JULY 2022

Investment Strategy Focus

Summary

1. **Tighter financial conditions pressure stocks, credit**: higher short- and long-term interest rates continued to hurt stock, credit and sovereign bond markets in June. Commodities also suffered a monthly reversal on tighter financial conditions. Loosening of financial conditions is key to a more positive stance on risk assets (stocks, credit, real estate).
2. **Recession fears increase on extreme energy costs**: the renewed surge in European natural gas prices on restricted Russian supply, plus elevated diesel fuel prices act as a heavy economic tax. The sharp fall in German long-term bond yields since mid-June reflects pricing of an increased recession risk.
3. **The result? Inflation expectations fall, reflecting weaker demand, improving goods supply**: with the first fall in monthly US inflation statistics, falling domestic consumption is being reflected in weak economic activity. Growth is the primary concern, over inflation.
4. **Too early to upgrade stocks, credit**: while investor sentiment has reached a pessimistic extreme, we await clearer signs of turning points in financial conditions (looser) and inflation rates (lower). We remain neutral on stocks and credit markets for now.
5. **Appealing investments**: for more conservative investors, we like short-/medium-term US investment grade credit. More dynamic investors can scale into dividend/buyback stocks and energy/commodity producers. But cautious on US and UK residential real estate.

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FASTEST TIGHTENING OF US FINANCIAL CONDITIONS IN THIS FED HIKING CYCLE

Source: San Francisco Fed

Edmund Shing, PhD

Global CIO
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BNP PARIBAS WEALTH MANAGEMENT

The bank for a changing world

Our Key Convictions: biased towards real assets

Buy:

1. **UK equities**
2. **Global energy and mining companies**
3. **Gold and precious metals**
4. **Warehouse/logistics real estate**
5. **Global macro/trend-following alternative UCITS/hedge funds**

Avoid:

1. **Euro cash**

Asset Allocation: No Changes in July

	Very underweight	Underweight	Neutral	Overweight	Very Overweight
Equities			=		
Government Bonds			=		
Corporate Credit			=		
Real Estate				+	
Alternatives				+	
Cash		-			

Note: Alternatives include Commodities, Infrastructure and Alternative UCITS/hedge funds

July Focus: Where next for energy prices?

Maximum Russian pressure via gas supply

Russia cuts natural gas exports to Europe: since the end of last year, Russian piped gas exports to European Union countries have been cut by 60% from over 10 billion cubic metres to just over 4 as of June 2022.

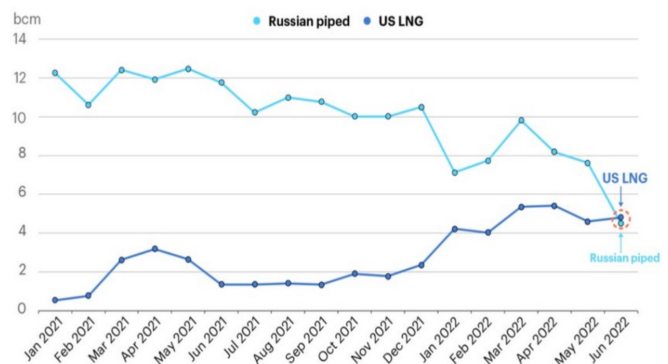
The key Nordstream 1 pipeline is due to be shut down for 10 days of scheduled maintenance in July. The risk is that Russia does not then resume piped gas exports to Europe at this reduced runrate, leaving Europe unable to rebuild its gas stockpiles before winter.

These lower Russian gas exports have resulted in a doubling of the European gas price in a month to early July, acting as a supertax on the European economy and specially on Germany, the Netherlands and Italy.

Diesel prices drive logistics costs higher: goods transportation by road and sea depends crucially on diesel-powered engines. A doubling in US and European diesel prices since early 2020 is a key driver of core inflation, as companies build in this higher logistics cost into goods and services prices.

