
# Asset Allocation Monthly April 2022

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## Running to catch up with inflation

- Financial markets have seen a relief rally since mid-March as the worst predictions of how the Ukraine war might go were unfulfilled and investors focused more on the potential for a negotiated solution.
- While markets seesaw on news reports, expectations for the level of central bank policy rates are ratcheting higher as inflation repeatedly outpaces expectations. Unlike at the start of the year, however, the corresponding rise in real yields has not led to an equity market sell-off. Our concern is that when worries about the Ukraine are eventually behind us, the focus will return to the prospect of higher discount rates.
- We increased our US duration short during March as central banks clearly signalled their primary concern is well-above-target inflation rather than GDP growth possibly slowing due to the Ukraine war. We also altered our regional equity exposures mix (see box page 2). The fact that GDP growth prior to the conflict's outbreak was well above trend provides some cushion.
- Though rising rates will challenge equity returns, the asset class should still outperform fixed income. We prefer to take our equity exposure in markets with attractive valuations and supportive monetary/fiscal policy, namely, China and Japan.

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**Portfolio perspectives**

- On 2 March, we **increased our US duration short**. The decision was driven by attractive valuation as yields had rallied on economic growth worries stemming from the war in Ukraine. Our medium-term view on core bonds is unaltered and still cautious. We believed that the risk was more for higher inflation, not only via via 'traditional' commodities (oil, agicultural products, palladium, gas), but also in less anticipated segments – for example, semiconductors. Semiconductors, which have been central to global supply chain shortages, may be vulnerable as Ukraine is the biggest producer of neon (40%-50% of global supply), a bi-product of steel, which is necessary for lasers to produce semis. We further increased our short on 22 March.
- Longer term, the role of government bonds as a source of diversification for multi-asset portfolios is also questionable. First, low yields, broadly languishing at or around 50-year lows, lock in (similarly) low prospective returns and offer little by way of a protective buffer. Second, we are seeing all the ingredients for higher bond yields: Acute labour shortages, large-scale stimulus rolling back faster than expected, globalisation reversing and an oil shock overlaid upon a larger and longer-lasting inflation shock from Covid-19 than anticipated.
- We **reduced** our remaining **overweight to European stocks** on 9 March. We felt markets were too optimistic about the potential for the EU to reduce its dependence on Russian energy. Moreover, earnings expectations for the region had been rising, despite greater growth and inflation worries, when we anticipated they would ultimately decline. The upgrades stemmed from swift increases in earnings-per-share (EPS) estimates by analysts for commodity sectors, while downgrades in other sectors would likely be slower to materialise. As a result, price-earnings ratios appeared better than they actually are.
- As we had hit our trailing stop, **we took profit on our commodities position** on 10 March, reducing our position to neutral. This move was a consequence of valuations rather than any change in our fundamental view per se.
- We **upgraded our position in emerging market (EM) equities** on 22 March **via the MSCI China index**. We already had an existing overweight to EM equities. The change was driven both by valuations and fundamentals. Chinese equity valuations are extremely cheap – more than 1 standard deviation cheaper than global equities – and the fundamental 'trigger' came the prior week with China Vice Premier Liu He's 'whatever it takes' announcement and strongly coordinated policy response/communication. The announcement should unlock a potentially meaningful rerating, particularly for Chinese technology companies. The position was funded by selling down our remaining modest US equity exposure, taking profit after a strong rally. The S&P 500 was less than 6% below its all-time high and had gained almost 9% in the previous couple of weeks, shrugging off the US Federal Reserve's (Fed's) more hawkish commentary and a broader discount rate shock.
- We decided to **raise European credit**, both high yield and investment grade, to favour. This was not a call on broader credit, or indeed European credit, but rather to seek more granularity for pure fixed-income mandates where European credit is on balance more attractive than US or emerging market credit. European credit spreads seem high versus history, but valuations are fair in the context of softer fundamentals, particular with deepening macroeconomic concerns and lagging microeconomic indicators (defaults and debt levels are low, but these are strongly backward-looking). Technicals are more favourable, with no maturity wall in high yield for example, high cash balances, and an ECB rate path that seems well priced into spreads.
- By contrast, the outlook in the US is clearly weaker: Valuations are less attractive, and both fundamentals and technicals more challenged by the Fed, which the market has priced in to hike fairly aggressively this year and to start to unwind asset purchases. EM indices meanwhile continue to be buffeted by developments the Russia/Ukraine conflict and related benchmark changes.

