

# MID-YEAR OUTLOOK 2021



Daniel Morris  
Chief Market Strategist

- We believe the rally in US Treasury yields is overdone and anticipate higher nominal yields through the rest of the year. But in contrast to the first quarter, we anticipate the increase will come primarily from higher real rates rather than inflation expectations.
- The outlook for equities remains good thanks to a solid economy and strong earnings growth. We foresee more variation in returns by style and size as a function of changes in the components of nominal interest rates.
- A key risk to our outlook remains the appearance of a vaccine-resistant Covid variant that could lead to the reimposition of lockdowns.

## THE NEXT PHASE

The view of investors on the outlook for US growth and inflation has varied significantly over the course of the year. Following the positive vaccine trial results last November, and particularly with the Democratic Senate victories in Georgia and the prospect for yet more fiscal stimulus, the initial focus was on accelerating growth and inflation.

The mood shifted in the second quarter. Investors began to anticipate a peak in US growth, and the US Federal Reserve's (Fed) message that inflation would prove transitory led to a decline in US Treasury yields. The belief that the central bank was still aiming for an overshoot in inflation nonetheless kept policy rate expectations (and hence real interest rates) in check.

Since the June Federal Open Market Committee (FOMC) meeting, it has become clear that the Fed is less tolerant of an inflation overshoot than was believed. Persistent, higher-than-expected realised inflation has led to rising policy rate predictions in the near term, even as medium-term inflation expectations remain anchored.

We believe the rally in US Treasury yields is overdone and see the next phase of the recovery similar to the first, with higher nominal yields through the rest of the year. But in contrast to our belief prior to the Fed meeting, we anticipate the increase will come primarily (but not entirely) from higher real rates rather than inflation expectations.

The outlook for equities remains good thanks to a solid economy and strong earnings growth. We foresee more variation in returns by style and size as a function of changes in the components of nominal interest rates.



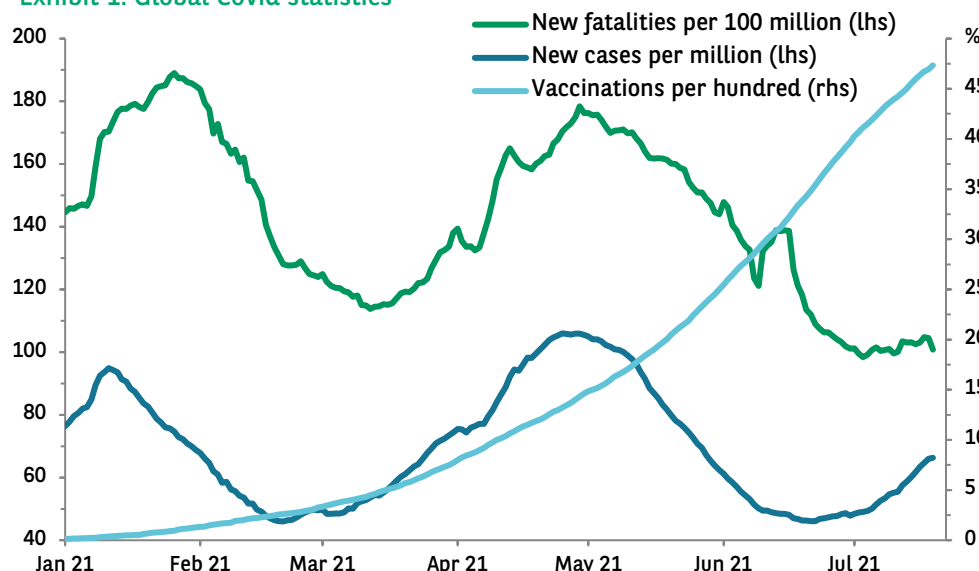
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“THE RACE BETWEEN VACCINES AND VARIANTS IS VERY MUCH ONGOING.”

Exhibit 1: Global Covid statistics



Data as at 19 July 2021. Sources: Our World in Data, BNP Paribas Asset Management.

The pandemic, of course, is not over and the race between vaccines and variants is very much ongoing. One of the key risks to our outlook remains the appearance of a vaccine-resistant Covid variant that could lead to the reimposition of lockdowns. The rapid spread of the latest Delta mutation is likely one of the drivers of the recent decline in core government bond yields. Despite the virus mutations, however, infection and fatality rates are lower than during previous waves and vaccinations are increasing (see Exhibit 1).

