EQUITY OUTLOOK
4Q 2024

IT'S THE ECONOMY

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- The start of the cutting cycle by the US Federal Reserve (Fed) has raised hopes for a soft landing. While lower rates are helpful for equities in the short term, developments from here will depend much more on the evolution of economic growth. If our expectations for a soft landing prove to be warranted, equities will likely continue to rise.

- With the outcome of the US election (both for the presidency as well as for Congress) uncertain, political risk may be subdued until the actual results are known. Regardless of the victor, the US economy should continue to expand, but with a different mix of winners and losers in equities depending on the configuration of government.

- China's recent surprise stimulus package ought to lead to a continued tactical rebound in the market, but whether the medium-term outlook has fundamentally improved remains to be seen.

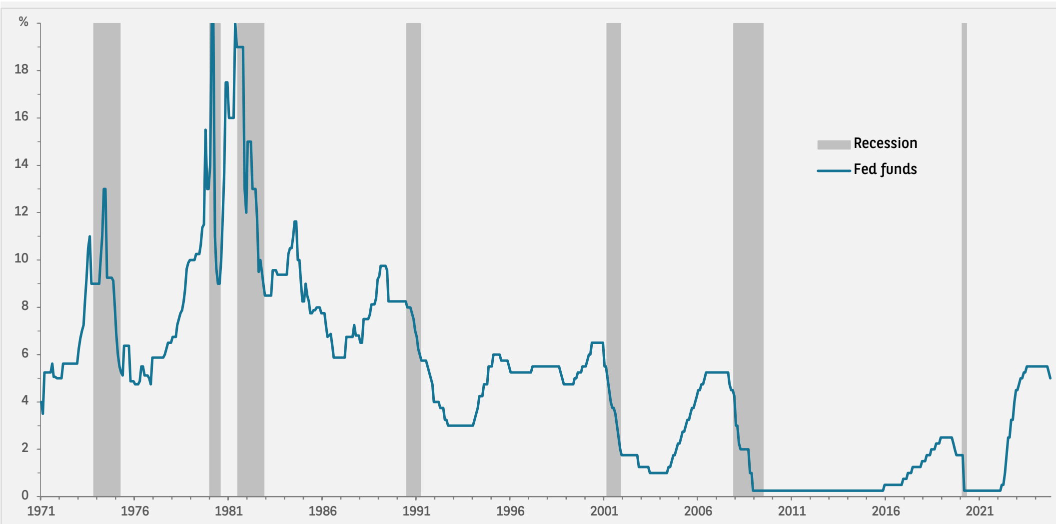
The start of the cutting cycle by the US Federal Reserve (Fed) has boosted equities and raised hopes for a soft landing, especially as the 50 basis point (bp) cut was larger than expected. Such hopes to some degree fly in the face of history: In the last five cutting cycles, a recession occurred in four (see Exhibit 1). The exception was the cycle that began in 1984, when GDP growth merely slowed to its trend rate. We believe the US economy will again see a soft landing this time.

Following the Fed's cut, there has been much analysis of how different asset classes perform in cutting cycles. Simply taking the average returns of the previous five episodes, however, misses significant variation and ignores the crucial factor of the impact of economic growth on asset prices.

Exhibit 1

Most Fed cutting cycles were followed by a recession

Fed funds rate and US recessions



Data as at 30 September 2024. Sources: FactSet, BNP Paribas Asset Management.

What is critical is not just the fact that there was a recession in four out of the five previous cycles, but the timing. Asset returns in the 12 months following the first cut depended much more on whether the recession occurred sooner or later (if at all).

In other words, while all five episodes had falling policy rates in common, it is economic growth which primarily explains the differences in returns. One's forecast of the outlook for GDP is thus more important than accurately predicting the number and timing of Fed cuts.

At a high level, an environment where interest rates are falling and economic growth is slowing or even negative should clearly be better for fixed income relative to equities, and defensive stocks versus cyclicals. Taking the average returns of the five episodes, this is what occurred (detailed returns can be found in the appendix).

