JUNE 2021

Investment Strategy Focus

Summary

1. **Inflation obsession**: financial markets are obsessed with one topic - inflation. Will US inflation explode and force the Fed to act sooner than planned? Consumer expectations of US inflation have surged to a 7 year high. We are not so sure, given ongoing structural deflationary forces, and high unemployment suggesting labour market slack. Too early to buy US Treasury bonds, as the May US inflation print will likely be higher than April's.

2. **Value stocks outperform, Europe and EM Value preferred:** for once, European stocks are the preferred stock market destination, outperforming the US and attracting substantial flows. Value stocks continue to outperform, helped by higher inflation expectations and a strong Q1 results season. We remain positive on equities overall, and prefer Eurozone, UK, Brazilian and Russian stocks.

3. **Precious metals surge:** gold has breached the $1900/oz mark for the first time since January, handily outperforming sovereign bonds in the process. We continue to favour gold and silver.

4. **Little value in European investment-grade credit**: Euro investment-grade corporate bond yields sit at a mere 0.4%, leaving little opportunity to obtain positive absolute performance in Euro credit unless average yields turn negative. US IG credit yields 3.4%, while Euro AT1 co-co bonds yield 4-5%. We downgrade Euro IG credit from positive to neutral, and prefer US IG credit and Euro co-co bonds.

5. **Taking tactical profits on base metals:** our positive stance on copper, nickel and other base metals such as tin has been well rewarded with new all-time highs in copper and tin. With China's economy cooling in the short term, we take tactical profits and downgrade base metals to neutral.

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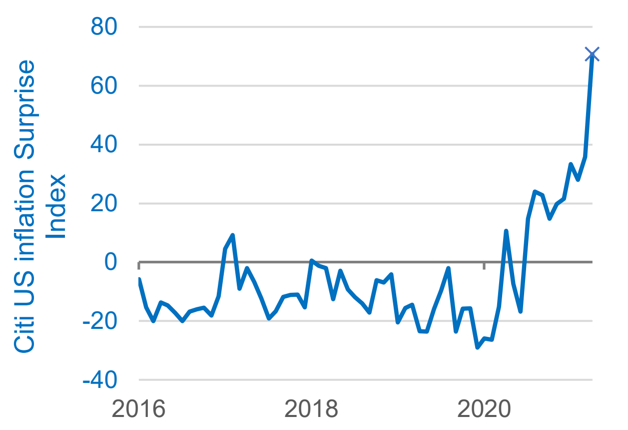
SURGE IN US INFLATION SURPRISES ECONOMISTS



Source: Citi, Bloomberg

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BNP PARIBAS
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The Big Picture

Inflation chatter reaches a crescendo

Inflation obsession: financial markets are obsessed with one topic - inflation. Will US inflation explode and force the Fed to act sooner than planned? Most investors expect US inflation to stay higher for longer.

The general consensus is that inflation pressures are building in a number of areas:

1. **Housing prices and construction costs**, pressured by the rising cost of lumber & resurgent demand;
2. **The cost of used cars** (the Mannheim index of used car prices is today 41% higher than pre-pandemic);
3. **Commodity price surges** driven by energy, base metals, corn and coffee (China raw materials input prices have risen 15% y/y);
4. **Imbalance of supply and demand** in imported goods following the recent Suez canal blockage.

Transitory phase or lasting inflation? The US Federal Reserve maintains that these inflationary pressures are "transitory". However, the University of Michigan consumer expected inflation rate in 1 year has surged to 5.7% (May), 5-year expected inflation up to 3.5%.

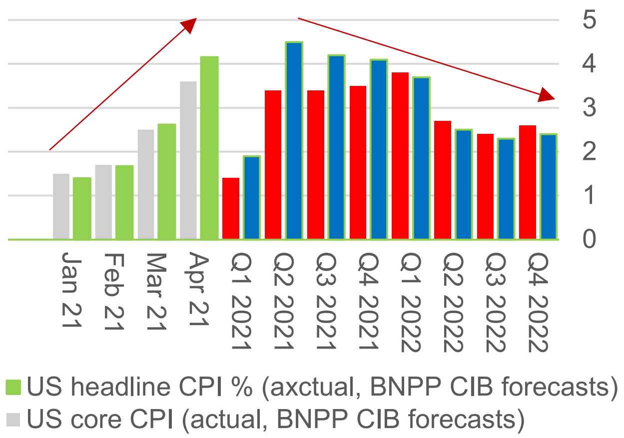
Reasons to believe the Fed: we are not so sure that the financial markets are right in thinking these inflationary pressures will persist longer term.

