JULY 2021

Investment Strategy Focus

Summary

1. **COVID-triggered structural changes to drive longer-lasting productivity improvement?** There have been big changes to working practices due to the pandemic, including accelerated investment in technology infrastructure to support remote working. These changes in working practices, plus higher levels of investment, can drive improved productivity.

2. **Equities not so expensive in an "everything is expensive" world:** while global equities' forward PE of 18.7x looks modestly expensive against a long-term average of 15x, government bonds, credit and cash look even worse value. We maintain our positive stance on equities.

3. **Long-term expected stock market returns remain positive:** the combination of dividend income, profit growth and P/E valuations point to 5%+ nominal long-term expected returns for Euro, UK, EM and Japanese equities, with US a little lower. Prefer world ex-US equity exposure.

4. **Raising our forecast for US 2-year yields:** the risk of an acceleration in the Fed's timing of a tapering announcement, combined with more hawkish interest rate rhetoric, informs our new year-end US 2-year yield forecast of 0.6% (versus 0.4% previously). We downgrade short-term US Treasuries to neutral from positive.

5. **US dollar bear market over, or just a head fake?** Modestly higher 2-year yields lend some support to the US dollar, but portfolio flows may remain negative as US bonds and equities lose their allure. We adjust our 12-month EUR/USD target to USD1.22 per euro.

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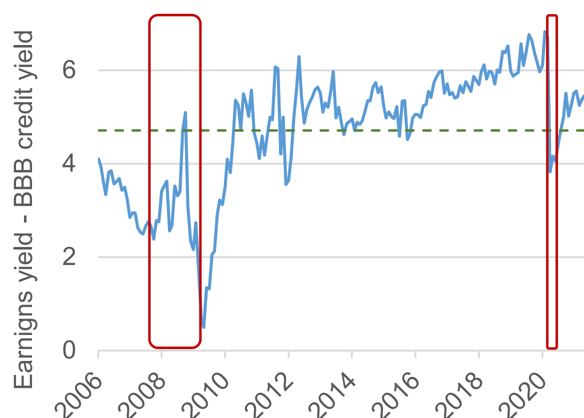
EUROPEAN EQUITIES LOOK GOOD VALUE VERSUS BBB CREDIT AND BONDS



Source: BNP Paribas Wealth Management; Bloomberg.

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BNP PARIBAS WEALTH MANAGEMENT

The bank for a changing world

The Big Picture

Huge rebound today – but what comes next?

Chinese momentum is settling: the global economy is going through a desynchronised cycle, due to the phased impact of exiting domestic lockdowns.

On the one hand, Chinese economic momentum is settling as consumption growth moderates post early exit from lockdowns, and as the Chinese authorities rein in credit growth. We see Chinese quarterly GDP growth running at a 1.3%-1.4% quarterly pace over H2 2021.

The US should continue to post strong growth in Q3 as in Q2, but then decelerate: thanks to a successful vaccination campaign, and a subsequent surge in domestic consumption on re-opening. Q3 2021 quarterly growth of 2.4% should then fall to below 1% on a quarterly basis from Q4 2021, continuing in 2022.

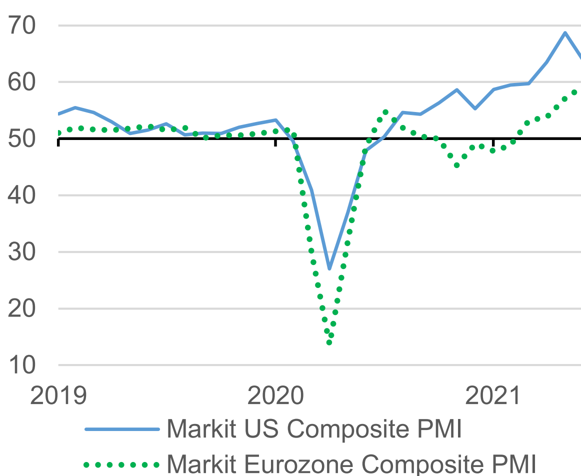
But Europe still accelerating: then we have the European laggards; where vaccination programmes were slow to start, and where domestic re-opening was delayed as a result. Here we expect a peak in growth to occur in Q3 this year at 2.8%; then the Eurozone and UK are both projected to continue to grow faster than the US in Q4 2021 and again in Q1 2022. Investment growth should aid Europe in 2022.

