthly

As we approach mid-year, macroeconomic data has continued to be mixed. Looking at Nowcast data and consensus forecasts across the main economies, momentum appears to be rolling over in most places. For example, the US Federal Reserve of Atlanta's GDPNow model estimate for real US GDP growth in the second quarter of 2023 was a seasonally adjusted annual rate of 1.9% on 26 May, down from 2.9 % on 17 May.

The US housing market may have troughed after an eight-quarter drag on GDP. Better housing data has (so far) failed to close the gap with weak and weakening business surveys (at 5%, residential investment matters much less for GDP compared to around 12% for business investment.

Overall, we see sufficient data, particularly leading indicators (including in the labour market), that is consistent with recession unfolding. Business and consumer sentiment are weak and the regional US banking debacle has added to already contractionary lending standards. Companies are following a more standard 'playbook', where capital expenditure is cut first, then hiring is paused, before employees are laid offs as recession unfolds. We see the US cycle as particularly 'long in the tooth'.

One notable implication is that the tail risk of renewed overheating that markets were pricing in for the US economy just a couple of months ago now appears firmly off the table. We see roughly even odds of US recession or stagflation in the next 12 months.

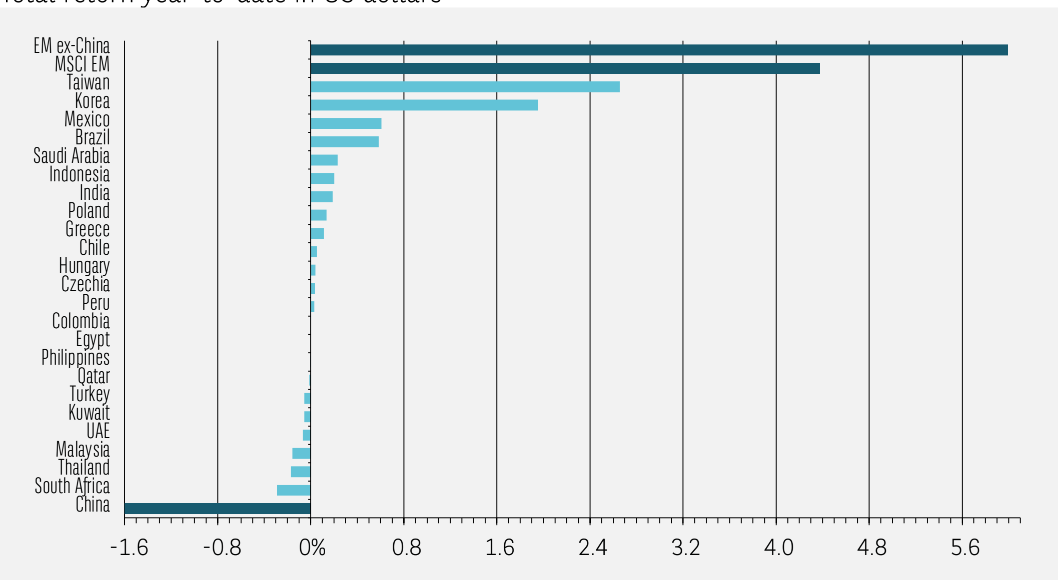
In Europe, recent data showed the German economy contracted by 0.3 % in the three months to March after a downward revision from the initial estimate of zero growth. This second consecutive quarterly decline meets the technical definition of recession. Nonetheless, second-round effects are becoming 'baked in' to negotiated wages, fiscal policy is easy and monetary tightening is further behind than in the US. This supports our short European duration position put on after-market dislocations around Silicon Valley Bank and Signature Bank in the US. Such an environment also supports our short towards European equities, where margin pressures are rising and analyst earnings expectations appear lofty relative to the economic outlook.

Investor sentiment has remained negative towards China, which explains much (though not all) of the underperformance of emerging market equities so far this year (see Exhibit 1).

