Challenging narratives

Higher inflation and more mixed growth

Recent growth and inflation data have challenged the 'immaculate Goldilocks' narrative the market has been following since the closing months of last year. After pricing in at one point six to seven 25bp cuts from the US Federal Reserve over the course of 2024, market expectations have fallen back in the face of stronger-than-expected inflation data. And this hasn't just been a US phenomenon. Inflation surprises – which seek to measure the gap between consensus expectations and actual inflation outcomes – have moved higher globally.

Growth data has been more mixed, with the US losing some steam just as other areas – notably manufacturing-led Europe (excluding Germany) and parts of Asia – have perked up. Although risks to the broader US economy remain tilted to the downside, the combination of improving sentiment, depressed inventories, and early signs of prospective 'green shoots' in manufacturing activity may lift some of these weaker areas. Notably, these are also the markets that, unlike equities more broadly, are attractively valued. Don't forget: growth and earnings already slowed meaningfully in most areas outside the US in 2023.

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BNP PARIBAS
ASSET MANAGEMENT

The sustainable investor for a changing world

Against this background, we have made four changes to multi asset portfolios since our last monthly:

- **Going long Japanese equities,** where both fundamentals and valuations are appealing. Japan stands out as the only area where expected earnings have increased as the market has rallied, preserving a 15% forward price-earnings (P/E) and 50% forward price-book (P/B) discount to global stocks.

- **Implementing a modest tactical long to domestic China**, where valuations are extremely depressed and where triggers for unlocking this value – in the form of policy support and incipient manufacturing recovery – are increasingly present.

- **Closure of our European equity short**, where bad news may be baked into current prices and expectations, and economic data is increasingly surprising positively. Germany appears to be an outlier. With a more constructive bottom-up picture following last year's earnings recession, we turn neutral. We also closed our relative-value trade – long UK, short Europe – as part of this.

- **Reducing our long US TIPS exposure**: on strong rallies, and as the growth-inflation narrative shifts.

- As a result, we are now **mildly overweight select equities** (by around 2%), but with **long duration** remaining our **largest risk position**. Risk taking remains in the second quintile relative to the maximum.

Green shoots for manufacturing?

In recent weeks, PMIs (Purchasing Manager Indices) and new orders have moved more persuasively from contraction to expansion, and with more breadth across countries, regions and components (see Exhibit 1). Although tentative, a mosaic of more optimism seems to be forming around global manufacturing. In addition to PMIs, regional Federal Reserve Bank new orders are firmer, EM ex-China exports – notably Korea – are stronger, and EM surveys seem buoyant (pointing to upside risks to growth). Japanese machinery orders, a higher frequency indicator of manufacturing activity, seem to be bottoming out. And notably, there were signs of optimism in company guidance: for example, Morgan Stanley research reveals mentions of 'green shoots' in the Q4 reporting season were the highest they have been since at least 2005 (see Exhibit 2).

Recent additions of Japanese and Chinese (A 50) stocks seek to capture this, alongside a neutralisation of our European equity short mentioned above.

In Japan, equities have risen sharply, as have delivered and expected earnings, such that forward P/E ratios trade at a 15% discount to global equities, and P/B is 50% of ACWI (see Exhibit 3). With a clear structural focus on raising shareholder returns (and the only major market with rising trailing and expected earnings), and high operational leverage to tentative 'green shoots' in global manufacturing as well as to the technology sector, Japan is particularly well placed to benefit from the current market set up. Korean data, often a leading indicator, is also showing rising new orders and sequentially improving exports. Tighter monetary policy may be supportive for financials, and the link between the yen and equity market returns is not especially stable. Our equity portfolio managers also share a constructive view of earnings, with Japan described as a top overweight.

The investment case for Chinese stocks is more tactical, seeking to take advantage of very low/'un-investible' valuations (that have cheapened as earnings collapsed ahead of prices) with two near-term triggers: first, increasing policy support, as the 'red line' for intervention seems to be around current growth levels, and second, broadening improvement in global manufacturing and new orders, with low inventory stock.

