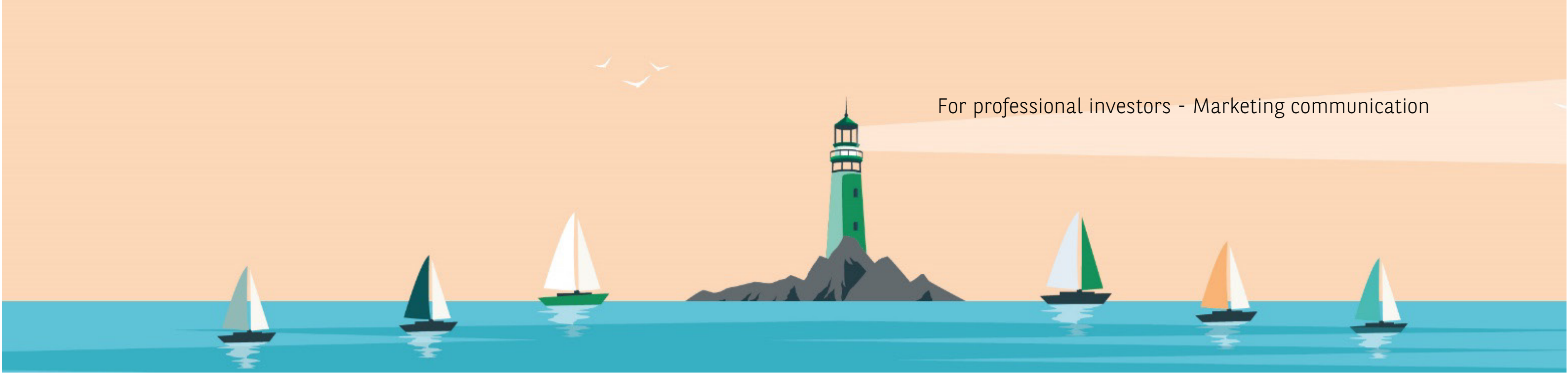

Asset allocation monthly August 2022


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Four shifts

- This downturn is global, not US-centric. The current gap between optimistic equity analysts and cautious economists is particularly pronounced. We believe earnings estimates are at risk as the slowdown we anticipate materialises.
- One reason for recently buoyant equity markets and robust earnings forecasts is the belief that central banks will no longer raise interest rates by as much as had been feared. We do not believe central banks will be dissuaded so easily, however, as inflationary pressures are still strong and persistent.
- BNPP AM Multi asset portfolios remain cautiously positioned. We made four shifts over the month to portfolio positioning:
    - Upgraded credit to 'favour', with exposures pointed towards European investment-grade credit
    - Tactically deepened our duration short after the sharp rally in European yields
    - Increased our exposure to commodities
    - Tidied up our equity positioning to get to neutral

Portfolio perspectives

Gyrations from inflation to recession worries have continued to roil financial markets, with wild swings in both bond and equity prices. These market moves can be understood in context of European gas prices more than doubling in recent weeks, soggier macroeconomic data with still heightened inflation, and a muddled start to the earnings season. BNPP AM Multi asset portfolios remain cautiously positioned: we are seeking to dial up risk gradually in areas such as high-grade corporate credit and commodities, while remaining cautious on duration and neutral on equities. As such, we made four changes over the month to portfolio positioning:

First, we upgraded credit to 'favour', with exposures pointed towards European investment-grade credit where distress is now pronounced and where the valuation opportunity looks increasingly attractive. European IG appears to be pricing in a particularly adverse scenario, with an 8-10% implied default rate on the iTraxx Europe Main index, for example. That is twice the worst five-year default rate and eight times the historical average. Swap spreads have also widened dramatically – this is unusual given that monetary policy is tightening.

The relationship between implied defaults and actual defaults is extremely weak: stressed implied defaults have *never materialised* for high-yield nor notably for IG. Yet spreads trade on implied rates rather than delivered ones, so the implied rate matters more. On one hand, based on history, things *might* get worse – during the GFC and eurozone crises, default rates peaked at 16-17%. But importantly, on the other hand, this would require either a deep and protracted recession that forced waves of defaults, or profound balance sheet issues. On recession, our colleagues in central research expect only a shallow 2001-style correction, against which the 8-10% default rate that the market has already priced seems exaggerated. On the balance sheet issues, our colleagues are pointing to broadly healthy corporate balance sheets, reaffirmed by the latest earnings reports.

