

MID-YEAR INVESTMENT UPDATE

JULY 2024

Navigating political turmoil

- The slowing US economy should continue to weigh on employment and wages, helping inflation to trend lower and US Federal Reserve (Fed) policy rates to fall in the quarters ahead. Treasury returns in the third quarter will likely be driven primarily by the income provided by bond yields.
- Risks, meanwhile, are growing – particularly for the US government’s fiscal outlook – as we approach the November presidential election.
- The political landscape in Europe has changed and uncertainty has risen, meaning volatility is likely to remain high. Particularly for France, the political outlook remain unclear.
- US growth stocks have rallied so far this year — despite the reduction in the number of expected cuts in the fed funds rate — thanks to positive earnings momentum. We anticipate that momentum will continue, and valuations are reasonable.



Daniel Morris
Chief Market Strategist



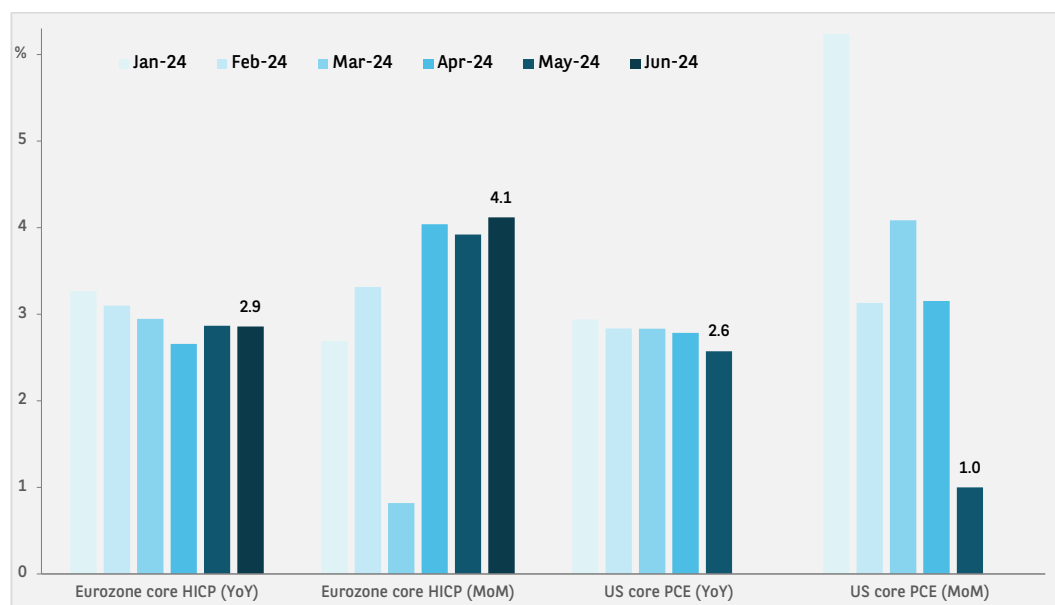
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The US economy is still on a soft landing path, even if the speed and timing of the touchdown vary after each economic release. The most recent US inflation data show price rises slowing more quickly than in the first part of the year. The eurozone, by contrast, continues to see persistently higher inflation (see Exhibit 1).

Exhibit 1

Core inflation lower in the US but still high in the eurozone



Data as at 2 July 2024. HICP = Harmonised Index of Consumer Prices. PCE = Personal Consumption Expenditures. Sources: Haver Analytics, BNP Paribas Asset Management.

The slowing US economy should continue to weigh on employment and wages, helping inflation to trend lower and US Federal Reserve (Fed) policy rates to fall in the quarters ahead. This view is largely priced into bond markets already, suggesting that Treasury returns in the third quarter will be driven primarily by the income provided by bond yields.

Risks, meanwhile, are growing – particularly for the US government’s fiscal outlook – as we approach the November presidential election. Budget deficit worries could put upward pressure on inflation expectations.

Slowing consumption should weigh on the economy

While US growth is slowing, we do not expect a recession (the consumer and corporate sectors are too robust for that), but we do believe consumption is running out of steam. Excess savings built up during the pandemic have largely been spent, and real inflation-adjusted wages are not high enough to sustain the spending levels we saw last year.

Low and middle-income households, in particular, are increasingly showing signs of stress. Car loans, consumer loans and credit card delinquencies have all risen above pre-pandemic levels.

