OCTOBER 2021

Investment Strategy Focus

Summary

1. **US Treasury yields break out**: high inflation rates plus imminent tapering of bond purchases push US 10-year yields to 1.6% and boost the US dollar. We adjust our 12-month EUR/USD forecast to USD1.18 per euro based on a first Fed rate hike brought forward to Q4 2022.

2. **Chinese assets in a holding pattern**: expect further short-term volatility as Chinese authorities try to arrange an orderly restructuring of Evergrande, not at all guaranteed as of yet. Investors able to take a long-term, multi-year view may look to buy Chinese domestic A–shares, mid-/small-caps.

3. **Global equities survive September unscathed**: with a mere 2% drop over September in euro terms, global equity markets remain in a firm uptrend, supported by positive earnings momentum, abundant liquidity and share buybacks (USD 800bn annualised in the US). We affirm our positive equities stance, biased towards Europe, the UK and mid-/small-caps.

4. **Commodity crunch**: the commodity bull is rampant in both energy (gas, electricity, oil) and base metals markets. But strong final demand and the likely temporary nature of these price hikes suggests stagflation fears are overdone. Commodity roll yield-focused funds remain an excellent way to earn yield from backwardation.

5. **Private equity promise**: we believe that investors should hold a private equity allocation for exposure to excellent long-term returns. Positive on growth, LBO private equity fund exposure within Alternatives.

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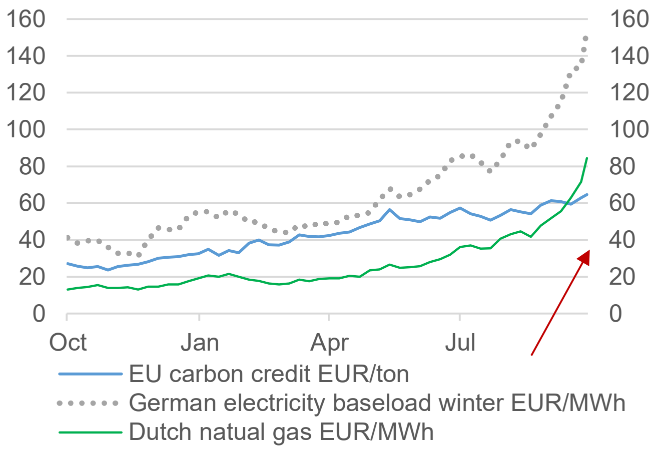
EUROPEAN ENERGY PRICES ROCKET HIGHER



Source: Bloomberg, BNP Paribas Wealth Management

Edmund Shing, PhD
Global CIO
BNP Paribas Wealth Management

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The bank for a changing world

Theme in Focus

China Crisis: buy, hold or avoid?

Surprisingly resilient domestic Chinese equities: the headlines from China have shifted from the broad regulatory tightening to the big property developers' funding pressures. Offshore Chinese markets have suffered, with the Hang Seng China Enterprises Index down 6.4% month to date. Despite contagion risk concerns from Evergrande's debt difficulties, the onshore A-shares market has remained resilient with the CSI 300 Index up 1.5% MTD.

No Chinese Lehman moment: we disagree that the Evergrande crisis is China's "Lehman moment", and expect the Chinese authorities to avoid the worst-case scenario of disorderly bankruptcy and full liquidation of Evergrande and other large property developers.

Asia Markets (financial press) reports a deal that will see China Evergrande restructured into three separate entities is currently being finalised by the Chinese Communist Party and could be announced within days. State-owned enterprises are said to underpin the restructuring, effectively transforming the property developer into a state-owned enterprise.

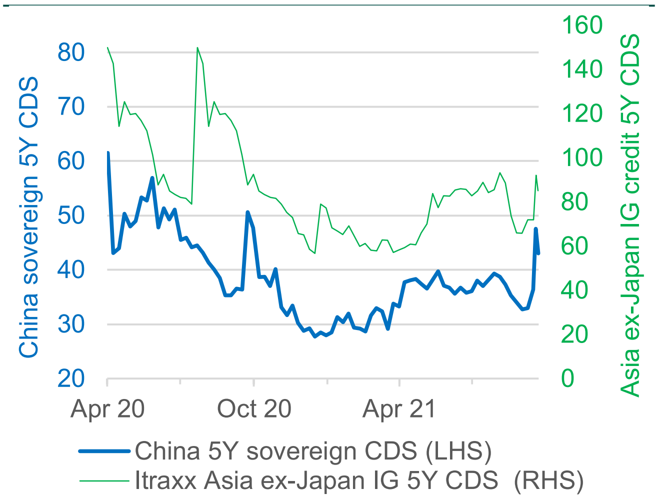
Evergrande scrambles to sell assets: Evergrande is looking to sell assets to raise cash, including its 50% stake in Evergrande Life Assurance Co., which could raise USD 600m.