Productivity boost – temporary or longer-lasting? Productivity growth is one of the two key drivers of economic growth (the other being labour force growth). This growth factor has been in structural decline over the last 20 years, according to the OECD (see chart below). We see today a post-lockdown boost in productivity growth, typical post recessions.

COVID-triggered structural changes to drive longer-lasting productivity improvement? There have been big changes to working practices due to the pandemic, including accelerated investment in technology infrastructure to support remote working. Can the combination of these changes in working practices, plus higher levels of investment, lead to a step change higher in productivity growth?

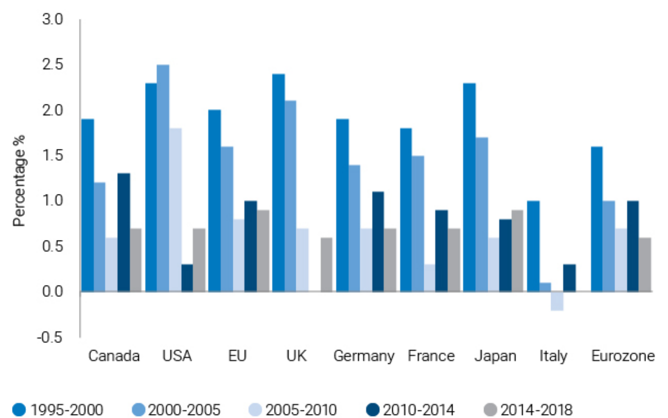
Optimists like myself would argue yes, as higher investment is likely to persist for some time thanks to ultra-cheap financing and technological advances (e.g. in artificial intelligence/machine learning and the impact of 5G). This is crucial if the economies are to grow fast enough to simultaneously raise salaries for the lower-paid, and also start to reduce the elevated debt/GDP post pandemic spending.

EUROZONE OPTIMISM ACCELERATED IN JUNE, WHILE US SENTIMENT PEAKED IN MAY



Source: Markit

DEVELOPED WORLD PRODUCTIVITY HAS DECLINED OVER THE 21ST CENTURY



Source: OECD

CONCLUSION

There is potential to see a longer-lasting benefit to global growth from the change in working practices (lean and flexible working) post pandemic, the accelerated adoption of new technologies (video conferencing, AI/deep learning, cloud computing) and higher investment (not only in tech but also in energy transition, automation and healthcare).

Equity and Commodities Outlook

Are stock markets too expensive?

Should I stay or should I go? Investors are understandably nervous about their stock market exposure, after a near-30% rise in global equities since the end of October 2020. No-one wants to be long of equities, should they experience another sharp bear market as seen only too recently in March 2020, and before that in late 2018.

But valuations have not risen much globally of late: the MSCI World index's forward PE ratio has only risen from 18.1x in October 2020 to 18.7x today. Since November 2020, forward earnings have risen 26% on strong quarterly earnings reports, as the world recovers from pandemic-induced recession.

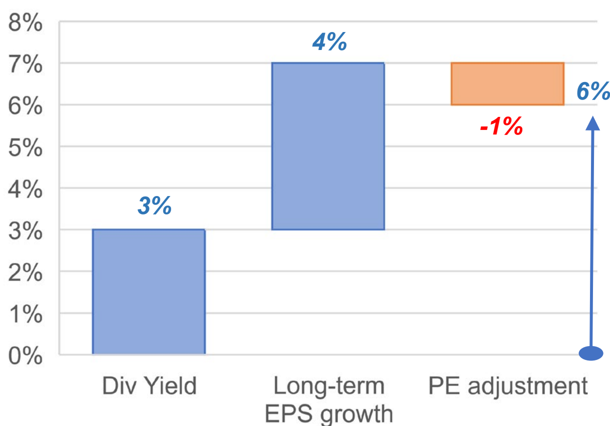
Equities not so expensive in an "everything is expensive" world: while the S&P 500's 12-month forward PE of 22.2x looks expensive against a long-term average of just over 16x, other asset classes such as government bonds, credit and cash look even worse value (see the next page).

