SEPTEMBER 2021

Investment Strategy Focus

Summary

1. **Real assets drive 2021 performance:** to end-August, 2021 has been a banner year for developed market equities, real estate and infrastructure with 20%+ returns in each case. We maintain our positive stance on real assets, namely European equities, commercial real estate and global infrastructure.
2. **Markets await direction from the US Fed:** financial markets await a tapering announcement from the Federal Reserve, anticipating lower monthly bond purchases by year-end. The sharp recent slowing in US economic momentum complicates the Fed's decision. No reason to move away from our negative government bond stance.
3. **A long-term buying opportunity in China?** Chinese tech stocks have suffered from regulatory tightening, driving the Hang Seng Tech index down 40% from February peak. Similar corrections have been seen before, in 2011, 2015, and 2018. Domestic A-shares are at an attractive entry point for long-term investors.
4. **Precious metals battle the US dollar:** precious metals have suffered from a stronger US dollar, but gold has recovered to USD1800/oz. Negative long-term real yields and a weaker US dollar remain key for a further rebound in precious metal prices.
5. **Downgrading US Investment Grade Corporate bonds to Neutral:** US Investment Grade spreads have returned to historic lows of 0.8% indicating high valuations, while underlying US Treasury yields are expected to rise in the coming months. We downgrade US IG corporate bonds to Neutral.

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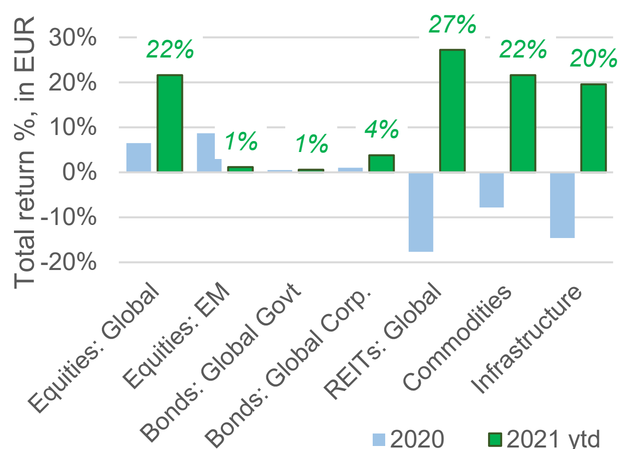
2021 A GOOD VINTAGE SO FAR FOR REAL ASSETS



Source: BNP Paribas Wealth Management; Bloomberg.

Edmund Shing, PhD

Global CIO

BNP Paribas Wealth Management

The Big Picture

Huge rebound today – but what comes next?

Easy rebound phase over: since mid-2020, economists have been surprised by the size and speed of the global economic recovery. However, this is now coming to an end, with recent US economic data missing economists' expectations, according to the US economic surprise index which has dipped back to below zero (see chart below). The long-awaited USD 1.2bn US infrastructure spending plan hangs in the balance: if approved by Congress, this could boost US macro momentum.

Tapering announcement next: the focus has turned to the imminent announcement of tapering (reducing of monthly bond purchases) by the US Federal Reserve at their September meeting. This will signal the first steps in the renormalising of US monetary policy, after a long period of the Fed supporting the US economy.

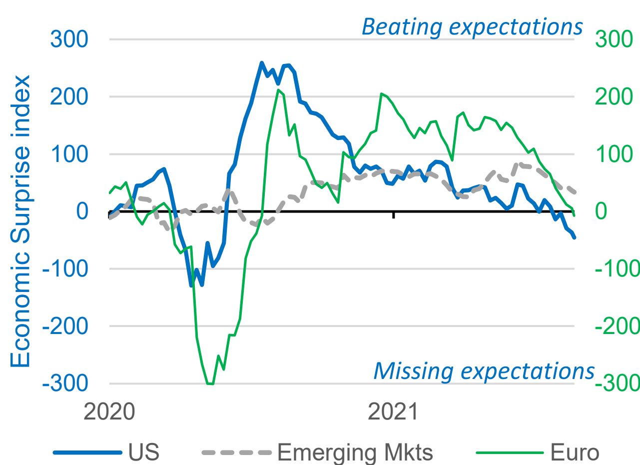
Europe still motoring ahead: do not succumb to pessimism just yet. Europe continues to post strong activity indicators, including robust PMI survey readings and consumer confidence close to historic peaks. With global investment spending picking up, Europe should enjoy further strength in manufacturing in 2021-22.