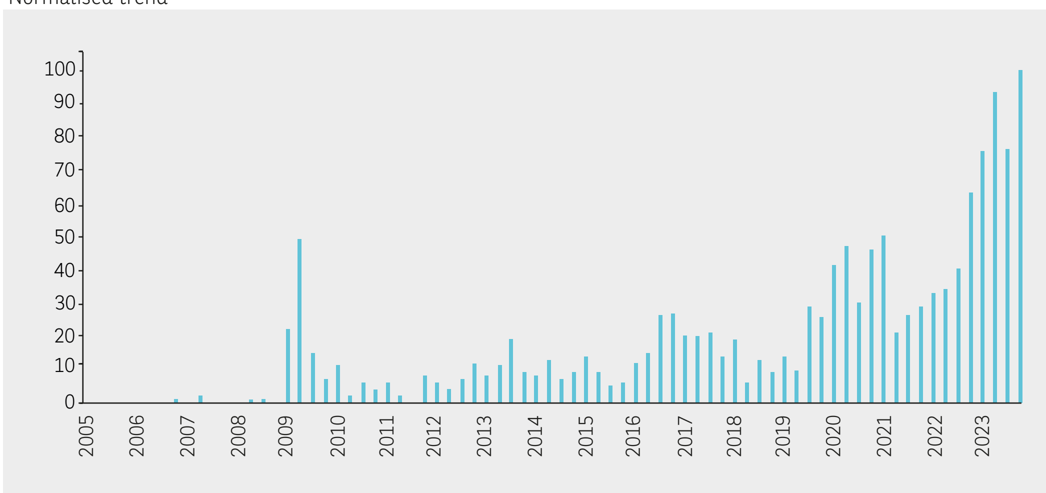
Exhibit 1
Purchasing manager indices (PMIs)

Sector	Country	Mar-23	Apr-23	May-23	Jun-23	Jul-23	Aug-23	Sep-23	Oct-23	Nov-23	Dec-23	Jan-24	Feb-24	1mo chg
SERVICES	US ISM*	51	52	51	54	53	54	53	52	53	51	53	52.6	-0.8
	US PMI	53	54	55	54	52	50	50	51	51	51	53	52.3	-0.2
	China	58	56	56	54	53	51	51	51	51	52	52	52.0	0.3
	Germany	54	56	57	54	52	47	50	48	50	49	48	48.3	0.6
	France	54	55	53	48	47	46	44	45	45	46	45	48.4	3.0
	Italy	56	58	54	52	51	50	50	48	50	50	51	52.2	1.0
	Spain	59	58	57	53	53	49	50	51	51	52	52	54.7	2.6
	UK	53	56	55	54	51	49	49	50	51	53	54	53.8	-0.5
	Japan	55	55	56	54	54	54	54	52	51	51	53	52.9	-0.2
MANUFACTURES	US ISM*	47	47	47	46	47	48	49	47	47	47	49	47.8	-1.3
	US PMI	49	50	48	46	49	48	50	50	49	48	51	52.2	1.5
	China	51	49	50	50	49	50	50	50	50	50	50	50.0	0.0
	Germany	45	45	43	41	39	39	40	41	43	43	46	42.5	-3.0
	France	47	46	46	46	45	46	44	43	43	42	43	47.1	4.0
	Italy	51	47	46	44	45	45	47	45	44	45	49	48.7	0.2
	Spain	51	49	48	48	48	47	48	45	46	46	49	51.5	2.3
	UK	48	48	47	47	45	43	44	45	47	46	47	47.5	0.5
	Japan	49	50	51	50	50	50	49	49	48	48	48	47.2	-0.8

Data as of 4 March. Sources: FactSet, BNP Paribas Asset Management.

