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MONTHLY MARKET VIEWPOINT

DELAYED (SOFT) LANDING

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- Recent high US inflation alongside disappointing economic data has renewed concerns about the investment outlook.
- A re-acceleration in activity could prove problematic as it would put gradual dis-inflation at risk. Equally, a sharp slowdown in spending could spook investors and risk assets. Instead, we think global growth will be broadly steady this year – the softest of soft landings.
- The increase in real yields this year has had a predictable effect on equity prices (particularly growth stocks), stalling the rally in markets. Positive earnings results, however, have offset much of the interest rate drag. Earnings for the first quarter are coming in much better than expected, and a broadly positive economic outlook suggests that the gains should continue.
- Equity overweights in our multi-asset portfolios are to the US (NASDAQ), Japan and China.

One might have thought that, four years after the start of the pandemic, investors would have some confidence in the outlook for economic growth and inflation. Unfortunately, that is not the case.

The long series of mostly upside surprises to inflation from 2020 to 2022 was followed by more predictable (and falling) inflation last year, leading to a strong consensus view for an economic 'soft landing' in the US.

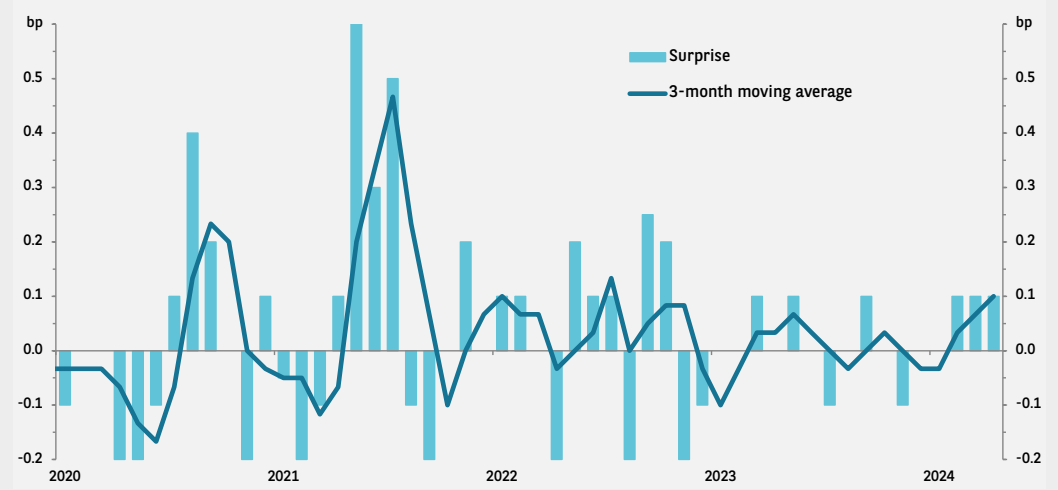
The start of 2024, however, has seen three-months in a row of higher-than-expected inflation (see Exhibit 1).

Inflation has continued to surprise, first lower at the end of last year, then re-accelerating in the first quarter of 2024

Exhibit 1

Core US CPI surprise: difference between consensus estimate and actual result (bp)

For month-on-month change in core consumer price index (CPI)



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

Given the strength of inflation, the question then became whether it would persist and be accompanied by strong growth — raising the risk of a newly overheating economy — or by much slower growth and a potentially stagflationary outlook.

February retail sales and March non-farm payrolls supported the first scenario, and expectations for the number of times the US Federal Reserve (Fed) would cut policy rates this year fell to close to zero. Benchmark US 10-year Treasury yields rose to 4.7%.

Subsequent data, however, has pointed to slower growth beginning with US GDP (1.6% versus 2.2% forecast), followed by purchasing manager indices (1-3 points below forecast for the Institute of Supply Management series, and levels below 50, indicating contraction), and finally private, non-farm payrolls, which came in 60,000 jobs (seasonally adjusted) below consensus estimates.

This slowdown is encouraging, insofar as inflation is unlikely to decelerate sufficiently without it. How quickly that happens, and how far the slowdown in growth needs to go, is the key worry for investors. Our view is that the soft landing is still on track, even if the reversion of inflation to target is delayed, and that growth will remain above the long-run trend rate of 1.8% through 2025. We anticipate the Fed will cut rates by the end of the year, with rather more cuts to follow in 2025.

The Fed itself seemed to endorse the view that a soft landing was still in sight. At the most recent press conference, Fed Chair Powell pushed back against the idea that the bank might need to increase policy rates, pointing out that they are already sufficiently restrictive to do the job.