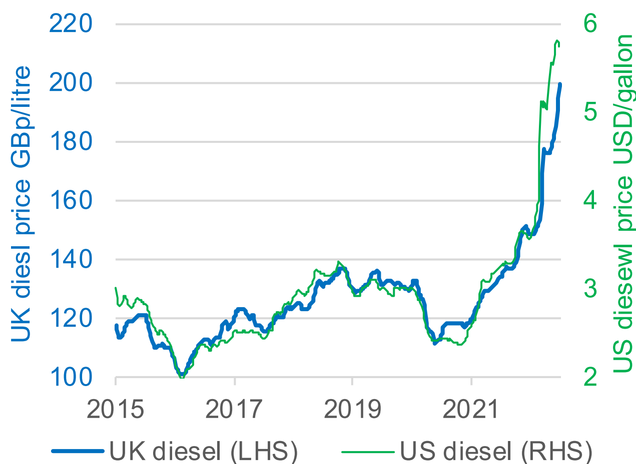
Have US gasoline prices finally peaked? One ray of hope comes from US gasoline prices, which are finally following crude oil prices lower. A further decline in gasoline prices as households and companies reduce energy demand would start to help, rather than hurt discretionary household spending. Lower refining margins are the key to lower gasoline and diesel prices, as they remain abnormally high at present.

US LIQUEFIED NATURAL GAS OVERTAKES RUSSIAN GAS PIPED IN EUROPEAN IMPORTS



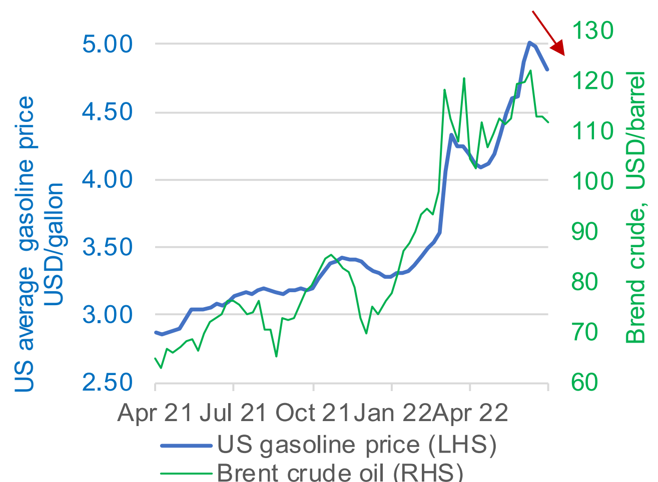
Source: International Energy Agency

UK, US DIESEL PRICES HAVE NEARLY DOUBLED SINCE EARLY 2020



Source: Bloomberg

US GASOLINE PRICES FINALLY START TO FOLLOW CRUDE OIL LOWER



Source: BNP Paribas, Bloomberg

INVESTMENT CONCLUSION

We need to see increasing signs of demand destruction in energy markets to allow natural gas, diesel and gasoline prices to fall from current highs, as it is unlikely that we will see any significant increase in supply in the short term. So far, demand destruction has been limited. This promises to remain a positive environment for energy producers, both countries and companies.

The Big Picture

Guy Ertz, PhD

Rising recession risks as energy prices surge

In a context of an accelerated normalisation of monetary policy by the Federal Reserve (Fed), the US economy is clearly slowing down. Worsening key indicators such as the University of Michigan consumer sentiment survey and selected business surveys even suggest that a recession is likely.

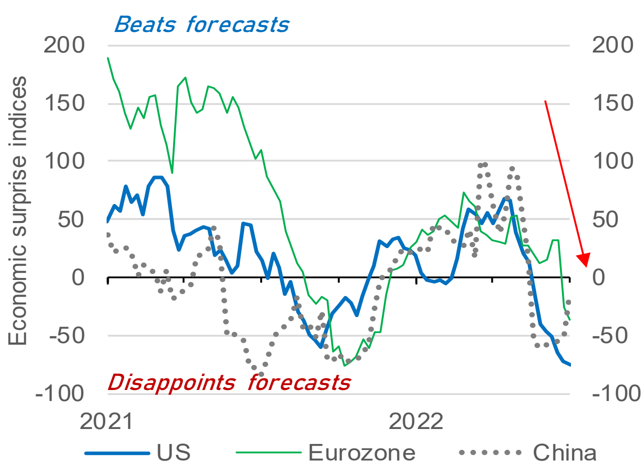
Two Conference Board indexes are useful to assess the state of the economy. The Coincident Economic Index (CEI) tracks current economic activity, and suggests that the US economy should rebound in the second quarter, after a sharp contraction in the first.