## Getting to neutral

So far this year, two main factors have driven equity market volatility: A reassessment of the policy rate outlook in the US, and the war in Ukraine. Initially, markets fell as real yields rose and multiples compressed. Once the earnings reporting season began, the focus returned to GDP growth still being positive. Then, with the outbreak of hostilities in Ukraine in late February, real yields fell well below where they had started the year. Equities followed suit on investor concerns about growth.

Since mid-March, worries about the war's impact on economic growth (if not on inflation) have eased somewhat on the possibility of a negotiated end to the conflict, leading to a relief rally. As the first quarter closes out, investors are counting on the continued flow of Russian oil and natural gas to Europe. Europe needs Russian gas as much as Russia needs European cash. Any challenge to that assumption, however, could swiftly turn markets back down.

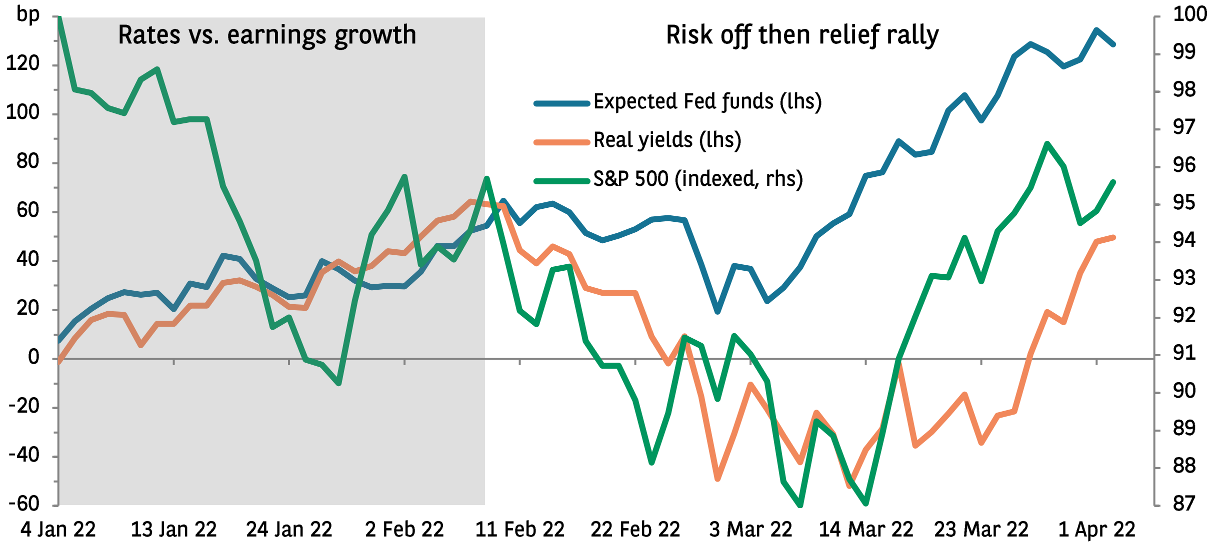
Meanwhile, central banks have signalled that they are more concerned about the inflation outlook than they are about risks to growth from the conflict. As a result, monetary policy will tighten more – and sooner – than previously expected.

One might have anticipated that consequent rise in policy rate expectations would lead to a renewed decline in equity markets, as it had at the beginning of the year. So far, however, equities seem to be ignoring the threat. This may be because the policy rate outlook has not yet been entirely reflected in real yields as worries about Ukraine are still weighing on market sentiment (see Exhibit 1). In any event, we have used the surprising resilience of markets in this environment to take profits in our mutli-asset portfolios. We did this most recently in US equities, which are heavily skewed towards long-duration technology companies and hence particularly vulnerable to higher discount rates. Valuations are comfortably above the 10-year median for both the S&P 500 and Nasdaq, and with more negative earnings yet to come, multiples are higher than they appear.

