

Equity Risk Management: Adopting a neutral stance

Key Messages

Elevated energy prices act as a global “tax”: the combination of elevated natural gas and crude oil prices (Brent crude oil at USD95/barrel at present) continue to act as a global tax on the global economy. The longer this remains the case on the back of potential Russia/Ukraine military action, the greater the effect on slowing global growth.

High inflation impacts consumer spending: the high inflation rates suffered by US households in particular has already translated into sharply lower consumer sentiment, the lowest since mid-2020 (depressed by the first COVID-19 pandemic wave). This in turn is translating into lower forecasts for near-term US economic growth.

Inflation rates will decline, but timing remains uncertain: we believe that inflation rates are likely peaking soon. The key question is: how quickly will they decline? This will depend to some extent on the evolution of energy prices, which remains very uncertain.

Equity, credit valuations likely to cheapen, near term: we have been positive on equities as an asset class for several years. But we want to manage the rising risks to stocks, locking in 2021's impressive stock market gains.

Conclusion: we downgrade our stance on equities to neutral (from positive). We downgrade our regional equities views as follows: **US to negative** (from neutral), **Europe to neutral** (from positive). We also downgrade the **US technology and Consumer Discretionary sectors to negative**. We raise allocations to gold (a beneficiary from uncertainty, stagflation concerns and need for portfolio diversification) and to lower-volatility investment products.

What could drive an equity upgrade back to positive? a) Lower oil prices on any de-escalation of Russia/Ukraine tensions, b) a clear sign of easing goods inflation pressures (from supply chain improvement) and c) service sector rebound from a continued decline in Omicron COVID infection rates, leading to a release of remaining restrictions.

Positive on equities longer term, but managing risks shorter term

There are many reasons to hold a longer-term positive view on equities: a) robust earnings and cash flow growth, supported by b) above-trend real and nominal economic growth (aided by government infrastructure programs), c) long-term real yields still below zero, d) high levels of accumulated savings, and e) a forthcoming boost from the elimination of COVID-related mobility restrictions globally.

However, **in the short term** we see that a number of key macro risks have increased sharply recently:

1. **Multi-decade high inflation rates** (including 40%+ oil and gas price inflation) are depressing consumer sentiment more than expected, and point to lower consumer demand (the US consumer represents two-thirds of the US economy);
2. **Tightening financial conditions and weakening credit growth**, even before the US Federal Reserve raises rates, putting pressure on the valuation of risk assets;
3. **Russia/Ukraine geopolitical tensions could deteriorate further**, potentially increasing oil & gas prices even more. This could delay the normalisation of inflation, keep the pressure on global central banks, and lead to a further drag on global economic growth.
4. **Higher uncertainty around central bank policy weighs on the risk appetite for equities:** since late January, the interest rates futures market has moved to price nearly 7 rather than 4 Fed Funds rate hikes in 2022. This suggests that markets fear a much faster rate hiking cycle, which historically has been less favourable to equity markets. The uncertainty should fall later this year as inflation peaks.

Edmund Shing, PhD

Global CIO
BNP Paribas Wealth Management



Managing stock market risk until growth uncertainty subsides

Energy prices pressure inflation, consumers

Geopolitical tensions have continued to rise over recent days. Rumours of a possible invasion in the Ukraine have put additional pressures on financial markets. The Brent crude oil price has hit new multi-year highs.

In such a context, we expect inflation numbers to remain elevated – or even to climb higher – as energy prices could rise more in the short-term and begin to affect other segments of the inflation basket. We are still looking for a peak in inflation later this year. The renewed sources of inflation will probably depress consumer confidence even more and delay the recovery, despite positive signals regarding the pandemic and mobility restrictions. Consumer demand represents more than 60% of total demand; the weakness in consumer confidence on both sides of the Atlantic should lead to weaker-than-expected GDP data at least for the first quarter of this year.

We still expect growth to accelerate over the rest of year as consumers see inflation peaking and thanks to the re-opening and huge amounts of accumulated savings.

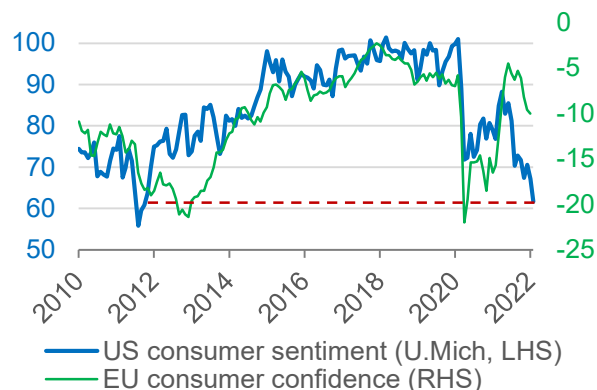
Medium-term trends linked to the massive government stimulus programs will also play a key role and multiplier effects should be high. Growth should thus stabilize above pre-Covid levels over the course of the year.

The Fed should keep talking a tough line to avoid investors extrapolating the recent record high inflation data into the future. At this stage, long-term inflation expectations remain well anchored. Political pressure on the Fed should fall back once inflation has peaked. Therefore, it should not be pushed to raise its policy interest rates at each meeting this year (as per current market expectations).