Our simple long-term model points to modest expectations: we have constructed a long-term expected returns model for equities, on the basis of 3 factors:

1. **Forward dividend yield**: the income expected over the next 12 months from the stock market;
2. **Long-term earnings growth**: how quickly have earnings grown over the long term?
3. **Valuation adjustment**: is the stock market overly cheap or expensive versus the long-term average? If expensive, then returns will be lower; if cheap, then expected returns should be boosted.

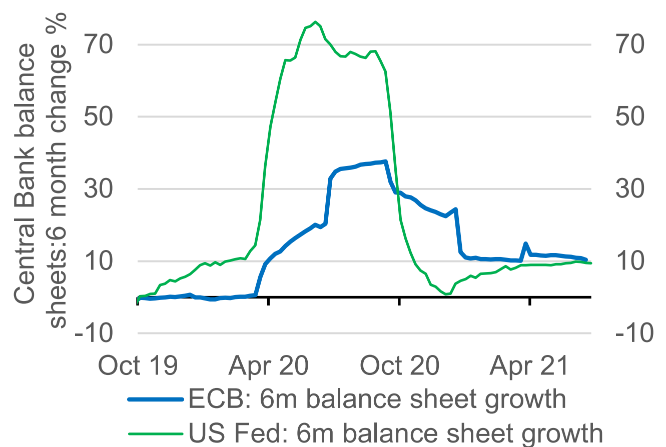
= Expected stock market returns of 5%+: from this simple model, we estimate long-term returns for developed stock markets of 5% or more, with World ex US equities projected higher returns than the US. Even accounting for inflation, stocks should still deliver positive real returns, unlike bonds, credit or cash.

OUR 3-FACTOR MODEL POINTS TO A c. 6% EUROPE 5-YEAR EXPECTED RETURN



Source: BNP Paribas Wealth Management. In nominal terms

FEDERAL RESERVE, ECB ASSETS STILL GROWING AT > 20% ANNUALISED



Source: Bloomberg

CONCLUSION

Our –year expected returns model suggests a 5%+ 5-year average nominal return for global stocks. There is more potential in Eurozone, UK and Emerging Market stock markets than in the US, given the much higher US market valuation, a lower income yield, and the potential negative impact on US mega-cap tech of the new global 15% minimum corporate tax (which should have no significant effect on European, Asian companies given their far higher national and effective corporate tax rates).

Bond, Credit and FX Outlook

Low yields today = low long-term returns

What is the best predictor of government bond and corporate credit returns in the long term? The answer to this question is surprisingly simple: **the current bond yield**. This is not good news for investors, given the historically low level of long-term bond yields in Europe, Japan and the US.

Consensus long-term expected returns suggest 1.2% nominal returns for government bonds: averaging three sets of long-term expected returns give a 1.2% expected return on global government bonds. Investment-grade credit offers only a 1.5% average expected return. Both are lower than the 2% expected inflation rate.

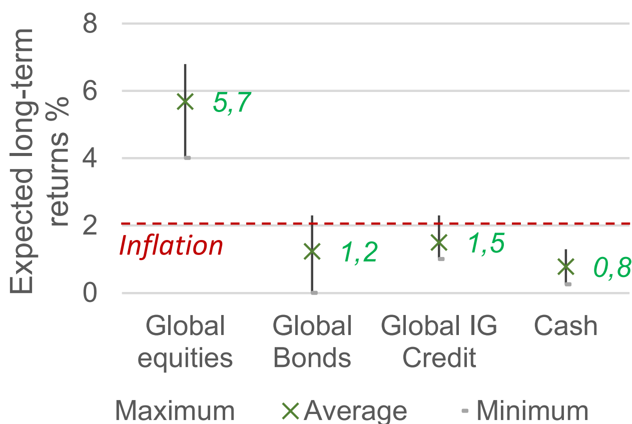
Watch the Fed like a hawk: the Fed made an hawkish pivot at the June FOMC meeting. It showed less tolerance for high inflation and signalled earlier-than-expected rate hikes according to the median of all policymakers' rate forecasts.