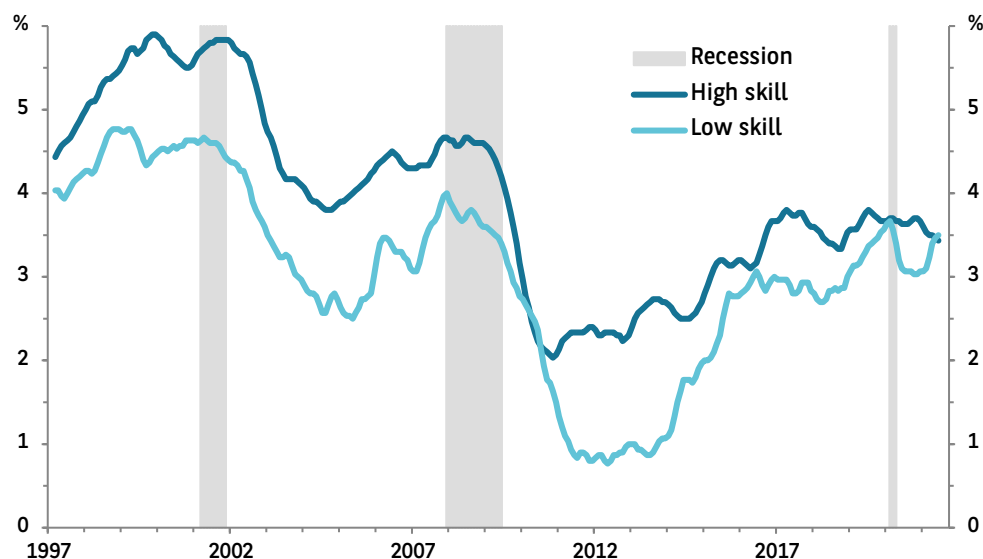
## FIXED INCOME

### United States

The two factors that will determine the path of US Treasury yields are the persistence of recent inflationary pressures and the timing of Fed tapering. To assess the outlook for inflation, we can look at cyclical categories of inflation such as rents and owners’ equivalent rent (OER), where there is very strong evidence that shelter prices will drive the consumer price index (CPI) higher in the coming months. Indeed, commercial real estate data suggests that in many cities, apartment rents have already recovered from the declines in 2020, and are now back above pre-pandemic levels.

For price increases to persist, however, one needs to see wages rise – otherwise rising prices quickly eat into disposable income. Hence the outlook for the labour market will be crucial. Wages have generally remained stable throughout the pandemic, but have begun to rise for low-skill workers, although much of this evidence is anecdotal and not yet evident in the data.

In prior recessions, wages fell as unemployment rose, which underlines the fundamental difference between an output loss driven by lockdowns with generous fiscal transfers and one driven by an unwinding of financial imbalances. Our expectation is that as fiscal and monetary policy support return the US economy to full employment in the first half of 2022, the labour market will resume its position on the pre-pandemic Phillips curve, generating solid wage gains (around 3.5% a year) that should result in a period of persistent, cyclical inflation.

**Exhibit 2: Atlanta Fed wage growth tracker (YoY %) and US recessions**

Data as at 20 July 2021. Sources: Atlanta Fed, BNP Paribas Asset Management.

about the financial stability risks of keeping policy too easy (with some of them pointing out the boom in house prices). If this interpretation is correct, then the FOMC's true reaction function is in fact closer to a more traditional inflation targeting framework.

If the FOMC is indeed less tolerant of inflation overshoots, there are several implications:

- (i) The right-hand tail of the inflation distribution is now compressed. A more hawkish Fed weakens the rationale for pricing in an inflation overshoot at longer maturities, or pricing in an inflation risk premium. The implication is that 10-year breakeven inflation (BEI) rates should be closer to 2.3% than 2.6%, and longer-dated nominal Treasury yields should be lower.
- (ii) The FOMC will act earlier and more swiftly to head off upside inflation risks, which implies a more rapid normalisation of policy. Tapering of asset purchases would likely be less drawn out, and rate hikes would come earlier and be less gradual. The front end of the Treasury curve is therefore less anchored.
- (iii) Markets will become increasingly sensitive to employment and inflation data as investors seek to assess progress towards the 'sufficient further progress' conditions for the tapering of quantitative easing (QE) to begin.