Exhibit 2
'Green shoots' Transcript Mentions

Normalised trend

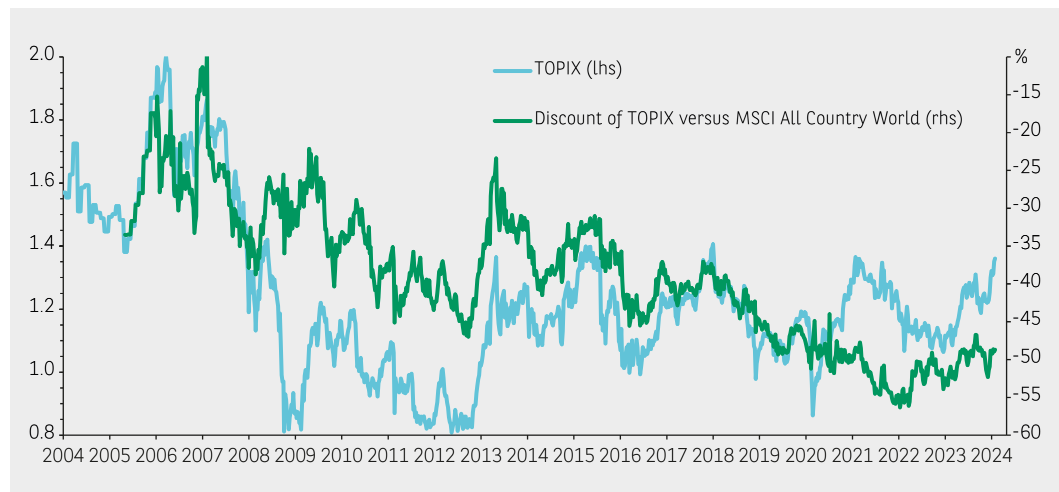


Data as at 2 February 2024. Note: As the latest period (calendar 1Q) is not complete, the bar is an adjusted intra-quarter data point. Sources: AlphaSense, Haver Analytics, Morgan Stanley Research. Top charts pulled from earnings transcripts. The normalized trend is calculated as a function of the number of documents containing hits on the keyword and the total documents that would be found for the same search without the keyword. Searches are inclusive of synonyms. Universe is US public companies with market caps >$1B, excluding Financials.

Exhibit 3

Japanese equities are cheap

Price-to-book ratios



Data as at 29 February 2024. Sources: Datastream, BNP Paribas Asset Management.

US vs. Europe

The US seems most at risk of rates staying higher for longer, given the robustness of US growth in recent years that remains in stark contrast to the rest of the world. Inflation is also stickier. That services and housing inflation have picked up should not perhaps have been such a surprise given that wages (as measured by average hourly earnings) and house prices (as measured by the Case-Shiller index) have risen over the last couple of months.

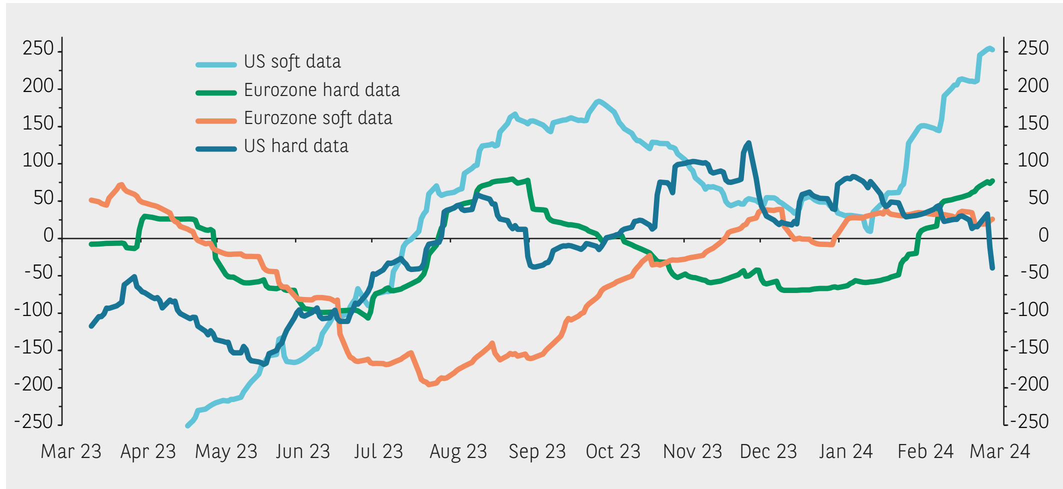
We remain concerned that as the impact of previous fiscal stimulus wanes, and without the cushion of COVID-era excess savings, that risks to growth remain skewed to the downside as the Fed delivers tighter policy. Recent data lend some support to this view. Both the latest services PMI and ISM (Institute of Supply Management) indices as well as the manufacturing ISM index unexpectedly fell, retail sales were weak, and the NFIB (National Federation of Independent Business) survey – which reflects sentiment of smaller businesses that employ more than half the active labour market – looking particularly poor across components. Unlike Europe, or indeed Japan, the broader US economy benefits much less from an improved outlook for manufacturing.

Besides weaker US growth, we see four other key risks for this year: uncertain central bank policy reaction functions (partly linked to an upturn in manufacturing); contagion from real estate/non-bank lending to the broader economy; the impact of mega-caps on equity market returns; and deflationary deleveraging in China.

In Europe, higher inflation data (particularly services) was similar to what we have seen in the US. Growth, though, is improving, moving in the opposite direction to the US. February's PMIs have generally shown activity either expanding at a faster pace or at least not contracting as quickly (see Exhibit 1). Germany is the notable outlier, with continued weakness in cars contrasting with strength in other cyclical sectors such as chemicals. Much of the bad news around Europe is arguably already reflected in current prices and expectations and there is room for better-than-expected data to continue (see Exhibit 4). This supports the closure of our European equity short this month.

Exhibit 4

Eurozone surprises have room to rise



Data as at 6 March 2024. Sources: Bloomberg, BNP Paribas Asset Management.