This has two implications, in our view. First, the Fed may slightly speed up the taper process so that it is completed before the end of 2022, allowing it to make the first rate hike in 1Q23, instead of 3Q23 as we previously thought.

Second, US short-term bond yields will become less anchored by the Fed over the next few quarters and may grind higher. Hence, **we raise our 2-year yield forecast to 0.6% from 0.4% in 12 months**. As a consequence, the risk of a zero expected return on US short-term government bonds has increased given the current very low level of yields so **we turn neutral from positive on that asset class.**

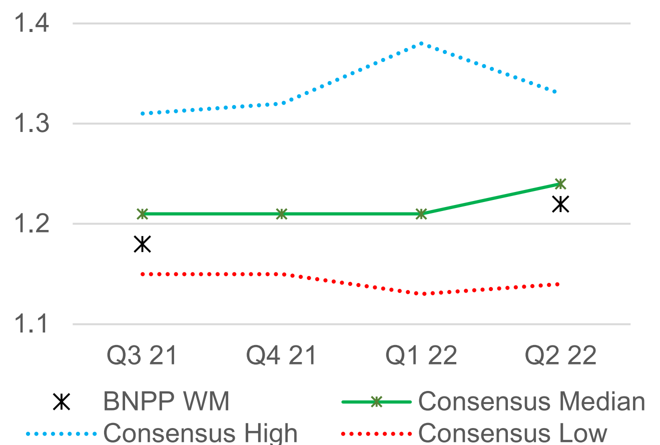
Adjusting our EUR/USD forecasts: following our US 2-year yield forecast upgrade, we adjust our EUR/USD currency forecasts to USD1.17 per euro in 3 months (USD 1.20 previously) and USD 1.22 in 12 months (USD 1.25 previously).

BONDS, CREDIT AND CASH ALL EXPECTED TO RETURN LESS THAN INFLATION IN THE LONG TERM



Source: Blackrock, Research Affiliates, Robeco. Vertical lines represent range of forecasts, X indicates the average forecast. In nomlnal USD terms

EUR/USD CURRENCY RATE FORECAST TO STRENGTHEN VERY MODESTLY OVER NEXT 12 MONTHS



Source: BNP Paribas Wealth Management, Bloomberg

CONCLUSION

We raise our 2-year yield forecast to 0.6% from 0.4% in 12 months. This, in turn, drives our downgrade of short-term US Treasury bonds to neutral from positive.

In turn, we adjust our EUR/USD currency forecasts to take account of this higher US 2-year yield forecast, now expecting EUR/USD at USD 1.17 per euro in 3 months, and USD 1.22 in 12 months.

Real Estate Outlook

Seize the post pandemic real estate opportunity

Pandemic provides Real Estate opportunities: the global economic dislocation that has resulted from lockdowns provides excellent entry points into Real Estate from a long-term valuation viewpoint. Certain pandemic-hit equity sectors like Travel & Leisure and Retail have rebounded sharply since March 2020; in contrast Real Estate has lagged.

Don't be scared of Offices: the remote working trend is not the death of the office. Do not ignore the deep psychological need for colleagues to collaborate physically, including networking and boosting creativity as well as supporting psychological well-being. Prime location is key.

Several current property hotspots: in sector terms, residential, industrial/logistics and specialist (mobile phone masts, data centres, self-storage) combine structural demand growth with good rental yields. Regionally, a number of European prime city locations perform well with low vacancy rates, including Amsterdam, Berlin and Munich.