Our view remains that the US economic recovery should maintain momentum, amid ongoing vaccinations, fiscal support and self-reinforcing employment gains. We expect hiring to gather pace in the coming months as temporary restrictions on the availability of labour fall away. Paradoxically, the Fed's more hawkish stance at the June meeting has helped to lower Treasury yields and to further ease financial conditions. We acknowledge that fiscal support will fall away in 2022, but note that it will likely no longer be needed as the economy should reach full employment at some point in the first half of next year.

The primary risk to this outlook is the rapid spread of the Delta Covid variant, which is already rampant in the UK. For some under-vaccinated communities in the US, the result may be a sharp rise in hospitalisations. With vaccines now freely available, however, we cannot conceive that US state governments will ask their citizens to lock down once again to protect those who have declined to protect themselves. Nevertheless, the surge in Delta infections has the potential to unsettle investors and support a bid for Treasuries.

Following the June FOMC meeting, we now anticipate that QE tapering will start in early 2022, and the signal will likely come in September, or perhaps even at the August Jackson Hole Symposium. Our new timeline for rate lift-off is set for March

Our assessment of how the Fed will react to these pressures has changed since the 16 June FOMC meeting. We had believed the Fed's new Flexible Average Inflation Targeting (FAIT) framework meant it was actively looking to overshoot its 2% target in order to make up for previously below-target periods. We now believe that, while an inflation overshoot may be an objective, there is no commitment to achieving it.

In fact, it now seems that many members of the FOMC (i) merely want to ensure they do not tighten pre-emptively; (ii) still have limited tolerance for inflation overshoots; and (iii) have additional concerns

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*"The US economic recovery should maintain momentum, amid ongoing vaccinations, fiscal support and employment gains."*

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2023, with the Fed to deliver a 25bp rate increase per meeting, taking the fed funds policy rate target to 1.75–2.00% by end of 2023. Overnight index swap (OIS)-based forwards, however, are pricing end-of-2023 OIS rates at 68bp at the time of writing. The market’s projection warrants investors establishing a short-duration position in front-dated nominal Treasuries, but investors would need to see a more rapid pace of employment gains to contemplate the scenario for rate increases.

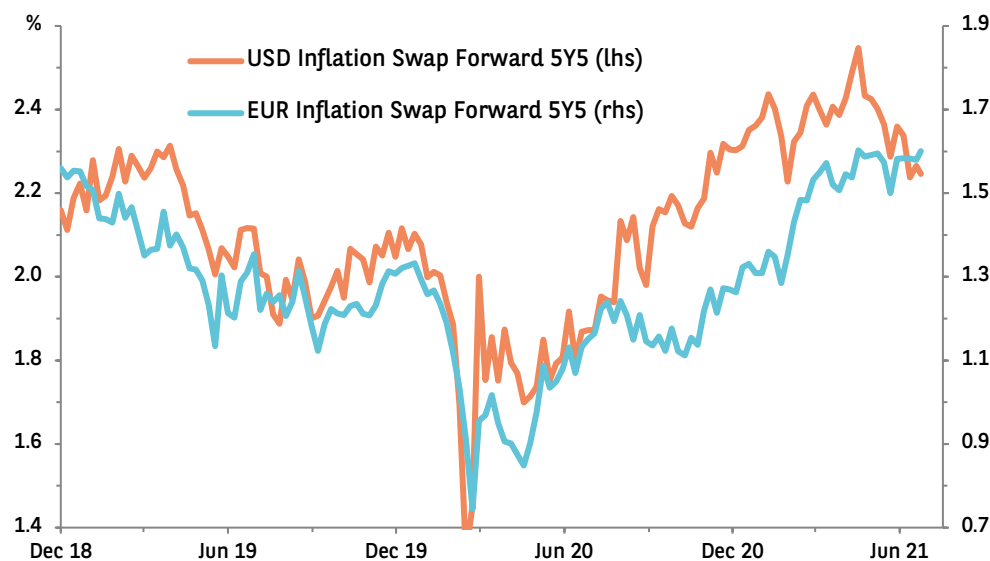
Looking at longer maturities, we believe the current retracement in 10-year US Treasury yields from May’s peak from 1.70% to 1.24% (at time of writing) mostly reflects the partial stop-out of crowded reflation trades, a relative lack of net supply at the global level, and growing concern over the Delta variant and the possibility of other variants against which current vaccines are ineffective. It is possible that the market has overshot, but positioning surveys suggest investors remain very short versus their benchmarks, and a further wave of stop-outs cannot be ruled out. Our revised target for the 10-year Treasury yield at the end of the third quarter is 1.50%, with 1.75% pencilled in for the end of 2021. The prospect of tapering in early 2022 provides for further upside later.