Low inventories, elevated order backlogs: the combination of recovering employment, excessively high savings, and extremely low retail and manufacturing inventories support economic growth into 2022. **Positive multiplier effects** from high savings and wealth, fuller employment, higher wages and ongoing benefits could drive surprisingly strong US + European consumption into next year.

Capacity utilisation rates will remain high as order backlogs have grown to elevated levels over the course of this year to date. This suggests that it will take several months to restore inventory levels to more normal levels. This will also boost higher corporate investment spending, as companies look to increase production to meet demand.

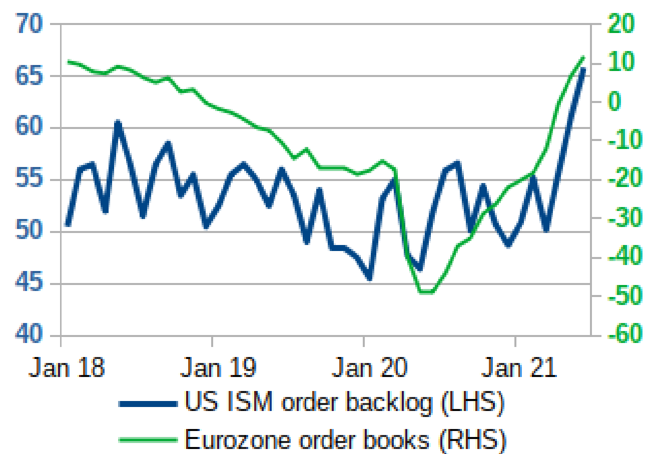
Exuberant housing markets: US and European housing markets have been red hot over the last 12 months, driven by lockdown-linked demand for suburban homes, and record-low mortgage financing rates. House prices have enjoyed double-digit growth rates, leading to accelerating residential construction activity – a further economic growth booster.

US ECONOMY STARTS TO UNDERSHOOT ECONOMISTS' FORECASTS



Source: Citi, Bloomberg

HIGH US, EUROPEAN ORDER BACKLOGS TO UNDERPIN MANUFACTURING



Source: ISM, Markit

Conclusion

The fears over a further drag on global growth from the Delta COVID-19 variant seem overdone. The greater near-term risk to the global economy remains overtightening of monetary policy by the US Federal Reserve, just as US economic momentum is already slowing. Global manufacturing and investment growth should be boosted by continued order backlogs; combined multiplier and wealth effects boost consumer spending.

Theme in Focus

Record Q2 2021 corporate results

USA: more than 80% of earnings beat expectations

We are reaching the end of the Q2/H1–2021 reporting season and it has been among the best ever! In the US, more than 80% of companies have reported better-than-expected earnings. Q2 2021 earnings are almost double those of the depressed level of Q2 2020 when the COVID-19 was biting hard and many countries were in lockdown. Furthermore, US companies have beaten expectations by an impressive +15%. And earnings revisions – especially 2021 expected earnings (see chart below) - continue to trend upwards and have almost reached USD 200 for the S&P 500.

All sectors beat earnings expectations. Financials and Communications services (social networks such as Alphabet and Facebook are the major component of this sector) beat the most. **Regarding 2021 revisions, cyclicals and some techs are leading** (Energy, Communication services, Financials and Materials) whereas defensives lag, particularly Utilities.

In Japan, 70% of companies reported better-than-expected earnings.

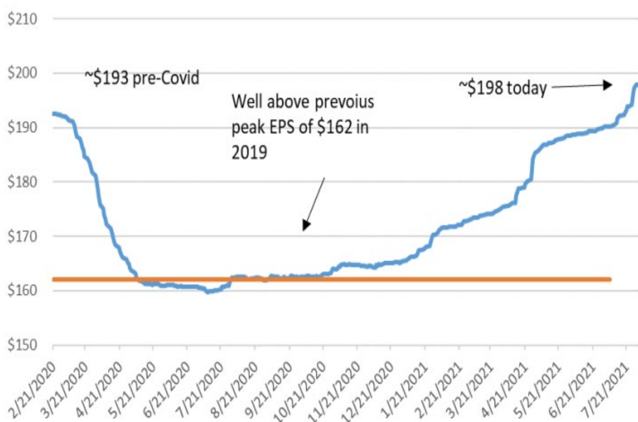
Europe : best sales beat since 2009!

