MARCH 2021

Investment Strategy Focus

Summary

1. **Falling COVID infection rates boost macro**: COVID new infection and hospitalisation rates continue to fall sharply in the US and most European countries. This, together with successful vaccine programs boosts prospects for the re-opening of economies over Q2.
2. **US consensus growth forecasts raised:** Consensus now forecasts 5% US GDP growth in 2021e, with boosts from further stimulus and strong consumption, housing trends.
3. **No risk of change in central bank policy**: the US Federal Reserve remains relaxed about the prospect of temporarily higher US inflation. Positive monetary and fiscal stimulus supports strong economic growth.
4. **Could we see a new commodity supercycle?**: Stronger demand and tight supply are driving commodity prices higher across the board. Positive on industrial metals, boosted by renewable energy/electric vehicle growth.
5. **Cyclicals enjoy a fantastic February**: Greater growth optimism drove "re-opening" cyclical sectors and mid-/small-cap exposure. Remain positive on US and European small-/mid-cap exposure in equities.
6. **Upgrading Banks, downgrading Utilities**: steeper yield curve, strong Q4 results and resumption of dividend payments all inform our positive view on Banks. We downgrade Utilities to negative, Healthcare to Neutral.
7. **UK assets on a roll**: Sterling appreciates against the US dollar and euro, boosted by the prospect of re-opening in Q2. Positive on sterling, UK mid-cap equities.

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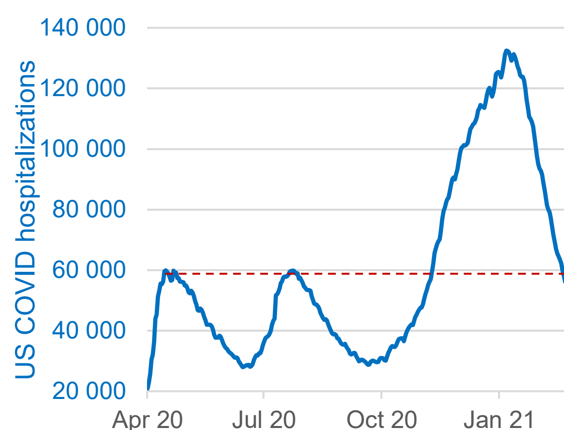
SHARP FALL IN US COVID HOSPITALISAT5IONS



Source: covidtracking.com

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The Big Picture

Is everyone afraid of a market crash?

Is a stock market crash widely expected? The number of searches on the Google search engine for the phrase "stock market crash" have surged over the last month. In general, bear markets do not start when everyone is expecting one.

In contrast, the end of a bull market in stocks is generally marked by excessive euphoria, and a narrowing of market breadth to a handful of leading stocks. In essence, one can spot cracks in the bullish market narrative well before a market crash starts to unfold.

In 2007, there were early warning signs in the overheated US housing market. In 2000, US market breadth indicators had already been deteriorating since early 1998, a sign of fewer and fewer mega-cap stocks leading the overall market higher.

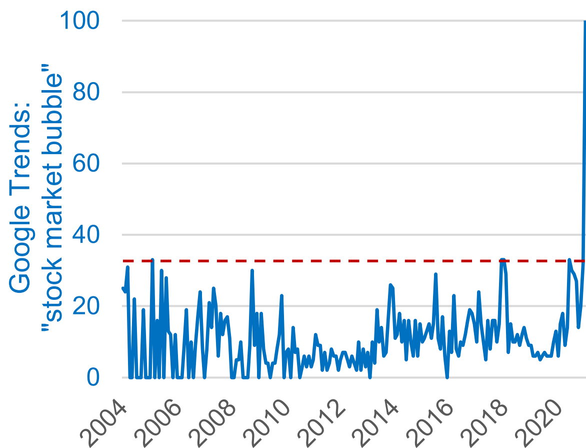
Watch Central Banks: Most importantly, central banks led by the US Federal Reserve had raised short-term interest rates well in advance of each subsequent recession and bear market – in 1988-89, in 1999-2000 and in 2004-06.

Pricing earlier US rate hikes: As the possibility of a very large relief package in the US has increased, traders have repriced the path of US interest rate hikes. The sequence was pulled forward and moved higher. In December 2020, the Fed Funds futures market was pricing only half of a rate hike in 2024. As of end-February, Fed Funds futures are pointing to a full rate hike of 25 basis points by early 2023, and two additional hikes in 2024.