We would employ a similar line of argument for the ECB. We thus see limited potential for upside surprises on interest rates, once short-term inflation pressures have eased. By the end of 2023, policy rates should stabilize around 2% in the US and around 0.75% in the Eurozone. We keep our targets unchanged for the 10-year yield with 2% in the US and 0.25% for Germany. However, we cannot exclude some overshooting of these bond yield levels in the short-term.

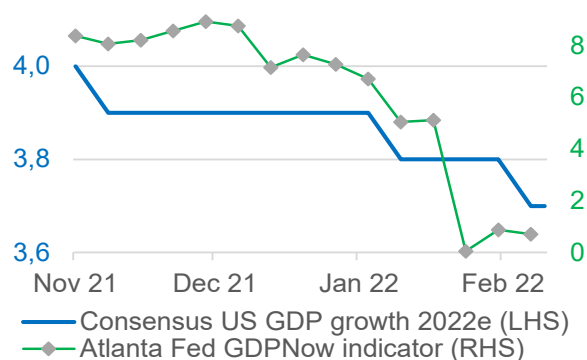
Guy Ertz, PhD

US, EU CONSUMER SENTIMENT HEAVILY IMPACTED BY HIGH INFLATION



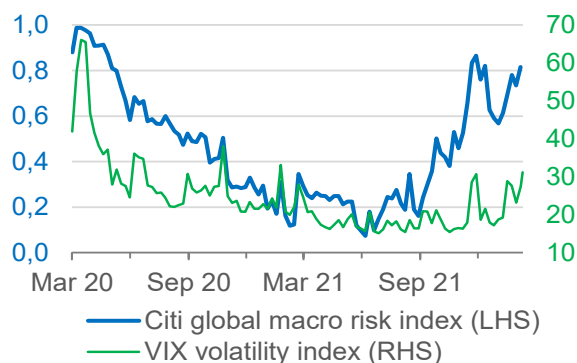
Source: BNP Paribas Wealth Management, Bloomberg

US GDP GROWTH FORECASTS BEING REVISED LOWER IN LINE WITH WEAK EXPECTED Q1



Source: BNP Paribas Wealth Management, Bloomberg

MACRO RISK, EQUITY VOLATILITY INDICES HAVE SURGED IN RECENT WEEKS



Source: BNP Paribas Wealth Management, Bloomberg



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Take some stock market profits now, wait for a clearer re-entry point

On the back of a) the current elevated uncertainties around inflation and central bank responses, combined with b) the risk of higher risk premia as geopolitical tensions continue to rise, we prefer to adopt a **neutral** stance on equities as an asset class. The potential for a “growth scare” to develop, largely from a downwards revision to consumer spending, remains live. This could drive a further stock market correction in the short-term, eroding investors’ 2021 stock market gains.

Sector allocation changes

US equities are expensive (exp. 2022 P/E = 21x), and uncertainties have increased, especially with respect to both inflation and interest rates. With more money going to pay ever-increasing energy bills, consumers are likely to reduce other areas of spending. This is not yet fully priced in our opinion. Thus, expensive growth stocks and sectors remain vulnerable, especially the US Technology and US Consumer discretionary sectors.

Therefore, **we downgrade both the US Technology and the US Consumer discretionary sectors from neutral to negative**. In the medium term, a few segments in these sectors should perform better than the rest, due to higher expected growth rates (cf. the Metaverse theme). Whereas most tech stocks are likely to underperform in the short term, we remain neutral on Semiconductors, 5G, e-gaming, cybersecurity, electronic payments and artificial intelligence. The European technology sector is more exposed to these segments; so we retain a neutral rating on European tech. European Consumer Discretionary is also relatively cheaper than its US counterpart, and offers good growth prospects - we thus retain a neutral rating.

Alain Gérard

Conclusion

We downgrade our stance on equities to neutral (from positive). We downgrade our regional equities views as follows:

US to negative (from neutral),

Europe to neutral (from positive).

We would raise allocations to the following asset classes:

Gold (benefits from uncertainty, stagflation concerns, boosts portfolio diversification),

Lower-volatility investment products, such as absolute return bond funds, lower-volatility alternative UCITS fund strategies, floating-rate bond and credit funds.

Diversification remains a crucial element in smoothing the volatility in investors’ portfolios, via alternative asset classes including real estate, infrastructure, commodity exposure and alternative UCITS funds, particularly those offering credit-like volatility properties.

What could drive an equity upgrade back to positive?

a) Lower oil prices on any de-escalation of Russia/Ukraine tensions,

b) Clear signs of easing goods inflation pressures (from supply chain improvement), and

c) A strong service sector rebound from a continued decline in Omicron COVID infection rates, leading to a release of remaining mobility restrictions.

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FRANCE

Edmund SHING

Global Chief Investment Officer

ASIA

Prashant BHAYANI

Chief Investment Officer

Grace TAM

Chief Investment Advisor

BELGIUM

Philippe GIJSELS

Chief Investment Advisor

Alain GERARD

Senior Investment Advisor, Equities

Xavier TIMMERMANS

Senior Investment Strategy, PRB

LUXEMBOURG

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