In Europe, Q2 2021 results were excellent. Earnings beat forecasts in 62% of cases. And sales were better in 67% of cases. Bank of America calculates that "*Consensus Stoxx 600 EPS growth projections for 2021 as a whole have risen from 35% in March to 56%*". It is huge. Expected 2021 earnings are now quite higher than 2019 profits.

Rising costs: besides great results and improving expectations, inflation and cost pressures were often mentioned by companies in their reporting. At the moment, they mostly can pass through these costs to their clients even with rising profit margins (see chart below). **Typically, inflation boosts corporate results and indexes until interest rates increase, as it then provokes a slowdown in demand.**

Historically, most vulnerable sectors to rising costs have been **Industrials, Utilities, Consumer Staples & Discretionary.** This is a reason why we are relatively more cautious on these sectors.

S&P 500 2021 CONSENSUS EPS NOW HIGHER THAN ESTIMATES IN EARLY 2020!



Source: FactSet, Raymond James research

S&P 500 EBIT MARGIN FORWARD YEAR CONSENSUS, FORECAST (Q - 20 YEARS)

Source: Factset, Raymond James research

Conclusion

This is the fourth consecutive quarter that corporate results are much better than expected. The huge support brought by governments and monetary authorities keeps helping. Beware, however, rising costs/inflation potentially hitting some sectors and companies although these pressures **have been a tailwind, an opportunity so far, rather than a headwind.**

Alain Gérard, Senior Investment Advisor

The Chinese Conundrum

Oversold opportunities for the long term

Markets take fright at regulatory crackdown: the growth sectors in Hong Kong and US ADR markets have been the hardest-hit areas, amid Chinese regulatory tightening focused on the Internet and tech sectors (fintech, video games and education) and policy uncertainty, while domestic A-shares with lower exposure to these affected sectors have outperformed.

Investor sentiment could remain fragile in the near term, given the lack of obvious upside catalysts. We would point out that this is not the first time that regulatory compliance has weighed on Chinese stocks.

In reality, nothing new: according to the MSCI Inc. CEO, regulatory tightening has driven a Chinese stock market sell-off *"every three, four, five years [2011, 2015, 2018] and obviously the markets have sold off at the time. But very quickly afterwards, the markets have recovered and gone to new heights."*

We believe that this current episode of regulatory tightening and associated market volatility remain classic signs of the maturing of an emerging market. Likely to remain a testing environment for investors in the short term (next 3 months), those with a truly long-term (12-month+) investing horizon can consider this period a good time to accumulate Chinese stocks.

Macro catalyst coming? The recent weaker-than-expected Chinese economic data across the board raise market expectations of imminent policy easing to support growth.

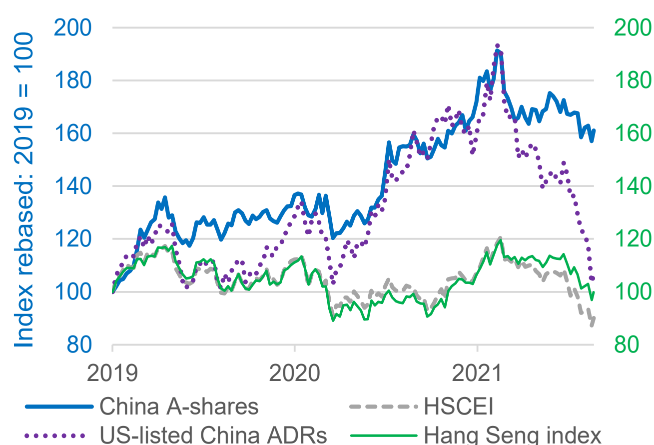
Long-term attraction in Chinese stocks: some leading tech names have fallen to the bottom of their historic valuation ranges, pricing in abundant pessimism. We continue to believe that as long as the underlying secular internet/tech growth trend remains intact, long-term investors could benefit from entering at more attractive valuations. The largest Chinese internet/tech companies currently trade at a 25% 12-month forward P/E discount to the tech-heavy Nasdaq 100 index, having traded at a significant valuation premium earlier in the year.