**Exhibit 1**

**Change in real yields, policy rate expectations, and US equities**

2 January 2022 = 0 (yields) or 100 (equities)

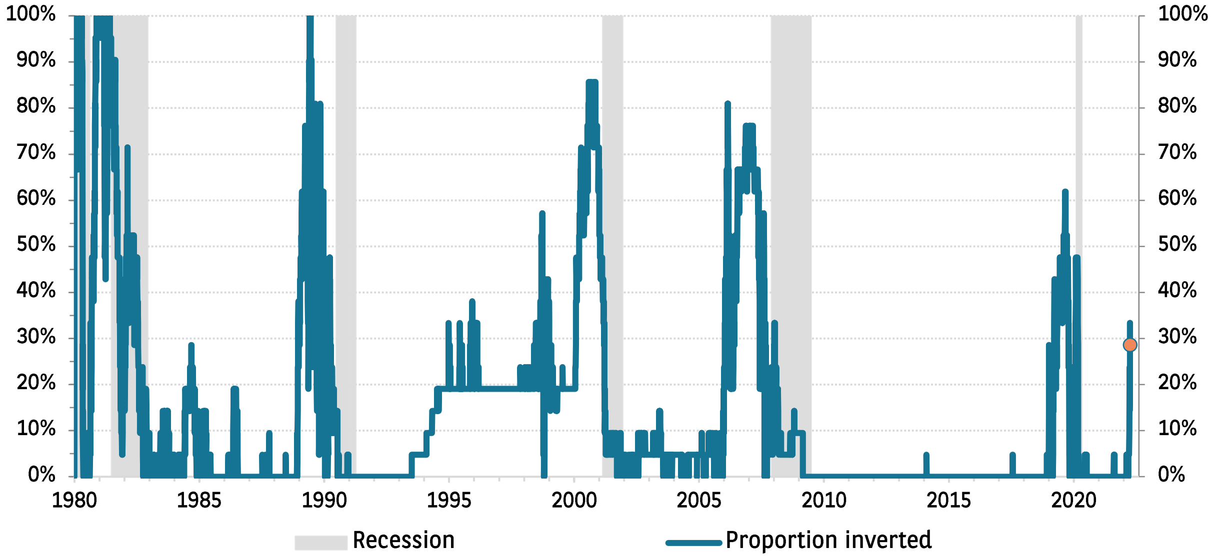



Note: 2-year yields. Sources: Bloomberg, BNP Paribas Asset Management, as at 4 April 2022.

More broadly, financial conditions remain very loose. The Fed has belatedly acknowledged that they are in fact far *too* loose given the level of inflation and US economic capacity, but there is a limit to how fast the central bank can normalise. To judge by the most recent Fed 'dot plot', policy rates will return to above the Fed's own estimate of neutral within the next couple of years. The risk to equities (alongside the risk of recession), should meaningfully increase only if the Fed needs to move further into restrictive territory in order to return inflation to its target. Though the recent inversion of the parts of the US yield curve has raised worries about an imminent recession, the signal is far from clear: Less than 30% of the US yield curve is currently inverted vs. the at least 60% that tends to precede rescessions (see Exhibit 2).

Exhibit 2

Proportion of yield curve inverted and US recessions




Source: Bloomberg, NBER, BNP Paribas Asset Management, as at 5 April 2022.

In the meantime, the focus is on expectations for corporate earnings, particularly in Europe. Despite the economic growth environment being poorer than a month ago, aggregate EPS forecasts have not fallen. This is because large, positive revisions in commodity sectors have more than offset negative revisions in other sectors. The upcoming earnings season will be highly important.

The jump in commodity prices stemming from the war in Ukraine will challenge earnings growth in Europe more than that in any other region. Even if, as one hopes, the situation improves soon, the pressures on prices will linger. While we do not anticipate a recession in Europe, higher inflation will nonetheless slow growth. A comparable period is 2011, when oil prices rose by a similar amount and remained high for several years. A recession did ultimately ensue, but it was more due to the eurozone debt crisis than higher oil prices. GDP growth was lower before oil prices jumped in 2011, averaging about 2% per year, compared to today when it is twice as high. The economic momentum of the region's rebound from the pandemic allows some room for a slowdown in growth without a significant risk of recession.