*“A more hawkish Fed reduces inflation and real yield term premia on longer maturities, and raises the odds of earlier (but more limited) rate hikes.”*

On the inflation front, we anticipate the US economy will generate a modest overshoot in core CPI and core personal consumption expenditures price index (PCE) inflation in 2022 and 2023, helped by rising shelter costs and upside pressures in services from wage gains. Longer maturity breakeven inflation should be contained by the Fed’s intolerance for sustained overshoots. We see the new fair value for 10-year BEIs as likely to be around 2.3% (revised down from 2.6%).

A more hawkish Fed reduces inflation and real yield term premia on longer maturities, and raises the odds of earlier (but more limited) rate hikes at shorter maturities. Nevertheless, we feel it is too early to position for a flattening yield curve, especially as QE tapering has to precede rate hikes.

**Exhibit 3: Inflation expectations**



Data as at 20 July 2021. Sources: Bloomberg, BNP Paribas Asset Management.

**Eurozone**

Hard data in the eurozone is still lagging sentiment surveys such as the Purchasing Manager Indices, but with an improving labour market and strengthening sentiment, the recovery in demand will likely pick up some momentum in the coming months, barring any major deterioration in the public health situation.

The extension of emergency expansionary government fiscal responses in the first quarter should help to soften the blow to businesses and employees harder hit by the renewed lockdowns. Spending from the Next Generation EU

(NGEU) fund should also support the economic recovery. Longer term, however, it remains uncertain whether policymakers will agree to provide sufficient support to the post-pandemic recovery. The EU Stability and Growth Pact is still suspended for 2022. But it is unclear what kind of agreement will be reached on the 2023 budgets, and a possible return to fiscal discipline has already started to weigh on the fiscal expansion plans of national governments.

The upcoming German and French elections cast uncertainty over the EU-wide fiscal policy stance. The setting-up of the NGEU fund was feasible because of strong political support and commitment from Germany and France. If top policymakers are replaced by politicians with a less favourable view on fiscal sharing, or by those with Eurosceptic ambitions, then the idea of the NGEU as a template for an EU-wide fiscal response to a future crisis, or the hope of reforming EU fiscal rules, would be challenged.

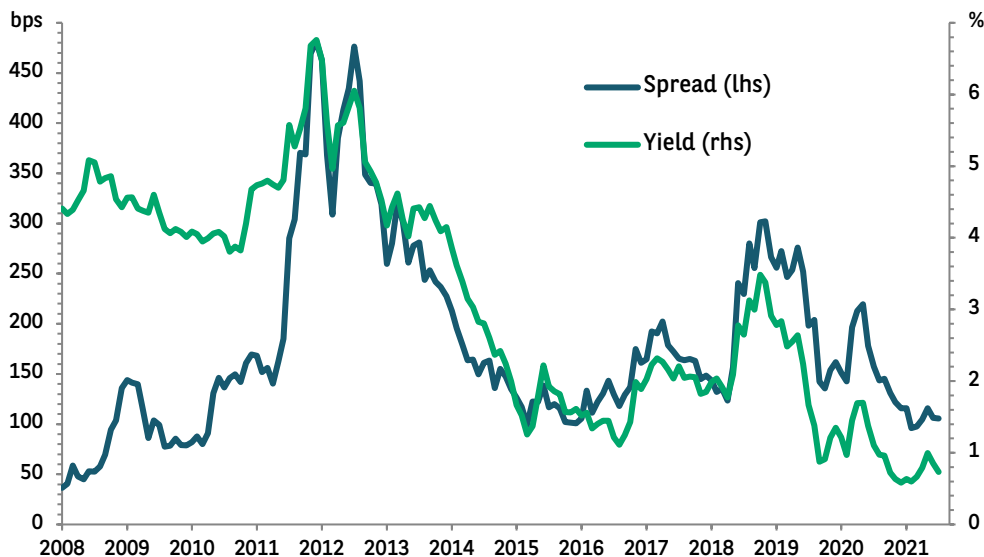
From a monetary policy perspective, the outcome of the ECB strategy review was disappointing. While there were important clarifications of the ECB's inflation goals, the changes are moderate, largely formalising what former ECB President Draghi had pushed for in the aftermath of the global financial crisis (GFC) and the European sovereign debt crisis. There is no intention to target an inflation overshoot, and a lack of urgency in addressing the problem of persistently subdued underlying inflation in the strategy review. The minutes of the June ECB meeting showed meaningful resistance from some members of the Governing Council against the decision to keep purchases under the pandemic emergency purchase programme (PEPP) at a higher pace. This suggests that we could see a slowdown in the pace of PEPP purchases in the coming months.