The US tended to outperform the rest of the world, growth beat value, large caps outperformed small ones, and the top performing sectors were consumer staples, healthcare and materials (see Exhibit 2).

Exhibit 2

Relative asset class returns during Fed cutting cycles

Which asset class outperformed in the 12 months after the first cut in fed funds

	Beginning of cutting cycle					
Asset class	**1984**	**1989**	**2001**	**2007**	**2019**	**Average**
Months till recession		**13**	**2**	**3**	**6**	
Equities vs bonds	Bonds	Equities	Bonds	Bonds	Equities	**Bonds**
US vs ROW	ROW	US	US	US	US	**US**
Growth vs value	Value	Growth	Value	Growth	Growth	**Growth**
Large vs small	Large	Large	Small	Small	Large	**Large**
Defensive vs cyclical	Defensive	Defensive	Cyclical	Defensive	Defensive	**Defensive**
Top 3 sectors	Finan-cials	Telecom	REITs	Staples	Techno-logy	**Staples**
	Utilities	Energy	Materials	Energy	Health Care	**Health Care**
	Health Care	Staples	Discretio-nary*	Materials	Media & Ent	**Materials**

Data as 30 September 2024. Sources: FactSet, BNP Paribas Asset Management. *Excludes Amazon.

But the relative returns between the two 'near-term recession' (NTR) cycles (2001 and 2007), and the 'late or no recession' (LNR) cycles (1984, 1989, 2019) were often quite different. In the LNR cycles, equities often bested bonds. The exception in 1984 may have had more to do with the starting point for Treasury yields at 14%, which subsequently dropped by almost 700bp. We believe we will see a rather smaller reduction this time (and perhaps even a rise in yields).

Growth outperformed value in two out of the three LNR cycles, while the NTR cycles were split. Perhaps surprisingly, small cap stocks did best during the NTR cycles, though this more reflects the massive underperformance of technology stocks in 2001 and financial stocks in 2008 than superior performance of small cap shares. Cyclicals outperformed defensives just once, in 2001 (when utilties fell significantly). Sector returns were quite varied, with no single sector in the top three more than twice.

US OUTLOOK

With a gradually slowing US economy and any near-term recession risks quite low, in our view, the environment is positive for US equity outperformance. The latest Atlanta Fed GDPNow forecast for the third quarter is 2.5% (SAAR), compared to 3% growth in the second quarter. Lower oil prices versus 2023 should provide a further boost to growth, reducing some of the previous drag on lower-end consumers from high inflation, and reducing input costs for companies. Developments in the Middle East, though, could quickly reverse the trajectory.

If third quarter GDP is boosted by a build-up in inventories (as it was in the second quarter), it would suggest that consumer demand is weakening. The most recent retail sales data suggested as much. A slowdown is not in and of itself a worry, however; growth has to moderate if the economy is to reach the Fed's 2% GDP growth forecast and its 2% personal consumption expenditures (PCE) inflation target. The worries will likely only arise if it appears that the deceleration is going further, either to a sub 2%, or in the worst case, a negative rate.