We see a number of reasons to expect inflation rates to calm in Q3 this year:

1. **Unit labour costs** are declining, which has historically led to a subsequent fall in the core inflation rate. This should be unsurprising, given that the service sector dominates the US economy.
2. **Sharply higher housing prices are putting buyers off**: increasing numbers of households are deciding to stay put rather than buy, given the sharp increase in US house prices (Case/Shiller house price index +13% y/y in March).
3. **Commodity prices are already cooling off**: the lumber futures price has already declined 17% from peak in the last few weeks, while corn prices have already fallen 19% from early May peak.

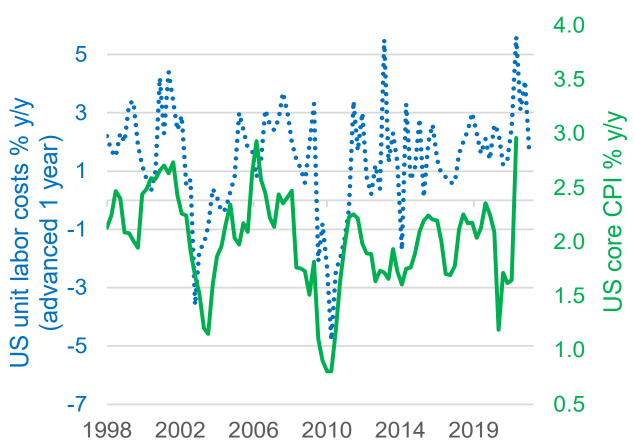
Our colleagues in BNP Paribas Markets 360 see US core inflation falling back from a peak of 3.8% down to 2.4% by Q3 2022, well within the Fed's comfort zone given their symmetrical 2% inflation target.

US CPI FORECAST TO PEAK IN MAY, AND THEN DRIFT LOWER TO LATE 2022



Source: BNP Paribas Markets 360, Bloomberg

FALLING US UNIT LABOUR COSTS SHOULD CAP CORE INFLATION



Source: BNP Paribas Wealth Management, Bloomberg

CONCLUSION

We expect the phased withdrawal of pandemic-linked household benefits in the US over the next few months to spur a return of discouraged people to seek work, thus easing short-term service sector labour shortages. This should, in turn, ease worries over an inflationary spiral in wage inflation. At this point, nominal US Treasuries may become a more attractive asset class – but not yet.

Theme in Focus

An Oriental opportunity in China and Taiwan

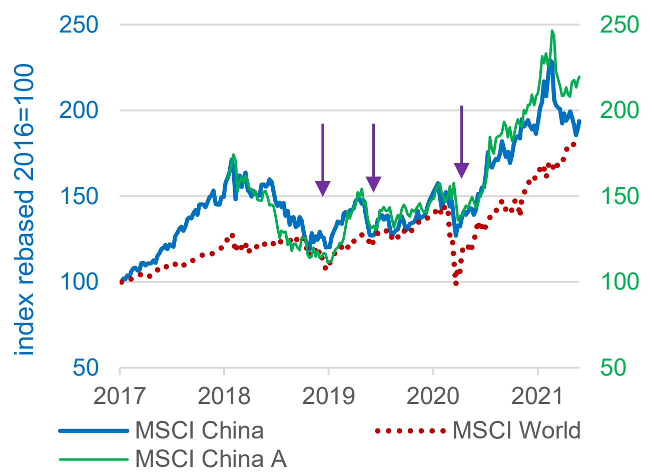
Asian equity correction since mid-February: after a strong rebound of 91% from the March lows last year, the MSCI AC Asia ex-Japan index has corrected 13% since mid-February this year, triggered by the surge in US yields and the intensified regulatory pressure on China mega tech companies.

Has the negative regulatory news flow passed? Regulatory tightening remains an overhang in the near term. However, we expect a re-rating of China's internet sector once there are clearer signals from the regulators indicating a wrapping up of this round of regulatory changes. After all, we believe the government's goals are to promote fair competition, prevent systemic risks, and ensure that the internet giants shoulder a certain level of social responsibility, rather than severely limiting their growth potential.