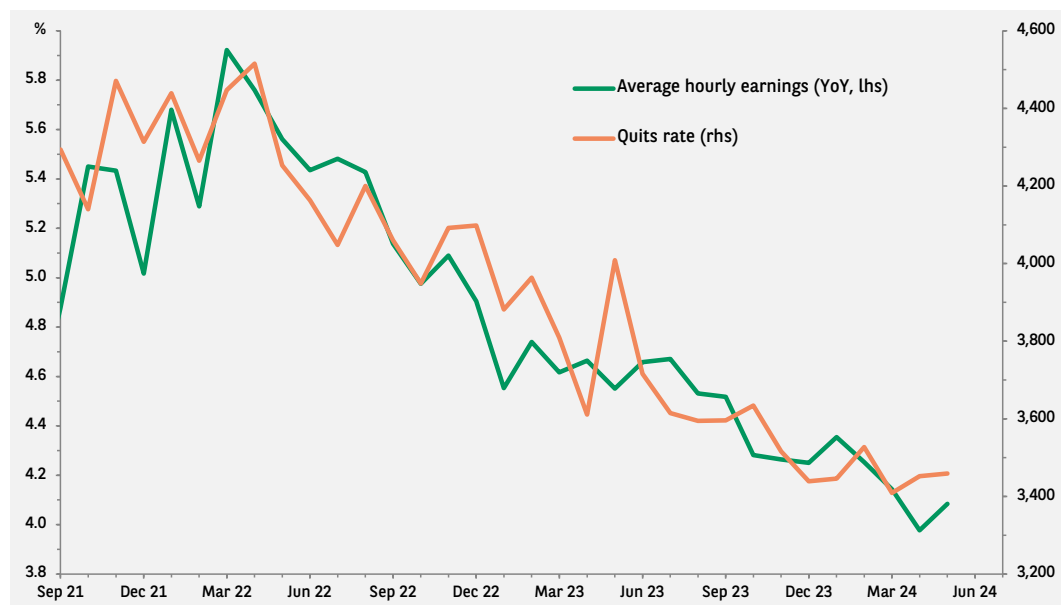
Rising home prices, while boosting homeowners' wealth, have taken a toll on discretionary spending. More buyers are finding the larger down-payments required to purchase a home prohibitive and are forced to remain renters in an increasingly costly rental market. Until interest rates fall enough to make loan payments more manageable and housing more affordable, we expect consumers to be increasingly cautious.

The labour market is returning to equilibrium

The jobs market has been strong, but increased immigration and a rise in the labour participation rate has created an unusual environment in which wage gains are slowing even as jobs openings are rising. The swell in workers has helped fuel consumption. We think, however, that this anomalous period is coming to an end. The gap between job openings and the number of job seekers is closing, and the rate at which employees are quitting their jobs has slowed. Unsurprisingly, the pace of wage growth has recently moderated (to about 4.2% a year) as workers are less able to demand higher wages (see Exhibit 2).

Exhibit 2

Wage growth slows as workers stay in in their jobs



Data as at 2 July 2024. Sources: BLS, BNP Paribas Asset Management.

We expect wage growth to continue to fall as the labour market returns to balance. We are closely monitoring the pace of hiring for signs of a downturn and keeping an eye out for an uptick in layoffs. Either one could confirm a peak in the employment cycle, putting additional downward pressure on both wage growth and inflation.

...but inflation risks remain

Despite the normalisation of the labour market, the risk of higher inflation remains. Shelter cost inflation could rise if the shortage in rental units persists. Although building construction recovered after the Global Financial Crisis (GFC), soaring building costs during the pandemic, and now higher borrowing costs, have cooled investment in housing just as more is needed to accommodate a growing population.

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More recently, rapidly rising insurance premiums as a result of natural disasters (wildfires in California, rising seas in Florida) and higher tax rates in some states has only added fuel to the fire and doused the appetite for new construction.

The good news is that non-shelter services inflation should continue to moderate as wage growth slows, and goods inflation has fallen back to roughly zero. Even so, we think the 'last mile' of disinflation could prove to be the hardest due to second-round effects. Furthermore, exogenous factors abound, from conflict in the Suez Canal (threatening global supply chains) to the possibility of higher oil prices or a loosening of fiscal discipline in the US and Europe as a result of upcoming elections.

The election raises the inflation stakes

While the US presidential election is still four months away, the two leading candidates have signalled their comfort with some combination of higher spending, lower taxes, and higher tariffs – all of which could have a significant impact on inflation. A more restrictive immigration policy (supported by both candidates, though to different degrees) could reduce the supply of labour, putting upward pressure on wage growth. Markets to date have seemed little concerned about whether these policies could end up as law, but we expect the focus on fiscal policy to intensify as the quarter progresses and the election nears. We appreciate that these policies are intended to gain voters' attention and likely to be scaled back post-election, but there is some chance that the outlook for fiscal policy in the US will look very different after 5 November.

Inflation risk is undervalued

The market consensus for inflation to slowly decline and for policy rates to fall modestly is already reflected in current prices for both Treasuries and Treasury Inflation-Protected Securities (TIPS). While we do not disagree that inflation and rates should both decline in the months ahead, we do think the risk that inflation rises – or at least stays stubbornly high – is greater than the risk it falls faster than is priced into the market.