*“The outcome of the ECB strategy review was disappointing. There is no intention to target an inflation overshoot. A sense of urgency is lacking.”*

In terms of inflation, the pandemic has caused large swings and distortions in price levels within individual goods and services categories. The combined effects of the use of the imputation technique in cases of price collection difficulties and evolving seasonal sales patterns as businesses adjust to lockdown measures have introduced a lot of noise to the inflation prints. In addition, the technical changes in Harmonised Index of Consumer Prices (HICP) basket weights, while probably improving the representation of shifts in consumption patterns during the pandemic, have the side effects of amplifying other pandemic-related price volatility or distortions. The changes in weights interact with the seasonal pattern of price changes for certain items to create volatility in the year-on-year change in overall prices. As such, assessing the inflation trend over the next few quarters will be particularly challenging.

Eurozone inflation is expected to accelerate from late summer, and will likely breach the ECB's 2% target temporarily. In the near term, an increase in German VAT, supply shortages and bottlenecks, and positive impacts from the economic reopening should support inflation. In the longer term, we expect the cumulative drag from spare economic capacity and a downward shift in inflation expectations to continue to weigh on underlying inflation in the eurozone.

**Exhibit 4: Italian 10-year government bond spread versus Germany and yield**



Data as at 20 July 2021. Sources: Bloomberg, BNP Paribas Asset Management.

We expect a slower pace of PEPP purchases and improving economic activity to move bond yields higher. Technical considerations over the summer, however, with net negative issuance and thin trading liquidity, as well as growing concerns over the spread of the Delta variant in the EU, should keep yields low. Given the confluence of these opposing factors, we have turned neutral on eurozone duration.

We believe the diminishing risks of deflation and higher probability of better inflation outcomes have been fully reflected in BEI rates. A further rally in eurozone BEI rates

could prove difficult given the outlook for subdued underlying inflation, especially when the ECB is not looking to generate an inflation overshoot. We are also concerned about the longevity of the reflation theme. The June FOMC meeting was more hawkish than expected, and concerns over the emergence of new, vaccine-resistant variants remain.

While the Draghi-led unity government in Italy raised hopes for structural reforms and efficient use of the Recovery Fund, we realise that a lot of the good news has already been priced in. Looking ahead, the ECB will quite likely slow the pace of its PEPP purchases when vaccination progress and the public health situation allow the economy to reopen further, leading to reduced demand for

'peripheral' bonds from the central bank. And as Italian BTP–German Bund yield spreads have reached their lowest since the European sovereign debt crisis, a game-changing positive catalyst will be required to tighten BTP-Bund spreads meaningfully from current levels. In contrast, the upcoming elections in Germany and France pose a political risk to the pro-European agenda, and an eventual switch out of the ECB PEPP into the regular Asset Purchases Programme (APP) will also not be favourable for 'peripheral' bonds.