Since mid-February, the Hang Seng technology index has fallen 42%, while the Nasdaq 100 index has, in contrast, risen 12% - representing a 48% relative under-performance. But we recognise that patience will be required for the timing of a significant rebound.

A-shares focus: on the other hand, as the government continues to focus on upgrading both domestic industrial and consumption activity as well as targeting carbon neutrality, we see opportunities in the electric vehicle supply chain, renewable energy, upgrading of manufacturing (e.g. semiconductors) and home-grown consumer brands.

At an index level, investors may prefer to focus their attention initially on the domestic A-shares index, which has shown much better resilience since February. It only has a 15.8% weighting in technology, and trades at an attractive 13.7x 12-month forward P/E valuation.

CHINA DOMESTIC A-SHARES FAR OUTPERFORM MORE TECH-HEAVY INDICES



Source: Bloomberg

CHINESE TECH HEAVYWEIGHTS TRADE AT A 25% DISCOUNT TO US NASDAQ

Company	Forward PE +12m
Alibaba	17.5
Baidu	14.5
JD.com	29.8
Netease	19.2
Tencent	24.0
Average	**21.0**
Nasdaq 100	**28.1**

Source: Bloomberg, based on consensus estimates

Edmund Shing, Grace Tam, Prashant Bhayani

Equity and Commodities Outlook

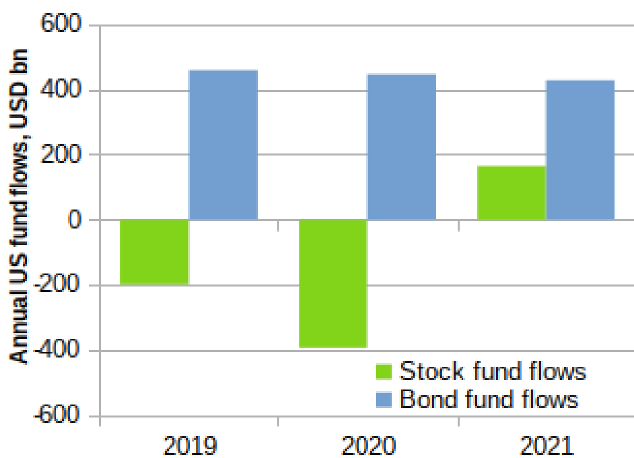
TINA finally has her day

There Is No Alternative (TINA) works at last: we have heard much about stocks being the only real liquid asset class for investors, given that cash, sovereign bonds and investment-grade corporate credit all yield less than inflation.

Over the last few years, this switching out of bonds into stocks has not been evident. But at last TINA now seems to have come true, judging by the gargantuan investor flows into stocks over 2021 to date after outflows in 2019 and 2020. However, this has not come at the expense of bonds, as US-based bond funds continue to attract inflows as in previous years.

Watch the ISM surveys closely: the ISM PMI surveys have a good historic record of correlating with US stock market momentum, particularly around turning points. Note that the ISM Composite (Manufacturing + Services) index is at a 20-year high reading of 63.6. Beware the risk of stock market stagnation if, as in 2004 and 2011, the ISM surveys now retrace lower.

US INVESTORS FAVOUR STOCK FUNDS IN 2021, AFTER OUTFLOWS IN 2019-20



Source: Investment Company Institute.
Note: 2021 data are to end-July

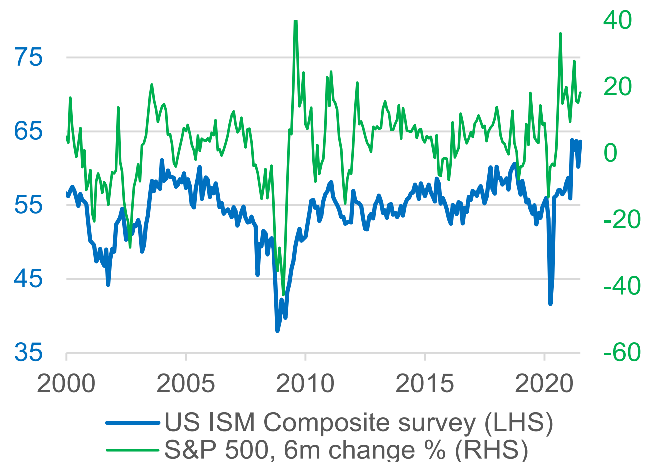
Supply disruptions boost commodities

Commodities take a short breather, but the trend remains up: on an equal-weighted basis, commodities are at their strongest for 10 years. Industrial metals, such as copper and tin, have led the way, but a host of other commodities (lumber, coffee and crude oil) have experienced price surges in recent months. We anticipate the Brent crude oil price trading in a USD70-80 range over the next 12 months.