Improving sentiment outside the technology sector in domestic China A-shares: China A-shares broke above recent ranges and outperformed in May. Investor concern over a corporate profit margin squeeze is fading as Chinese authorities have stepped up to contain commodity prices, easing inflation fears. Recent strengthening in the Chinese renminbi due to US dollar weakness, optimism ahead of Chinese Communist Party's 100th anniversary in July, as well as an absence of aggressive liquidity tightening as originally feared, also boosted market sentiment.

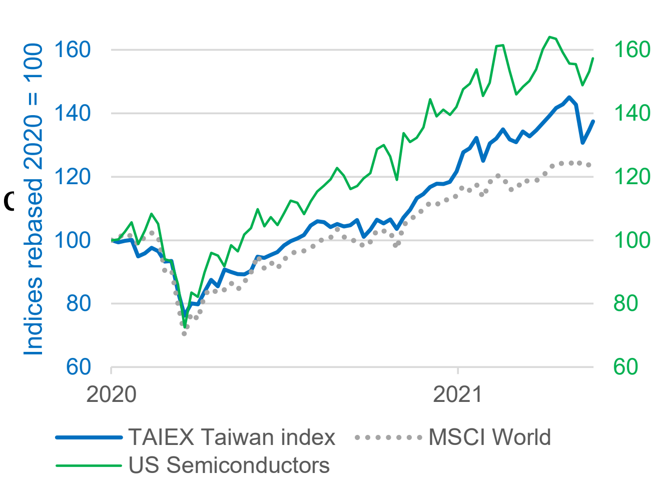
Attractive buying opportunities for Taiwan: the negative news on the surge in domestic COVID-19 cases is mostly priced following a 10% equity market correction in May. There are so far no signs of any supply chain disruptions, and business continues as usual. However, if the COVID-19 situation deteriorates rapidly, the government may raise the alert level to 4 which involves closure of some businesses. The recent correction offers good buying opportunities especially for the semiconductor sector, as the megatrend of electrification and de-carbonisation will continue to drive structural demand for semiconductor chips.

A GOOD TIME TO BUY INTO CHINA A (DOMESTIC) SHARES POST CORRECTION



Source: BNP Paribas, Bloomberg

TAIWAN AND THE SEMICONDUCTOR SECTOR CONTINUE TO MOVE IN LOCKSTEP



Source: BNP Paribas, Bloomberg

CONCLUSION

We retain our positive stance on Chinese and Taiwanese equities. Valuations have become more attractive post correction. Cyclical recovery together with an increase in structural demand due to the global green agenda will continue to drive the consumption, alternative energy, health tech and semiconductor sectors.

Equity and Commodities Outlook

Precious metals begin to glitter again

Europe in vogue: European stock markets led the way in May, gaining ground in absolute terms and outperforming both the US and Emerging Markets by 3%, driven by Travel & Leisure, Retail and Autos.

European growth is about to accelerate in nominal terms on the back of the re-opening of domestic economies combined with strong global industrial growth. European corporate earnings should thus enjoy further upwards revisions to 2021 expected earnings in aggregate, focused particularly in consumer-related and financial sectors.

Value still leads in May: Value continues to lead in factor terms thanks to robust earnings revisions trends. "Hyped" growth segments of stock markets including recent IPOs and loss-making Tech still suffer from heady valuations and uncertain profitability.

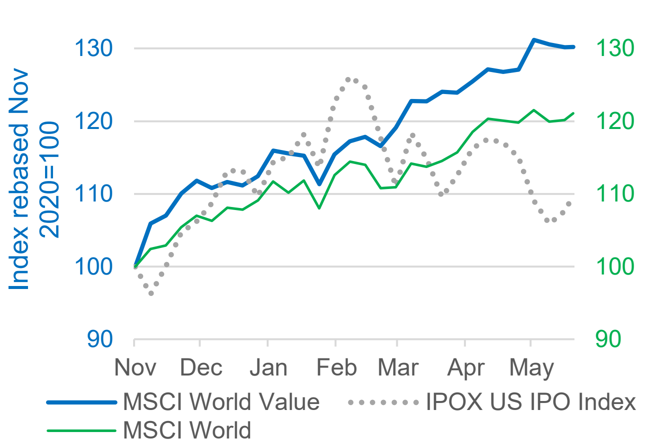
Emerging Market value attractive in Brazil, Russia: A combination of higher commodity prices, stronger currency and improving COVID-19 situations highlights the EM value stories in Brazil and Russia. We favour equity exposure in both countries.

Gold and silver glitter again: gold has found some momentum on the back of a renewed decline in long-term real yields, plus renewed fears around rising inflation. The result is that both gold and silver have risen to around $1900/oz and $28/oz respectively. There is some way to go to our end-year target of $2000/oz or more on gold.

