FLASH: 25 JANUARY 2022

Taper Tantrum sequel, or something worse?

Key Messages

Post an excellent 2021 for real assets and equities, a return to earth: after a 2021 which saw strong returns for real asset and stock markets with very little volatility, 2022 has started with a volatility wake-up call.

The key trigger – sharply higher US short-term, real bond yields: markets have moved quickly to price in four Fed funds rate hikes by the end of 2022. 2-year US Treasury yields have risen 80 basis points, while the US 10-year real yield has gained 50bp. Higher real yields, ceteris paribus, imply lower P/E valuations for stocks. Over January, the S&P 500 forward P/E has declined from 21.6x to 19.7x, with the STOXX Europe P/E falling from 15.8x to 14.7x.

The realisation dawns that we have already seen the peak in US growth and inflation momentum: higher interest rates, combined with a far lower fiscal stimulus boost in 2022 and the drag from high inflation, will inevitably drive slower growth this year. Federal Reserve monetary tightening risks a sharper-than-expected slowdown, particularly if energy prices (a global "tax") remain stubbornly high into springtime. This is not our central scenario, but we remain mindful of the risk of Fed policy error.

Retreat of previously ebullient retail investors: the flood of retail investor flows into more speculative areas of financial markets (non-profitable technology stocks, IPOs, SPACs, cryptocurrencies), and the accompanying jump in margin debt is now starting to unwind, amplifying this corrective move in stock markets.

Conclusion – we retain a positive equities stance for now with a focus on Europe, but we keep a very close eye on developments in Ukraine/Russia to monitor any further near-term increase in market risk. Were this risk to settle, the fading impact of the Omicron COVID-19 variant should drive higher consumption of services, supporting above-trend real and nominal growth momentum.

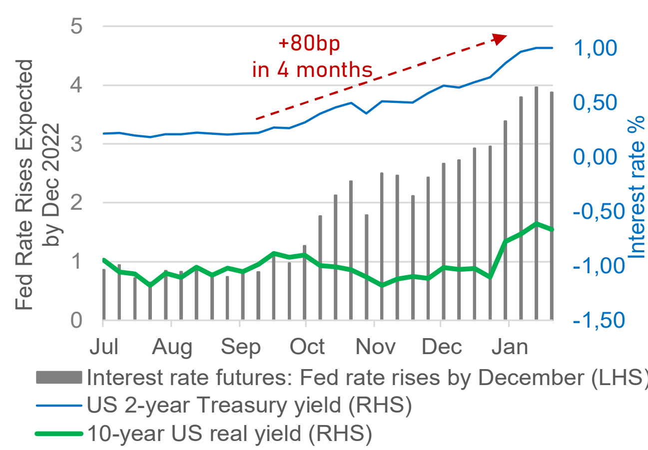
A hawkish Fed has a delayed impact on markets

Since September 2021, the US Federal Reserve has been sending increasingly hawkish signals regarding the start of a new rate hiking cycle, in response to the surge in US (and global) core and headline inflation that began in April 2021.

As the US Personal Consumption Expenditure core inflation rate (the Fed's preferred inflation measure) has soared from 1.5% at the beginning of 2021 to 4.7% as of November, interest rate expectations have reset from one expected Fed rate hike in 2022 to four rate hikes today.

This has driven both 2-year US bond yield and the 10-year US real yield sharply higher in the space of three months, triggering a corrective phase in stock markets.

SHARP RISE IN 2-YEAR US BOND YIELDS, REAL YIELDS HAS PRESSURED EQUITIES



Source: BNP Paribas Wealth Management, Bloomberg

Edmund Shing, PhD
Global CIO
BNP Paribas Wealth Management

Fearing a Q4 2018 episode repeat?

Q4 2018 redux – Fed policy error, swiftly corrected: over the last quarter of 2018, the S&P 500 index fell 18% and the Nasdaq Composite fell 21% from peak to trough as stock market investors feared that the Fed were overtightening monetary policy via Quantitative Tightening (reducing the size of their balance sheet by selling US Treasury bonds). But with this stock market selloff, the Fed reversed course.