The Leading Economic Index (LEI) helps to assess future recession risks. It combines 10 indicators that have been identified as moving ahead of the cycle. This LEI suggests a significant slowdown for the US economy, falling for the third month in a row in May, mainly due to a drop in two of its component indicators: the S&P 500 index and the number of building permits issued. A third component that has also weakened is consumer confidence, which has fallen sharply as consumer purchasing power declines.

The question therefore is at what speed the deterioration of the LEI will continue? If it falls rapidly, then it is possible that the US economy will fall into recession late this year or early next year. In our opinion, a recession is not the most likely scenario as the labour market is still very strong. For the US the main risk is related to higher/more sustained inflation. The key driver of such scenario is a structural change in inflation expectations, a so-called "un-anchoring" of inflation expectations. This would force the Fed to push rates even higher than currently expected to break this trend.

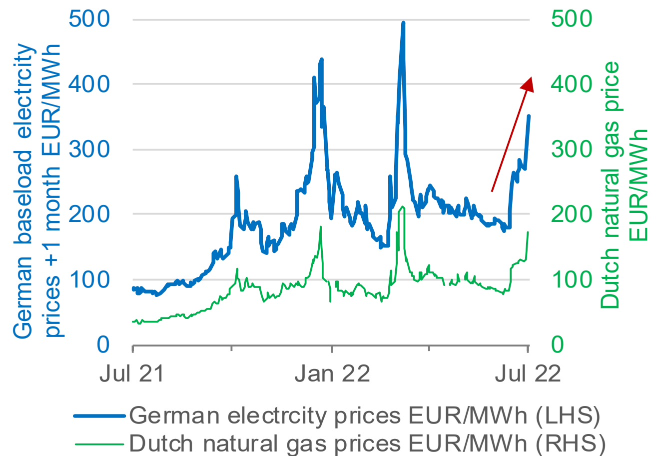
Eurozone growth is slowing, with the prospect of quasi-stagnation in the next quarter. Key leading indicators, including the IFO and Belgian National Bank business surveys, have slumped, as has consumer confidence. The probability of significant disruptions or a halt in oil and gas exports from Russia to Europe has risen sharply. Gas imports are the biggest threat for EU growth, if eurozone countries are not able to rebuild inventories as planned. This needs to be monitored closely and could lead us to downgrade the outlook for eurozone growth to include a temporary recession.

BRAKES ON US, EUROPEAN ECONOMIC MOMENTUM IN JUNE



Source: Citigroup, Bloomberg

EUROPEAN ENERGY PRICES ARE THE MAIN DRAG ONTHE SLOWING ECONOMY



Source: Bloomberg

Investment Conclusion

Recession risks are rising. But recession remains a risk, rather than our central scenario. Inflation will likely peak in the coming months. Normalisation will, however, be very gradual and spread over the next 18 months. The main risk in the US is higher and more sustained inflation. Gas imports are the biggest threat for EU growth.

Bond and Credit Outlook

Edouard Desbonnets

Too early to turn Positive

Terrible performance so far in 2022. Corporate bonds have suffered since the beginning of the year (see chart) as risk-free rates have soared and credit spreads have widened considerably. Hence the legitimate question: with yields soaring, is this the time to buy aggressively?

A difficult environment. The ECB is no longer actively supporting corporate bonds and the Fed is withdrawing liquidity from the system. Financial conditions are tightening, making corporate refinancing more expensive and access to capital markets more difficult.