Evergrande has 30 days from non-payment of dollar bond coupons before a default is declared: its 2022 USD bond had a coupon due on 23 September, with four more USD coupon payments due by 11 October.

Thus **Evergrande has until 22 October to** start paying these coupons if it wishes to avoid defaulting.

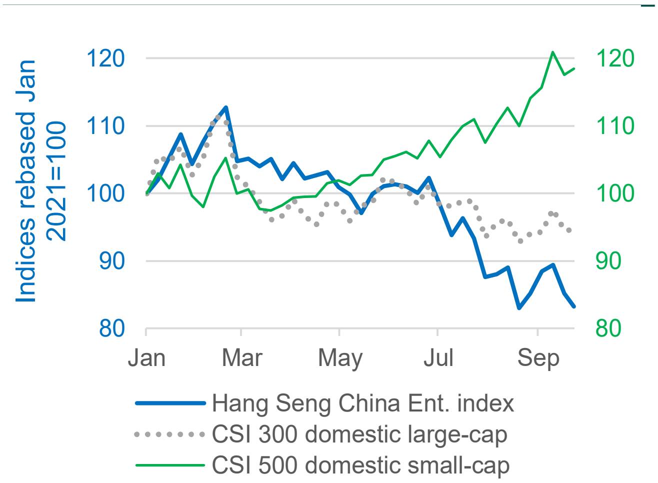
More monetary easing measures ahead: given the weaker-than-expected economic data plus the ongoing regulatory tightening campaign to achieve the central government's long-term goal of "common prosperity", we expect more selective easing measures in Q4 2021. We note that China's credit impulse has been bottoming out recently, with the PBOC injecting a net 100 billion yuan into markets on Monday 27 September.

CHINA SOVEREIGN, ASIA CREDIT CDS INDICES STILL NOWHERE NEAR 2020 HIGHS



Source: BNP Paribas, Bloomberg

THIS YEAR CHINESE DOMESTIC SMALL-CAPS HAVE PERFORMED SURPRISINGLY STRONGLY



Source: BNP Paribas, Bloomberg

CONCLUSION

Expect further short-term volatility as Chinese authorities try to arrange an orderly restructuring of Evergrande, which is not at all guaranteed as of yet.
Investors who able to take a long-term multi-year view may look to buy exposure to China via domestic A –shares, or even better, Chinese domestic mid-/small-caps.

The Big Picture

Will supply chain difficulties strangle growth and boost inflation?

Economic momentum slows, but due just to supply chain issues? After the breakneck pace of recovery-driven growth that we have experienced since June 2020, we are now seeing the inevitable slowing of economic growth rates to more "normal" levels.

One element of this slowing to more sustainable levels of growth is the brake from a range of supply chain constraints. A host of manufacturing industries, such as semiconductors, car production, bicycles, shipping, industrial gases and lumber, suffer both from a lack of spare capacity and from the hangover of coronavirus-related disruptions in Asia.

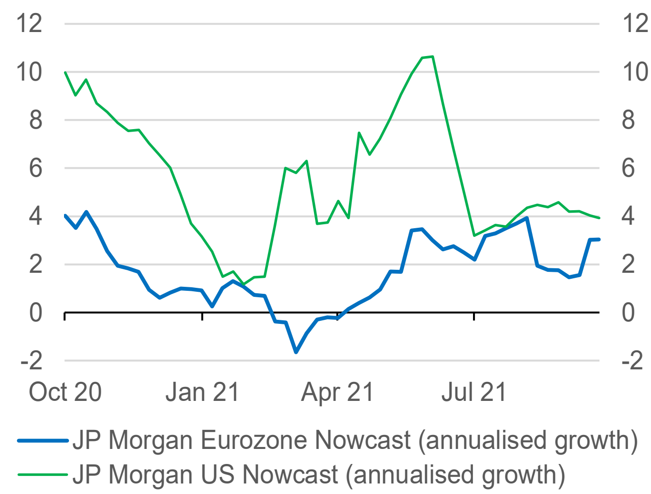
Transitory supply chain issues force inflation up: these widespread supply chain problems are restricting supply and forcing prices higher. When we add to this the inflationary pressures from higher energy prices (oil, natural gas, electricity), we have market commentators warning of a looming 1970s-style stagflation risk potentially ahead of us.