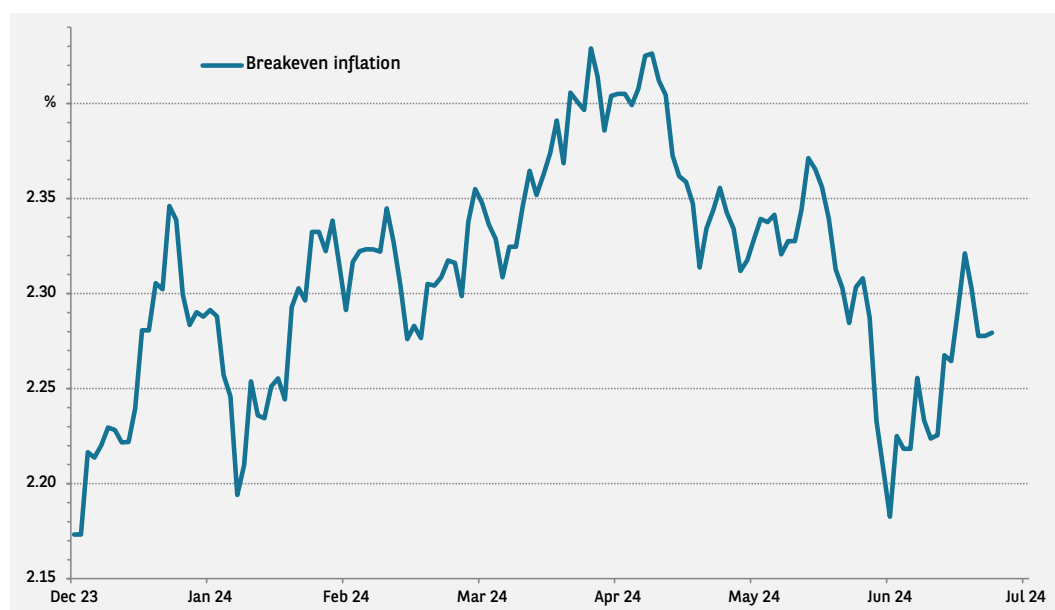
In our view, a faster-than-expected decline in inflation would require significantly weaker economic data, a sharp drop in energy prices, or an exogenous shock to the global economy or financial system. As none of these scenarios seems likely, we maintain our view that Treasury yields are more likely to be volatile within a range, say between 4.1% and 4.6% for benchmark 10-year Treasuries.

While our base case is that inflation is likely to slow, we encourage investors to be slightly more conservative than the consensus and note that the cost of protecting a portfolio against rising inflation is, in our view, curiously low.

Despite the risk that inflation remains sticky, or even rises after the election, the break-even inflation rate for 10-year TIPS is near 2.3% (see Exhibit 3). That is, the market is currently assuming that inflation averages 2.3% over the next 10 years. With the core Consumer Price Index (CPI) currently at around 3.4%, this is a market which looks priced for the best-case scenario.

Exhibit 3

Breakeven inflation (US 10-year)



Data as at 5 July 2024. Sources: Bloomberg, BNP Paribas Asset Management.

European Union: The return of political risk

The results of the European Parliament election in early June rattled markets when far-right parties made surprising gains, prompting an immediate flight to higher-quality bonds. The effect was amplified because many active investors were positioned for a typically slow, uneventful summer of low volatility. Credit spreads widened sharply as did sovereign bonds spreads for France and other peripheral eurozone countries relative to German Bunds.

The political landscape in Europe has changed and uncertainty has risen, meaning volatility is likely to remain high. Particularly for France, the political outlook will remain unclear even after the second-round parliamentary elections. If the result is a less cooperative stance towards European Union (EU) politics and policy, this could increase fragmentation or at least deter consolidation. Insofar as financial markets generally believe the eurozone needs more structural reform rather than less if it is to compete effectively with the US and China, a more protectionist approach on strategic industrial sectors and key materials would likely disappoint investors, weighing on long-term growth expectations.

Economic fundamentals improving

Economic growth in the eurozone has generally been holding up better than expected, led by peripheral countries. Higher real inflation-adjusted disposable income has fuelled the consumer sector. Headwinds from tightening financial conditions and Germany's economic slowdown have also begun to recede.

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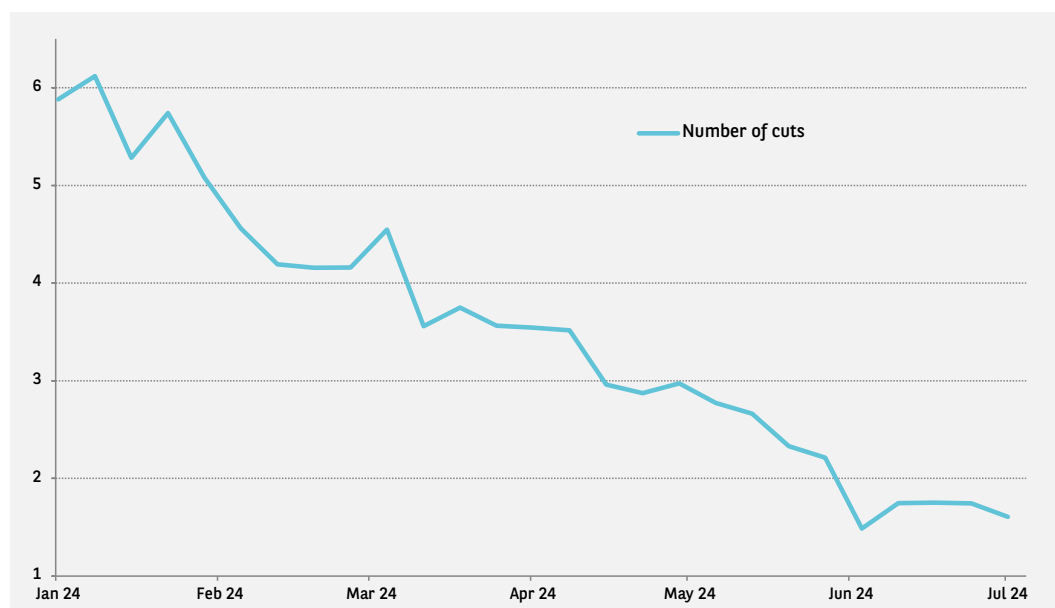
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Meanwhile, headline inflation is falling and we expect both headline and core inflation to continue falling towards the European Central Bank's (ECB) target and reach 2% next year, allowing the ECB to continue cutting interest rates.