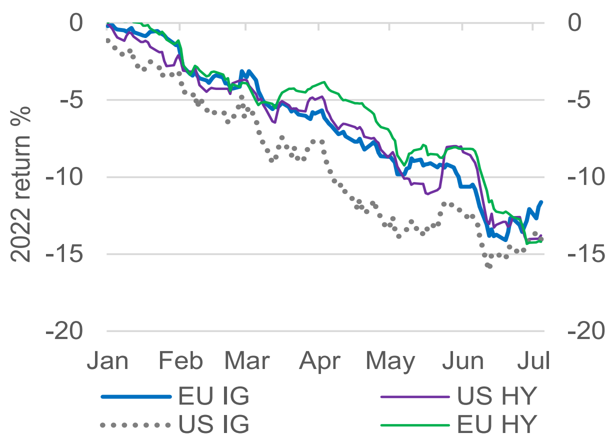
Peaking fundamentals. Corporate fundamentals are probably at their peak. On average, companies have strong balance sheets thanks to economic growth and good results over the past year, as well as less debt. In addition, companies refinanced massively at extremely low rates last year. As a result, the risk of default is relatively limited. Fitch ratings see only a handful of issuers at risk of default by the end of the year. It expects the HY default rate to double, albeit from a very low level of 1% at the end of the year, to 2% by 2024.

Rising spreads. Spreads have risen almost continuously since 1 January, reflecting a growing perception of recession risk. Lower-rated bonds have suffered more. In our view, the risks continue to point to a widening of spreads, as central banks remain determined to tighten financial conditions, as they prefer to fight inflation rather than support growth. Moreover, aggressive monetary tightening implies higher volatility, which is detrimental to corporate spreads, especially HY spreads.

Key levels for IG spreads. IG spreads have broken through key levels of 150bps in the US and 200bps in the eurozone (see chart). Historically, when spreads have crossed these levels, most of the time (not always!), spreads have risen rapidly, and a recession has sometimes followed.

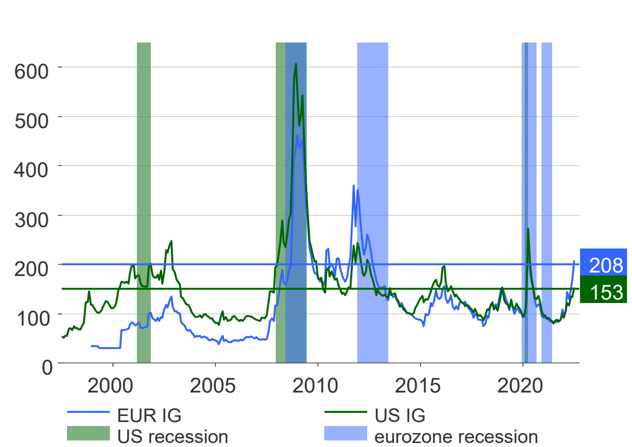
Stay defensive. Valuations are no longer expensive in the US and even cheap in the eurozone. Short-term quality IG corporate bonds seem to be a good defensive solution. The risk is limited and the yield attractive. For example, the average yield on a single-A corporate bond with a maturity of less than 3 years is 2.3% in euros and 3.8% in dollars.

TERRIBLE PERFORMANCE FOR CORPORATE BONDS (%)



Source: Bloomberg

INVESTMENT-GRADE SPREADS HAVE EXCEEDED SOME KEY LEVELS (BPS)



Investment Conclusion

With yields soaring, is this a good time to buy aggressively? In our view, the risks continue to point to a widening of spreads. Given the difficult environment, we prefer to stay defensive. Short-term quality IG corporate bonds seem to be a good defensive solution.

Equities Outlook

Extreme pessimism is not enough

Decade-low sentiment not enough: the combination of professional and retail investor sentiment to stocks has reached a low point not seen since 2008, in the throes of the Great Financial Crisis.

Traditionally this level of investor pessimism has been a good contrarian indicator of positive stock market returns over the 6 to 12 months that followed. But this single measure is not enough to support a more positive view on stocks.

Low valuations are still not enough. Secondly, stock market valuation levels are historically cheap for European, UK, and Japanese stocks in price/earnings terms. However, they are only just below average for US stocks, even after a 20% decline in share prices. So lower valuations are not enough to inspire an upgrade from our Neutral stock market recommendation.