Not so fast – forecast 2022 growth still above-trend: we still forecast 4.7% GDP growth in the US and 5.2% in the eurozone next year, while nowcast forecasts for annualised Q3 2021 growth in the US and the eurozone remain well above trend at 4% and over 3% respectively.

Final demand is robust: there has been little sign of a slowdown in final demand, with new capital goods orders still strong in the US and Europe in August. Order backlogs continued to grow in the US and in the eurozone in August, highlighting that supply chain issues remain the key brake on industrial growth.

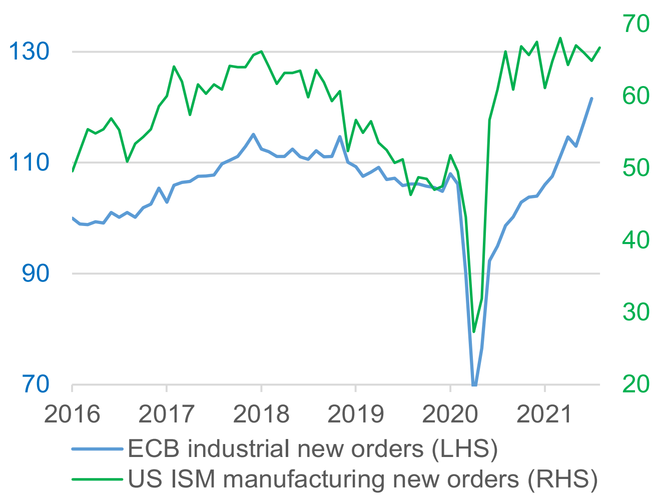
Labour market uncertainties: US employment trends remain difficult to divine at present, given huge distortions from just-expired enhanced unemployment benefits, early retirement, and the back-to-school season. This is a key variable for the US Federal Reserve, as the speed of US rate hikes will depend on how quickly the US returns to their definition of full employment (4-5% unemployment rate?).

RECENT MACRO DATA POINT TO 3-4% US, Q4 2021 EURO GROWTH



Source: JP Morgan, Bloomberg

NEW ORDERS POINT TO ROBUST FINAL DEMAND



Source: Bloomberg

CONCLUSION

Despite the obvious supply chain disruptions which are impacting global manufacturing, we believe that stagflation fears are somewhat overdone. Rather, we expect a period of robust growth plus moderating (albeit more persistent) inflation above central banks' targets as we move into 2022. This is less promising for sovereign and corporate bonds, but better for equities, real estate, infrastructure and commodities.

Stagflation: How likely is it?

Return to the 1970s?

The 1970s were notable for a number of trends: flared trousers, John Travolta's white disco suit in *Saturday Night Fever*, platform shoes and economic stagflation.

What is stagflation? It is persistently high inflation combined with slow macro growth. These higher prices lead to destruction of final demand, as they act as an extra "tax" on companies and households.

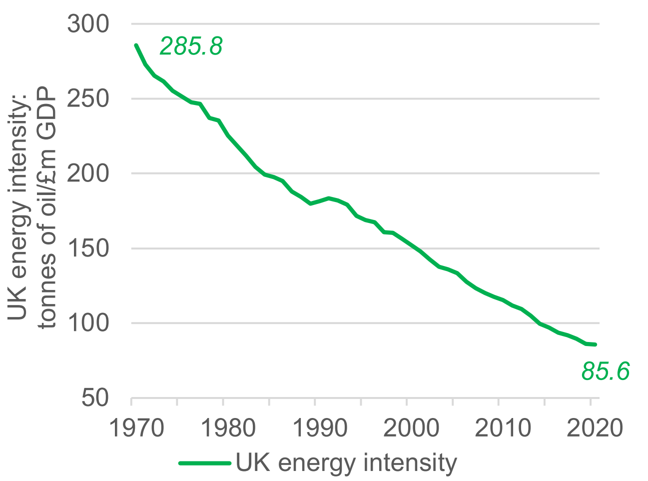
Could we really see a bout of stagflation today? The recent boost in inflation, and latterly food & energy prices in particular, have prompted stagflation fears.