Today, the Fed is expected to raise rates by a cumulative 1% between March and December, and further tighten monetary policy via tapering of bond purchases followed by Quantitative Tightening later in the year. Stock market investors seem to be harbouring fears of a Fed policy mistake similar to 2018, at a point when inflation momentum has already peaked and when growth is decelerating.

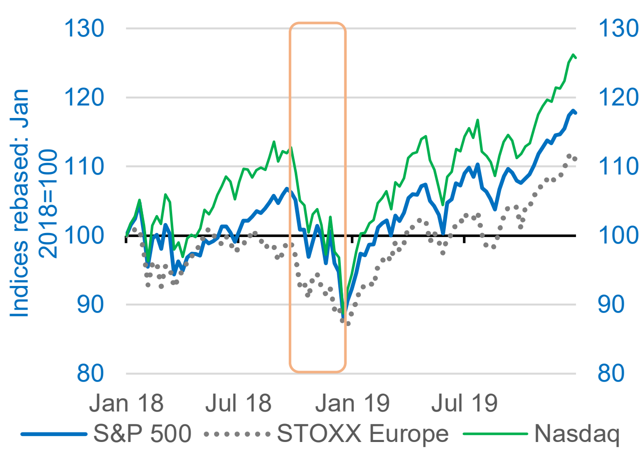
Triggering a reset in retail investor sentiment

Given the huge inflows to equities, and particular into the tech sector over 2021, we can look at the current stock market correction has a healthy resetting of retail investor expectations. This is a timely reminder that "*stocks do not just go up in a straight line*".

Assuming that both real and nominal (real growth + inflation) GDP growth remain above long-term trend in 2022, there is every reason to suppose that we can avoid a bear market as per the aftermath of the Year 2000 tech bubble.

We remain optimistic that solid earnings trends and a higher equity risk premium (on the back of a lower P/E and long-term interest rates that have moved relatively little) can support positive stock market performance over 2022.

Q4 2018: S&P 500 FELL 18%, NASDAQ 21% AS THE FED REDUCED ITS BALANCE SHEET



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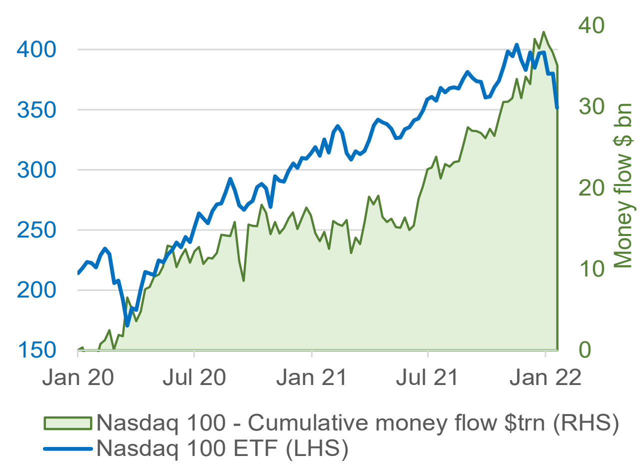
RETAIL INVESTORS HAVE POURED MONEY INTO THE TECH SECTOR IN 2021



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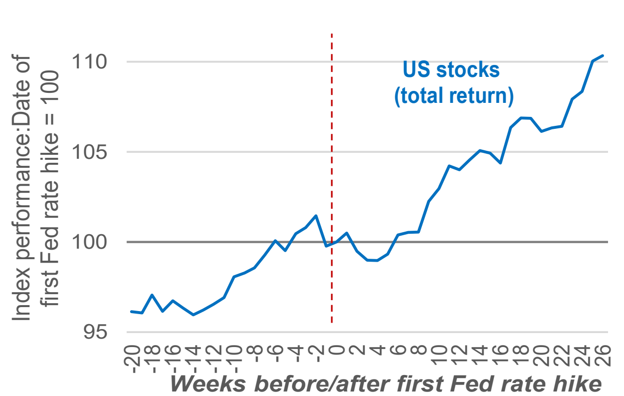
HISTORICALLY, STOCK MARKET INVESTORS SHOULD NOT FEAR THE FIRST FED RATE HIKE