The December 2020 Fed Funds futures pricing was in line with the Fed's projections of no rate hike until the end of 2023. The March 2021 FOMC meeting will provide an update of the economic and rate projections.

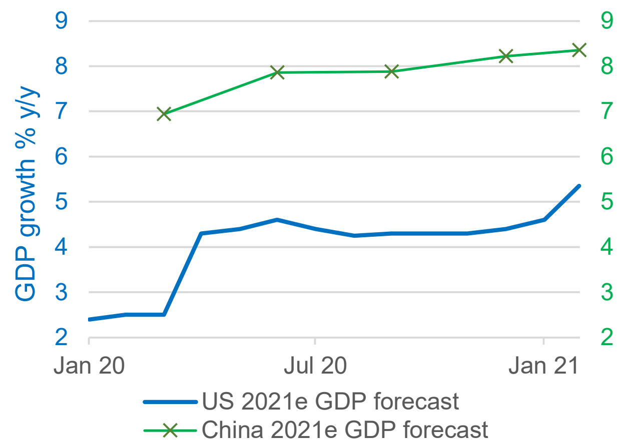
Analyst optimism on US economic growth: judging by consensus growth forecasts for 2021e, the US is well-placed to benefit from the combined fiscal and monetary stimulus boosts, with almost 5% growth now forecast for this year. China is also forecast a huge rebound in growth to 8.4% this year, helped by acceleration in industrial production and retail sales.

EVERYONE IS SEARCHING GOOGLE FOR "STOCK MARKET CRASH"



Source: Google Trends

ANALYSTS MORE OPTIMISTIC ON GROWTH THIS YEAR IN US, CHINA



Source: Consensus Economics

CONCLUSION

Generally, bear markets do not happen when everyone is expecting them. The key is a rising risk of economic recession, typically triggered by central banks raising interest rates to slow an overheating economy. This is not the situation today, with central banks relaxed about the prospect of higher inflation for the foreseeable future. With economic forecasts for 2021e growth rising, we remain optimistic.

Risk Radar

Has the Cyclical Rotation Begun?

The "momo" correction arrives: last month, I wrote of the rising speculative euphoria evident in different "momentum" corners of the global financial markets. The Citi Panic/Euphoria model, to take one such sentiment index, reached a euphoria score of 2.1 in February, an extreme level never before seen in the history of this index, going all the way back to 1987.

This month, here we arrive at the end of February 2021, with many of these more speculative assets such as Big Tech companies, Special Purpose Acquisition Companies and the Grayscale Bitcoin Trust all starting to correct from year highs earlier in the month.

The Cyclical Rotation Underway: However, this is certainly not true for all risk assets. As of February 23, the S&P 500 index was still 2.4% higher that at start-2021, with the Energy sector (+26%) and Banks (18%) leading cyclical value stocks higher at the expense of momentum growth stocks. In Europe, Miners have gained 17% over 2021 to date, while Banks have risen 13%.

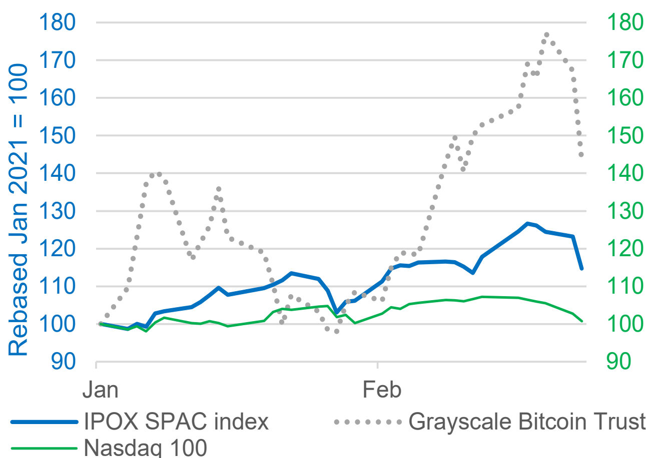
The climb is never smooth: In previous long-running equity bull markets, such as the 1991-2000 episode where the Nasdaq Composite index rose 1375% in just over 9 years (a compound annual growth rate of over 30% per year), there were plenty of "speed bumps" in the road higher.

Over these 9+ years, there were in fact 7 separate occasions when the Nasdaq dropped by over 10% (in spite of continued economic expansion), with a 30% peak-to-trough fall in Q3 1998 at the time of the LTCM crisis.