Equity market reaction

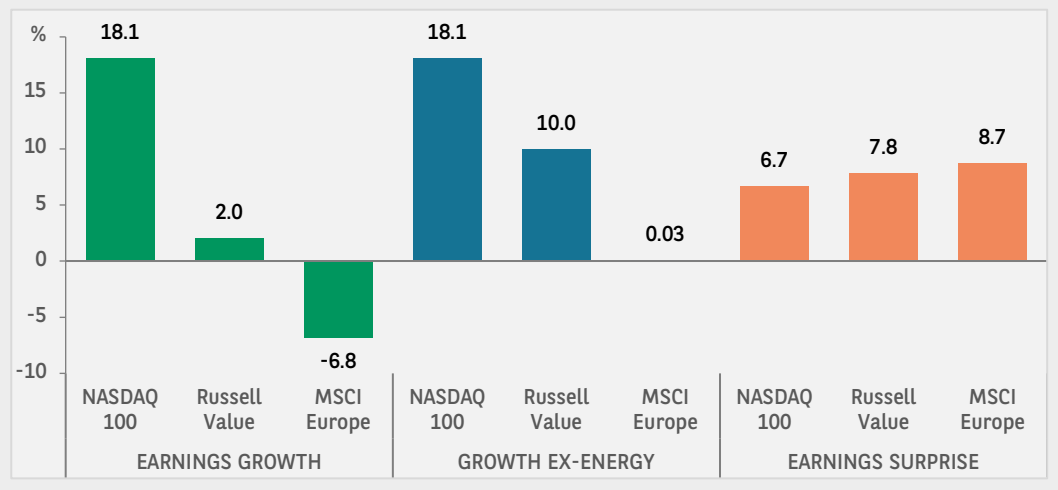
The increase in interest rates (particularly real yields) that we have seen this year has had the predictable effect of weighing on equity market prices, particularly growth stocks: the NASDAQ 100 is 1.3% off its peak from late March (as at 8 May 2024).

Given the size of the increase in yields, however, one might have expected a bigger decrease in equity prices. What sustained the market has been a good earnings season, both for US and European equities.

The impact on equities of changes in policy rate expectations has been predictable

The NASDAQ 100 was expected to see a double-digit year-on-year increase in earnings for the first quarter, while a decline was foreseen for the Russell Value index. Earnings for companies in the MSCI Europe index were also forecast to drop. The results so far have been rather better: earnings surprises have been 6-9%, when a typical quarter sees results 3-4% higher than forecast (see Exhibit 2).

Exhibit 2
Earnings surprises have been strong
First quarter 2024 earnings season; reported earnings growth year-on-year



Data as at 8 March 2024. Sources: Bloomberg, BNP Paribas Asset Management.

Assuming that policy rate expectations (and real yields) do not move much higher, earnings should remain the primary driver of equity indices. And as long as the slowdown in economic growth does not go too far, earnings should continue to rise.

China

Data for China has shown ongoing resilient growth, supported by demand for the country's exports and holiday-related travel activity. These positive factors are being offset, however, by the drag from weak property investment. The Chinese government is aware of the risks and we anticipate policy support will be stepped up in the coming months. Fiscal support is likely to be the key tool and this may be used sooner rather than later.

Since the 'two session' conference in March, equity markets have staged an impressive rally; the MSCI China index has outperformed global equities by 12% since the end of March (as at 8 May 2024)

A recovery in valuations has been the primary driver. Prior to the rally, the relative forward price-earnings ratio of the MSCI China index versus developed market equities had fallen to two standard deviations below average; it has now recovered to 1.3x, which still leavs a lot of scope for a further revaluation of the market.

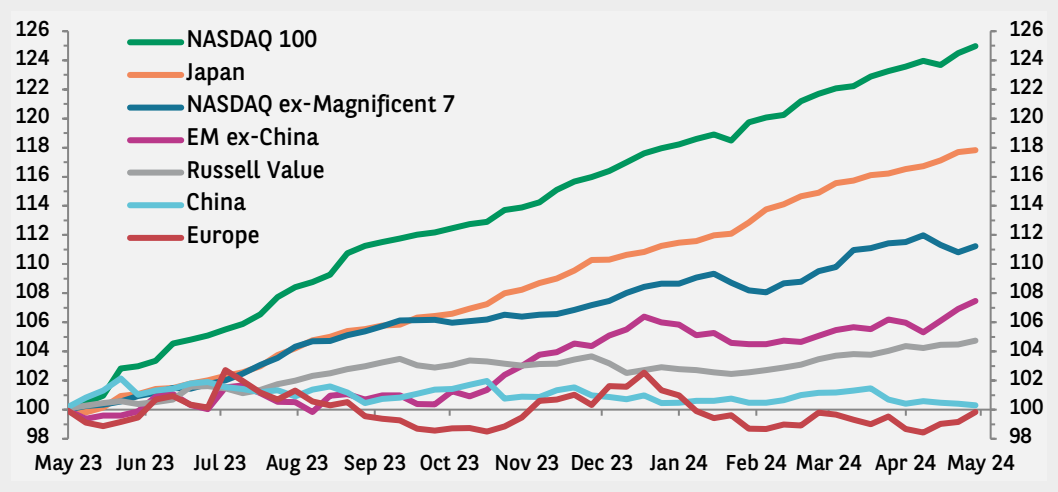
The gains in Chinese equities recently have largely been driven by a recovery in valuations

Earnings expectations, however, have not (yet) played much of a role. Over the last year, forward earnings per share (EPS) estimates for companies in the MSCI China have hardly risen, in contrast to those in other major market indices (see Exhibit 3). To the degree that foreign investor sentiment on China is beginning to recover (or at least not weaken further), valuations could continue to (partially) normalise, but eventually earnings will need to take over as the motor for price appreciation.