Notably, higher-quality corporate bonds look attractive from a relative cross-asset perspective, with European IG nearly 1 standard deviation cheaper relative to Stoxx 600 shares on long-run averages; for HY, this is just around average.

Second, after the sharp rally in European duration, we tactically deepened our short. Inflation is not going away in Europe anytime soon; the ECB looks unlikely to be cutting rates early next year as priced by the markets; and bond yields all in should be higher – not least reflecting the shift in the fiscal paradigm. To be sure, responses to the gas crisis are likely to be fiscally-led given the concerns around inflation in the near term.

Third, with the prices of many commodities down by 20% or more since the peak, we deepened our tactical exposure – this is a valuation led-move, with fundamental supports still in place or slightly firmer. These factors include strategic elements (such as resource nationalism, greenflation), but also geopolitics – commodities typically benefit in uncertain times. There is also a clear scarcity of supply, with low inventory buffers. Finally, there is support from Chinese macroeconomic policy which continues to lean towards easing in contrast to the rest of the world. Commodities have offered portfolios important diversification opportunities as one of few good places to 'hide' amid significant uncertainty over growth, inflation, earnings and policy.

Fourthly, at the start of the month, we tidied up our equity positioning to get to neutral, selling our modest emerging market exposure, while keeping our Chinese and Japanese exposures against a broadly offsetting European short. We have been a whisker away from neutral for some time, so this is a 'cleaning-up' trade rather than a shift in our underlying views, reflecting our assessment that equities are still not broadly cheap.

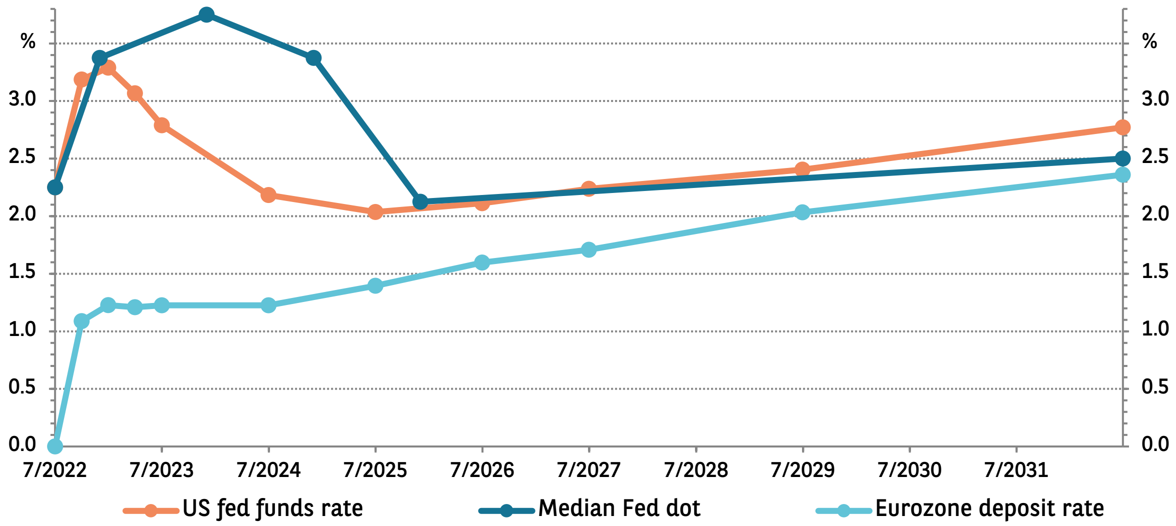
Risk taking is a smidgen higher after these moves over July, and duration a smidgen longer.

A sudden growth slowdown

The US economy is in a technical recession, with more weakness expected in 2023 when the labour market should come under pressure, too. Retail sales have struggled in many countries, consumer confidence has plummeted, and purchasing manager indices have dropped into contractionary territory. This downturn is global, not US-centric. Nor is it an environment where one would expect robust earnings growth ahead, though that is what is projected by analysts today. The current sizeable gap between optimistic equity analysts and cautious economists is particularly pronounced.