Rotation in market leaders? We should therefore not conclude that any market correction is a prelude to a far worse stock market fall. It is however possible that we could see the resurgence of value stocks, as economies progressively re-open around the world and as domestic consumption accelerates.

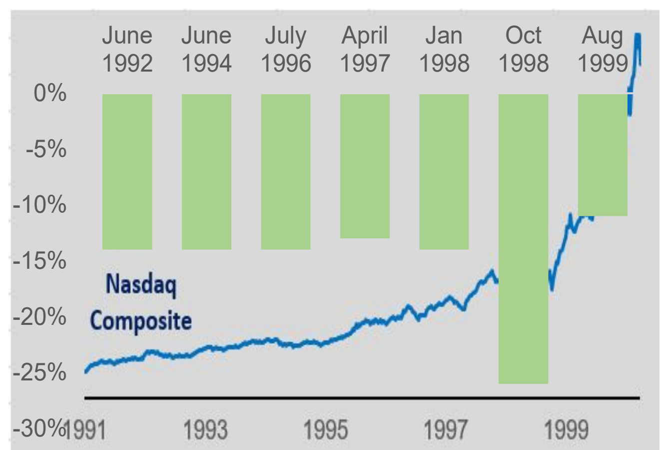
Ultimately, the end of the bull market will be signalled by a change in monetary policy by central banks, via higher interest rates which generally trigger recession.

CORRECTION IN MOMENTUM STOCKS, 2021 BIG GAINERS



Source: tradingview.com

1991-2000: NASDAQ ROSE 1375%, BUT SUFFERED 7 10%+CORRECTIONS



Source: BNP Paribas

CONCLUSION

The long-awaited mini-correction in momentum growth stocks (such as the US FAANG stocks) does not necessarily presage a sustained correction in the overall stock market. The evidence of the 1990s suggests that periodic corrections are part and parcel of any long-running bull market. But we can expect further sector rotation towards cyclical sectors, away from growth stocks which have outperformed hugely since 2009.

Theme in Focus

A New Commodity Supercycle?

Long-term bear cycle over, bull cycle starts: Judging from the Refinitiv equally-weighted commodity index, commodities as an asset class have been in a volatile bear market since 2008. From peak, this commodity index has fallen by over two-thirds, a poor investment when equity and bond markets have been so strong.

The rise in US inflation expectations has typically been a trigger for a commodities rally; but so far, the reaction in commodity prices has been notably modest.

From the low point touched in March 2020, this broad commodities index has already recovered 46%. The list of commodities that have registered sharp price rises is very broad, ranging from rhodium and tin in the metals space, to lumber and soybeans in the soft commodities space.

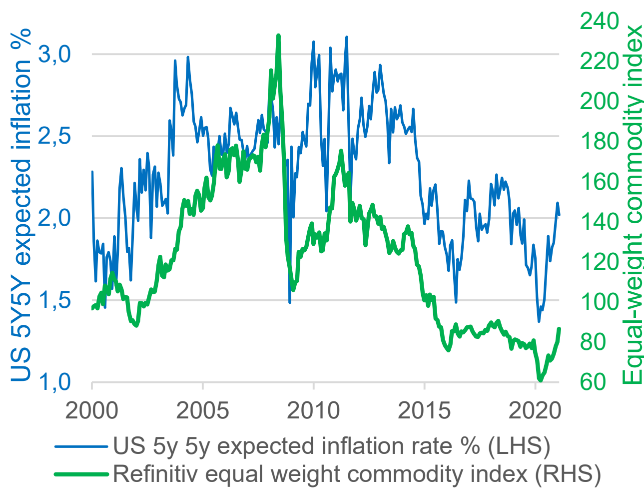
Beware the strength of any supercycle: while no two supercycles are the same, we should note that the last supercycle, from 1999 to 2008, saw this commodity index rise over 220% from trough to peak.

Reasons for believing in a new supercycle: 1) Strong demand growth from a recovering global economy, led by China and the US. The strong Chinese industrial recovery drives global commodity demand, as China is the marginal buyer for many industrial commodities. The US and Europe will also stoke demand for a range of industrial metals via their infrastructure spending plans, focused on renewable energy.

2) Supply remains very limited in a number of commodities, due to quota management (in oil) and persistent under-investment in new mines due to low prices. Warehouse inventory levels for a number of metals such as copper and tin have reached multi-year lows. In metals and agriculture, any supply reaction will take years, given long investment lead times.

