For professional investors - Marketing Communication - July 2023

ASSET ALLOCATION MONTHLY — JULY 2023

Frontrunning the beginning of the end

- As US 10-year Treasury yields have soared through 4%, with a nearly 40bp move higher in the eight trading days to 7 July, we begin to build long nominal US government bond positions, in addition to existing long-dated Treasury inflation-protected securities (TIPS).
- With significant (and opposite) moves in fixed income risk premia (higher) and equities (lower), our measure of fixed income premia is above that of equities for the first time since 2008. The cross-asset valuation support looks firm.
- We also stay long Euro investment grade (IG) credit as a ‘quality carry’ play.
- By contrast, equities look vulnerable. Cracks are starting to appear in higher frequency labour market data; leading economic data like Senior Loan Officer (SLO) and business surveys point to weakness in the pipeline in both the US and Europe. Neither forward valuations nor, beneath that, earnings expectations, are consistent with weaker growth (and lower inflation).
- Notably, investment will likely fall further in both the US and Europe. In the former, current levels are already consistent with meaningfully higher unemployment.
- Overall, we see the current market and macroeconomic constellation as warranting caution – yet equity valuations are fuller than in January, earnings estimates are still broadly optimistic, and our equity market temperature framework is flashing red. Areas where we are cautiously positioned (Europe and the US) stand out here, with emerging markets, our key long, notably attractive.

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BNP PARIBAS ASSET MANAGEMENT

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Rates – An opportunity to add

As US 10-year Treasury yields have soared through 4% in a few short trading days, we have begun to build long US government bond positions in active multi-asset portfolios, in addition to our exposure to long-dated US TIPS (our largest risk position). Bonds have sold off on firmer (but lagging) data in housing and labour markets, and fears of a more hawkish US Federal Reserve (Fed) reaction function underscored by recent Federal Open Market Committee (FOMC) minutes. A more hawkish Fed could see yields move to 4.25% or higher, levels at which we would be looking to add, all things being equal.

With renewed overheating firmly off the table, and data starting to roll over, we would place even odds on a recession or a recession with inflation ('stagflation') as the most likely macroeconomic outcomes over the next 6-12 months. As data weakens, nominal 10-year yields could go to 3% or lower depending on the severity of the growth correction. At 4%, the diversification benefit from US government bonds is also not to be scoffed at: investors last captured 4%+ yields in the period preceding the Great Financial Crisis.

On corporate bonds, meanwhile, we have seen a striking and indiscriminate tightening of credit spreads. While this could indicate that investors see the current macroeconomic environment as positive for carry trades, we are more selective. We continue to see European investment-grade credit (our view: favour) as the most attractive: it offers investors generous compensation for overly pessimistic expected default rates, but with strong, quality balance sheets. At current spreads European IG spreads compensate investors by more than average for the next highest credit rating. For example, AAA spreads offer a nice spread 'buffer' for AA credit risk. This is not the case with US IG.

Our most significant risk is currently the overweight in US TIPS, while our least risky position is in euro investment-grade credit (see asset class views table on page 5).

Our chief judgements at mid-year 2023

Judgement	Detail	Active positioning
More cautious on US growth and earnings	• Recessionary US data (labour market, consumer spending) • Companies are retrenching on capital spending • Taking a more hawkish view on central bank policy • Risk of (continued) US bank deposit flight • We see recession/stagflation as the central outcome	• Cautious on US (and EU) stocks as well as equities generally • Taking a neutral view on duration
Stickier inflation	• In Europe, second-round effects (wages) are 'baking in'; fiscal policy is easy and monetary tightening is lagging US policy • A margin squeeze is on course • Taking a more hawkish view on ECB and Fed policy	• Short Bunds vs. long Gilts • Short European equity versus Asia • Long US duration in TIPS
Regional divergence	• Growth in Asia strengthening • Real rates are high in many emerging markets, valuations and earnings expectations depressed • Scope for discount rates to fall and growth/earnings to rise	• Long EM vs. Europe • Modest short US equity
Valuation dislocation	• Commodities price in 70% odds of recession, but European (and US) earnings are expected to rise over the next 18 months • Chinese and emerging equities look cheap • European IG remains attractively valued	• Long commodities, Euro IG credit • Long European banks vs. broader Europe

Exploiting the gap between 10-year UK Gilts and 10-year Bunds

Amid sticky inflation, European bond yields reached our 2.5% target, and we have taken modest profits on our tactical short positions in multi-asset portfolios that were established when yields on German government bonds (Bunds) were trading at 2.21%.

This has been replaced by a duration-neutral long in 10-year UK Gilts versus a short in 10-year Bunds, seeking to exploit the pricing asymmetry.

Gilt spreads are close to the highs of last September's 'LDI crisis', when hedging needs and margin calls triggered a vicious circle of bond selling that forced the Bank of England to step in as the buyer of last resort and restore stability. Concerns over the ability of the UK government of the time to ensure debt sustainability 'broke' the Gilt market. Today, we believe a lot of concerns around UK politics and the BoE are baked into prices. European bonds, by contrast, are judged to reflect the 'best case'. This position also offers modest positive carry.

