JANUARY 2022

Investment Strategy Focus

Summary

1. **Oil market pullback provides investment opportunities:** with Brent crude oil easing back USD4-5/barrel below October's peak, lower crude oil prices provide attractive entry points in enhanced commodity ETFs/funds exploiting the roll yield, and also in oil producer shares.

2. **We still expect the US Fed to raise interest rates three times this year**. A June rate hike, although risks are now for an earlier lift-off, would come only two meetings after the end of tapering (reduction in the Fed's QE programme). Inflation developments, linked to the Omicron variant/supply chain disruptions, and labour market improvements will be key in determining the path of rate hikes.

3. **Don't be afraid of the Fed:** stock markets typically continue to rally circa 10% over the six months post the first Federal Reserve interest rate hike, as per previous Fed rate hiking cycles.

4. **Growth stocks have not all done as well as you think:** while the average S&P 500 stock has gained 24% in 2021; in contrast, the very growth-oriented ARK Innovation ETF in the US has lost 40% since February 2021 peak, and recent US IPOs are 27% on average below peak.

5. **Waiting for a trigger to upgrade fixed income:** with both 10-year sovereign yields and investment-grade credit spreads low by historic standards, it remains too early to buy back into these two asset classes. We await either a) more attractive yield levels, or b) clear signs that inflation rates are set to fall quickly before upgrading government bonds and credit.

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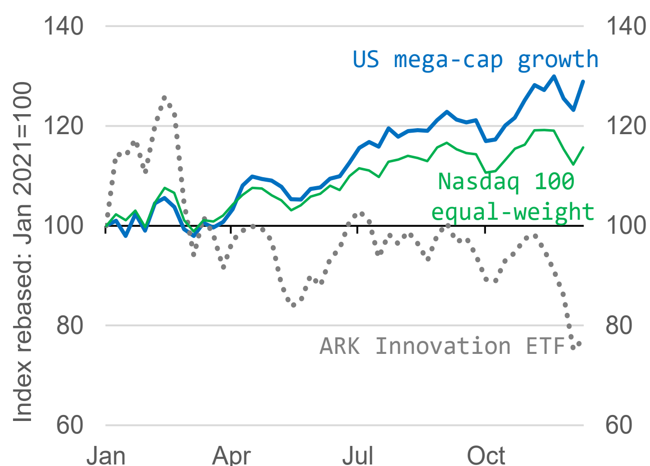
EXPENSIVE GROWTH STOCKS HAVE DIVERGED MASSIVELY FROM THE FANGS



Source: Bloomberg

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The bank for a changing world

The Federal Reserve strikes a hawkish tone in its minutes

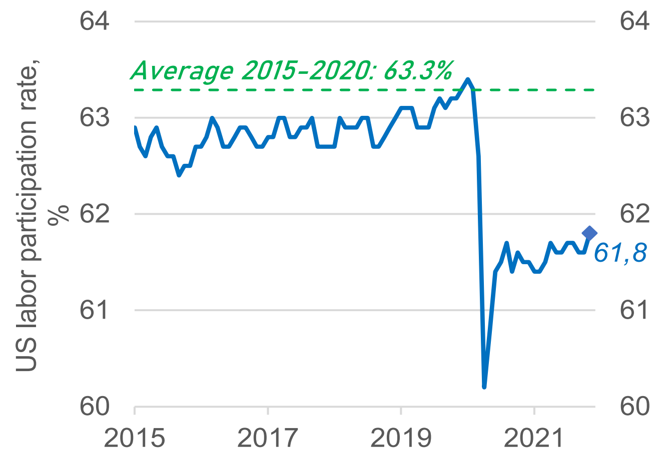
The minutes of the last FOMC meeting confirmed the hawkish pivot of the Fed and showed a greater concern about inflation. Discussions on policy normalisation are more advanced than markets expected on policy rates and also on balance sheet runoff.

Most participants believe that conditions for raising rates will be met "relatively soon", that the balance sheet runoff should start sooner after the policy rate lift-off and be faster than in the Committee's previous experience.

This is consistent with our assumption of three interest rate hikes this year, starting in June.