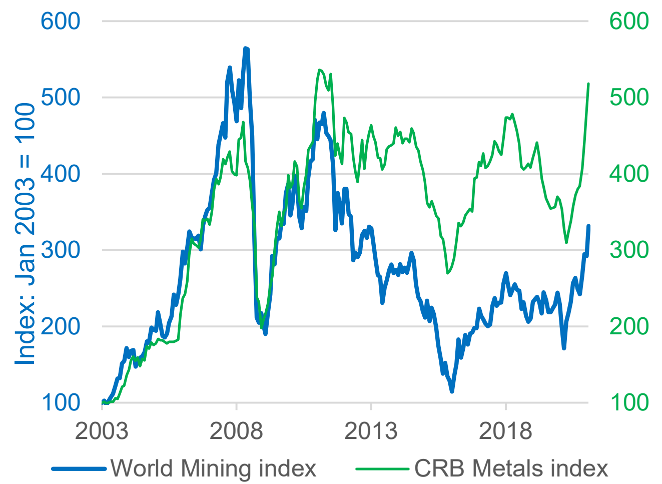
3) <u>Investment demand remains strong for commodities, from investors seeking diversification from equities and bonds, and protection from debasement of paper currencies at a time when real yields remain firmly in negative territory.</u>

COMMODITIES START TO FOLLOW INFLATION EXPECTATIONS HIGHER



Source: BNP Paribas, Yahoo Finance

INDUSTRIAL AND PRECIOUS METALS IN FOCUS, BOOSTING GLOBAL MINERS



Source: BNP Paribas, VanEck, S&P

CONCLUSION

The evidence is not yet definitive, but a number of supply and demand factors point towards the start of a new commodity supercycle, which should last for several years. The key question remains the durability of demand growth from China, still the most important marginal consumer of raw materials in the world.

Equity and Commodities Outlook

Too Early to Worry about Inflation

Don't fear rising bond yields: US Treasury yields have risen over the past month from 1.0% to 1.4% at time of writing, driven largely by rising inflation expectations.

As the chart shows, historically rising US inflation rates are not a hindrance to equity markets, while the inflation rate remains in the 1.5% - 4% range – in fact, the best returns from the S&P 500 index have come when inflation is in the 1.5% - 2.5% range.

Steeper yield curves help cyclicals: This comforts our preference for cyclical exposure, as cyclical stocks stand to benefit most from higher prices. The key sector to focus on at a time of steepening yield curves is the Banks sector, which has been a serial underperformer since 2009. The return to dividend payments this year is an added driver for Banks, which we upgrade to positive.

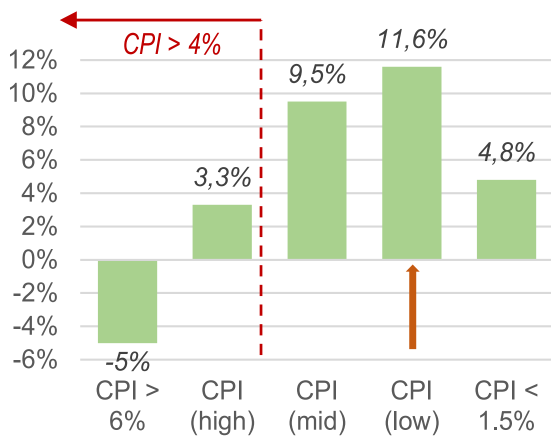
In contrast, we are downgrading our defensive sector exposure, taking our view on Utilities to negative (from neutral), and on Health care and European Technology down to neutral (from positive).

Crude oil surprises to the upside: While we have been positive on the outlook for oil markets, even we have been surprised by the strength in both Brent crude and West Texas intermediate oil prices. In less than 2 months, both have gained almost 30% to well over $60/barrel. OPEC+ are maintaining their quota discipline, while oil demand is rebounding, judging by the continued fall in US crude oil inventories.

That said, we would be cautious on oil exposure at this point, and would rather take profits and wait for a pullback before adding exposure to this commodity.