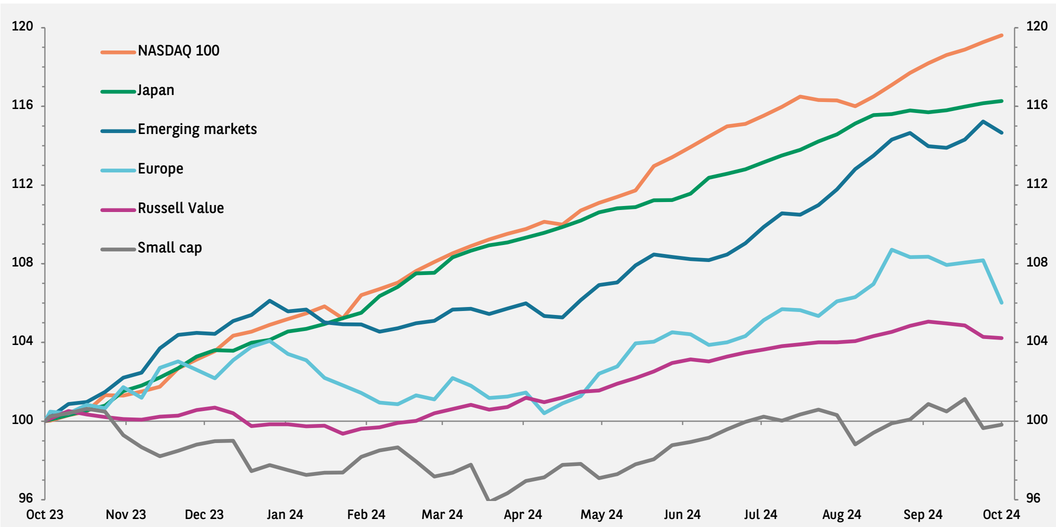
Our multi-asset team is modestly overweight US equities via NASDAQ.

Our multi-asset team is modestly overweight US equities via NASDAQ. This view is supported by steadily rising earnings expectations (see Exhibit 3). This rising pattern is notable, particularly for Japan and NASDAQ, given the volatility we saw in the markets over the summer. The sell-off was partly premised on a US recession and worries about the reasonableness of earnings forecasts for tech stocks. The latest US non-farm payrolls data has calmed recession concerns. The upward trend in earnings estimates reinforces the view that the summer volatility was primarily driven by technical factors such as the sudden unwinding of yen carry trades.

Exhibit 3

Earnings expectations mostly trending upward despite summer turmoil

Next-twelve-month earnings estimate; local currency terms



Data as at 4 October 2024. Sources: FactSet, BNP Paribas Asset Management.

Earnings are forecast to rise by around 3% year-on-year for the S&P 500 in the third quarter, but that figure masks a significant difference between the earnings for growth and value indices. The NASDAQ 100 index should see profit gains of just over 11%, while for the Russell Value index earnings are expected to decline by 2%. The weakness in the value index reflects strong gains for healthcare stocks offset by losses for energy companies.

The upcoming US election is clearly the wild card in these forecasts. With polls showing the race as extremely close, the election in the near term is unlikely to be a major factor for the markets. Markets are simply unable to price in either 'Trump trades' or 'Harris trades'. Only once the results are known – in particular the configuration of Congress – will markets be able to assess the likely policy impacts on the economy and on different sectors. If tariffs turn out to be one of the outcomes, some sectors could take a hit.

Aside from election uncertainty, geopolitics is an ever present concern and the world appears unlikely to become safer anytime soon.