Precious metals have been held back by US dollar strength: of the two key drivers for gold and other precious metals, the US dollar has been the real headwind, while negative real yields remain supportive. For gold to rally back closer to our $2000/oz target, the US dollar index needs to continue to move lower, after a steady rise since June.

Inflation concerns help commodities: commodities have historically been one asset class that has typically outperformed when inflation rates have risen sharply, unsurprising since energy prices have often been a key driver of higher CPI readings.

STOCKS AT RISK FROM WEAKENING US MANUFACTURING AND SERVICES



Source: Bloomberg

CONCLUSION

To end-August, 2021 has been a banner year for developed market equities, real estate and infrastructure with 20%+ returns in each case. We maintain our positive stance on real assets, namely commercial real estate, global infrastructure, and commodities (via the roll yield). While still positive on global equities, near-term stock market momentum relies on continued strong economic momentum. Weaker ISM PMI survey readings could be a potential trigger for near-term US stock market weakness.

Bond and Credit Outlook

How brave can the US Fed afford to be?

Tapering – when and how fast? The US Federal Reserve needs to think about how quickly they can afford to cut back on their support for the US economy. They have been very supportive since early 2020 with their quantitative easing programme, buying US Treasury bonds to suppress long-term interest rates.

Fed President Jerome Powell is expected to announce a "tapering" or reduction of this monthly USD 120bn of bond buying, either at the Jackson Hole symposium, or at the Federal Reserve's September meeting. We expect a tapering announcement at the September FOMC meeting and an execution in January 2022.

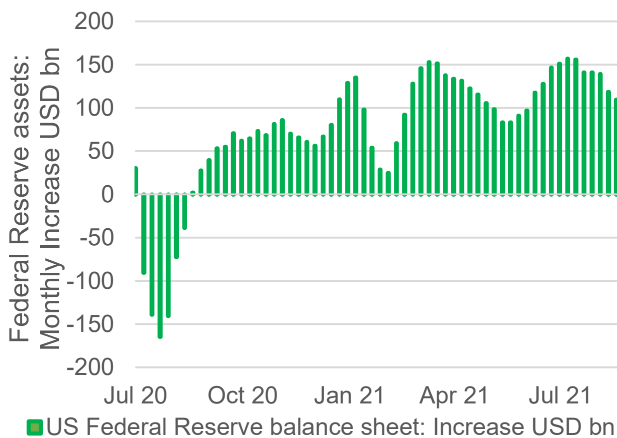
For now, the Federal Reserve's central scenario is an earlier but slower taper beginning before the end of 2021, with some uncertainty over the economic impact from the COVID-19 Delta variant, and also from any delay to the raising of the US debt ceiling.

From inflation fears to growth fears: concerns over growth have led bond yields to retrace a third of their prior ascent in just a couple of months. The reaction of real yields is particularly striking as they hit a new all-time low in August, in both Germany (at -1.9%) and the US (-1.2%).

In our view, growth is moderating but remains solid. Several factors such as: a) higher-than-expected job creations; b) a surprise in the proposed US infrastructure spending programme given low expectations, and c) more bond sovereign bond issuance may all put upward pressure on long-term bond yields, especially in the US where the Fed is likely to reduce its bond buying programme in the coming months.

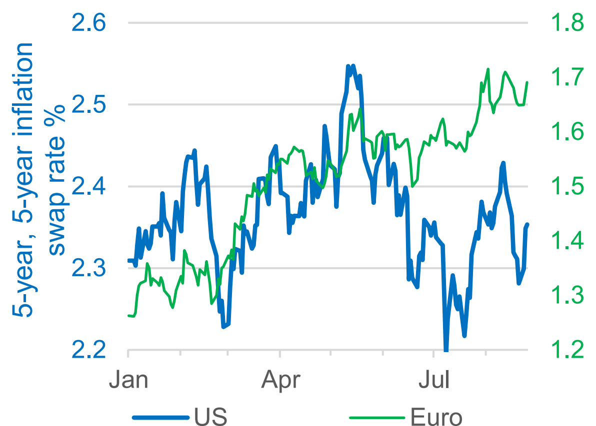
ECB to stay the course: conversely, we expect no monetary tightening from the ECB for the foreseeable future.