But Retail assets may not have stabilised yet: the Real Estate sector we hold back from is Retail, where the long-term effects of the pandemic plus the ongoing trend towards online shopping may put pressure on rental yields and occupancy rates for some time to come. While there may be value, we await stability.

Real Estate has a key role in a diversified portfolio: in an increasingly low-yield world, Real Estate can play a key role in diversifying away from equities and bonds/credit, providing income that is generally inflation-hedged and which is hard to find today in fixed-income. Since 2001, global listed Real Estate has outperformed global equities, sovereign bonds and credit, delivering an annual average 6.3% euro return.

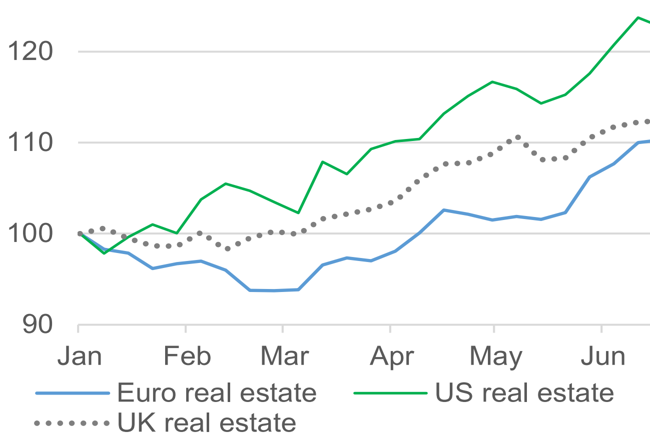
Commercial Real Estate (CRE) values have recovered almost back to pre-pandemic levels: according to Green Street, by April 2021 European CRE values had almost returned to pre-pandemic levels, while US CRE prices were only 3% below the February 2020 level.

Commercial Real Estate values have grown much faster than the economy: nominal economic growth (including inflation) has averaged 3.7% in the US and 2.2% in the eurozone since 2010. Over the same period, US commercial property has averaged a much faster 6.1% annual growth rate, and a strong 3.9% in the eurozone. To this we can add rental yields.

Commercial REITs returned > 6% p.a. in Europe, 12% in US since 2010: since 2000, the low interest rate environment has been a strong support for listed CRE total returns, with the combination of dividend yield and price growth delivering an average annual return since 2010 of 6+% in Europe, and 12% in the US.

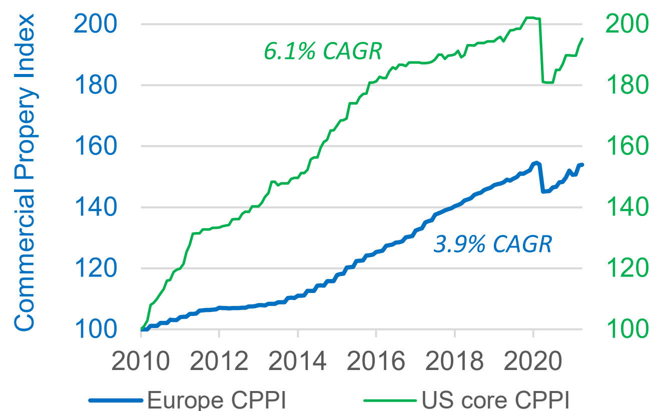
For more details, read our recent white paper: *Seize the Real Estate Opportunity, 14 June, 2021*.

LISTED REAL ESTATE CONTINUES TO RALLY



Source: Bloomberg

PRIVATE REAL ESTATE HAS BEEN A CONSISTENT PERFORMER IN US, EUROPE



Source: Green Street

Summary of Recent White Papers

How to profit from rising inflation concerns (17 June 2021)

Recent price trends have been driven by several transitory and idiosyncratic factors in the US and Europe. Inflation is expected to stay high until autumn, and gradually fall back to close to central bank targets next year. We still see the risk that inflation overshoots 2% over a longer period as moderate, especially for Europe. In the US, risks are rising and it will take until at least year-end before we can evaluate medium-term risks such as job market overheating.