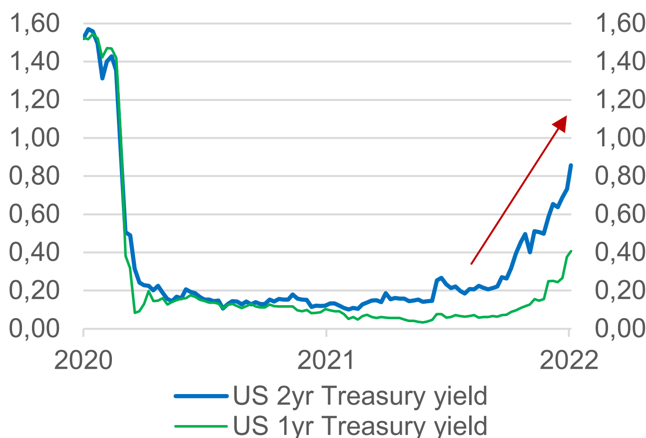
A June rate hike, although risks are now for an earlier lift-off, would come only two meetings after the end of tapering (reducing bond buying in the Fed's programme of quantitative easing). Inflation developments, linked to the Omicron variant/supply chain disruptions, and labour market improvements will be key in determining the path of rate hikes.

THE US LABOUR MARKET IS STILL MISSING 2.4 MILLION WORKERS VERSUS PRE-PANDEMIC



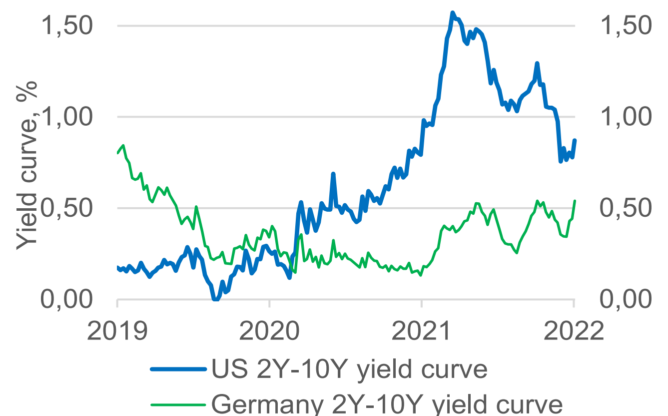
Source : Bloomberg

SHORT-TERM US BOND YIELDS RISE SHARPLY REFLECTING A MORE HAWKISH FED



Source : Réserve fédérale américaine

US AND GERMAN YIELD CURVES STEEPEN IN 2021-22



Source : Bloomberg

We monitor a number of key indicators closely, including the high yield spread, for signs of a shift from the reflation stage to the overheating/peak stage of the cycle. Thus far, with high yield spreads close to historic lows, we remain in Stage 2 reflation, and thus remain positive on equities, real assets and certain commodities. But this could of course change quickly in the weeks and months ahead, should growth decelerate and inflation remain worryingly high.

5 surprising facts about 2021's financial markets

We all know that 2021 was in general a pretty good year for investors, whether they were invested in stocks, property or commodities such as oil and copper. A euro-based investor with a portfolio composed of 60% global stocks, and 40% global bonds would have gained over 13% so far this year, in spite of the recent consolidation phase.

But here are five financial facts for 2021 that you may not have noticed:

1. Growth stocks did not do as well as you may think: while the average S&P 500 stock gained 24% in calendar 2021, the average Nasdaq 100 stock only gained 14% last year. The very growth-oriented ARK Innovation ETF in the US even lost 22% since the beginning of the year, and the average IPO lost 9% last year, according to the Renaissance IPO index.

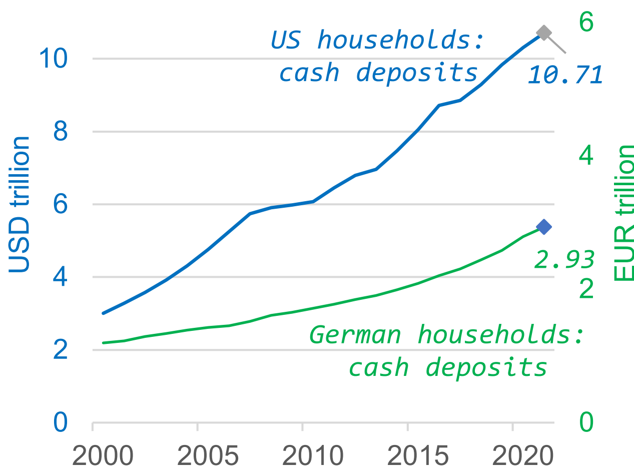
2. Apple's market capitalisation, at nearly USD3 trillion, is today greater than the total of the UK's largest 100 companies in the FTSE 100 index. And the Top 5 US tech mega cap stocks are today bigger than the entire European stock market!