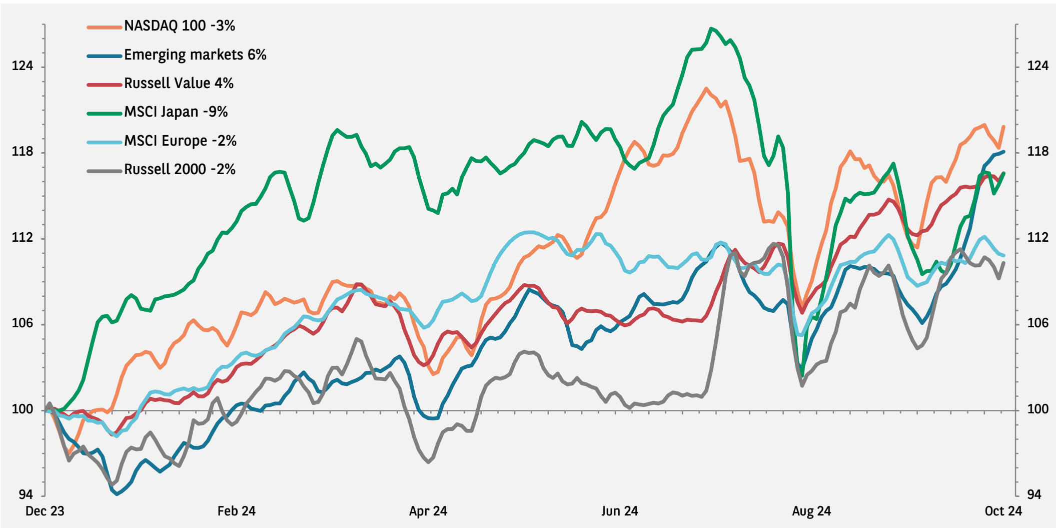
EUROPE

Along with most major indices, the MSCI Europe index has made up all the losses from the summer sell-off, though it had never declined as much in the first place (see Exhibit 4). Over the course of the year, Europe has lagged most of major regional indices as continental European growth has disappointed while it has surprised positively in the US and Japan has benefited from a weaker yen.

Exhibit 4

Most market have almost fully recovered from the summer selloff

Total return in local currency; figures in legend show level relative to summer peak



Data as at 4 October 2024. Sources: FactSet, BNP Paribas Asset Management.

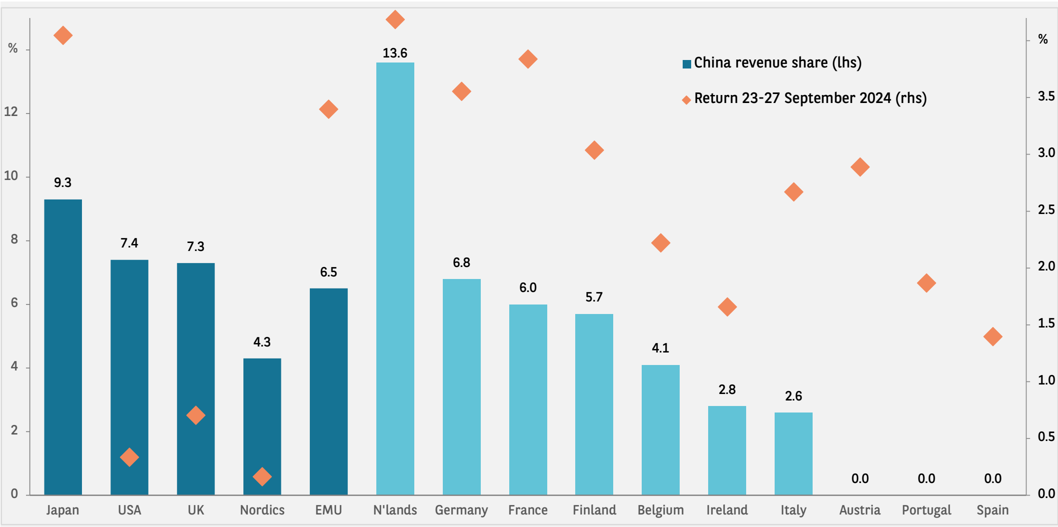
The market has received a boost recently following Beijing's unexpected announcement of a large stimulus package (see China section following). Many investors believe that continental Europe is more exposed to China than the US is, and the initial returns following the announcement on 23 September reflect that assumption: The MSCI EMU index gained 3.4% vs. 0.3% for the S&P 500.

Reality is not entirely aligned with these returns, however. US companies sell more in fact to China as a percent of their sales than Europe does. Sales to China account for 7.4% of large cap US corporate revenues compared to 6.5% for the MSCI EMU index. The UK share is also higher at 7.3%, as is the share for the Netherlands (13.6%). But even for other countries with a relatively large exposure (France, 6.8% and Germany, 6%), it is less than that for the US. The major market with the biggest exposure is Japan at 9.3%, and the returns over the last week for the MSCI Japan index have been commensurately greater at 4%.