How best to hedge inflation in the fixed-income universe? Inflation-linked bonds, but they are already expensive. We favour floating-rate notes and leveraged loans.

Commodities are an obvious investment destination: precious metals, battery metals and crude oil. Commodity-related equities too: gold/silver miners, industrial metal miners, chemicals, paper & pulp.

Real estate hedges inflation via rising rents, as long as real long-term yields do not rise sharply: since 2001, US REITs have outperformed the S&P 500, particularly during periods when US inflation expectations have risen quickly.

Targeting capital-light, hard-asset companies, information-based companies with high pricing power, low fixed costs: companies that can raise prices while maintaining a low, largely fixed cost base are attractive inflation hedges.

Does Sustainable Investing have to cost performance? (21 June 2021)

Responsible investing not an EITHER/OR choice, but an AND: does choosing to invest responsibly cost investment performance? The evidence says NO, that you can choose a sustainable/responsible investment strategy and outperform non-sustainable benchmarks.

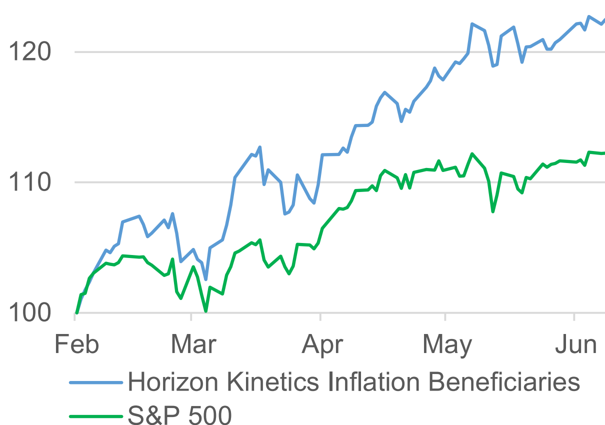
SRI, ESG, Low Carbon and Clean Energy indices have outperformed over the last 5 years: since 2016, general SRI/ESG indices as well as more specific low carbon/clean energy indices have all outperformed World and Europe benchmark indices to a greater or lesser extent.

Sustainable/responsible investing indices have also suffered lower drawdowns in corrections: in 2011, 2016 and 2018 stock market correction phases, SRI indices fell less than corresponding World and Europe benchmark indices.

If you buy ESG/SRI exposure, you are buying quality: according to EDHEC-Risk, ESG outperformance is mostly due to a quality factor bias. In our view, this is positive as the quality factor has delivered superior long-term returns at lower downside risk than benchmark indices.

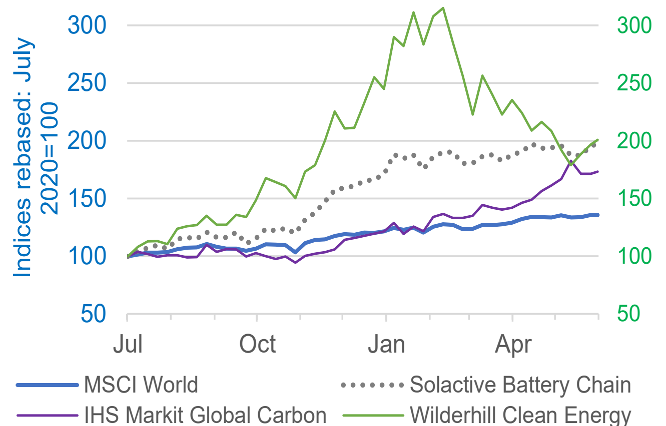
Reducing exposure to tail risk: Implementing improvement in Environmental, Social and Governance issues reduces tail risk for investors, including stranded asset risk in fossil fuels and corporate governance risks from fraud and lack of risk control, thus reducing idiosyncratic risks.