US FEDERAL RESERVE STILL ADDING > USD 100BN BONDS PER MONTH



Source: BNP Paribas Wealth Management, Bloomberg.
Note: calculated on a 4-week moving average basis

EURO INFLATION EXPECTATIONS RISE STEADILY, BUT HAVE COOLED IN THE US



Source: BNP Paribas Wealth Management, Bloomberg

Conclusion

Financial markets await a tapering announcement from the Federal Reserve, anticipating lower monthly bond purchases in 2022. The recent sharp US economic slowdown complicates the Fed's decision. Given that the bund yield is correlated to the Treasury yield, both are likely to rise. We target 0% and 2% respectively in 12 months. We retain our negative stance on government bonds. Further, given tight US Investment Grade Corporate bond spreads and the risk of higher US Treasury yields ahead, we downgrade US IG corporate bonds to Neutral (from Positive previously).

Edmund Shing, Edouard Desbonnets

FX Outlook

Expecting a modest euro recovery

Has US dollar strength peaked? The dollar strengthened over the summer months as global uncertainty was on the rise. Commodity currencies and in particular those linked to the Chinese demand (AUD and NZD) suffered more.

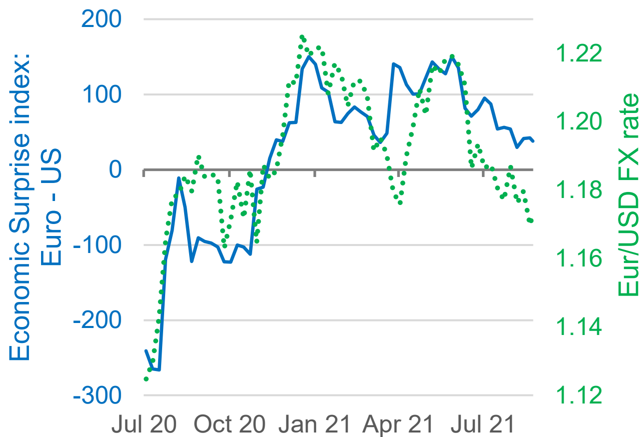
Looking at EUR/USD, it fell from 1.19 to 1.17 (value of one euro) over the first summer weeks. It temporarily fell below 1.17 around 20 August. From a technical point of view, the key resistance and support levels are 1.22 and 1.16 respectively. Short term, we expect the EUR/USD to hover at around 1.17 as uncertainty could drag on for a few more weeks.

On the macro front, eurozone inflation accelerated to 2.2% in July from 1.9% the previous month. This upward trend should continue over the coming months, with inflation temporarily reaching levels above 3% by the end of this year. US inflation has probably peaked.

Macro momentum to favour the euro: we expect the economic momentum (as measured by the economic surprise index) to show a growing divergence in favour of the eurozone. Indeed, the eurozone has been lagging somewhat due to the Delta variant and we expect some catching up during the autumn. This factor, together with a more favourable risk environment, suggests that the euro should make a comeback in the second half of the year.

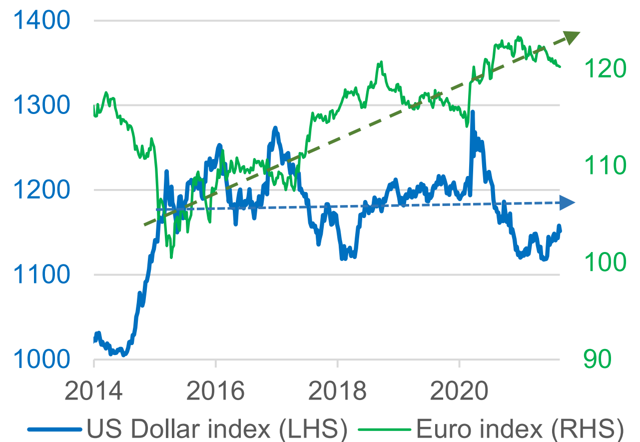
The upside potential for the euro is, however, more limited than forecasted previously. Indeed, the outlook for central banks has evolved somewhat as we expect the Fed to hike rates in Q1 2023, with higher US yields likely to support the USD late next year as the first interest rate hike approaches. At the same time, the ECB has proved more cautious than we expected, despite an increasingly strong European economic recovery. We expect no change in the policy rate for the ECB over the coming two years.