Gold seasonality very biased to July-January: since 1974, seasonality has been very marked for gold bullion prices, with the bulk of positive performance coming between the beginning of July and the end of January historically. If history repeats this year, then gold could easily exceed our minimum target before year-end, giving good grounds for continued optimism.

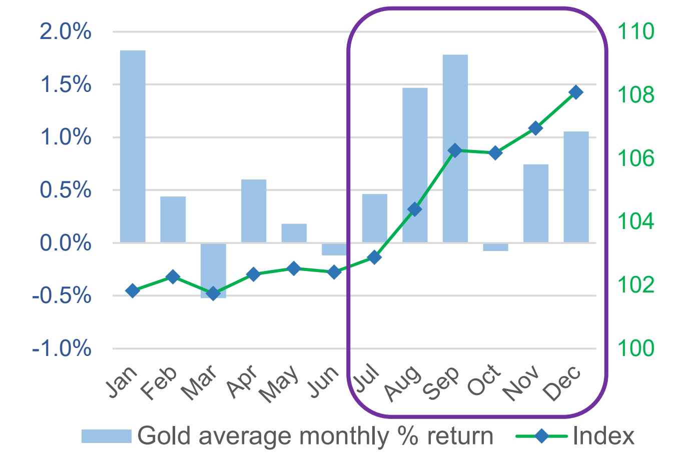
Taking tactical profits on base metals: our positive stance on copper, nickel and other base metals such as tin has been well rewarded with new all-time highs in copper and tin, and the Bloomberg industrial metals index hitting an 8-year high. But with China's credit impulse cooling, we take tactical profits and downgrade base metals to neutral.

VALUE FACTOR BEATS OVERHYPED IPO STOCKS BY > 20% SINCE NOVEMBER



Source: BNP Paribas, Bloomberg

GOLD PRICE SEASONALITY VERY SKEWED TOWARDS JULY-JANUARY



Note: Gold price 1974-2021. Source: BNP Paribas Wealth Management

CONCLUSION

Our positive stance on copper, nickel and other base metals has been well rewarded with new all-time highs in copper and tin, and the Bloomberg industrial metals index hitting an 8-year high. But with China's economy cooling, we take tactical profits and downgrade base metals to neutral. We maintain our positive stance on precious metals, with strong upwards momentum in gold and silver. This should also benefit the gold miners sector. Commodity price-related EM Value in Brazil and Russia is also attractive.

Bond, Credit and FX Outlook

May's US inflation print in focus

US Treasury bonds stabilise, but await May inflation: despite the sharp rise in US core inflation to 3% for April, US 10-year Treasury yields have drifted lower to under 1.6% over the month, with a modest fall in real yields being the main driver.

As we expect a further surge in May's inflation print, we remain negative on US and core Eurozone sovereign bonds for now, retaining our year-end targets of 2% for US and 0% for German 10-year bond yields.

US inflation expectations hover around 2.4%: financial markets do not seem to be panicking over inflation for now, with inflation expectations relatively steady over the month of May. In our view, medium-term US inflation expectations of under 3% should not be too much of a concern. But we watch closely for signs of higher labour participation rates in the months ahead, in the expectation that discouraged working-age Americans will start looking for work.

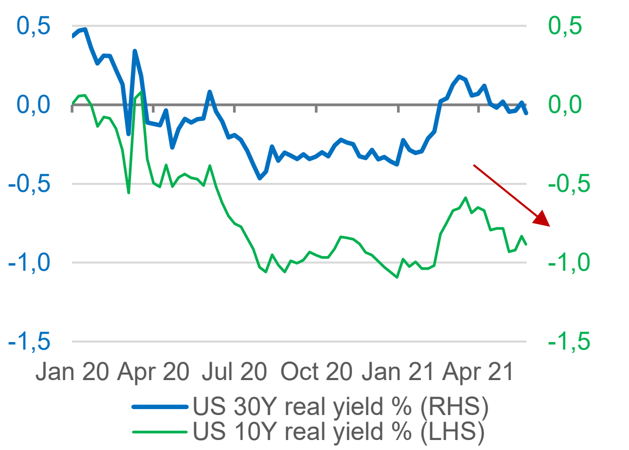
Little value left in European investment-grade credit: since March 2020, European investment-grade (IG) corporate bonds have performed impressively, returning 9.9%.