## China equities

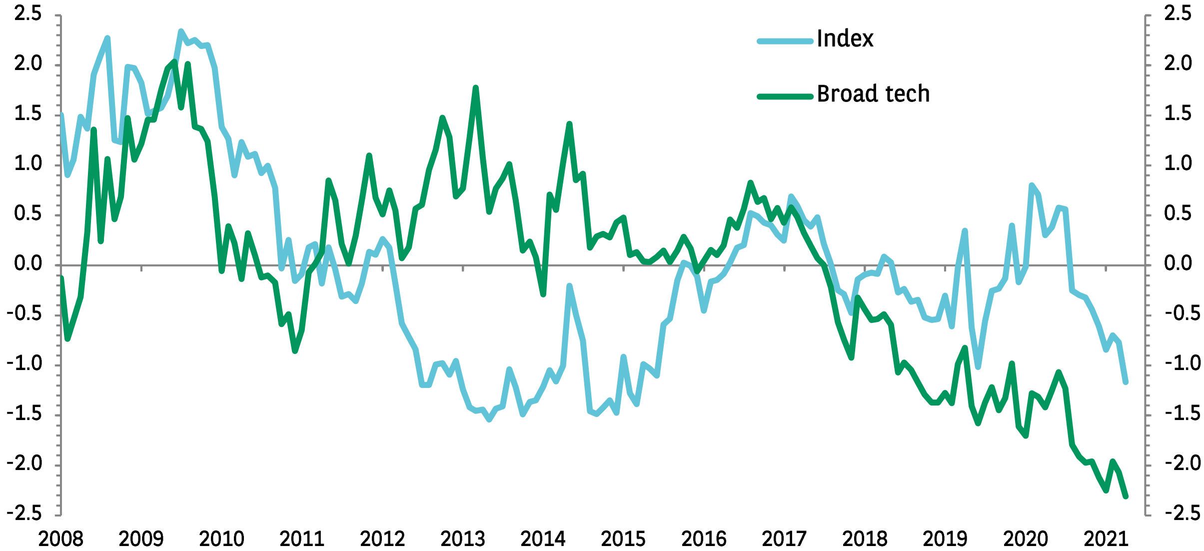
One area that stands out is China, where equity valuations are particularly attractive. Last year, emerging market equities deeply underperformed developed market (DM) equities. There were reasons for this: The post-lockdown reopening trade was patchier in emerging markets than in developed economies; EM policy, particularly monetary policy, was broadly tightening as DM continued to ease; and China 'got tough' on regulations in a highly unpredictable manner.

March's coordinated policy turn — where senior Chinese policymakers announced a more measured regulatory focus, with some focus on asset prices — could be a game changer. This view of our multi-asset investment committee is shared by our strategy team and colleagues managing bottom-up equity portfolios. Although the longevity of the market opportunity is less clear given the variety of structural challenges China faces, the short-term opportunity is, on balance, attractive.

The underperformance of Chinese equities has opened up a deep valuation discount, concentrated in technology. The forward price-earnings multiple relative to DM equities is more than one standard deviation below average, while for the broad technology sector it is nearly 2.5 times lower (see Exhibit 3). Our asset allocation porfolios built on our existing modest long in EM equities in March, adding specifically exposure to China equity.

**Exhibit 3**

**Relative forward price-earnings ratio z-score, MSCI China vs. MSCI All Country World**




Note: Broad tech comprises the information technology sector, internet retail, entertainment, and interactive media. Source: FactSet, BNP Paribas Asset Management, as at 31 March 2022.

We also believe Chinese equities will perform better given the significant divergence in monetary policy. Markets anticipate policy rates rising by 250 basis points (bp) in the US, and by 100bp even in the eurozone over the next year. By contrast in China, they should rise by just 40bp. A combination of looser monetary policy, currently negative sentiment, and a strong earnings recovery could be a powerful driver of returns this year. We also favour Japan, where rates should be flat.

## Asset class views

| | Strongly Dislike | Dislike | Neutral | Favour | Strongly Favour |
|---|---|---|---|---|---|
| Risk appetite* | | | X | | |
| Asset allocation | | Government bonds | Credit<br>Real Estate<br>Cash<br>Commodities | Equities | |
| Equity regions | | | US<br>Europe es-UK | Japan<br>GEM | |
| Equity style/size | | | EU large cap<br>EU small cap<br>US large cap<br>US small cap | | |
| Sovereign bonds | | US<br>Europe | Japan<br>EM local<br>Australia<br>UK<br>Linkers | | |
| Credit | | | US IG<br>US HY<br>EMD | EU IG<br>EU HY | |
| Commodities | | | Precious metals | Energy<br>Base metals | |
| FX | | | USD, AUD, GBP, EUR EM FX | JPY | |

* Risk appetite/return to risk - Data as at 31 March 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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