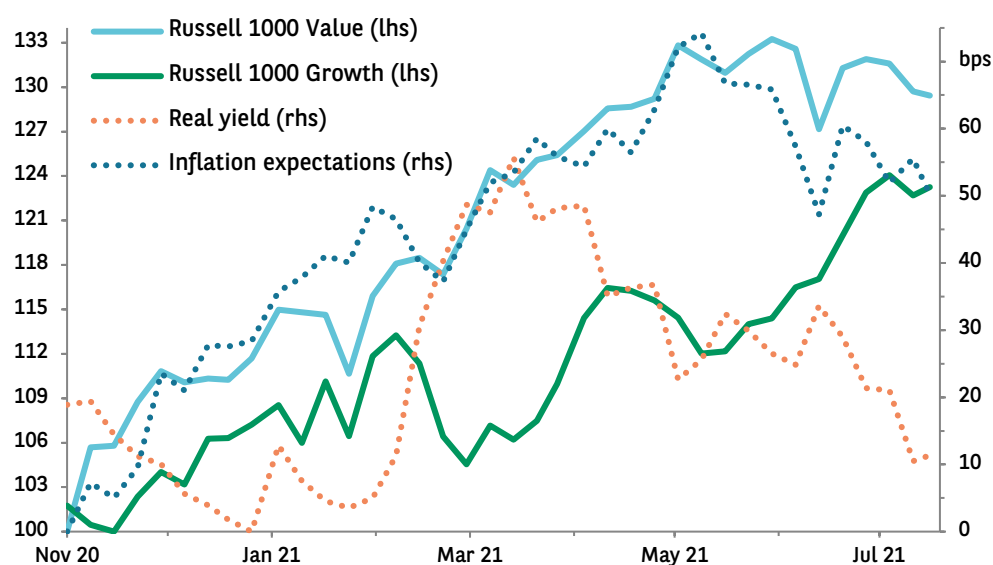
## EQUITIES

### Style and size

While interest rates are certainly important for the equity outlook, they are normally secondary to earnings. We are not in normal times, however, and at least in the near term, earnings are somewhat less fundamental now given how good the outlook is. Two years ago, average earnings per share (EPS) for the MSCI AC World index were forecast to rise by 6% over the following year, whereas now it is over 20%. Across the country indices, the average expected growth rate in 2019 was 8.6% vs. 25% forecast currently. The outlook for real rates and inflation, though, is far less certain. We expect equities broadly to rise given the solid earnings outlook, but there will be more variation in the returns between countries, sectors and styles depending on interest rate movements.

The reversal in the relative performance of US growth stocks versus value stocks in the second quarter has comparatively little to do with the performance of growth stocks and much more to do with value. The return for growth stocks from the announcement of the positive vaccine trial results last November through to the peak in value's relative outperformance in mid-May, and the returns since then, are similar. In both periods, the Russell 1000 Growth index gained around 9% and the sector contribution was broadly the same. By contrast, in the initial six-month period, the value index rose by 30%, but returns since mid-May have been slightly negative as economic growth and inflation expectations plateaued (see Exhibit 5). The surprisingly hawkish June FOMC meeting dampened inflation expectations even further. Value stocks have needed a reflationary outlook to advance while growth stocks have been more resilient in the face of changes in (real) interest rates and economic growth expectations.

**Exhibit 4: Russell Growth and Value indices and change in 10-year rates**



Data as at 13 July 2021. Note: Interest rate change is from low over period. Sources: Bloomberg, BNP Paribas Asset Management.

estimates have gained more than 50% for the value index since June 2020 vs. 38% for growth (see Exhibit 6). One perverse benefit of the delayed reopening due to the spread of coronavirus variants is that the expected recovery in earnings will play out over a longer period of time, meaning expectations for value stock earnings should continue to rise for longer.

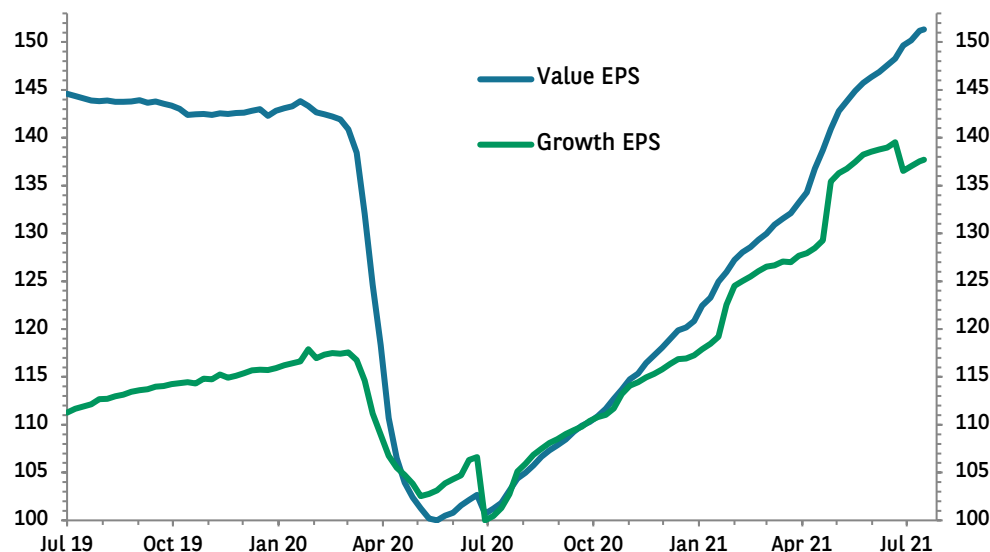
Besides earnings, valuations also favour value stocks. Relative price-earnings ratios (P/Es) are still very elevated for growth versus value with the z-score of the forward P/E of the Russell 1000 Growth vs. the Russell 1000 Value index at 2.1, the highest level since 2000. This is not to suggest that value stocks are inexpensive, just that they are comparatively less so than growth. The high valuations within growth do not just concern technology stocks, either. P/Es are well above average for the largest sectors making up the growth index (consumer discretionary, industrials, healthcare), while they are less elevated for the main components of value (financials, industrials).