WEAKENING US ECONOMIC MOMENTUM COULD UNDERMINE US DOLLAR STRENGTH



Source: BNP Paribas Wealth Management, Bloomberg.

LONG-TERM TREND IN EURO STILL UP, WHILE SIDEWAYS FOR US DOLLAR



Source: BNP Paribas Wealth Management, Bloomberg

Conclusion

The EUR/USD is expected to fluctuate at around 1.17 in the short term. Over the coming year, our EUR/USD target is 1.22 (value of one euro). This suggests some upside for the euro.

Guy Ertz, Chief Investment Advisor

Summary of our main recommendations

	Current Recom	Prior Recom	Constituents	We like	We avoid	Comments
EQUITIES	+	+	Markets	UK, Japan, EU and EM. China, Taiwan, India, Sth Korea, Singapore and Indonesia.		**China conundrum:** since February, Chinese equities have sold off on regulatory tightening and a weaker credit impulse. On a 12+ month time horizon, we think investors should accumulate on this weakness.
			Sectors	Financials, Health Care, Real Estate, Precious metals, Construction Materials, Semiconductors and EU Energy		**Healthcare in vogue**: Strong drug pipeline prospects with strength in particular in innovative healthcare devices and diagnostics. We like Financials, Health Care, Real Estate, Precious metals, Construction Materials, Semiconductors and EU Energy.
			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. We turn neutral from positive on US short-term bonds.
			Segments	Peripheral euro and eurozone convertible. and Fallen Angels.		We turn neutral from positive on US IG corporate bonds. Spreads have limited potential to compress further. We stay neutral on eurozone IG corporate bonds.
			Maturities	At benchmark		
CASH	=	=				
COMMO-DITIES	+	+		Gold		We expect gold to trade in the 1800-2000 range as supply and demand dynamic remain favorable. Our one-year target is \$70-\$80 with risks skewed on the downside in the coming months
FOREX			EUR/USD			**We keep our EURUSD 1.22 one-year target.** We see less upside for the AUD, NZD and CAD. Less downside for the CHF after the more dovish ECB comments.
ALTERNATIVE UCITS				Macro, event driven		We downgrade our rating from positive to neutral on Relative value. We have a preference for Macro and Event Driven strategies. Neutral on Relative Value and Long/Short Equity.

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	-4.7	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				
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

BNP Paribas Forecasts

CPI Inflation %	2019	2020	2021	2022
United States	1.8	1.2	3.9	2.7
Japan	0.5	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				
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

	Country	Spot		Target three months		Target twelve months	
		27/08/2021		Trend	Mid	Trend	Mid
Against euro	United States	EUR / USD	1,179	Neutral	1,17	Negative	1,22
	United Kingdom	EUR / GBP	0,857	Neutral	0,85	Positive	0,84
	Switzerland	EUR / CHF	1,077	Negative	1,10	Negative	1,12
	Japan	EUR / JPY	129,6	Neutral	130	Negative	135
	Sweden	EUR / SEK	10,19	Neutral	10,0	Neutral	10,0
	Norway	EUR / NOK	10,29	Positive	9,80	Positive	9,60
Against dollar	Japan	USD / JPY	110,0	Neutral	111	Neutral	111
	Canada	USD / CAD	1,263	Neutral	1,25	Neutral	1,24
	Australia	AUD / USD	0,730	Neutral	0,73	Positive	0,76
	New Zealand	NZD / USD	0,700	Neutral	0,70	Positive	0,73
	Brazil	USD / BRL	5,208	Positive	4,90	Positive	4,80
	Russia	USD / RUB	73,58	Positive	70,0	Positive	68,0
	India	USD / INR	73,70	Positive	72,0	Positive	72,0
	China	USD / CNY	6,480	Neutral	6,40	Neutral	6,40

Source: BNP Paribas, Refinitiv Datastream

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