Finally, the fiscal outlook for the region is improving, with the reinstatement of EU-wide fiscal rules and an acceptance of the need for fiscal discipline.

Volatility can create opportunities

We believe the economic outlook will remain the most important driver of sovereign bond yields in the months ahead. An extreme political outcome could change expectations, but with economic growth slowing and inflation falling the ECB is currently forecast to cut interest rates by 25 basis points two more times this year (see Exhibit 4). We foresee between one and two cuts and would see any significant deviation in market pricing from this as an opportunity to take a contrarian view.

Exhibit 4**Estimated number of additional 25bp cuts in ECB policy rate in 2024**

Data as at 5 July 2024. Sources: Bloomberg, BNP Paribas Asset Management.

We expect German Bunds to trade in a relatively tight range over the coming quarter and believe any significant widening in spreads for eurozone countries due to political uncertainty is likely to be an opportunity to add risk.

The US election wildcard

The result of America's presidential election could have a significant impact on global investor sentiment, regardless of which party assumes power. Recent campaigning from both parties has signalled a willingness to commit to higher spending, lower taxes and higher tariffs. Any or all of these could have a significant affect inflation and raise concerns about fiscal deficits and bond issuance. If markets come to believe US politicians will ultimately favour populism over fiscal prudence, we would expect the US Treasury yield curve to rise and steepen.

Though eurozone countries are strongly incentivised to comply with the EU fiscal framework, we would expect the eurozone yield curve would trade higher in sympathy with the US yield curve on fears that any US inflation or fiscal deterioration could be exported.

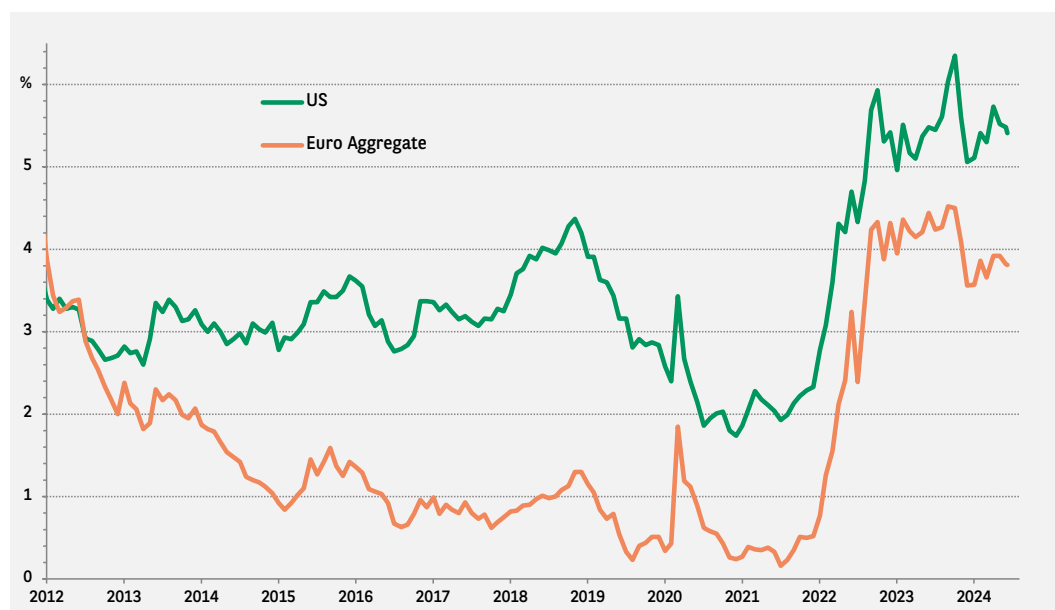
Corporate bonds: Focus on the yield

Global corporate bond spread volatility has risen but the asset classes' underlying fundamentals remain supportive, which justifies maintaining exposures for investors with a longer-term horizon. The US and eurozone economies are growing and look likely to avoid recession. Demand for the asset class remains robust.