3. Households increased their cash savings substantially since the start of the pandemic: today US households hold a record USD10.7 trillion in cash savings, some USD900 billion higher than at the end of 2019. German households hold EUR2.9 trillion in cash deposits at banks, despite an interest rate of 0%!

4. Fossil fuel prices exploded despite, or because of the push to renewable energy. European natural gas prices are 5x higher than at the beginning of last year, while Australian coal prices have doubled from January 2021 levels, and Brent crude oil prices are 50% higher than at the start of last year.

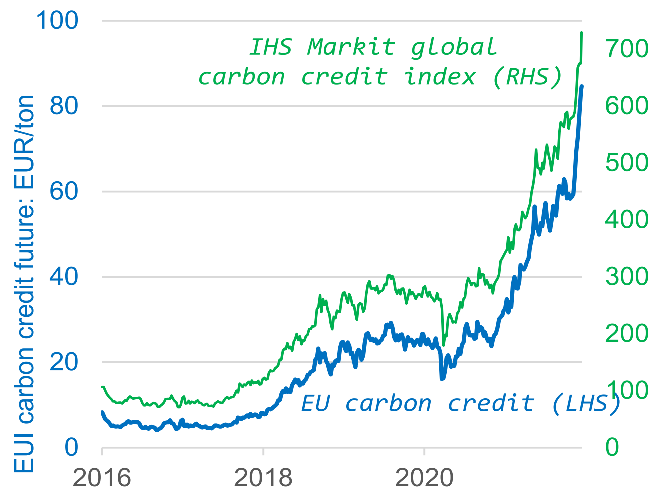
5. One of the best-performing commodities last year was European carbon credits. At a current price of over EUR 80/ton of CO2 emissions, these gained nearly 160% since the beginning of 2021, boosted by a combination of robust energy demand and lower-than-expected electricity generation from renewable sources (wind, solar).

CASH SAVINGS AT RECORDS DESPITE NEAR-ZERO INTEREST RATES



Source: US Federal Reserve, German Bundesbank

EU CARBON CREDIT PRICES INCREASED 160% IN 2021



Source: Bloomberg

There was still a lot of cash in the financial system at the end of December – i.e. "spare firepower" for investors to commit. Secondly, commodities very much woke up after years of under-performance and neglect. Thirdly, not all stocks did as well as you might think, providing plenty of investment opportunities for 2022.

3 trends to watch in 2022

Could rampant inflation inflect surprisingly quickly in 2022?

2021 has been a year of aggressive reflation on the back of abundant stimulus, vibrant commodity markets and the start of central bank tightening. What key trends should investors focus on in 2022?

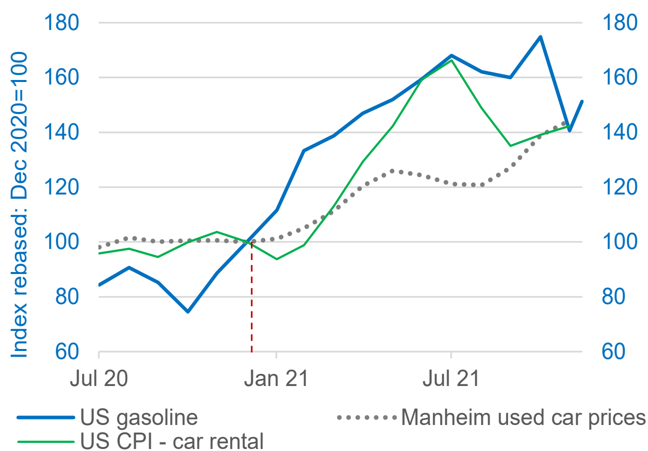
1. Rampant inflation today, but surprising disinflation tomorrow? While the market consensus has swung dramatically from the "transitory" inflation narrative to a US central bank that potentially drives medium-term growth back below 2%, we believe that this narrative could shift once again in early 2022.