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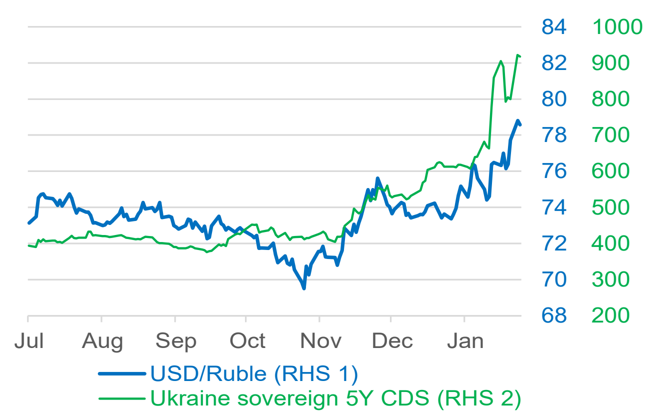
UKRAINE/RUSSIA GEOPOLITICAL SITUATION IS THE WILDCARD, TO BE MONITORED CLOSELY



Source: BNP Paribas Wealth Management, Bloomberg

The pressure on the US Fed from high inflation may be about to ease: if the signs from the ISM Manufacturing survey and the New York Fed's global supply chain pressure index are correct, then global and US goods inflation pressures should ease progressively over the next few months, reducing the pressure on the Fed to tighten policy rapidly.

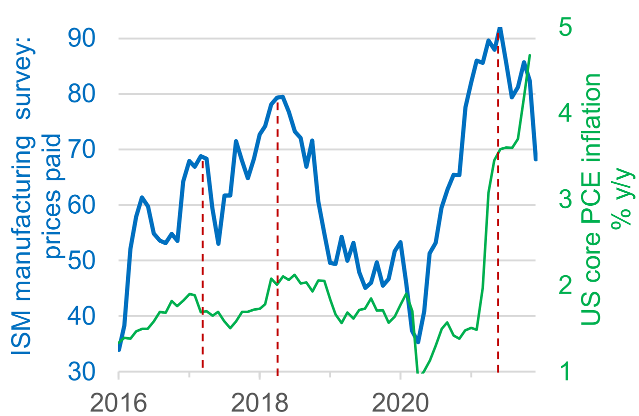
In many ways, the sharp increase in bond yields has already done much of the Fed's work for them, potentially reducing the need for the Fed to deliver the double tightening (Fed funds rate, reduction of balance sheet) that the stock market fears. US financial conditions have already tightened significantly since the end of December.

Conclusion

Should investors rush to increase their weightings to risky assets such as stocks, high yield credit and commodity currencies after this correction? We would caution against an aggressive "buy the dip" mentality, given the ongoing geopolitical uncertainties.

Should these concerns ease (flagged via strengthening of the rouble and a reduction in the Ukraine sovereign CDS index), then we would look to gradually increase stock market exposure, focusing on European stocks and quality factor/quality dividend strategies.

ISM MANUFACTURING SURVEY PRICES PAID COMPONENT FALLS, SHOULD LEAD A FALL IN US CORE INFLATION



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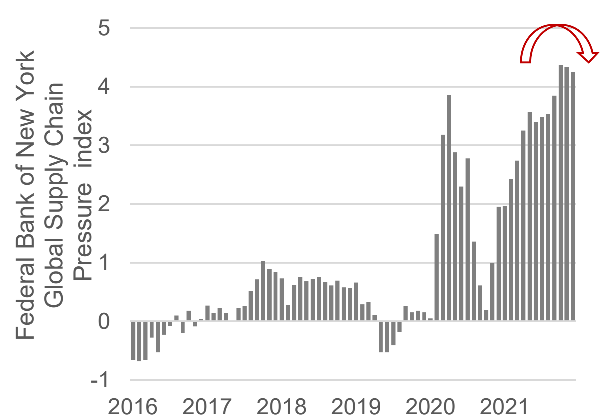
NEW YORK FED GLOBAL SUPPLY CHAIN PRESSURES INDEX POINTS TO SOME EASING OF SUPPLY CHAIN DISRUPTION



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THE INVESTMENT STRATEGY TEAM

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

Guy ERTZ
Chief Investment Advisor

Edouard DESBONNETS
Investment Advisor, Fixed Income

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