In our view, with yields in the eurozone currently between 3%-4%, and near 5.5% in the US, the income from investment-grade corporate bonds remains compelling (see Exhibit 5). We do not expect spreads to move significantly in the months ahead and see cautious bond markets limiting the upside in corporate bond returns.

Exhibit 5

Compelling investment grade corporate bond yields



Data as at 5 July 2024. Sources: FactSet, BNP Paribas Asset Management.

Elections have raised volatility...

The volatility of corporate credit spreads was relatively low through the first half of 2024. The European Parliament election in early June, however, rattled the eurozone markets.

Investor sentiment towards corporate bonds had been broadly positive, but the election results turned investors' attention to the risks that could emerge from the French and US elections.

...but yields remain compelling

Yields for investment-grade bonds are high by historical standards, and the resulting income can act as a significant buffer against elevated volatility weighing on bond prices.

In the US, the combination of stable economic fundamentals and still mixed inflation data has lead markets to expect official interest rates to be held higher for longer than thought at the beginning of the year. This expectation should support corporate bond yields in the region insofar, though it could weigh on some sectors and companies. Attention to sector and security selection remains critical.

High yield remains attractive

High yield valuations may seem high, but they reflect an underlying positive dynamic: The new issuance market has been very active (May saw the largest high-yield issuance in the eurozone since the Global Financial Crisis), and demand has so far met the increased supply, pushing back the 2025/2026 maturity wall. We believe demand for high yield will remain strong, which should make the market more resilient to the risk of further delays in rate cuts.

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In this context, we believe high-yield default rates have likely peaked, and we are focusing on the most rate sensitive companies, hence the importance of the issuer selectivity.

Favour the eurozone over the US

While election-related volatility has tempered our enthusiasm for eurozone investment-grade bonds, we believe valuations are more attractive than those for US bonds. Spreads in the US have returned to near pre-pandemic levels, while eurozone spreads remain above these lows.

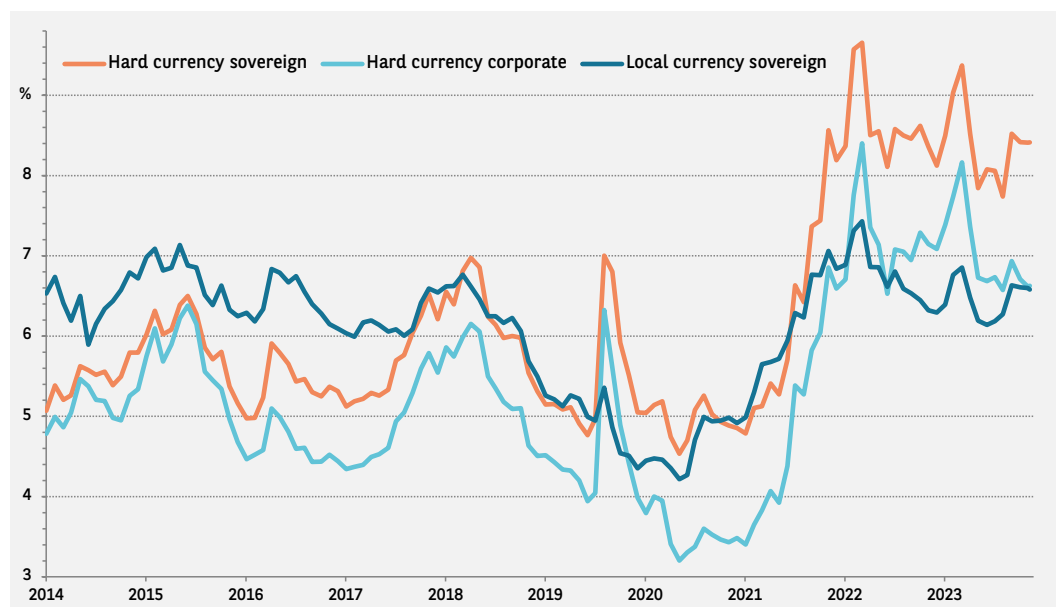
Eurozone corporate fundamentals have remained good through the recent economic downturn and high cash levels should help companies weather any economic or political uncertainty.

Emerging markets: Stay invested, selectively

High yields for emerging market (EM) debt provide a competitive level of income and we believe that rebounding economies, declining interest rates, and stronger currencies mean the asset class offers a compelling opportunity set for investors (see Exhibit 6).

Exhibit 6**Emerging market debt offers competitive levels of income**

Emerging market index yields



Data as at 5 July 2024. Sources: FactSet, BNP Paribas Asset Management.

Developed markets are beginning to grapple with election-related volatility, while emerging markets have already had a busy election calendar. The volatility that arises from elections may provide opportunities for active investors.

In countries that have strong fundamentals, such as South Africa or Mexico, election headlines can result in excess market reactions. In our view, focusing on a country's path of economic growth and commitment to reforms can reveal attractive opportunities.