Thanks to the ECB's extraordinary monetary policy, euro IG yields have been relatively stable, and have not suffered from the slight rise in high yield spreads and the volatility of peripheral spreads and VIX.

But the problem is the valuation. With Euro investment-grade corporate bond yields now offering a mere 0.4%, there is little opportunity to obtain further positive absolute performance in Euro credit unless average yields turn negative. In contrast, US IG corporate bonds yield 2.1% on average, Emerging Markets USD sovereign bonds yield 3.8% and Euro AT1 co-co bonds yield 4-5%.

We are therefore downgrading our Euro IG credit view to neutral this month.

US LONG-TERM REAL YIELDS ARE DECLINING ONCE AGAIN, SUPPORTING GOLD, EQUITIES



Source: Bloomberg

RECENT SPREAD WIDENING BETWEEN EURO AND US CREDIT YIELDS

Note: Bloomberg Barclays corporate bond indices. Source: Bloomberg

CONCLUSION

We downgrade Euro IG credit from positive to neutral, and prefer US IG credit, EM sovereign bonds and Euro co-co bonds (all of which we rate as positive). Note for euro investors, with a 1-year cost of hedging USD into EUR of 0.7%, US BBB-rated credit offers a 1.6% yield when hedged back into euros, 120 basis points above the average Euro IG credit yield.

Alternative Strategies

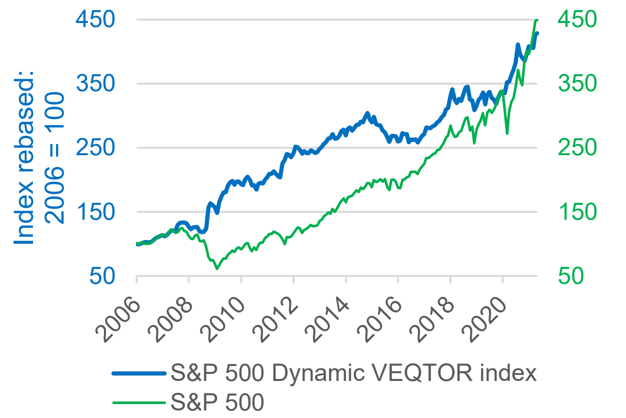
Equity with downside protection- have your (stock market) cake and eat it?

More defensive equity exposure over summer: we have previously written about the usually weaker historical performance of stock markets over the summer months ("Sell in May and go away"). This prompted our rotation in sector recommendations away from cyclicals (Industrials, Materials) towards Health Care last month, and highlighting of low volatility factor equity funds/ETFs.

Equity + volatility overlay: an alternative strategy allowing investors to partially de-risk their equity exposure but maintain exposure to stock market upside is a protected equity strategy. This combines an underlying long equity market exposure with downside protection, using either exposure to implied volatility or via buying put options.

An example of this stock market + volatility combined strategy is the S&P 500 Dynamic VEQTOR index, which has matched the performance of the S&P 500 index since 2006, but with reduced bear market drawdowns.

S&P DYNAMIC VEQTOR INDEX ONLY SUFFERED A 7% MAX DRAWDOWN IN MARCH 2020, VERSUS 34% FOR S&P 500

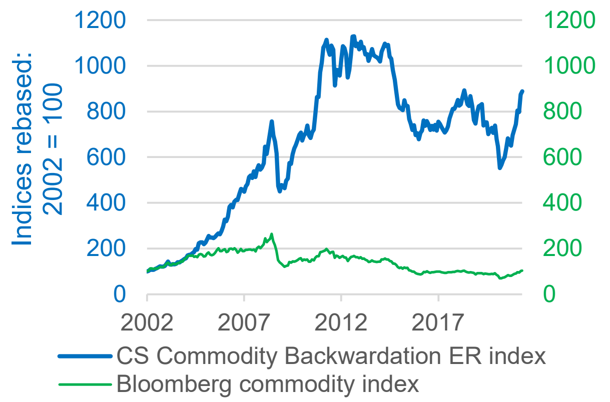


Source: S&P Dow Jones Indices, Bloomberg

Smart exposure to commodities via roll yield: when commodities are in a broad bull market, performance can be fantastic. Just look at the amazing performance of the likes of lumber, copper and palladium in recent years. However, since 2002 the average yearly total return from commodities has been just 1.4% on the Bloomberg commodity index, due to the long-running 2008-2020 commodity bear market.