We expect nominal US bond yields to rise through to the end of the year given the strength of US economic growth, but we see most of the gain coming from real yields (which are historically low), with a smaller contribution from inflation expectations (which will be held in check by a Fed poised to tighten policy). This environment is less supportive of an appreciation of value stocks, but there are other factors which should lead to value outperformance, while the rise in real rates will likely weigh on growth stock returns.

Even though earnings expectations have been rising for growth stocks, they have advanced even more for value since the low in expectations last summer. Forward EPS



**Exhibit 6: Forward EPS estimates for Russell 1000 Growth and Value indices**



Data as at 20 July 2021. Sources: Bloomberg, BNP Paribas Asset Management.

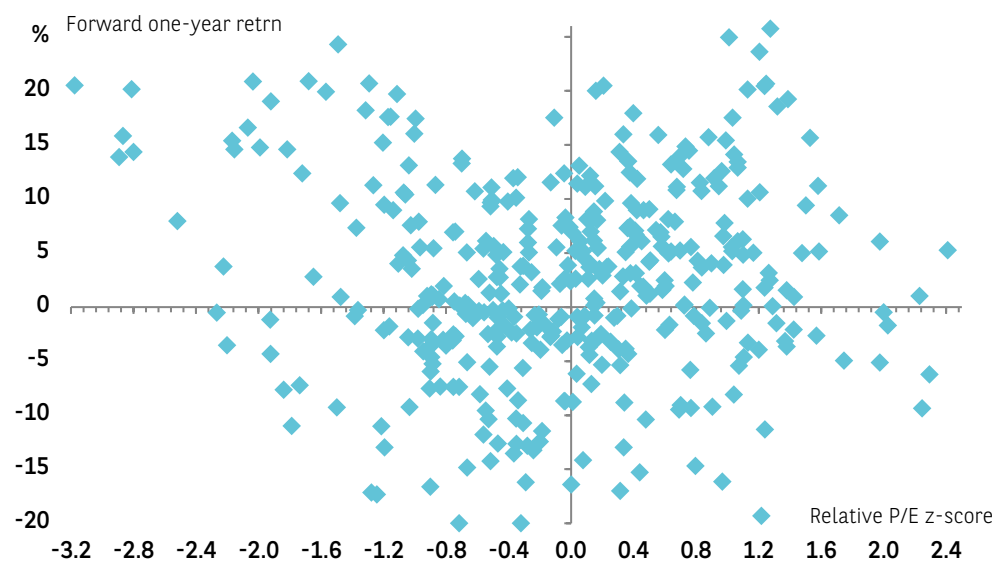
Restrained inflation expectations could also limit the outperformance of US small cap stocks versus large caps. Economic momentum, as shown, for example, by ISM new orders, is likely to roll over as US growth peaks, which would point to US small cap underperformance. The strong returns of mega-tech stocks in the large cap US indices have historically also been a high hurdle for small cap stocks to overcome. European small caps, by contrast, may still see more upside given that the cyclical momentum should be sustained for longer in Europe as the region reopens later and at a slower pace than the US.

**Geographic allocations**

We would anticipate US equities modestly outperforming European equities through the rest of the year, though there are factors which favour each market. Aiding the US is a much stronger economic growth outlook thanks to a greater willingness to remove lockdown restrictions and better progress on vaccinations, and the ongoing benefits of fiscal stimulus. The impact of the Biden administration’s proposed infrastructure packages is difficult to assess because it is still unclear in what form they will be passed (if at all) and to what degree the funding will come from corporate and personal tax increases as opposed to further deficit spending.