US dollar bonds offer compelling yields and selective opportunities

EM hard currency bonds have rallied significantly in recent months, supported by good fundamentals, declining defaults, and attractive yields. Even after the recent gains, hard-currency sovereign bonds offer spreads over equivalently rated US corporate bonds in excess of 200 basis points (2%). Furthermore, we expect supply to be restrained in the remainder of 2024 and into 2025.

This year, a number of countries have seen a significant rally in their government bonds as they have gone through a debt restructuring or negotiation of external financial support (Egypt, Turkey, Zambia). Looking ahead, countries such as Sri Lanka (which has yet to conclude its restructuring), and Ghana (which should finalise its restructuring soon given the upcoming election), may offer more potential upside. Even Argentina, which is still adjusting to the new president's economic agenda, is likely to reward investors with constructive market reforms and positive headlines.

Focus on security selection in corporate bonds

We believe EM corporate bonds remain attractive relative to their US corporate peers, particularly for high-yield corporate bonds.

EM corporate fundamentals continue to compare favourably to similarly-rated US companies. Emerging market companies have in aggregate higher cash levels, comparable interest-coverage ratios and lower leverage ratios. Additionally, as with EM government bonds, we expect the supply of corporate bonds to remain relatively modest through into 2025.

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As corporate index spreads have rallied over the last year, certain segments of the market look more expensive, notably within investment-grade. We see greater opportunities within frontier markets.

We remain positive on local-currency bonds

EM local currency-denominated bonds have fallen in price recently even though fundamentals remain supportive. Economies are recovering without the flood of fiscal stimulus seen in many developed countries, while central banks have been largely successful in meeting their inflation targets. We remain constructive on both currency appreciation and falling bond yields across emerging markets.

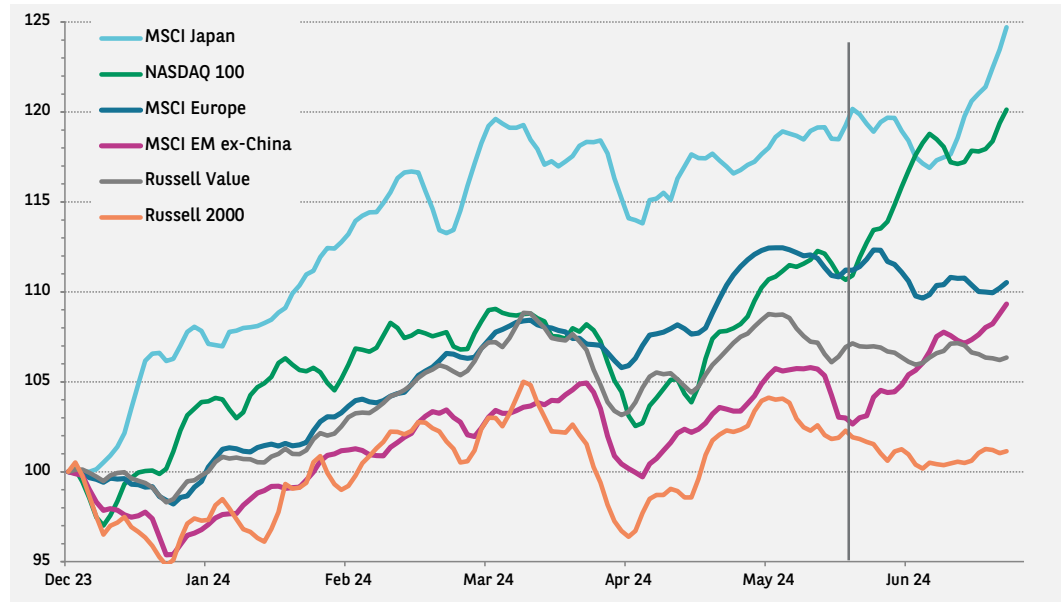
Valuations, in our view, remain attractive within Latin America and most of the EMEA region, while opportunities in Asia are more muted given the delayed easing cycle in South Korea, India and the Philippines.

US equities

The consensus view at the beginning of the year was that gains in US equities would be driven by the six to seven cuts in the fed funds rate markets had priced in. As those policy rate expectations fell to one to two cuts, US equities rallied nonetheless, particularly growth stocks (see Exhibit 7).

Exhibit 7**Market performance has started to diverge**

Total return indices in local currency terms except for regional indices (in USD)



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

The reason they gained despite the increase in discount rates was simply earnings: next-twelve-month earnings estimates have risen by 10% so far this year (7% excluding the 'Magnificent 7'). The more recent advance in the index has also come partly from renewed hopes that the Fed will be able to cut rates by more or sooner following the low level of monthly inflation in May (see Exhibit 1).

These hopes may yet be disappointed. The May print was a surprisingly large drop from the pattern over the preceding four months and June inflation could turn out to be closer to the level earlier in the year. Moreover, the increased odds of a Trump victory in November (and the inflationary policies that could follow), make it marginally less likely the Fed will cut rates this year, in our view. Were this scenario to play out, some of the NASDAQ's gain in June could be given back, but we are still confident in the medium-term outlook for earnings.