Looser financial conditions required. Financial conditions, including interest rates, credit spreads, financial market volatility and liquidity, need to improve from today's tight levels. But this is not yet the case in the US or Europe.

Beware: earnings forecasts are likely to fall

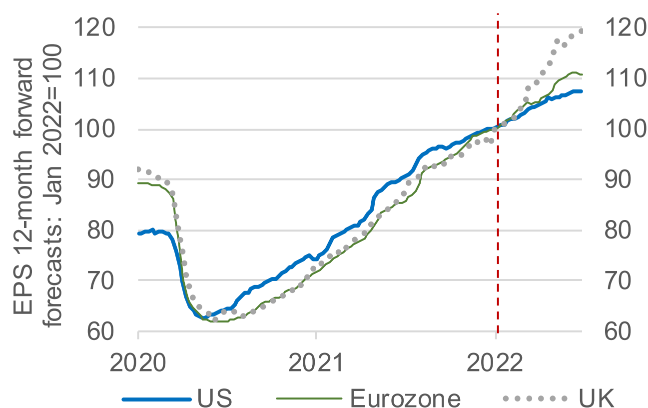
Economic reality not yet reflected in 2022/23 earnings forecasts: analysts remain reluctant to cut their company earnings forecasts. Thus far, the sharp global economic slowdown has been barely reflected in European company earnings forecasts, and not at all in US earnings forecasts.

We expect the Q2 earnings reporting season to trigger a round of downgrades to 2022 and 2023 earnings forecasts. We will wait until the Q2 earnings season is underway to see how share prices react to cuts in earnings forecasts before considering a more positive stance on stocks.

Opportunities do exist: high dividend and share buyback-related stock funds and ETFs are attractive given the strong balance sheets and strong cash flow generation of several stock market sectors, including commodity-related sectors, Healthcare and Financials.

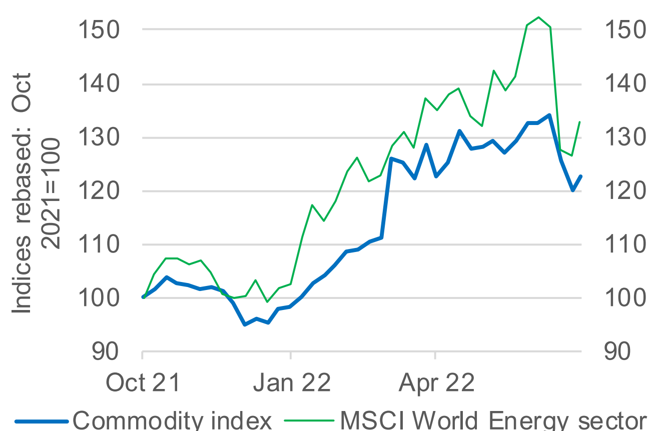
We also consider the recent sharp correction in global Energy and Mining stocks a buying opportunity, in view of the strong long-term demand and restrained supply outlook for many commodity-related markets.

US, EUROPE COMPANY EARNINGS FORECASTS HAVE NOT YET FALLEN



Source: BNP Paribas, Bloomberg

THE SHARP CORRECTION IN ENERGY STOCKS IS AN OPPORTUNITY, IN OUR VIEW



Source: Bloomberg

CONCLUSION

In addition to depressed investor sentiment and more attractive valuation levels (particularly in the eurozone, UK and Japan), we await downwards adjustments to company earnings forecasts and the key catalyst of looser financial conditions before upgrading our current Neutral stance on equities. An unexpected calming of hostilities (and thus less uncertainty) in the Ukraine conflict would also be a positive catalyst.