Weighing on the US is a comparatively more hawkish central bank. While the Fed’s inflation framework is more expansive than that of the ECB, the Fed is still likely to taper its asset purchases and raise rates well ahead of the ECB. Additionally, US equities remain expensive compared to those in Europe, but this ratio has historically been a poor predictor of subsequent performance thanks to superior earnings growth in the US (see Exhibit 7).

**Exhibit 7: US vs. Europe: Relative forward P/E z-score and forward one-year return**



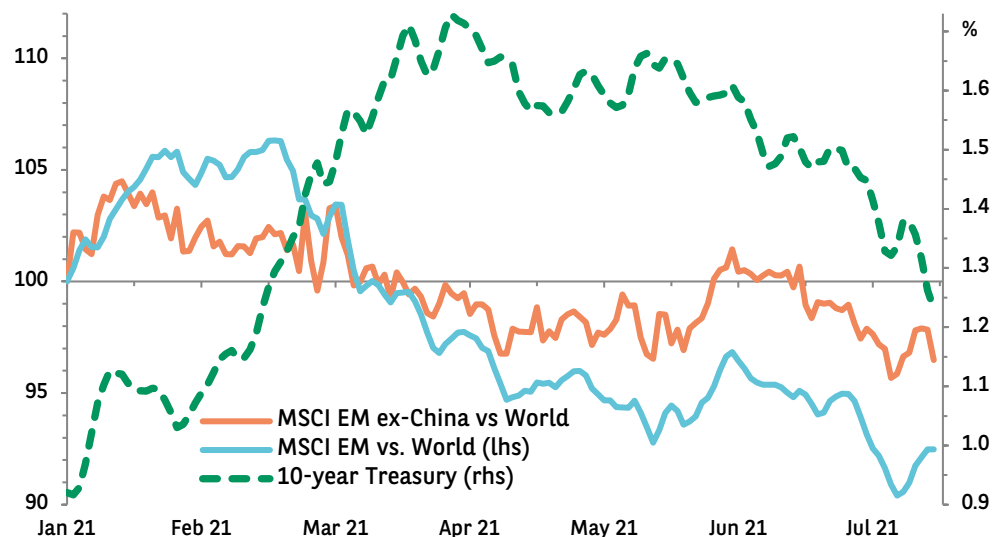
Data as at 14 July 2021. Note: Data since 1988. Sources: IBES, BNP Paribas Asset Management.

As in the US, the UK benefits from a high vaccination rate, although the country has been far slower to reopen its economy. Continental Europe has the Next Generation EU funds to look forward to. The recovery in European earnings has lagged that in the US, although much of this is due (as things often are) to the dominance of the US tech sector. Forward EPS estimates for the US market are 16% above pre-pandemic levels as at February 2020, but tech EPS is 48% higher, while for the rest of the market it is just 3%. For European equities, EPS is 1% higher, so there is further to go for Europe to catch up.

Along with the recovery in the value style, we would anticipate more cyclically oriented countries (such as Japan) and regions to continue to outperform. Emerging market equities are generally more cyclical than developed market equities, and had historically also been more value oriented when financial and commodity sectors had a high share in the indices. With the increasing weight of China in the emerging market equities index, however, the growth style has become more influential.

At the beginning of the year, the cyclical factor dominated the growth factor and emerging markets outperformed. But as US yields began rising more sharply, emerging market equity returns began to lag. Once yields began to moderate, returns **excluding China** were broadly flat, but the underperformance of China weighed on the broad EM index (see Exhibit 8). As Beijing has increased its scrutiny of the country’s technology companies, China’s underperformance has worsened. Rising corporate defaults and bank failures have also weighed on the financials sector.

**Exhibit 8: Relative performance EM and DM indices and US Treasury yields**



Data as at 20 July 2021. Sources: FactSet, BNP Paribas Asset Management.

Regulatory risk is always difficult to quantify, but particularly so in China. We nonetheless anticipate that the technology sector will recover given its strategic importance for Beijing, and the medium-term growth prospects remain very good. Monetary policy is becoming looser and, with a lag, should boost activity. Moreover, the country’s borders are still closed. As these re-open and as vaccination rates rise further, a fuller re-opening should allow corporate earnings growth to accelerate, not only in China but broadly across emerging markets.



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