Whether we truly see stagflation or not is linked to the comparison of "good" versus "bad" inflation. "Good" inflation emanates from vibrant growth/recovery and thus stronger final demand. In contrast, "bad" inflation derives from a supply shock, often due to geopolitical turmoil. In the 1970s stagflation episode, "bad" inflation in the form of sharply higher oil prices (1972 crude oil price average of USD 3.22/barrel surged to USD 12.52 average by 1974) was the main culprit for this unpleasant economic recipe.

Sharply higher energy prices raise the spectre of stagflation: with oil prices rising to their highest levels since 2018, and both natural gas and wholesale electricity prices also going up 4 times or more since March this year, investors are now starting to worry about potential stagflation. **Widespread supply chain disruptions** are adding to the worries of slower global growth, hurting for instance auto production due to the lack of semiconductor chips. But nowcast indices of current economic growth still point to strong current quarter growth in both the US and the eurozone, in spite of this effect. Crucially, new orders remain robust, suggesting no lack of demand for now.

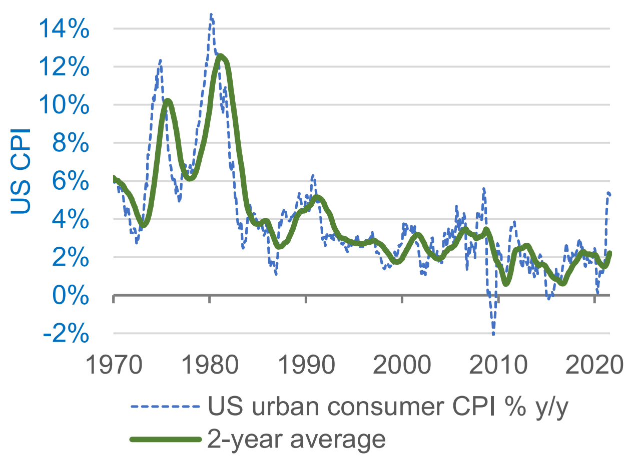
Inflation nothing like the 1970s: Comparing US inflation today to the 1970s, we remain far from the double-digit inflation rates seen then. One should take into account that the energy intensity of the major economies today is at least 70% lower than in the early 1970s pre-oil crisis, judging by the UK's example. A fall in the unionization over past decades also reduces somewhat the risk of a price-wage spiral.

THE UK'S ENERGY INTENSITY HAS REDUCED BY 70% SINCE 1970



Source: UK Government

US INFLATION NOTHING LIKE THE 1970S, MORE LIKE THE 2008 EPISODE



Source: Bloomberg

CONCLUSION

The ultimate drag from the current energy price surge on global economic growth will depend crucially on how long prices stay this high (or even rise more). Normally in commodity markets, the cure for high prices is high prices – energy suppliers are likely to react to these abnormally elevated prices by boosting output to take advantage, supply then catching up with demand. This should accelerate global renewable energy investment, given the added economic imperative from expensive fossil fuels.

Equity and Commodities Outlook

The trend remains your friend

Trend beats valuation; over 1 year or less: global equities look to have navigated the seasonally tricky month of September without major damage. Over the last month, US and European equity markets have registered a 5% pullback, which is not unusual at all for September. In contrast, the UK's FTSE 100 has only fallen 2% from its recent high, while in emerging markets, the Russian RTS index and the Indian Sensex index are both close to or at multi-year highs.

Our trend-following models (dual momentum, 200-day moving average) point to maintaining a positive exposure to US, Eurozone, UK, Japanese and Emerging Markets ex China equities for the month ahead.

Earnings momentum points higher: earnings revisions post the Q2 earnings season are once again positive, underlining the favourable profit dynamic.

Mid/small-cap exposure preferred in Europe, EM: we continue to advocate a bias to mid- and small-cap stocks in Europe, the UK, US and even EM/China.

Battery metals are still all the rage

Renewable energy investment boosts metals: a range of battery metals with wide industrial uses including tin (electronics), aluminium (packaging) and nickel (stainless steel) have seen prices run up to fresh multi-year highs on the back of strong demand and dwindling warehouse stocks. So far in 2021, industrial metals have gained 26%, and 90% since March 2020.

Energy prices rocket, pressuring households: a cold winter in Europe and North Asia could push gas prices higher due to low inventories.

Enhanced roll commodities index +33% in 2021: due to a strong backwardation, the 1-year roll yield of the Brent futures remains at ±9%.