Exhibit 3

Earnings expectations have not changed much for China

Next-twelve-month estimate, local currency terms



Data as at 8 March 2024. Sources: FactSet, BNP Paribas Asset Management.

Technology sector

The increase in earnings expectations for the NASDAQ 100 index shown in Exhibit 3 reflects the immediate impact of increased investment in the semiconductor industry thanks to the US CHIPS Act, spending on artificial intelligence (AI) model development, and anticipated earnings from AI as companies learn how to use the technology to increase revenues and/or reduce costs.

This increase has not been limited to the 'Magnificent 7' stocks. Forward earnings expectations have risen by 11% over the last year for the index excluding the Mag 7. While forecasts in our view are unlikely to continue rising at the same rate from now on (though there is no sign yet of a deceleration), they will nonetheless likely outpace those for other parts of the US market (as represented by the Russell Value index), or those of other countries.

The NASDAQ 100 index is now one of the more inexpensive of the major markets

Alongside this positive earnings outlook, valuations for technology indices are reasonable, especially now that prices have fallen slightly while earnings expectations have continued to rise. The forward price-earnings ratio for the NASDAQ 100 today shows it to be one of the least expensive major markets (see Exhibit 4).

Exhibit 4

Z-scores for forward price-earnings ratio

Calculated relative to each market's own history from index inception

Market	P/E	Market	P/E
United States	1.4	EM ex-China	0.7
Japan	0.9	NASDAQ	0.3
Russell Value	0.9	Emerging Markets	-0.1
US Small Cap	0.8	Europe	-0.2
Developed Markets	0.7	China	-0.5

Data as at 8 May 2024. Sources: FactSet, IBES, Bloomberg, BNP Paribas Asset Management.

Were inflation to again come in stronger than expected and policy rate forecasts to rise, valuations and prices would likely fall back, but the positive earnings trend should eventually reassert itself.

ASSET CLASS VIEWS

MULTI ASSET

- In April **we increased our equity long positions**. Overall risk consumption has moved from 'dislike' to neutral.
- We initiated a **long Nasdaq position** and **added to Japanese equities** as the global cycle shows few signs of decelerating. These markets exhibit the most promising combination of profitability and valuation given that they have the earnings power to grow into their valuations. 'Longer duration' markets like the Nasdaq would also benefit from prospective US rate cuts. We maintain our modest long towards Chinese equities.
- We opened a **long eurozone banks** versus the broader European market. The structural improvement in profitability after the end of NIRP is reflected in regular EPS upgrades greater than those for the broader market. Valuations are attractive and the ECB is likely to be among the first developed market central banks to start cutting rates. This should lead to curve steepening, which will benefit the banking sector.
- We entered a 5 year-30 year Bund steepener (duration neutral) as the yield curve remains inverted even as the start of the ECB rate cutting cycle approaches (expected in June).
- We **reduced our long US TIPs** (20yr) position by half as the growth and inflation narrative continues to shift. Our key long duration positions remain EM local bonds (unhedged) and European investment grade bonds. Against this we are **short JGBs**, where rates are still expected to be below 1% in 5 years' time.
- We remain **long gold** as a hedge to inflation and geopolitics, and because it is a beneficiary of an increasingly multi-polar world.

FIXED INCOME

- **Rate cuts are on the agenda** in 2024 in the US and within eurozone, but central bankers have tried to push back the presumption of an imminent cut in key rates. We do expect June to be the start the first round of cuts.
- Following the recent increase in rates, we **increased our exposure towards duration** to an overweight. We prefer euro duration to US duration. We still like the 0–3 years segment that could benefit from this environment.
- We expect the **curve to steepen** as cuts emerge at a time where supply may put additional pressure on the long end.
- With a low growth in Europe, high yields spreads appear stretched to us and we consider **emerging market debts in hard currency to be more resilient** in this context.

GLOBAL EQUITIES

- We have a **constructive view on global equities** for 2024 underpinned by strong fundamentals with:
- Earnings recovery: **earnings growth is set to resume** in 2024 with consensus seeing double digit earnings growth in the US market. This comes after near 0% growth in 2023 and importantly, more sectors are seeing a pick-up in EPS growth versus 2023 leading to a broadening of leadership. Indeed, the post COVID years have been characterized by desynchronisation between goods and services. We saw stark divergences in various end markets with, for instance, a healthy recovery in air travel while rail volumes were still depressed owing in part to inventory normalisation in goods.
- **Stronger economic growth**: US GDP growth has been surprising to the upside with the Fed recently revising its forecasts for 2024.
- This very much looks like a **goldilocks scenario for equities** but note that while recession risk has been reduced, geopolitical risk remains elevated. As such we have been marginally adding to beta in our portfolio and are now slight greater than one, and are adding to small- and mid-cap stocks, which should benefit from better economic prospects. Regionally, we have a preference for the US and Japan where earnings growth is stronger.

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VIEWPOINT

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ASSET MANAGEMENT

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