Recently, the ECB upgraded its inflation forecasts to levels that are still above its medium-term target of 2% throughout the forecast horizon. Unit labour costs appear to be driving these changes, suggesting some stickiness in this forecast. Our macro team sees the ECB raising rates once more in July – to 3.75% – and then cutting rates from the first quarter of 2024.

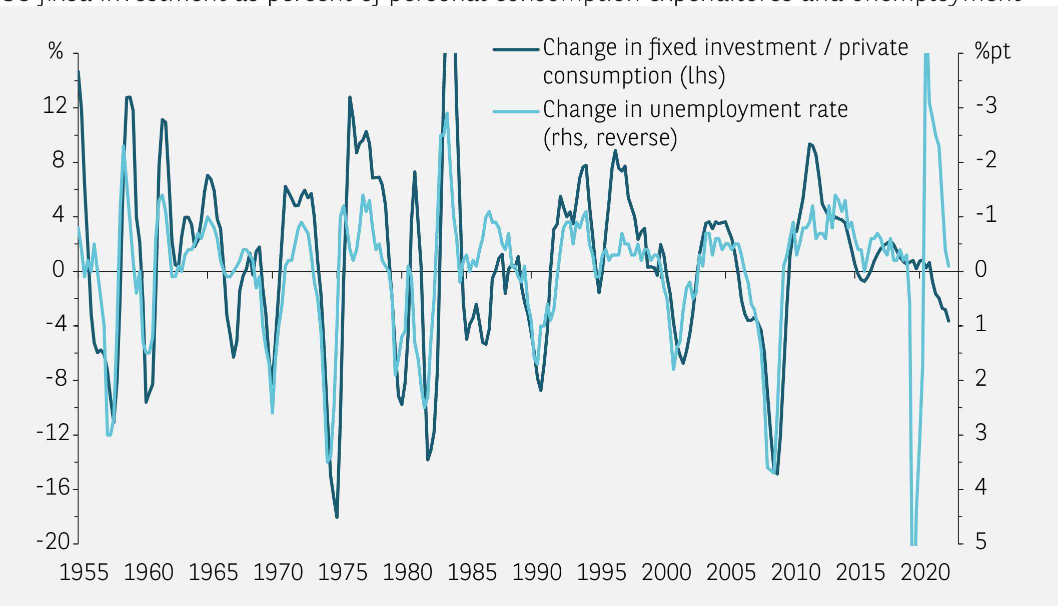
Risk appetite

A broad appetite for risk would seem to us to be at odds with the cracks that are starting to appear in recent macroeconomic data such as US weekly jobless benefit claims (rising) and the SLO and business surveys (indicating weakness in the pipeline in both the US and Europe). US investment levels are already consistent with higher unemployment (see Exhibit 1).

Exhibit 1

Focus on investment, not consumption

US fixed investment as percent of personal consumption expenditures and unemployment



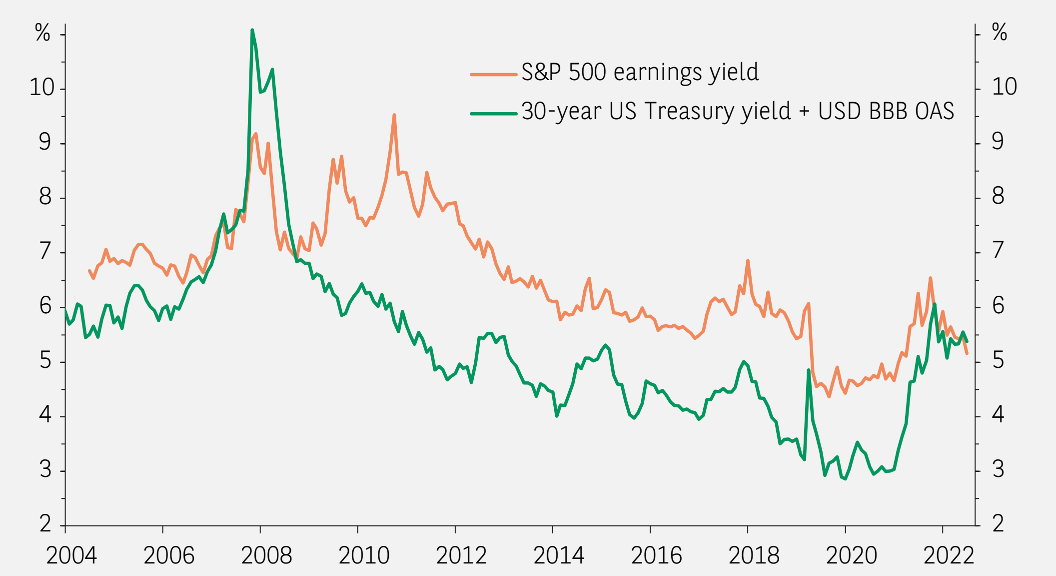
Data as at 11 July 2023. Sources: ASR, FactSet, BNP Paribas Asset Management.