Exhibit 1

China has detracted from the performance of emerging market equities this year

Total return year-to-date in US dollars



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

However, we see Asia recovering even as the US and Europe move towards recession. Chinese data have disappointed recently, but activity is still running at a 6.5-7% growth rate and we believe the scope to ease policy remains intact, unlike in developed countries. With real rates high for many emerging markets, and valuations and earnings expectations depressed, we see potential for discount rates to fall and earnings growth to improve. This supports the positive position we have on emerging market equities (two-thirds emerging markets, one-third MSCI China) relative to European and US stocks.

Earnings expectations

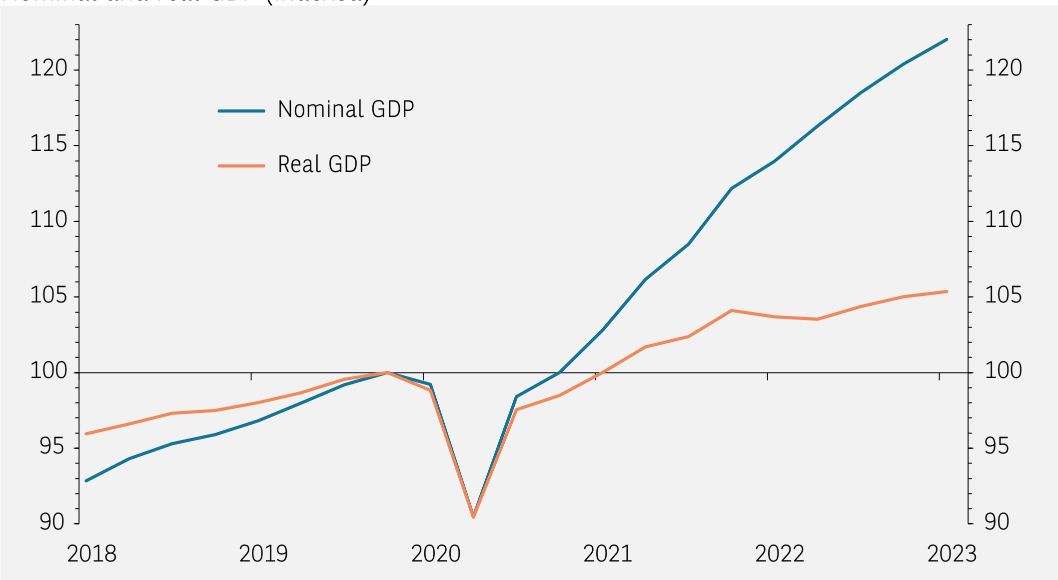
In our view, earnings expectations for S&P500 companies do not reflect this environment with flat earnings-per-share (EPS) growth expected in 2023 (+5% excluding energy), followed by double-digit rises (11-12%) in 2024 and 2025. We would expect overall corporate earnings to fall instead as the recession unfolds – by double digits (12-15%) (and perhaps more given the boost from higher nominal growth, or the 'money illusion').

Waning economic momentum supports the view that the federal funds rate is at or around its peak for this cycle, but it also poses a challenge to corporate America. Margin expansion may be ending as companies find it increasingly difficult to pass on price increases – the real challenge of the 'money illusion' that is created by high inflation in combination with weakening real growth (see Exhibit 2).

Exhibit 2

Money illusion at play

Nominal and real GDP (indexed)



Data as at 31 May 2023. Sources: FactSet, BNP Paribas Asset Management.

US equities increasingly vulnerable

The robust performance of US equities this year has relied almost entirely on the technology sector, with more than half of the S&P 500 index return due to Apple, Microsoft and NVIDIA. When we exclude technology, the market is roughly flat. We are concerned over the negative signals coming from individual sectors. Consumer discretionary stocks, for example, are now underperforming consumer staples on average, suggesting the US consumer is starting to run out of steam.

Liquidity conditions are challenging for US stocks. The US banking sector remains exposed to the risk of a deposit flight with already tightening liquidity conditions amplified by the removal of liquidity via the Fed's quantitative tightening.