Valuations, naturally, are a concern, but perhaps surprisingly less so for the NASDAQ than for other parts of the US market. While the NASDAQ has gained significantly since last October, when optimism about a Fed pivot towards lower policy rates was at its peak, earnings expectations have gained, too, keeping the forward price-earnings ratio (P/E) in line.

Today, the z-score for the NASDAQ 100 P/E ratio is just 0.4. This is rather less than for the Russell 1000 Value index (z-score = 0.8), making growth stocks the more attractive proposition when considering only valuations. Small cap stocks are similarly priced to value stocks (see Exhibit 8).

Exhibit 8
Z-scores for forward price-earnings ratio

Market	United States	Japan	EM ex-China	Developed Markets	Russell Value	US Small Cap	NASDAQ	Emerging Markets	Europe	China
z-score	1.6	1.2	0.9	0.9	0.8	0.8	0.4	-0.1	-0.2	-0.7

Shading					
z-score	>1	>0.5	-0.5 - 0.5	<-0.5	<-1

Data as at 5 July 2024. Sources: FactSet, BNP Paribas Asset Management.

This combination of a positive earnings outlook and reasonable valuations explains why our multi-asset team is overweight NASDAQ.

The risks to a continued positive performance for US equities are more likely to materialise next year. To the degree that growth needs to slow further to get US inflation back to target, earnings may not rise as much as analysts currently expect (forecasts are for 18.8% year-on-year earnings growth in 2025 vs. 2024 for NASDAQ and 13.3% for Russell Value).

It is impossible to anticipate the reaction of the Fed to any inflationary policies from a Trump administration, but higher rather than lower policy rates would also have a negative impact on the markets. The near-term outlook, however, still looks propitious to us.

European equities

At least through the end of May, European equities performed in line with the NASDAQ, a rather unusual occurrence. More recently the market has lagged, losing 1% in June while the NASDAQ gained 6%.

The recent divergence reflects a broader phenomenon: in the first part of the year, correlations across markets were very high, with most indices moving up or down together (though obviously to varying degrees).

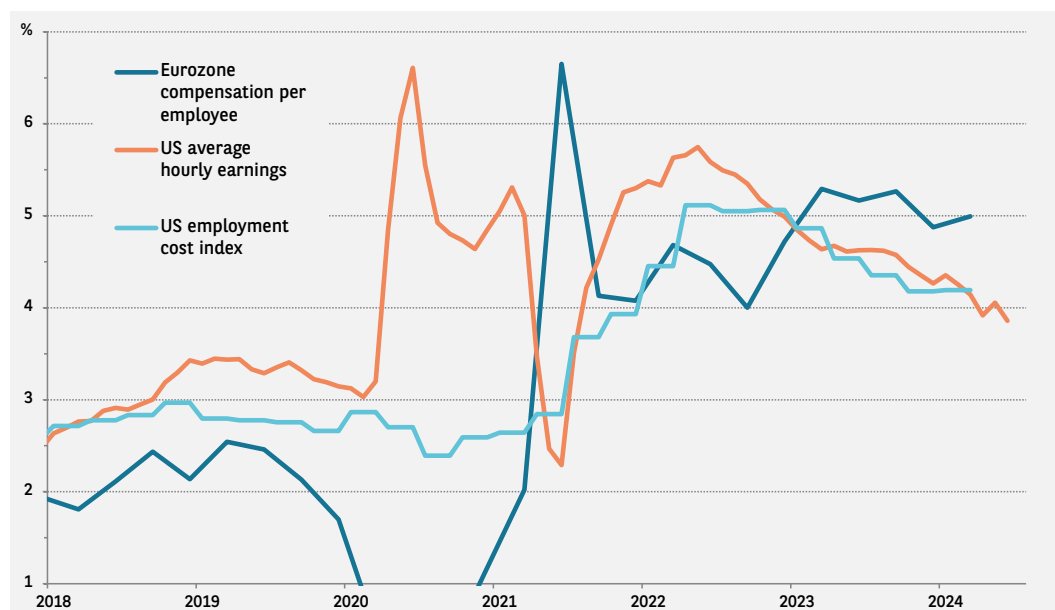
More recently, idiosyncratic factors have begun to matter. In the US, low inflation has boosted growth stocks, while inflation has been stickier in Europe. Political risk is higher currently in Europe, and more recent economic data has disappointed (industrial production, retail sales, Purchasing Managers’ Indices).

The poor showing for European retail sales (month-on-month declines in France and Spain in May, declines in Germany and Italy in April) is perhaps surprising given that there are reasons to believe consumer demand should be accelerating. The region's unemployment rate is at historic lows and wage gains have accelerated, outpacing those in the US (see Exhibit 9).

Exhibit 9

Wage growth in the eurozone outpacing the US

Year-on-year change



Data as at 5 July 2024. Sources: FactSet, BNP Paribas Asset Management.

The reason this has not translated into higher consumption may be due partly to the source of the wage gains. While salaries have increased for some, income gains have also come from one-off bonuses to compensate for previous inflation. Given that household incomes have not increased permanently, there may be a tendency to save the gains rather than spend them.