One reason that equity earnings are holding up better than expected appears to be a belief that central banks will no longer raise interest rates by as much as had been feared: bad economic news is seen as positive for monetary policy and markets. With economies already slowing, policy needs to do less to damp demand and bring down inflation. The level that markets expect the US federal funds rate and the ECB's deposit rate to reach in a year's time has dropped by over 100bp over the last six weeks. The Fed is projected to cut rates by next spring despite its own forecast for further rate rises through the end of 2023. The ECB is predicted to end its own rate rising cycle fairly soon (see Exhibit 1).

Exhibit 1
Benchmark rate forecasts



Sources: Bloomberg, US Federal Reserve, BNP Paribas Asset Management, as at 31 July 2022.

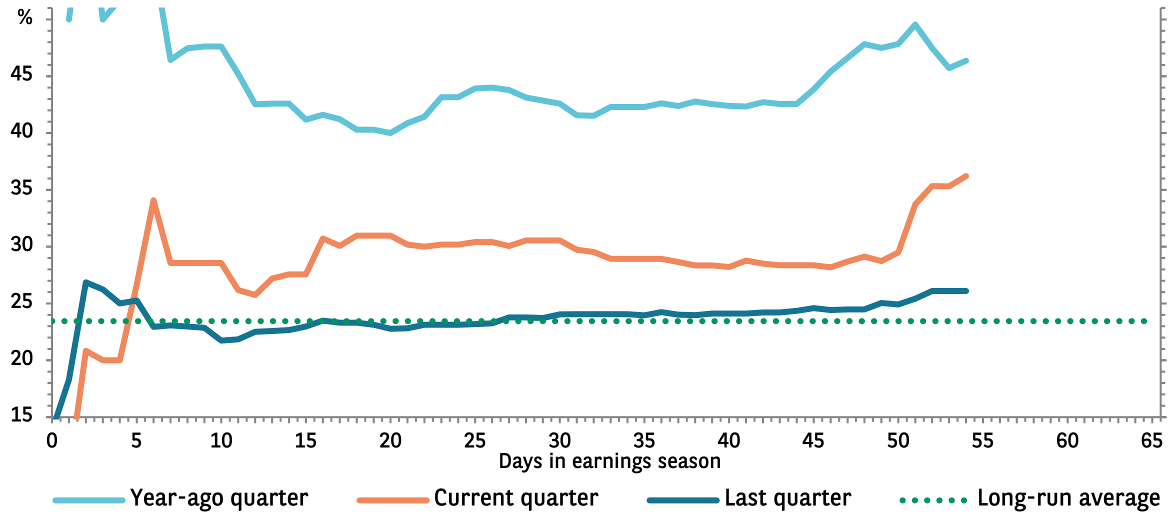
We disagree. While central banks are worried about recession – and the ECB may yet have to deal with the stagflationary fallout of a cut-off of Russian gas this winter – inflation is unlikely to fade quickly enough to allow them to pause so soon. The conflict in Ukraine will likely keep commodity prices high, and while this primarily determines headline inflation, there is a pass-through to core inflation. China is still struggling with Covid, meaning that supply-chain bottlenecks will not be easing anytime soon. High house prices will likely keep pressure on rents for months to come. Unemployment is low and wage demands are rising in response to high inflation. The German Lufthansa trade union Ver.di is merely the latest to strike, demanding a 9.5% pay raise. We believe it will take more tightening, and a bigger slowdown in growth, before inflation falls to anywhere near central bank targets. Consequently, we are underweight duration.

Earnings season

In this context, the latest earnings season has nonetheless been modestly reassuring. Large profits in the energy sector have been offset by equally large losses for financials, but excluding those two sectors, earnings have risen by 4% in both the US and Europe. Sales and earnings surprises have been positive. Sales growth has been even greater than earnings growth thanks to inflation, but cost pressures have limited how much of that makes it to the bottom line. Some companies have lowered their outlook due to the impact of rising food and fuel costs on consumer spending (e.g., WalMart), but the share of US companies raising their outlook is running at 36% versus a 23% historical average (see Exhibit 2). To look at it from the opposite perspective, typically 38% of companies lower their guidance in a quarter, while so far the figure has been only 34%.