However, over this same period, a commodity roll yield strategy that aims to harvest yield from commodities in "backwardation" (where spot prices are higher than futures prices) has generated an annual average 11.9% return. This roll yield strategy works well in commodity bull markets, such as the current bull market that started last year. We are firm believers of this strategy in a structural bull market over the long term for both precious and industrial metals. We see roll yield strategies as an excellent way to gain diversified exposure to this structural trend.

EXPOSURE TO THE BACKWARDATION ROLL YIELD IN RISING COMMODITY MARKETS HAS PROVIDED 12% ANNUAL AVERAGE RETURNS



Source: Bloomberg

CONCLUSION

With bond yields close to historic lows, there is an increased risk that bonds will no longer play their diversification role (versus equities) effectively in a balanced portfolio. In order to construct a balanced portfolio that can benefit from stock market momentum, but which does not fall sharply in a market correction phase, we advocate a portfolio mix combining long equity exposure with long implied volatility exposure.

Summary of our main recommendations

	Current Recom	Prior Recom	Constituents	We like	We avoid	Comments
EQUITIES	+	+	Markets	EU, UK, Japan, EM: China, Taiwan, Sth 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 month should be more volatile.
			Sectors	Financials, Real Estate, Healthcare, Semicond, 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	Our 10-year bond yield targets are 2% in the US and 0% in Germany in one year. We stay negative on long-term bonds and positive on US short-term bonds
			Segments	Peripheral euro and eurozone convertible. US IG credit and Fallen Angels.		We turn neutral from positive on eurozone IG corporate bonds, while maintaining our positive stance on US corporates. We prefer to stay neutral on the HY asset class. We stay positive on EM bonds
			Maturities	At benchmark		
CASH	=	=				
COMMO-DITIES	+	+		Gold		Base metals - We move Base metals from positive to 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 1.25 (from 1.20) and 1.25 (value of one euro) for the next 3 and 12 months, respectively. This suggests further upside for the euro.
ALTERNATIVE UCITS				Macro, relative-value and event-driven		We turned neutral on Long/Short Equity last month

Economic, FX forecast tables

BNP Paribas Forecasts				
GDP Growth %	2019	2020	2021	2022
United States	2.2	-3.5	6.9	4.7
Japan	0.3	-4.8	3	2.3
United Kingdom	1.5	-10.2	6.1	6
Eurozone	**1.3**	**-6.8**	**4.2**	**5**
Germany	0.6	-5.3	3	4.8
France	1.5	-8.2	6.1	4.4
Italy	0.3	-8.9	5	3.9
Emerging				
China	6.1	2.3	9.2	5.3
India*	4.2	-7.2	12.5	4.1
Brazil	1.1	-4.1	2.5	3
Russia	1.3	-4.5	4	3

* Fiscal year
Source: BNP Paribas – 25/05/2021

BNP Paribas Forecasts				
CPI Inflation %	2019	2020	2021	2022
United States	1.8	1.2	2.5	2.2
Japan	0.5	0.0	-0.3	0.0
United Kingdom	1.8	0.9	1.4	2.1
Eurozone	**1.2**	**0.3**	**1.7**	**1.4**
Germany	1.4	0.4	2.1	1.5
France	1.3	0.5	1.4	1
Italy	0.6	-0.1	1.5	1.4
Emerging				
China	2.9	2.5	1.8	2.8
India*	4.8	6.2	4.9	4.6
Brazil	3.7	3.2	6.5	4
Russia	4.3	3.4	5.1	4

* Fiscal year
Source: BNP Paribas – 25/05/2021

	Country	Spot 25/05/21		Target 3 months	Target 12 months
Against euro	United States	EUR / USD	1.22	1.20	1.25
	United Kingdom	EUR / GBP	0.86	0.85	0.84
	Switzerland	EUR / CHF	1.10	1.11	1.14
	Japan	EUR / JPY	134	133	139
	Sweden	EUR / SEK	10.11	10	10
	Norway	EUR / NOK	10.10	9.8	9.60
Against dollar	Japan	USD / JPY	109	111	111
	Canada	USD / CAD	1.20	1.24	1.22
	Australia	AUD / USD	0.77	0.78	0.80
	New Zealand	NZD / USD	0.73	0.72	0.75
	Brazil	USD / BRL	5.22	5.30	4.80
	Russia	USD / RUB	73.36	74.0	68.0
	India	USD / INR	72.9	75.0	75.0
	China	USD / CNY	6.38	6.40	6.40

Source: BNP Paribas, Refinitiv Datastream

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