We believe demand will improve, however, particularly now that the ECB has begun cutting policy rates. As a result, our multi-asset team has an overweight to the eurozone small cap index versus large cap as greater household demand should disproportionately benefit domestically-oriented companies. Valuations are also attractive, with the relative P/E ratio below the long-run average.

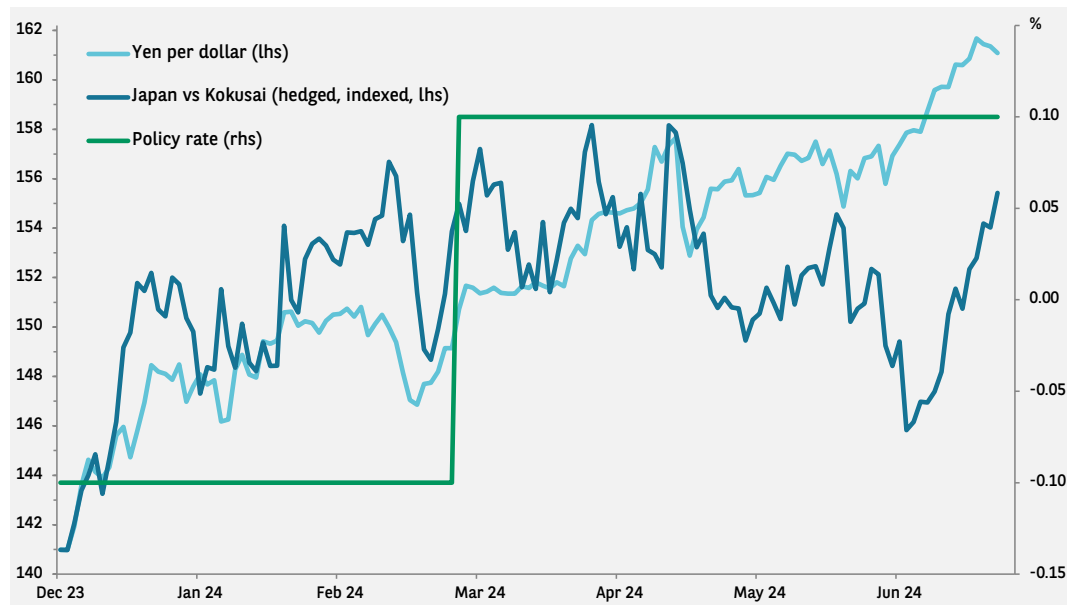
Asian equities

The main Asian markets, Japan (MSCI Japan market cap USD 3.9 trillion) and China (MSCI China market value USD 1.9 trillion), have delivered wildly different outcomes for investors so far this year. Japan has delivered the best returns of the top five largest equity markets after the US (total return in local currency terms through 4 July 2024), while China has delivered the worst.

The gains in Japanese equities have been driven to a meaningful degree by the weakening yen (return year-to-date for the MSCI Japan index in yen terms is 26% but just 10% in USD). As the Bank of Japan moved from negative to positive policy rates, that depreciation stalled, and along with it the relative outperformance of Japanese equities versus the rest of the world (Kokusai Index; see Exhibit 10).

Exhibit 10

Japanese equities are making up some lost performance



Data as at 4 July 2024. Note: Kokusai = Global equities ex-Japan. Sources: FactSet, BNP Paribas Asset Management.

The recent renewed bout of yen weakness has helped the market make up some of the underperformance of the last two months, but we question whether the yen trend can continue, and hence whether Japanese equities can maintain their world-beating performance.

Chinese equities

The performance of the MSCI China equity index has been in its own way just as surprising as that for the MSCI Japan index, but in a negative rather than a positive way. Expecting the Chinese equity market to perform like those of the US and Europe after their economies reopened was perhaps unwarranted given the significant differences in the length and depth of the respective pandemic lockdowns. But after three years of severe restrictions in China, it seemed reasonable to think there would be a sustained, outsized increase in corporate profits and hence in stock prices. Instead earnings expectations have stagnated, moving up by just 2% over the last 12 months.

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The reasons for this are numerous (US tariffs and import restrictions, investor disappointment in government policy, ongoing drag from the property market).

There was a period, after the top-level 'two sessions' conferences in March, when the off-shore MSCI H-shares index outperformed thanks to a shift in foreign investor sentiment. It was notable at the time, however, that domestic investors did not seem as enthused (the A-share index rose by much less).

Most of the H-share index outperformance has since faded. The upcoming Third Plenum could yet be a catalyst for renewed market gains, though it would likely require the authorities to announce particularly robust stimulus measures for the economy, something we do not anticipate.

This report includes significant contributions from Cedric Scholtes, Head of Global Sovereigns, Inflation & Rates; Alberto Talero, Portfolio Manager, Euro Sovereigns; Christophe Auvity, Head of Global Corporate Credit; and Alaa Bushehri, Head of Emerging Market Debt.

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