Exhibit 2

Positive share of corporate guidance



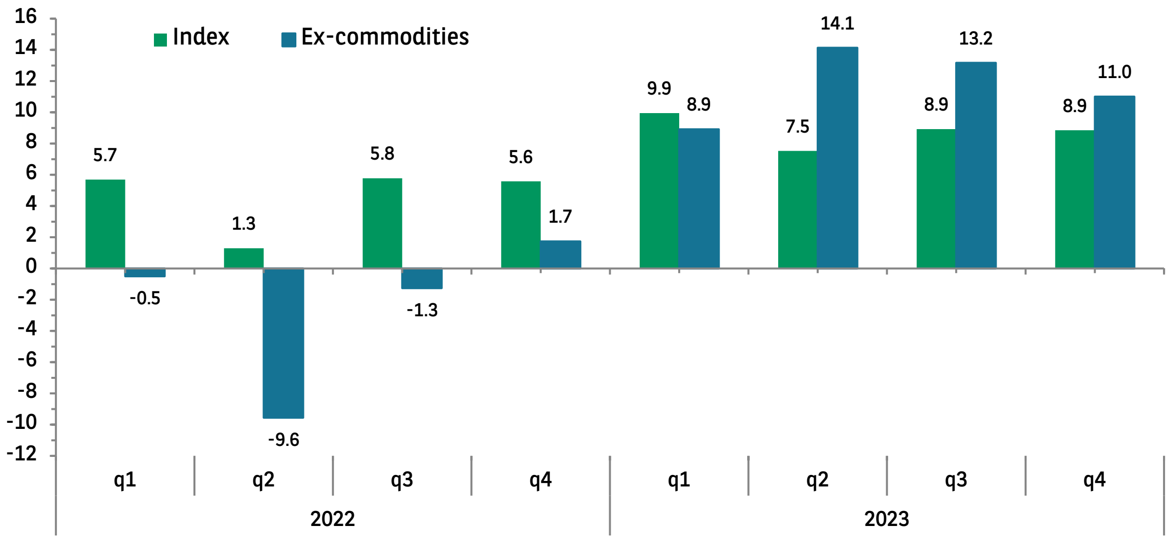
Sources: Bloomberg, BNP Paribas Asset Management, as at 31 July 2022.

We are nonetheless cautious about the outlook, particularly for earnings in Europe ex-UK. We do not believe the current consensus forecasts for growth (8% this year and 6% next year) are consistent with the economic slowdown we anticipate. US forecasts are similarly robust (see Exhibit 3). While we appreciate that published earnings estimates are a lagging indicator, at some point, earnings per share estimates will likely begin to fall more quickly and equity prices should follow suit.

Last year's broad equity market returns were driven mostly by valuation gains, in turn secured by lower real rates. So far this year, market declines have been driven by falling valuations, with hardly any change in the scale of relative overvaluation given current rates and earnings trends. Put differently, the lack of any contraction in global earnings forecasts is in stark contrast to the 9-17% one would expect should EPS return half way or fully to trend levels. A modest 9% fall in EPS, with real rates of around 60bp, would imply an index level 16% lower than what we have today. A larger 17% fall in earnings, with real rates at say 10bp, gives a similar degree of mispricing. The much more pessimistic scenario of a meaningful recession with high inflation could see a 35% fall in EPS and real yields over one percent, pointing to a potential 45% market decline.

Exhibit 3

Consensus US year-on-year earnings growth estimates



Ex-commodities excludes energy, fertilizers and agricultural chemicals, metals and mining, and agricultural products. Sources: MSCI, FactSet, BNP Paribas Asset Management, as at 31 July 2022.

Asset class views

	Strongly dislike	Dislike	Neutral	Favour	Strongly favour
Risk appetite*		X			
Asset allocation		Government bonds	Equities Real estate Cash	Credit Commodities	
Equity regions		Europe ex-UK	US UK Emerging markets ex-Asia	Japan EM Asia	
Equity style/size			EU large cap EU small cap US large cap US small cap		
Sovereign bonds		US Europe Japan	EM local Australia UK Inflation-linked bonds		
Credit			US IG US HY EU HY EM debt	EU IG	
Commodities				Energy Base metals Precious metals	
FX			USD, AUD, GBP, EUR, JPY, EM currencies		

* Risk appetite/return to risk - Data as at 31 July 2022. The views reflect those of the Investment Committee of the Multi-Asset team at MAQS. Other specific/tactical trades may be implemented in addition.

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