Exhibit 5

Europe's exposure to China is not the largest

China's share of last 12 months' revenues and index return 23-27 September 2024



Data as at 2 October 2024. Sources: FactSet, BNP Paribas Asset Management.

While any marginal increase in sales to China resulting from the stimulus package should benefit European corporates, earnings will depend much more on sales within Europe and to the US, which represents over 24% of revenues.

While demand from the US should remain robust, the outlook within Europe remains challenging. Consumer sentiment is improving but is still depressed, economic data has disappointed, and the ECB has less scope to stimulate growth as policy rates are lower than in the US. Consensus earnings estimates reflect this. In 2025, profits are expected to rise by just 9.3%, compared to double digit gains elsewhere (based on FactSet estimates).

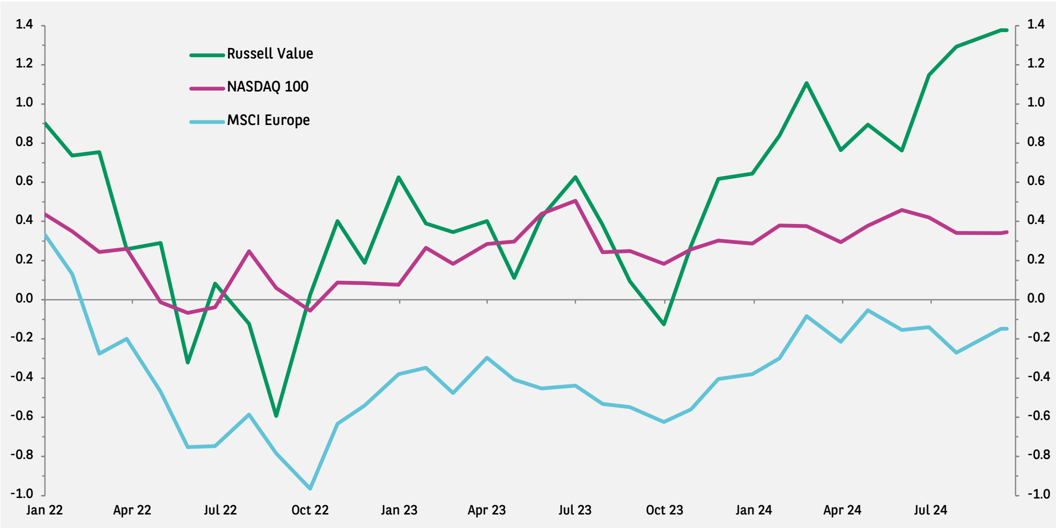
The primary advantage of European equities is valuations, but that has been the case for the last two years.

The primary appeal of the market is valuations, but that has been the case for the last two years. The z-score for the MSCI Europe index has been negative since March 2022 while it has been positive for the NASDAQ in the US (and rising sharply for the Russell Value index; see Exhibit 5), yet these indices have outperformed. Europe needs a catalyst to unlock the valuation potential, and right now it is difficult to see what that catalyst might be.

Exhibit 6

European equity valuations have been low for two years

z-score for next-twelve-month price-earnings ratio (calculated from 1987)



Data as at 4 October 2024. Sources: FactSet, BNP Paribas Asset Management.

CHINA

The recent announcements from the Chinese government of renewed stimulus for the economy have been warmly received by the markets. Not only has the MSCI China index gained 17% since 23 September, but some markets linked to China, such as Japan and the MSCI EMU index, have also outperformed global benchmarks. Judging by previous rallies following big policy announcements, the period of Chinese equity outperformance could last many months (Exhibit 6).

Part of the outperformance reflects previously poor foreign investor sentiment, underweight positions in many institutional portfolios and short positions for hedge funds.

The stimulus package conveyed the message to investors that the government is paying attention to weak growth.