At a sector level, we retain a selective bias to cyclical value in the form of commodity-related sectors (Oil & Gas, Basic Resources) and Financials (Banks, Life Insurance).

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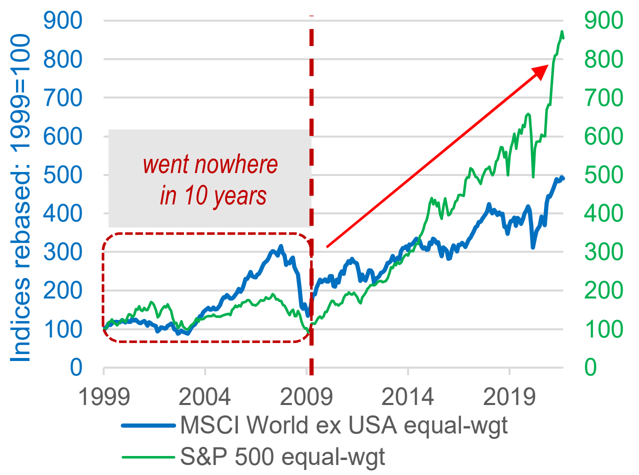
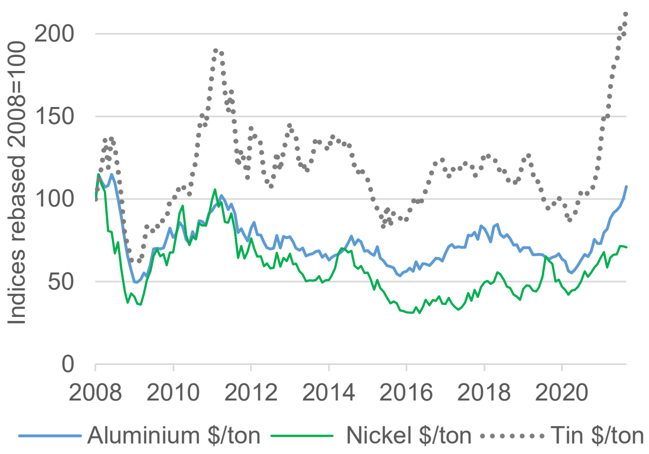
THE AVERAGE US, GLOBAL STOCK CONTINUES TO MAKE NEW HIGHS



Source: BNP Paribas, Bloomberg

TIN, NICKEL AND ALUMINIUM PRICES AT FRESH MULTI-YEAR HIGHS



Source: Bloomberg

CONCLUSION

Global equity markets remain in a firm uptrend, supported by positive earnings momentum, abundant liquidity and share buybacks (USD 800bn annualised in the US). We affirm our positive equities stance, biased towards Europe, the UK, Japan and mid-/small-caps. At the sector level, a selective cyclical value stance is advised favouring the European Oil & Gas, Construction Materials, Mining and Financials sectors.

Bond, Credit and FX Outlook

Sovereign bond yields head higher

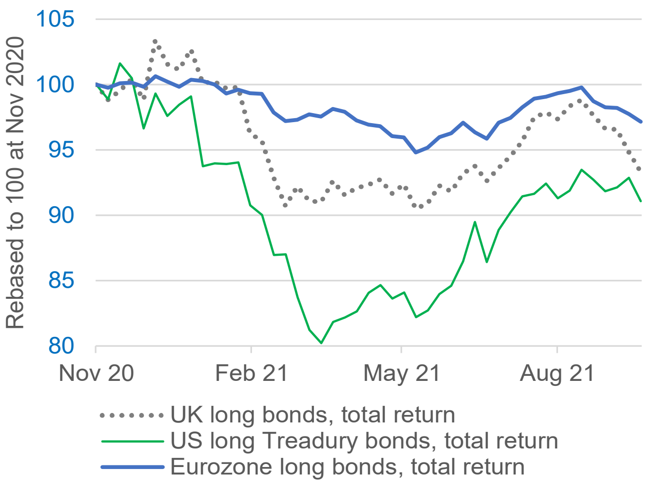
Sovereign bonds underperform on US taper talk: the prospect of a forthcoming shift in monetary policy away from today's ultra easy stance has been clearly signalled recently in both the US and UK. The Bank of England is projected to raise its base interest rate by February 2022 judging from interest rate futures, while the US Federal Reserve is expected to start tapering monthly bond purchases before the end of this year. These factors, together with persistently above-target inflation rates, are weighing on UK gilts and US Treasuries – with the US 10-year bond yield exceeding 1.6%. **Emerging market sovereign bonds offer attractive yields:** despite the decent China-driven turmoil, hard currency (USD) emerging market bonds have outperformed the Barclays Global Aggregate Bond Index by over 5% since November last year, and offers a much higher yield at 3.8%, and even 5% for EM sovereign bonds priced in local currency. In a yield-starved world, these yields remain attractive.