A key variable will be the speed of normalisation in global supply chains, focusing on semiconductor chip production and the easing of logistics backlogs. Base effects on inflation from depressed 2020 prices and one-off VAT cuts will disappear in 2022, while supply chain-linked inflationary components, such as new and used car prices, plane tickets and household energy prices should all deflate. We could even be surprised by a return to a "Goldilocks" macro growth scenario.

2. Returns from fixing today's urgent problems: huge amounts of capital have gone to the latest technology trends and fads, including cryptocurrency and blockchain, electric vehicles and connected home fitness equipment. Thus, opportunities exist for investors to help fix today's pressing problems, resulting from chronic underinvestment. Shipping and road/rail logistics bottlenecks are one area, producing the battery metals required for energy mobility and storage solutions in a decarbonised economy is another. The ongoing need for "cleaner" fossil fuels and nuclear energy as interim solutions amid the electrification of the global economy is a third area.

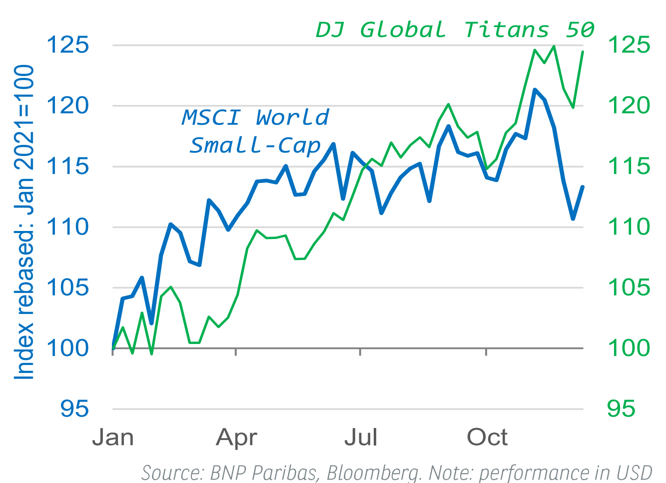
3. Revenge of mid/small-caps to come? 2021 was most definitely a year to be invested in US tech mega-cap stocks, as the DJ Global Titans 50 index gained nearly 25% versus 13% for MSCI World small-caps. However, since 1999 global small-caps delivered a cumulative 749% return in US dollars, versus just 261% for the Global Titans. Strong growth fundamentals support a mid/small-cap return in 2022.

US CPI COMPONENTS WHICH COULD TURN FROM INFLATIONARY TO DISINFLATIONARY IN EARLY 2022



Source: BNP Paribas, Bloomberg

GLOBAL MEGA-CAPS (LED BY TECH) HAVE SHARPLY OUTPERFORMED MID/SMALL-CAPS SINCE APRIL/MAY 2021



Source: BNP Paribas, Bloomberg. Note: performance in USD

Investors need to be wary of a number of emerging investment bubbles in currently "popular" trends, where valuations have been inflated by very strong price momentum running ahead of fundamental growth. Rather than extrapolate 2021's trends, we prefer to focus on potentially interesting inflections in these trends which could give rise to excellent investment opportunities.

Equity and Commodities Outlook

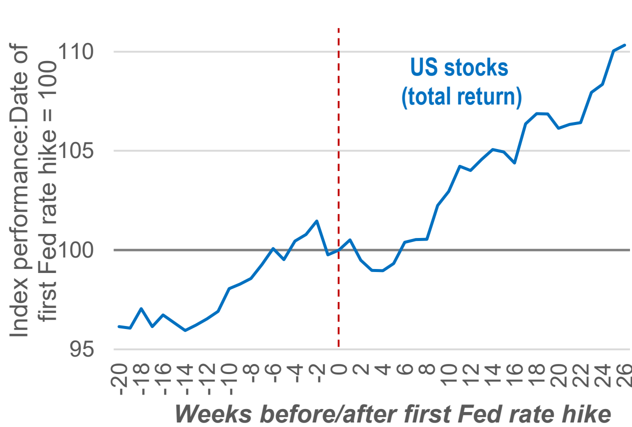
The first Fed rate hike is not bad for stocks

Don't be afraid of the Fed: stock markets typically continue to rally for at least six months post the first Federal Reserve interest rate hike, judging from previous Fed rate hiking cycles. Analysing the last 7 Fed rate hike cycles since 1983, the S&P 500 index rises about 5% prior to the first rate hike, and on average a further 5% in the 6 months post the first hike. Any initial sell-off is generally small, and leads to further stock market gains in the following months.