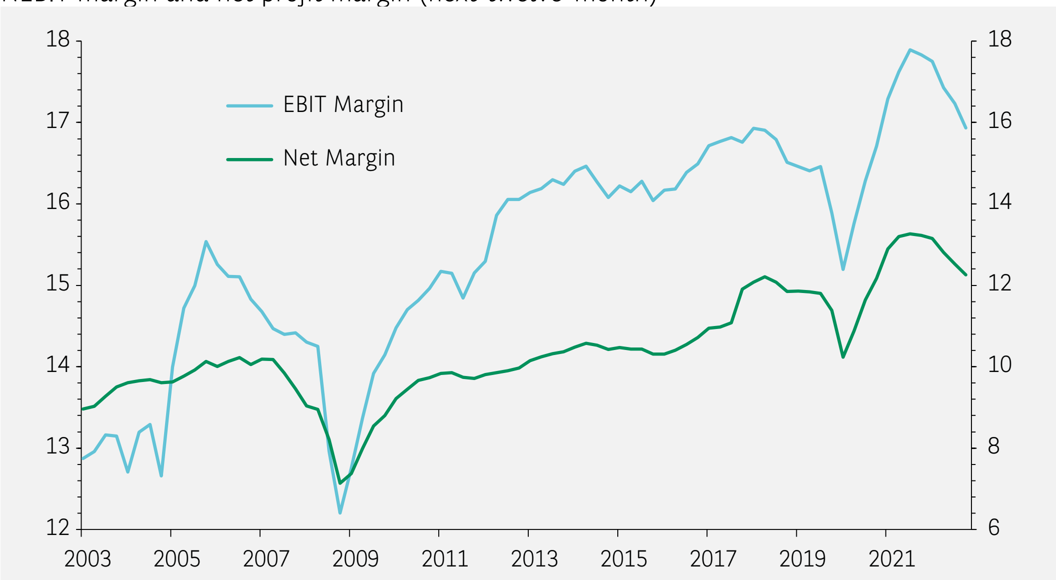
Valuations are stretched

While forward price-earnings ratios for the S&P 500 index fell in 2022, they have increased this year: relative to global stocks (as represented by the MSCI All Country World Index) the forward premium is 16%, which is near the highs seen since the Global Financial Crisis. Much of this premium is concentrated in the technology sector, though the index is no less vulnerable for it. The 2022 premium may have been justified by better returns-on-equity, but both trailing and forward-looking measures are rolling over now (see Exhibit 3). According to our longer-term valuation frameworks that incorporate trend earnings valuations, the US market may be 'mispriced' by 30-35%.

Exhibit 3

Softer margins expected

NEBIT margin and net profit margin (next-twelve-month)



Data as at 31 May 2023. Sources: FactSet, BNP Paribas Asset Management.

Despite this context, investor positioning appears to be less underweight risk assets than some sell-side surveys suggest, with modest and falling interest in having an underweight in stocks. Real money investors appear to be overweight equities at levels corresponding to around the average levels of the last decade or so.

Given all these factors, we downgraded US equities to 'dislike' (see table below) and our active portfolios are starting to be positioned more cautiously. This extends the direction of travel from January when we were modestly constructive before turning more neutral in February/March and then initiating a modest underweight in late April.

Positioning for a pause as cycle of US rate hikes ends

We have raised our allocation to government bonds from underweight to neutral, expressed by a tactical short towards EU sovereigns on the one hand along with an overweight position in long-dated US linkers.

Supporting the long Treasury Inflation Protected Securities position is the asymmetric and attractive risk reward as the Fed approaches the end of its hiking cycle, though this remains highly conditional on the course of inflation. Yields on 20-year TIPS are near the highs of the decade and at levels associated most recently with renewed economic overheating. We believe, however, that the recent turmoil in the US banking sector means that overheating is no longer plausible and that there is consequently a clear valuation disconnect.

Our asset class views

	Strong dislike	Dislike	Neutral	Favour	Strongly favour
PRR/risk appetite			X		
Asset allocation		Equities	Real estate Cash Government bonds	Commodities Credit	
Equity regions		Europe ex-UK US	Japan UK EM ex-Asia	Emerging 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	Inflation-linked bonds	
Credit			Emerging market debt US IG US high-yield EU HY	EU investment-grade	
Commodities				Energy Base metals Precious metals	
FX		CHF	EUR, USD, AUD, GBP, EM currencies	JPY	

Views as at June 2023

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VIEWPOINT

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