SINCE FEBRUARY, INFLATION BENEFICIARY STOCKS HAVE BEATEN THE S&P 500



Source: BNP Paribas, Bloomberg

SUSTAINABLE INDICES HAVE OUTSTRIPPED MSCI WORLD SINCE MID-2020



Source: BNP Paribas, Refinitiv Datastream

Summary of our main recommendations

	Current Recom	Prior Recom	Constituents	We like	We avoid	Comments
EQUITIES	+	+	Markets	EU, UK, Japan, EM: China, Taiwan, 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 as the summer months should be more volatile.
			Sectors	Financials, Real Estate, Healthcare, Semicond, Construction Gold mines, EU Energy	Utilities, HPC	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	We turn neutral from positive on short-term US Treasury bonds, with a 12-month yield target raised to 0.6% (from 0.4% previously)
			Segments	Peripheral euro and eurozone convertible. US IG credit and Fallen Angels.		
			Maturities	At benchmark		
CASH	=	=				
COMMO-DITIES	+	+		Gold		Base metals – We are Neutral as we expect a lower demand from China in H2. We could have reached an intermediate top as the long-term trend remains bullish.
FOREX			EUR/USD			We adjust our EURUSD target to 1.18 (from 1.20) and 1.22 (value of one euro) for the next 3 and 12 months, respectively. This suggests modest upside for the euro.
ALTERNATIVE UCITS				Macro, relative-value and event-driven		

Economic, FX forecast tables

GDP Growth %	BNP Paribas Forecasts 2019	2020	2021	2022
United States	2.2	-3,5	6,9	4,7
Japan	0,3	-4,7	2,2	3,3
United Kingdom	1,5	-9,8	7,8	5,6
Eurozone	**1.3**	**-6,7**	**4,8**	**5,2**
Germany	0,6	-5,1	3,7	5,5
France	1,5	-8	6	4,6
Italy	0.3	-8,9	5,2	4,5
Emerging		**-4,7**	**5,6**	**5,2**
China	6,1	2,3	8,7	5,3
India*	4,2	-7,2	8,4	9,4
Brazil	1,1	-4,1	5,5	3
Russia	1,3	-4,5	4,5	3

* Fiscal year

Source: Refinitiv - BNP Paribas - CIB 22/06/2021

CPI Inflation %	BNP Paribas Forecasts 2019	2020	2021	2022
United States	1,8	1,2	3,9	2,7
Japan	0,5	0,0	0,0	0,2
United Kingdom	1,8	0,9	1,8	2,5
Eurozone	**1,2**	**0,3**	**2,1**	**1,8**
Germany	1,4	0,4	2,7	1,8
France	1,3	0,5	1,8	1,3
Italy	0,6	-0,1	1,5	1,9
Emerging		**3,9**	**4,9**	**4,3**
China	2.9	2,5	1,7	2,8
India*	4,8	6,1	5	5
Brazil	3,7	3,2	7,2	4,8
Russia	4,3	3,4	5,8	4,3

* Fiscal year

Source: Refinitiv - BNP Paribas - CIB 22/06/2021

	Country	Spot 30/06/2021		Target 3 months	Target 12 months
Against euro	United States	EUR / USD	1,186	1,17	1,22
	United Kingdom	EUR / GBP	0,857	0,85	0,84
	Switzerland	EUR / CHF	1,096	1,11	1,14
	Japan	EUR / JPY	131,6	130	135
	Sweden	EUR / SEK	10,14	10,00	10,00
	Norway	EUR / NOK	10,20	9,80	9,60
Against dollar	Japan	USD / JPY	111,0	111	111
	Canada	USD / CAD	1,238	1,22	1,22
	Australia	AUD / USD	0,751	0,78	0,80
	New Zealand	NZD / USD	0,699	0,72	0,75
	Brazil	USD / BRL	5,018	4,90	4,80
	Russia	USD / RUB	73,05	70,0	68,0
	India	USD / INR	74,33	72,0	72,0
	China	USD / CNY	6,461	6,40	6,40

Source: BNP Paribas, Refinitiv Datastream

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