Risk premium index underlines rebound potential: the BNP Paribas risk premium index sits at extreme levels, suggesting that the worst may already be priced for risky assets such as stocks. In the same vein, the CNN Money Fear and Greed index is giving a Fear reading (26/100), a sharp contrast to end-November's Extreme Greed reading (78/100).

But new market leaders are unlikely to remain the same: post consolidation of a stock market setback, it is usual to see a rotation in stock market leadership. Today, this would imply that mega-cap technology is unlikely to lead any further market advance.

STOCKS PERFORM WELL LEADING UP TO, AND AFTER THE FIRST FED RATE HIKE



Source: BNP Paribas, Bloomberg
Note: average of 7 US Fed rate hike cycles since 1983

Oil: a welcome pause amid upside risks

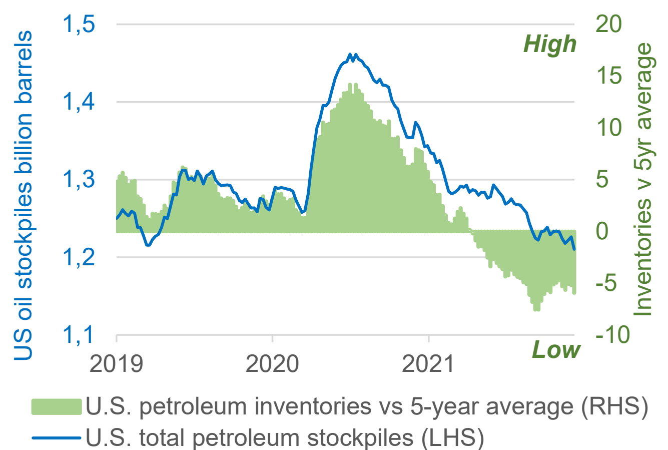
Brent crude oil prices have pulled back 6% to USD81/barrel from their end-of-October highs. Should investors see this as an opportunity or a danger?

We forecast Brent prices to stabilise at around USD70-80/barrel in the first half of 2022, and potentially USD80-90 in the second half. If, as we believe, global economic growth slows, but remains above trend growth, Brent could exceed USD100 in 2023-24.

For investors, near-term low crude oil prices should provide opportunities to reinforce positions in both oil ETFs/funds and in shares in oil companies. Higher energy prices should also support renewable energy.

The structure of oil prices in the futures market remains in backwardation (i.e. the further away the expiration date of the futures contract, the lower the futures price). In other words, ETFs and funds investing via futures benefit from an additional return generated by the rolling of mature contracts into a longer-term one. This return, known as the roll yield, is currently 7.4% in 1 year for Brent and 8.5% for WTI as of 3 January 2022.

US CRUDE OIL STOCKS ARE WELL BELOW THE SEASONAL AVERAGE



Source: BNP Paribas, Bloomberg

Don't be afraid of the Fed: stock markets typically continue to rally for at least six months post the first Federal Reserve interest rate hike, judging from the last 7 Fed rate hiking cycles going back to 1983. At a sector level, we see a good entry point in enhanced commodity funds exploiting the roll yield in commodities with backwardation in futures curves, and also in the Oil & Gas equity sector post oil price pullback.

Bond, Credit and FX Outlook

The central bank rate-hike cycle in play

The Bank of England, the latest central bank to raise rates: after surprising markets by not raising their bank base rate previously, the Bank of England finally moved off zero – raising its base rate from 0.1% to 0.25% in December. A baby step, but this still represents the beginning of a new UK rate hike cycle.

US, Australia, Canada central banks expected to raise rates in 2022: but according to market anticipations (as of 3 January 2022), benchmark interest rates are only expected to reach 0.8% in the US, Australia and the UK by end-2022. Canada is the only major central bank expected to raise rates above 1% (1.3% expected).