Summary of our main recommendations

	Current Recom	Prior Recom	Constituents	We like	We avoid	Comments
EQUITIES	=	=	Markets	UK, Japan, Latin America, S. Korea, Singapore and Indonesia		Historically low long-term real rates and accommodative financial conditions support the upward trend in global stocks in the long term. We continue to recommend a more defensive sector stance.
			Sectors	Financials, Health Care, Precious/'battery' metals, Semiconductors		We remain defensive in our sector allocation. We continue to recommend a more defensive sector stance, biased towards quality dividend/dividend growth and buyback strategies.
			Styles/ Themes	Megatrend themes		Inflation hedging, Circular Economy themes
BONDS	=	=	Govies	US short-term Treasuries		We raised our 10-year bond yield targets to 3.25% in the US and 1.75% in Germany in one year.
			Segments	US short- to medium-term IG credit. EM bonds in HC & LC.		
			Maturities	Lower than benchmark		
CASH	-	-				
COMMO-DITIES	+	+		Gold, Base metals		Gold: Investors looking to hedge stagflation risks and CB purchases should keep gold in the USD 1900-2100 range in the next 12 months. Industrial metals: The supercycle for base metals is reinforced by the need to accelerate the energy transition and reduce dependence on Russia. Oil should stabilise in the USD 105-115 range at the end of 2022.
FOREX			EUR/USD			We keep our EUR/USD target of USD1.12 (value of one euro) for the next 12 months.
REAL ESTATE	+	+		REITs, warehouses, Health Care, UK commercial		BNP Paribas REIM favours healthcare property exposure given strong demographic drivers and a lack of good quality assets. UK to outperform Continental Europe.
ALTERNATIVE UCITS				Macro, trend-following and event-driven		

Economic, FX forecast tables

BNP Paribas Forecasts

GDP Growth %	2021	2022	2023
United States	5.7	2.6	1.9
Japan	1.7	1.4	1.1
United Kingdom	7.4	3.6	1.5
Eurozone	**5.3**	**2.5**	**2.3**
Germany	2.9	1.3	2.2
France	6.8	2.3	2.1
Italy	6.6	2.8	2.0
Spain	5.1	4.1	2.5
Emerging			
China	8.1	3.7	5.7
India*	9.3	8.3	6.2
Brazil	4.6	1.5	0.0
Russia	4.5	-7.0	0.8

* Fiscal year

Source: BNP Paribas Group Economic Research

BNP Paribas Forecasts

CPI Inflation %	2021	2022	2023
United States	4.7	7.5	3.9
Japan	-0.2	1.9	1.0
United Kingdom	2.6	8.0	4.4
Eurozone	**2.6**	**7.9**	**4.1**
Germany	3.2	8.1	4.6
France	2.1	5.9	3.6
Italy	1.9	7.7	4.5
Spain	3.0	8.0	3.6
Emerging			
China	0.9	2.3	3.4
India*	5.4	7.9	5.9
Brazil	8.3	11.0	7.1
Russia	7.1	14.0	10.5

* Fiscal year

Source: BNP Paribas Group Economic Research

	Country	Spot 06/07/2022		Target three months		Target twelve months	
				Trend	Mid	Trend	Mid
Against euro	Untited States	EUR / USD	1,01	Neutral	1,08	Negative	1,12
	United Kingdom	EUR / GBP	0,85	Neutral	0,84	Neutral	0,84
	Switzerland	EUR / CHF	0,99	Negative	1,02	Negative	1,02
	Japan	EUR / JPY	138,69	Negative	144,00	Negative	146,00
	Sweden	EUR / SEK	10,60	Neutral	10,40	Neutral	10,70
	Norway	EUR / NOK	10,26	Positive	9,60	Positive	9,60
Against dollar	Japan	USD / JPY	137,19	Negative	140,00	Positive	130,00
	Canada	USD / CAD	1,30	Positive	1,25	Positive	1,25
	Australia	AUD / USD	0,68	Positive	0,74	Positive	0,74
	New Zealand	NZD / USD	0,62	Positive	0,68	Positive	0,68
	Brazil	USD / BRL	5,38	Positive	5,00	Positive	5,00
	Russia	USD / RUB	60,13	Negative	100,00	Negative	90,00
	India	USD / INR	79,64	Positive	78,00	Neutral	80,00
	China	USD / CNY	6,72	Neutral	6,60	Positive	6,50

Source: BNP Paribas, Refinitiv Datastream. As of 7 July2022

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