Expected credit market returns underwhelm: with both investment grade (IG) and high yield (HY) spreads now historically tight (US IG spread of 0.82% vs 1.54% long-term average), credit market long-term expected returns are also low at around 2% on an annual average basis. This effectively prices default rates remaining extremely low, and gives little scope for further upside in balance sheet strength.

With sovereign bond yields on the rise, IG credit will struggle to post positive returns in the near term.

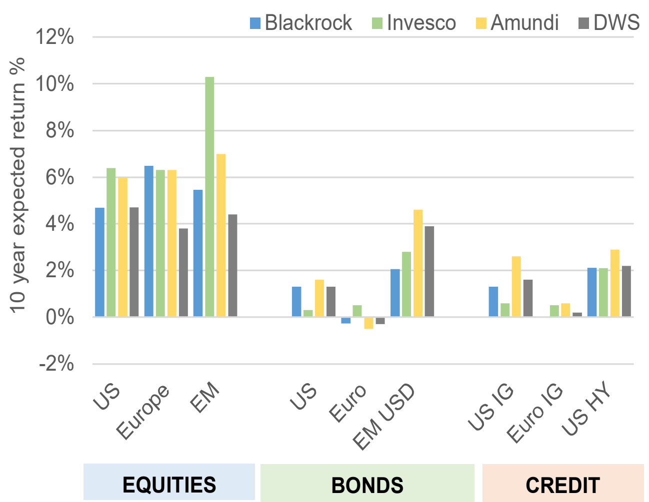
Higher US Treasury yields support the US dollar: 2-year bond yields have jumped to 0.3%+ on the back of a more hawkish-sounding Fed. This gives the US dollar a boost via positive interest rate differentials and US portfolio flows. Our 3-month EUR/USD forecast of USD1.17 per 1 euro has been met, but we adjust our 12-month forecast to USD1.18 per 1 euro, given the likely earlier taper from the US Federal Reserve.

UK AND US SOVEREIGNS ARE THE MOST AFFECTED BY HIGHER INFLATION RATES



Source: Bloomberg

10-YEAR EXPECTED RETURNS ARE VERY LOW FOR US, EURO SOVEREIGN BONDS



Source: Blackrock, Invesco, Amundi, DWS

CONCLUSION

We forecast a 2% US 10-year yield in 12 months, but do not expect US dollar strength to persist as US growth normalises. We look for little change in the EUR/USD over the next 12 months, adjusting our 12-month forecast to USD1.18 per 1 euro (USD1.22 previously).

Alternative Asset Outlook

Private equity is an excellent portfolio choice over mid/late-cycle

Private equity is a key alternative asset class to include in a diversified portfolio: private equity funds have historically delivered outstanding long-term returns, 14% CAGR since 2000 in US dollars according to the Refinitiv Private Equity Buyout Index.

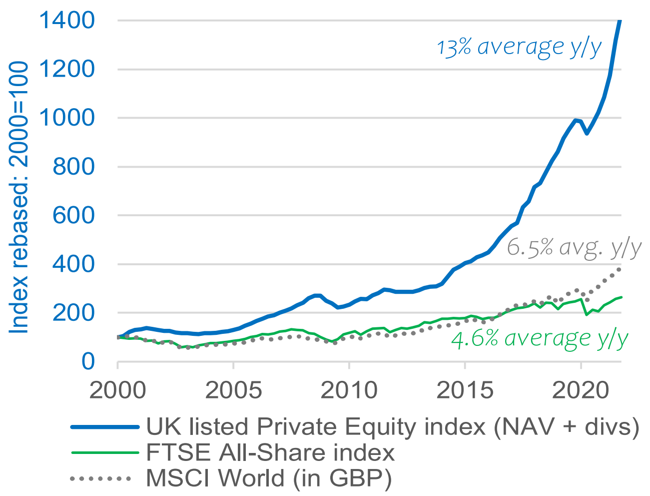
A way to access smaller unlisted growth companies: increasingly today, growth companies in the technology, healthcare and sharing economy spaces are increasingly opting to stay private for longer, and only go public when they become mega-cap companies. Thus private equity is now one of the only ways to invest in companies during their early high-growth stage of development.