No change in the eurozone or Japan: the ECB and Bank of Japan are not expected to touch their zero interest rate policy at all in 2022, remaining at zero until at least 2023. Cash will thus continue to give negative real returns in 2022 in each of these currencies.

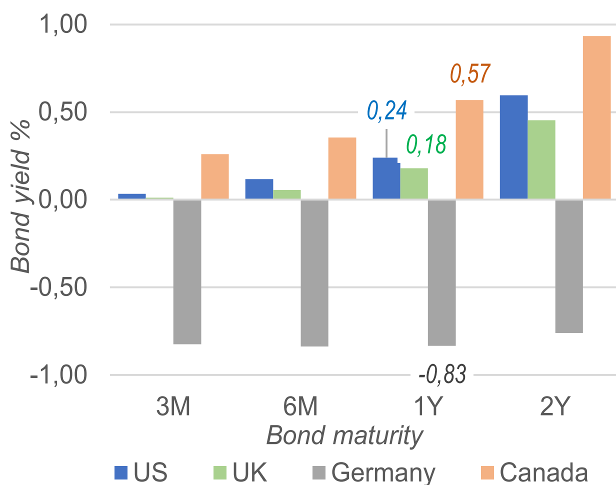
Negative bond returns in 2021

Emerging market bonds offer attractive yields: while even BBB-rated investment grade corporate bonds only offer 0.5% in the eurozone and 2.5% in the US, yields improved both in high yield credit (3.5% in euro, 4.5% in US) and also in Emerging market sovereign bonds (4.5% in US dollar-denominated bonds, 5.1% in local currency bonds).

2021 – a year of negative fixed income returns (except in inflation-linked bonds, high yield): nominal sovereign bond indices all registered modest negative 2021 returns (-1% to -3%), as did US and euro investment grade credit (-1%). Only inflation-linked bonds and high-risk credit (correlated with equities) delivered positive returns (US high yield +3% in USD, euro AT1 hybrid bonds +12% in euros).

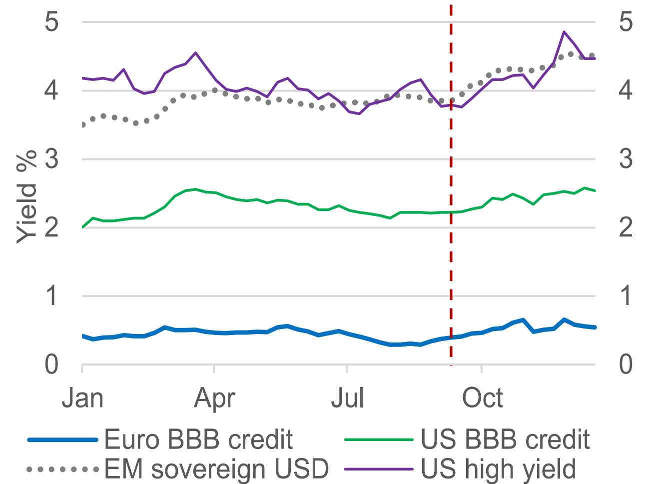
US, euro sovereign bonds could post negative returns again in 2022: we forecast 10-year bond yields of 0% in the eurozone (versus -0.1% now), and 2.0% in the US (v 1.7% now) at end-2022.

US, UK, CANADA SEE RISING YIELDS OVER NEXT 2 YEARS, BUT GERMAN YIELDS FLAT



Source: Bloomberg

CREDIT, EM SOVEREIGN YIELDS HAVE DRIFTED HIGHER SINCE SEPTEMBER



Source: Bloomberg

A positive outlook on developed market sovereign bonds requires investors to expect sharp falls in underlying inflation rates over 2022 from today's elevated levels. With both 10-year sovereign yields and investment-grade credit spreads low by historic standards, it remains too early to buy back into these two asset classes, in our view. We await either a) more attractive yield levels, or b) clear signs that inflation rates are set to fall quickly before upgrading our stance on government bonds and IG credit.