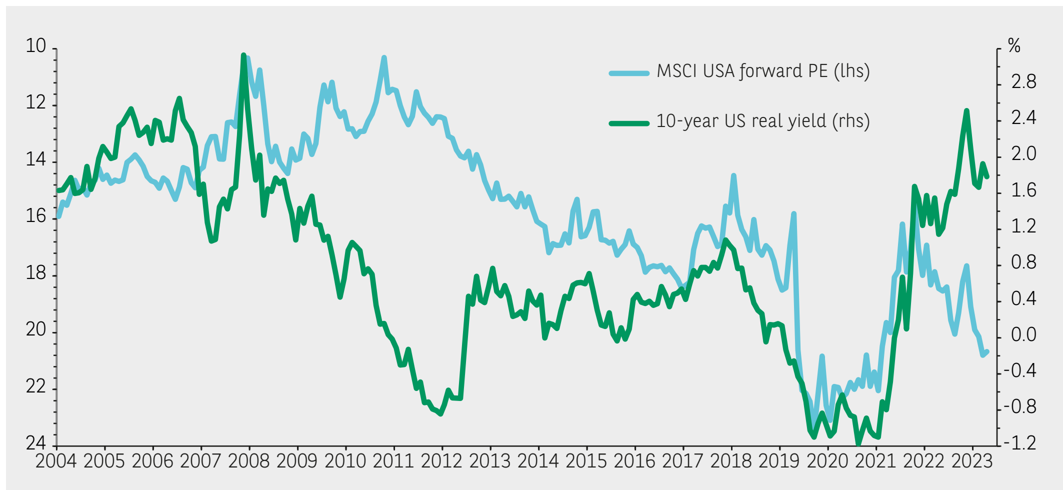
Asset valuations

Strong returns for equities as rates have risen has inevitably led to richer equity market valuations and cheaper bond market valuations. We see this across a host of metrics, including the gap between forward P/E ratios and real yields (see Exhibit 5). Purely from a valuation perspective, there is considerably more risk premium on offer in bonds relative to equities, with the size of the gap today being seen only a handful of times in the last century.

Exhibit 5

Equities richer, bonds cheaper

MSCI USA forward 12-month price/earnings ratio and US 10-year real yield



Data as at 6 March 2024. Sources: Bloomberg, FactSet, BNP Paribas Asset Management.

Credit markets have seen corporate bond spreads tighten more broadly, with narrower spreads in most markets year-to-date. Eurozone high-yield has led, joining US high-yield and US investment-grade in the 20th percentile of historical ranges. US securitised bond spreads (ABS and CMBS) have narrowed aggressively. Eurozone investment-grade credit has the most compelling valuations as spreads are at only average levels, and we believe they have room for further compression.

Within equities, cyclical sectors generally appear expensive (communication services, industrials, consumer discretionary), while defensive sectors are mixed (utilities and consumer staples seem cheap to fair value, while healthcare looks expensive). Assessing equity market valuations with a longer-term view, US valuations look rich, driven by the high multiple being place on forward earnings (EPS) that are more line with their trend. The Magnificent-7 stocks, however, stand out with well-above-trend earnings forecasts. In Europe, by contrast, a lot of bad news seems to be reflected in current prices.

In other assets, we observe a a more pessimistic economic view in market positioning in commodities, though it is less clear from relative price moves. Currencies are moving versus the US dollar increasingly in line with relative rate differentials, with real rates most important for EUR-USD, while nominal rates are more relevant for USD-JPY.

Our market temperature indicators continue to show equity markets looking stretched with narrow leadership. Fixed income appears more neutral, with a notable green flag from very short CFTC (Commodity Futures Trading Commission) positioning in US Treasury 10-year futures. Gold and the US dollar have moved back to the neutral camp.

Our asset class views

	Strongly dislike	Dislike	Neutral	Favour	Strongly favour
PRR/risk appetite		X			
Asset allocation			Real Estate → Commodities Cash	**Equities** Government bonds Credit	
Equity regions		→	**Europe ex-UK** US UK EM ex-Asia	Japan EM Asia	
Equity style/size			EU large cap EU small cap US large cap US small cap		
Sovereign bonds		Japan	Europe UK Australia	US linkers US MBS EM local debt	
Credit			EMD US IG US HY EUR HY	EU IG	
Commodities			Energy Base metals	Precious metals	
FX			EUR, USD, AUD, GBP, JPY	EM FX	

Twelve-month, risk-adjusted view. The above view(s) represent our judgement as at the date of this presentation and may be subject to change without notice.

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

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