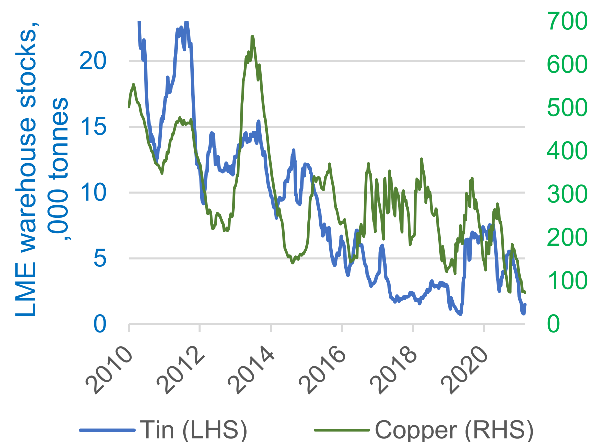
Copper and Tin lead the commodity pack: in contrast, we continue to favour exposure to industrial metals with strong upwards momentum, particularly those with evident near-term supply constraints. With LME warehouse inventories at 10-year lows, both copper and tin remain among our favourite industrial metals for positioning both to global economic rebound, and also to structural demand growth from renewable energy infrastructure.

US EQUITIES PERFORM WELL WHEN INFLATION RANGES FROM 1.5% TO 4%



Source: Elroy, Dimson, March (2013)

COPPER, TIN STOCKS AT LME WAREHOUSES AT HISTORIC LOWS



Source: LME

CONCLUSION

A macro environment with rising producer prices, strong projected nominal growth and negative real yields remain a heady cocktail for risky assets such as equities and commodities, alongside high yield credit. We upgrade the Banks sector to positive, given the resumption of dividend payments in 2021 and the benefits from a steeper yield curve. Within the commodity space, we maintain our positive stance on industrial metals, which continue to enjoy strong positive momentum.

Bond, Credit and FX Outlook

Poor start to the year for Govies

Acceleration in US yield curve steepening: from under 0.6% in August 2020, and 0.9% at the turn of the year, 10-year US Treasury yields are threatening to return to pre-pandemic levels, recently breaching the 1.4% mark for the first time in a year.

Risk-on sentiment since November 2020: Since the beginning of November, investors have preferred risky assets such as equities, commodities and high yield credit. In contrast, the global bond market has returned -3% in euro terms since November, and -2% in US dollar terms since the turn of the year.

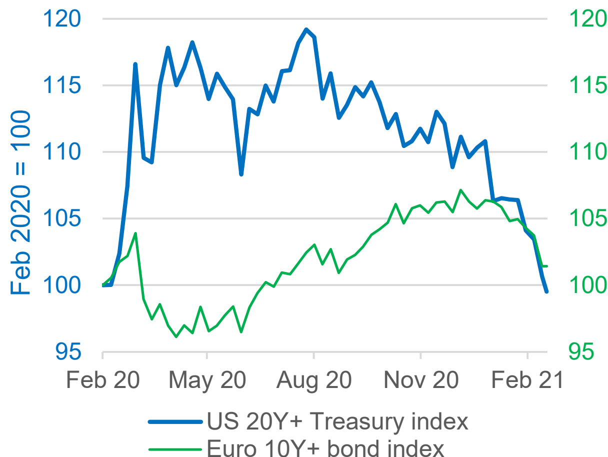
Most of the damage done by inflation expectations: while core inflation rates have remained well below central bank targets in the US and the Eurozone, bond markets have acted to price higher expectations of future medium-term inflation, especially in the US.

We retain our cautious view on core sovereign bonds.

UK pound rallies back: the clear upwards momentum in the UK pound sterling evident since September last year actually accelerated n February. Cable (GBP/USD) breached USD1.40 for the first time since early 2018 (versus our 12-month target of USD1.45), while sterling has strengthened against the euro to a EUR/GBP exchange rate of under 86 pence per euro.

UK vaccine boost: This strength in the island's currency has been driven both by the reduction in Brexit-related uncertainty, but even more by the relative success of the rapid rollout of the UK's coronavirus vaccine program. To date, over 25% of the population have now received at least 1 dose. Prime Minister Boris Johnson has outlined the UK government's "roadmap" out of current restrictions, spurring optimism over a sharp spurt in pent-up consumption over Q2 and Q3 of this year.

LONG-TERM SOVEREIGN BONDS HAVE LOST THEIR PANDEMIC GAINS



Source: Yahoo Finance

CABLE APPROACHES 2016 PRE-BREXIT REFERENDUM LEVELS

Source: Yahoo Finance

CONCLUSION

We continue to prefer corporate credit to US and euro sovereign bonds, with Fallen Angels high yield credit performing particularly well. Emerging Market sovereign bonds denominated in USD continue to outperform US Treasuries on a relative basis, while offering a near-4% aggregate yield. The US dollar looks to be resuming its downwards trajectory – we prefer GBP exposure and commodity currency exposure e.g. CAD, AUD.