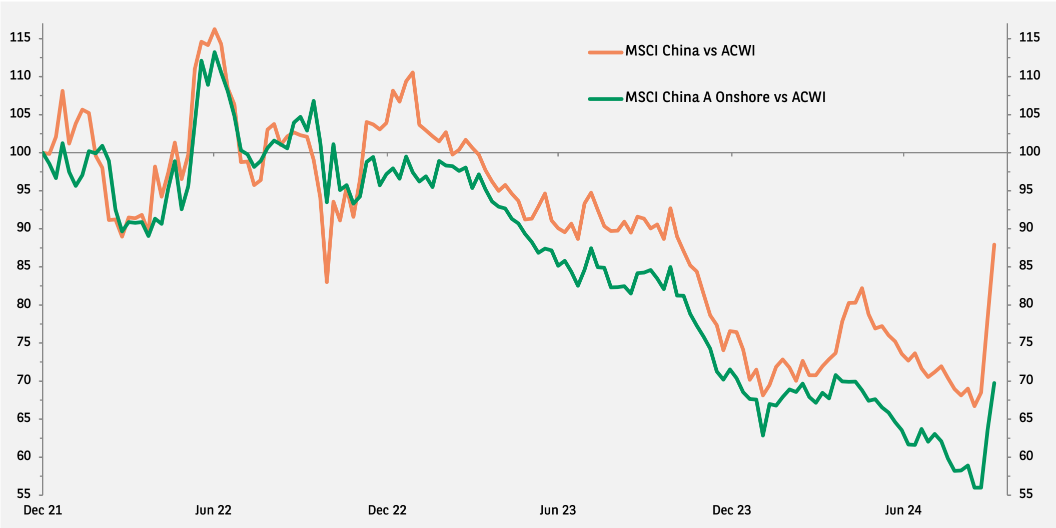
The announcement conveyed to investors that the government is indeed paying attention to weak growth in the country. After a long period of relatively minor stimulus, the belief was taking hold that the government had decided to prioritise national security over the economy.

In contrast to previous efforts, this move includes a greater fiscal component, including cash handouts to stimulate consumption, and liquidity support for the stock market. There were also further efforts to support the property market, which is recognised as the main fundamental near-term problem facing the country. Thanks to these measures, China's leaders now at least have a chance of reaching their 5% GDP growth target for the year.

Exhibit 7

Another rebound for Chinese equities but will it last?

Relative performance in local currency terms



Data as at 4 October 2024. Sources: FactSet, BNP Paribas Asset Management.

But what about in the longer term? The government's other growth target is to double per capita income by 2035, which requires 5% annual growth every year over the next 10 years. We question whether this objective will be reached.

As pointed out by our Asia strategist, some of the government's policies are **contradictory**. At the same time the government is aiming to boost growth, it also wants to re-industrialise as a high-tech economy. This means a retreat from old economy industries and less reliance on infrastructure and property investment. These policies are slowing growth.

Another factor is that it is not certain the areas chosen by the government as part of 'new quality productive forces' can generate GDP growth in the way infrastructure and property did in the past. Analysis by Goldman Sachs Global Investment Research suggests that the share of GDP represented by new energy vehicles, wind/solar and battery (known as the 'new three'), is only a fraction of property's share.

Massive investment in the new three is only likely to generative overcapacity. China's attempts to export its excess production in these and other sectors has driven net exports and hence GDP growth over the last few quarters, but given rising protectionist sentiment globally, this strategy is unlikely to be sustainable.

Instead of net exports or investments driving growth, China could focus on consumer demand, developing an economy more like that of the US or Europe. This would require improving the welfare state and the healthcare system so that households feel less need to accumulate a lot of savings to help them through times of trouble. There have been few measures taken over the years, however, to promote this evolution.

Even the recent cash handouts for those in extreme poverty are likely to have little impact on consumption, not just because they are directed towards a small share of the population (fewer than five million people are classified as living in extreme poverty in China). Given the high share of household wealth represented by property, people are understandably concerned by the decline in real estate prices. Until they are convinced the market has turned the corner, they are unlikely to have the confidence to increase their spending. None of the latest measures announced by the government suggests that turnaround is imminent.