Summary of our main recommendations

	Current Recom	Prior Recom	Constituents	We like	We avoid	Comments
EQUITIES	+	+	Markets	EU, UK, Japan, EM: China, S Korea, Brazil, Russia.		Historically low long-term real rates and accommodative financial conditions are supporting the upward trend in global stocks. We continue to recommend a more defensive sector stance for now.
			Sectors	Financials, Real Estate, Healthcare, Semicond, Construction Precious/ battery metals, EU Energy	Airlines, aeronautics, travel & leisure	We have become more defensive in our sector allocation. We continue to recommend a more defensive sector stance for now, biased towards quality dividend/dividend growth strategies.
			Styles/ Themes	Megatrend themes		
BONDS	-	-	Govies	EM bonds (USD + local currency)	US long-term Treasuries and German Bunds	
			Segments	Eurozone convertibles. Rising Stars		
			Maturities	Lower than benchmark		
CASH	=	=				
COMMO-DITIES	+	+		Gold		Gold faces headwinds (higher real rates, strong USD) but supply demand dynamics remain favourable and it remains our preferred hedge asset. Industrial metals – We are Neutral but MT prospects remain positive.
FOREX			EUR/USD			Last month, we adjusted our EUR/USD target to USD1.12 (value of one euro) for the next 12 months.
REAL ESTATE	+	+		REITs, warehouses, healthcare, UK		BNP Paribas REIM favour healthcare property exposure given strong demographic drivers, a lack of good quality assets. UK to outperform Continental Europe,
ALTERNATIVE UCITS				Macro and event-driven		

Economic, FX forecast tables

BNP Paribas Forecasts

GDP Growth %	2020	2021	2022	2023
United States	-3.5	5.5	4.7	2.8
Japan	-4.7	1.7	2.6	1.6
United Kingdom	-9.8	7.1	5.4	2.1
Eurozone	**-6.7**	**5**	**4.2**	**3**
Germany	-5.1	2.6	3.6	3.6
France	-8	6.7	4.2	2.5
Italy	-8.9	6.3	4.9	3
Emerging				
China	2.3	7.9	5.3	5.5
India*	-7.2	8	11	6
Brazil	-4.1	4.8	0.5	2
Russia	-4.5	4.5	3	1.8

* Fiscal year

Source: Refinitiv - BNP Paribas - 03/12/2021

BNP Paribas Forecasts

CPI Inflation %	2020	2021	2022	2023
United States	1.2	4.7	4.6	2.1
Japan	0	-0.2	0.7	0.5
United Kingdom	0.9	2.5	4.5	2.1
Eurozone	**0.3**	**2.5**	**3.1**	**2**
Germany	0.4	3.1	3.4	2.2
France	0.5	2	2.5	2.1
Italy	-0.1	1.8	2.9	1.7
Emerging				
China	2.5	0.9	2.1	2.5
India*	6.1	5.4	5.7	5
Brazil	3.2	8.3	8.3	4.3
Russia	3.4	7	6.3	4.1

* Fiscal year

Source: Refinitiv - BNP Paribas - 03/12/2021

	Country		Spot 02/01/2022	Trend	Target 3 months (vs. EUR)	Trend	Target 12 months (vs. EUR)
	United States	EUR / USD	1,14	Neutral	1,12	Neutral	1,12
	United Kingdom	EUR / GBP	0,84	Neutral	0,84	Neutral	0,84
	Japan	EUR / JPY	130,95	Positive	124	Positive	124
	Switzerland	EUR / CHF	1,04	Negative	1,06	Negative	1,08
	Australia	EUR / AUD	1,56	Neutral	1,53	Neutral	1,53
	New-Zealand	EUR / NZD	1,66	Positive	1,60	Positive	1,60
	Canada	EUR / CAD	1,44	Positive	1,40	Positive	1,40
	Sweden	EUR / SEK	10,30	Positive	10,00	Positive	10,00
	Norway	EUR / NOK	10,03	Positive	9,75	Positive	9,60
Asia	China	EUR / CNY	7,25	Neutral	7,28	Neutral	7,28
	India	EUR / INR	84,53	Neutral	85,12	Negative	87,36
Latam	Brazil	EUR / BRL	6,33	Positive	6,16	Positive	5,88
EMEA	Russia	EUR / RUB	85,30	Positive	80,64	Positive	80,64

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