Summary of our main recommendations

	Current Recom	Prior Recom	Constituents	We like	We avoid	Comments
EQUITIES	+	+	Markets	EU, UK, Japan, EM: China, Taiwan, India, S. Korea.		The combination of historically low long-term real rates and accommodative financial conditions are giving a powerful boost to global stocks. . Attracted to the pro-cyclical profile of Euro Area, Japanese and UK stocks. Positive on Emerging Markets, based on a superior earnings growth profile and room for further re-valuation.
			Sectors	Banks, Real Estate, Industrials, Materials, Insurance, EU Energy	Consumer staples, Utilities	Positive on these pro-cyclical sectors: Materials, Industrials, Construction, Real Estate and Banks. In Europe: positive on Energy.
			Styles/ Themes	Megatrend themes		Good potential remains for secular themes such as 5G, connected consumers, health tech, water, waste, infrastructure.
BONDS	-	-	Govies	EM bonds (USD + local currency)	US long-term Treasuries and German Bunds	We are negative on German govies,, and on long-term US govies.
			Segments	Peripheral euro and eurozone convertibles . IG credit and Fallen Angels.		We prefer corporate bonds over government bonds. We like EUR and US IG bonds with a duration at benchmark (5 and 9 years, respectively).We are positive on eurozone convertible bonds. We are neutral on both US and eurozone HY. We prefer fallen angels. We are positive on EM bonds, in both hard and local currency.
			Maturities	At benchmark		
CASH	-	=				
COMMO-DITIES	+	+				Gold - positive: The sharp corrections after the vaccine news seems excessive. Negative real rates and inflation worries should drive gold back above USD2000/oz. Oil - neutral: OPEC+ restrictions, lower US production and recovering demand thanks to vaccines should keep Brent prices in the USD45-55 range. Base metals - positive: prices are underpinned by the Chinese rebound and by pro-cyclical policies in Europe and US.
FOREX	+	+	GBPUSD			▪ Positive view on sterling, helped by progressive re-opening and reduction in Brexit-related uncertainty.
ALTERNATIVE UCITS				Long-short equity, relative-value and event-driven		

Economic, FX forecast tables

BNP Paribas Forecasts

GDP Growth %	2019	2020	2021	2022
United States	2.2	-3,6	4,2	4,1
Japan	0,3	-5,3	1,1	3
United Kingdom	1,5	-11,1	4	8,6
Eurozone	**1.3**	**-7,3**	**3,8**	**5,5**
Germany	0,6	-5,6	2,7	5,1
France	1,5	-9	5,5	4,7
Italy	0.3	-9	4,5	4,4
Emerging				
China	6,1	2,3	9,5	5,3
India*	4,2	-11,4	11,6	5
Brazil	1,1	-4,5	3	3
Russia	1,3	-4,5	3,8	3

* Fiscal year
Source: BNP Paribas - 15/01/2021

BNP Paribas Forecasts

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

* Fiscal year
Source: BNP Paribas - 15/01/2021

	Country		Spot 25/02/2021	Trend	Target 3 months	Trend	Target 12 months
	United States	EUR / USD	1.22	Neutral	1.20	Negative	1.25
	United Kingdom	EUR / GBP	0.86	Negative	0.88	Neutral	0.86
	Japan	EUR / JPY	129	Positive	125	Neutral	128
	Switzerland	EUR / CHF	1.10	Neutral	1.08	Neutral	1.11
	Australia	EUR / AUD	1.53	Negative	1.58	Negative	1.56
	New Zealand	EUR / NZD	1.64	Negative	1.67	Negative	1.67
	Canada	EUR / CAD	1.53	Negative	1.52	Negative	1.56
	Sweden	EUR / SEK	10.06	Negative	10.20	Negative	10.20
	Norway	EUR / NOK	10.20	Neutral	10.20	Neutral	9.90
Asia	China	EUR / CNY	7.87	Neutral	7.80	Negative	8.00
Asia	India	EUR / INR	88.3	Neutral	90.0	Negative	93.75
Latam	Brazil	EUR / BRL	6.59	Positive	6.36	Positive	5.63
EMEA	Russia	EUR / RUB	89.7	Neutral	88.8	Positive	85

Source: BNP Paribas, Refinitiv Datastream

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