Privileged information and activist management can boost portfolio company profitability: unlike public equity market fund managers, private equity funds have legitimate inside information on their companies.

Ability to back entrepreneurs: private equity funds have the ability to back entrepreneurs at an early stage, and also to help them with their experience and advice to succeed, usually involved in deciding the strategic direction of the company.

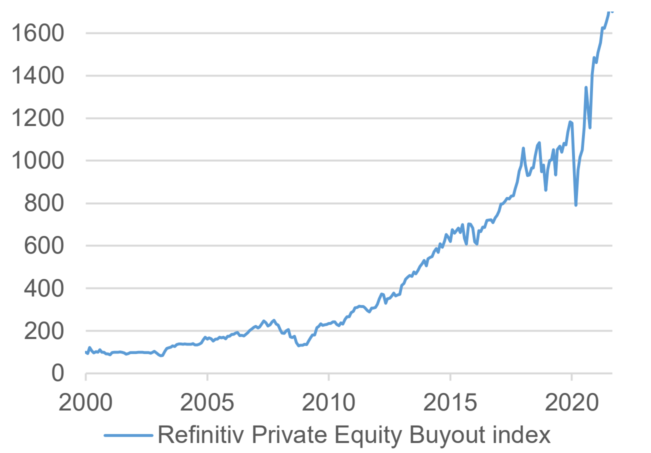
However, investors must accept relative illiquidity and a long-term investing horizon: but clearly, investors must be able to commit investment capital for the long term, typically at least 3 and up to 10 years in order to give PE funds quasi-permanent capital to allow them to invest themselves over the long term. **Two preferred ways to invest in private equity**: via well-established private equity fund managers with a consistent record of delivering strong long-term returns to investors, but also potentially via listed private equity fund vehicles, such as the investment trusts that exist in the UK.

UK-LISTED PRIVATE EQUITY FUNDS HAVE DELIVERED A 13% AVERAGE ANNUAL RETURN



Source: The AIC, Bloomberg

US PRIVATE EQUITY BUYOUT FUNDS HAVE DELIVERED 14% CAGR SINCE 2000



Source: Refinitiv Datastream

CONCLUSION

We believe that investors should hold a private equity allocation for exposure to excellent long-term returns. We have a positive recommendation on both growth-oriented and Leveraged BuyOut private equity fund exposure within Alternatives.

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.
			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	
			Segments	Peripheral euro and eurozone convertible. Fallen Angels.		
			Maturities	At 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 as we expect a lower demand from China in Q4 but MT prospects remain positive.
FOREX			EUR/USD			We adjust our EUR/USD target to USD1.18 (value of one euro) for the next 12 months.
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 10/10/2021	Target 3 months	Target 12 months
Against euro	United States	EUR / USD	1,154	1,16	1,18
	United Kingdom	EUR / GBP	0,851	0,85	0,84
	Switzerland	EUR / CHF	1,071	1,10	1,12
	Japan	EUR / JPY	128,4	129	131
	Sweden	EUR / SEK	10,17	10,00	10,00
	Norway	EUR / NOK	9,93	9,80	9,60
Against dollar	Japan	USD / JPY	111,2	111	111
	Canada	USD / CAD	1,263	1,25	1,24
	Australia	AUD / USD	0,726	0,73	0,76
	New Zealand	NZD / USD	0,691	0,70	0,73
	Brazil	USD / BRL	5,501	4,90	4,80
	Russia	USD / RUB	72,43	70,0	68,0
	India	USD / INR	74,98	72,0	72,0
	China	USD / CNY	6,462	6,40	6,40

Source: BNP Paribas, Refinitiv Datastream

THE INVESTMENT STRATEGY TEAM

FRANCE

Edmund SHING
Global Chief Investment Officer

ASIA

Prashant BHAYANI
Chief Investment Officer, Asia

Grace TAM
Chief Investment Advisor, Asia

BELGIUM

Philippe GIJSELS
Chief Investment Advisor

Alain GERARD
Senior Investment Advisor, Equities

Xavier TIMMERMANS
Senior Investment Strategist, PRB

LUXEMBOURG

Guy ERTZ
Chief Investment Advisor

Edouard DESBONNETS
Investment Advisor, Fixed Income

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