In our view, investor risk appetite is now close to extreme risk-seeking territory. Risk premia for fixed income and equities have moved in opposite directions, leaving fixed income premia above those for equities. Notably, this has occurred for the first time since 2008 (see Exhibit 2). .

Exhibit 2

Fixed income risk premia exceed those for equities

Equity earnings yield (next-twelve-month) vs bond proxy



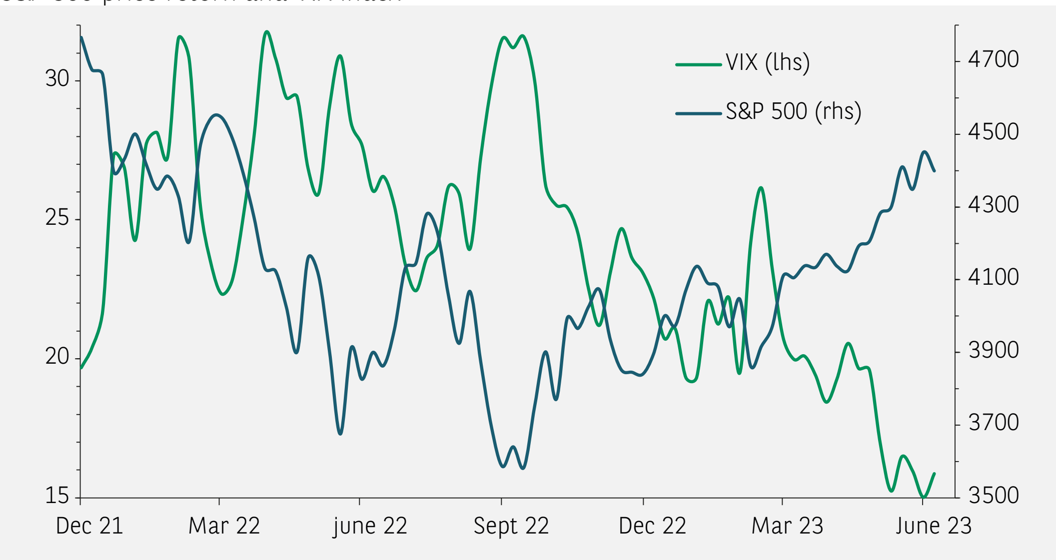
Data as at 7 July 2023. Sources: Bloomberg, BNP Paribas Asset Management.

Broadly speaking, we believe equity price-earnings valuations are full, 2024 earnings estimates are (overly) optimistic, and our equity market temperature gauge is flashing red. Areas where we are cautiously positioned – Europe and the US – stand out here. We are struck by the gap between weakening US manufacturing sector survey data – which can be seen as a proxy for the wider economy – and recent equity market trends (see Exhibit 3).

Exhibit 3

Equities have rallied while volatility has fallen

S&P 500 price return and VIX index



Data as at 7 July 2023. Sources: FactSet, BNP Paribas Asset Management.

We nonetheless anticipate continued outperformance of European banks relative to the broader European market. This view is based on good expected earnings (after one of the best quarterly results ever), strong net interest margins (which will be supportive for a few years), and rising returns on equity. Profitability, in fact, is at decade highs. Operational and regulatory trends are positive, and loan loss provisions have already been taken. We also see banks as a semi-utility that offer better prospective returns in a higher inflation world; 34% of the market cap is expected to be returned this year in dividends and buybacks. Valuations are cheap across a range of metrics (forward price-earnings ratio, dividend yield), at, if not through, multi-decade lows.

Asian equities – Taiwan, South Korea and Japan

The flatlining of Asian equity performance – our preferred long against a short in Europe – masks a wide dispersion, with stock markets in Taiwan and South Korea doing much better than China. Similar, but less, dispersion can be seen in the evolution of analyst estimates for calendar-year earnings per share: Only South Korean EPS has shown a notable upturn.

Macroeconomic data in South Korea has improved, but large index components (Samsung and Hynix) have only partly re-rated. Taiwan, by contrast, has benefited from the media and market hubbub around artificial intelligence of recent months. Relative to the global tech sector and to the global semiconductor sector, the market is trading at a discount to its historical valuation. Finally on Japan, where we have stayed neutral so far, data on real activity and inflation is improving and indicators on the important factory automation sector look to be troughing. Fund flows are returning, but remain well short of the levels of nearly a decade ago. Corporate reform and a focus on profitability are coming back into the fold, and the market is an interesting opportunity at the right price.

Cross-asset barometers such as the performance of Asian high-yield debt relative to that of US HY credit suggest to us that the performance of the broader MSCI EM equity index relative to that of the developed market index has lagged the narrowing in credit risk triggered by the reopening in China.

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	Japan EM local Australia	US 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			EUR, USD, AUD, GBP, JPY, EM currencies		

Views as at July 2023

July 2023 - Design: Creative Services BNPP AM - P2307028

VIEWPOINT

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