Appendix

Asset class returns during Fed cutting cycles

Twelve months following first cut, 1984 to present, total return in USD

		All periods†	Fed cutting cycles					
			1984-86	1989-1992	2001-2003	2007-2008	2019-2020	**Average**
Months till recession				13	2	3	6	
EQUITIES	S&P 500	12.7%	18.2%	16.6%	-11.9%	-11.1%	11.9%	**4.8%**
	World ex-US	10.7	26.5	2.8	-21.2	-12.6	-1.3	**-1.1**
	Emerging markets	11.3	58.6	26.0	-2.4	-9.8	6.9	**15.9**
	Russell 2000	13.3	15.7	0.4	2.5	-5.5	-4.6	**1.7**
	Growth	12.5	15.0	20.3	-20.4	-6.8	29.8	**7.6**
	Value	14.1	24.0	8.8	-5.6	-14.7	-6.0	**1.3**
	Quality growth	14.3	19.6	22.1	-9.4	-5.8	18.5	**9.0**
	Cyclical	10.4	16.1	5.4	-6.4	-13.3	7.4	**1.8**
	Defensive	8.7	17.1	23.4	-14.3	-2.3	-0.8	**4.6**
	Energy	11.0	9.2	26.9	-10.4	5.2	-38.3	**-1.5**
	Materials	8.9	10.1	6.2	3.5	2.1	6.3	**5.6**
	Industrials	10.6	20.3	18.6	-5.7	-10.4	-5.7	**3.4**
	Discretionary*	10.6	17.2	13.5	-2.6	-18.1	11.3	**4.3**
	Staples	8.7	19.5	25.5	-6.4	6.6	8.1	**10.7**
	Health Care	12.3	21.6	25.1	-11.9	-3.5	18.8	**10.0**
	Financials	9.0	26.4	1.8	-9.0	-34.8	-12.8	**-5.7**
	Technology	15.3	4.8	16.8	-25.9	-8.9	38.9	**5.2**
	Telecom	5.5	11.1	28.8	-12.2	-20.0	1.6	**1.9**
	Media & Ent	11.4		-8.2	-10.8	-16.1	17.9	**-4.3**
	Utilities	5.9	24.2	10.7	-30.4	0.2	5.8	**2.1**
	REITs	7.1	18.0	-10.8	5.9	-7.0	-4.4	**0.3**
BONDS	Global Aggregate	4.8		0.2	1.6	7.6	7.8	**4.3**
	US Aggregate	6.7	24.2	9.4	8.4	5.9	10.1	**11.6**
	US Treasury	6.5	22.1	8.7	6.7	8.6	11.8	**11.6**
	EMBI	8.4			9.7	6.8	3.0	**6.5**
	TIPS	4.9			7.9	11.9	10.4	**10.1**
	Global IL	5.0			4.0	10.8	7.2	**7.3**
	EM IL	8.7				10.5	10.1	**10.3**
	Investment grade	7.3	23.6	8.3	10.7	1.5	12.0	**11.2**
	High Yield	8.2		5.3	4.5	-1.4	3.1	**2.9**
	FRNs	2.4				2.1	2.0	**2.1**
CMOD/FX	Gold	6.9	-4.3	0.3	2.6	23.4	39.8	**12.4**
	Commodities	2.3	-14.2	-2.2	-4.9	12.5	-9.1	**-3.6**
	DXY	0.6	1.5	10.7	-6.2	4.4	5.5	**3.2**
	EM fx	-3.1			-13.5	6.0	-11.2	**-6.2**

†Annualised average monthly return. *Excludes Amazon.

Note: Cyclical = Materials, Industrials, Consumer Discretionary, Financials, Technology, REITs; Defensive = Energy, Consumer Staples, Health Care, Telecom Services, Utilities.

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