OCTOBER 2023

Investment Strategy Focus
US bond tantrum

Summary

1. **Inflation slowdown to intensify:** housing, weaker household demand, goods imported from China, cooling food prices and lower household energy costs combine to drag headline inflation closer to a more comfortable level. Falling inflation should eventually support bond prices.

2. **Peak Central Bank rates, what next?** The Bank of England last month joined the US Fed in pausing its rate hikes, as inflation rates unexpectedly fell. While central banks repeat "Higher for Longer", we are not so sure. Expect the Fed to cut rates in June 2024.

3. **But US bond yields continue to rise:** the bond market struggles to absorb huge US treasury bond supply - the Fed and foreign investors are no longer buyers, and domestic buyers prefer short-duration, higher yielding bonds. Higher yields continue to offer an attractive opportunity to build bond portfolios for the long term.

4. **Don't expect oil prices to exceed $100:** OPEC+ quota cuts and rising global demand have pushed Brent crude 30% higher from June lows. But much higher oil prices could trigger global recession and hurt oil demand, thus current oil prices are in a sweet spot for OPEC+. We favour European and global value factor funds.

5. **Japanese stocks boosted by higher bond yields, weaker yen:** the standout stock market over the summer remains Japan. Financials benefit from higher bond yields; exporters benefit from an even weaker yen. We continue to favour Japanese stocks, with a value bias.

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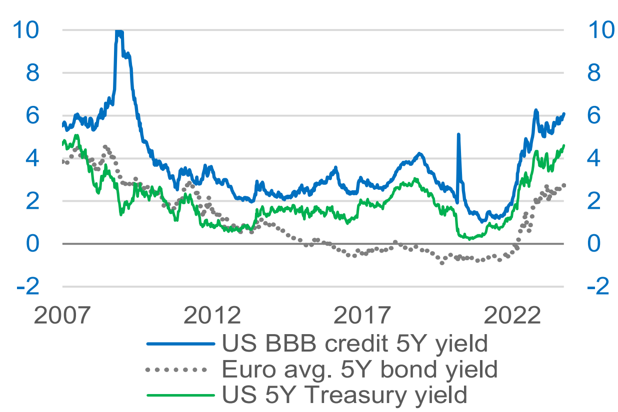
5-YEAR BOND YIELDS AT HIGHEST SINCE 2007 IN US, 2011 IN EUROPE



Source: BNP Paribas, Bloomberg

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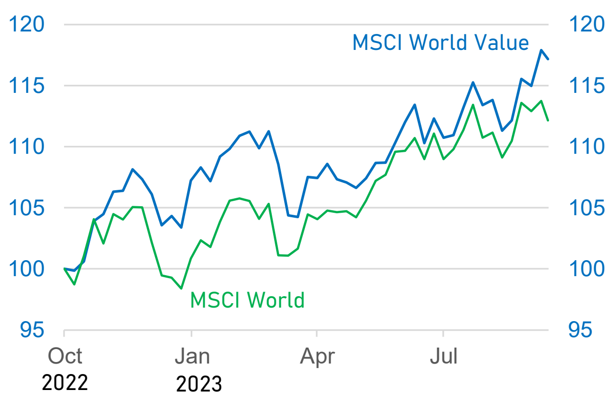
The bank for a changing world

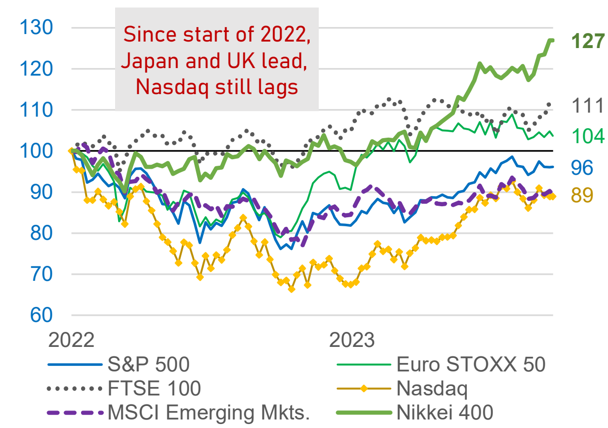
Key Calls: coming to the end of seasonal weakness in stocks

STOCKS: VALUE STYLE BREAKS NEW HIGHS



Source: BNP Paribas, Bloomberg. Note: total return indices

JAPANESE STOCKS CONTINUE TO LEAD



Source: BNP Paribas, Bloomberg. Note: local currency indices

Asset Allocation: still favour Japanese stocks

Outlook Summary

	Very underweight	Underweight	Neutral	Overweight	Very Overweight
Equities				+	
Government Bonds			=		
Corporate Credit				+	
Real Estate			=		
Alternatives				+	
Cash		-			

Note: Alternatives include Commodities, Infrastructure and Alternative UCITS/hedge funds

Central Banks: Have we seen the peak in interest rates?

This is the key question. Over the last 12 months, G7 central banks have increased reference interest rates rapidly, from the US and the eurozone to the UK.

Recall that just over 12 months ago, interest rates were close to (or even below) zero in these regions. Today in contrast, we see central bank interest rates that range from 4% in the eurozone to 5.5% in the US - a very sharp increase in a very short space of time, historically speaking.

But the ECB did raise European interest rates to 4%the inflection point seems to have been reached. The UK surprisingly has not risen interest rates September, rather maintaining its base rate at 5.25%. Neither did the US, and while , this looks likely to be the last rise given economic slowdown, no matter what central bankers communicate.

Firstly, remember what central bankers are trying to achieve when they raise interest rates. They are trying to curb (above-target) inflation, but the way they achieve this is by first curbing economic activity. So you need to cool the economy first. Central banks aim to cool household and corporate demand, in order to then cool inflation as a consequence.

The evidence is that economic activity is cooling everywhere, just as central bankers wanted. In the eurozone, activity indicators suggest the economy is already on the edge of a recession.

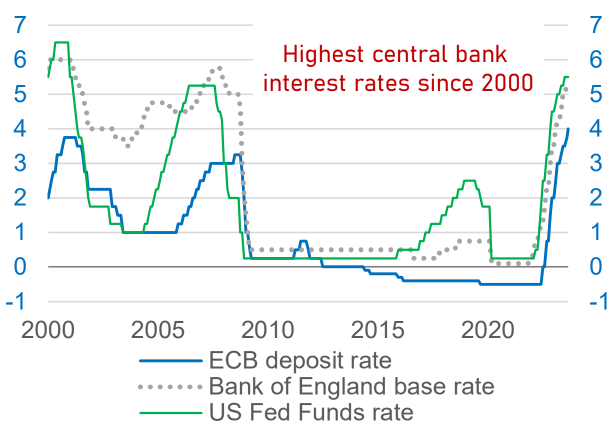
This is why we maintain our now out-of-consensus view that the US economy will not only slow down, but will likely enter a modest recession early next year. So step one, economic activity is indeed slowing,

Inflation still on the wane

Step two, are inflation rates slowing? Yes they are. inflation rates have already slowed to around 3% In the US, CPI have taken a bit longer to come down in the UK and Europe, but they are clearly trending lower on the back of this weaker activity. We may not yet be back at the central banks' 2% target, but we are getting closer.

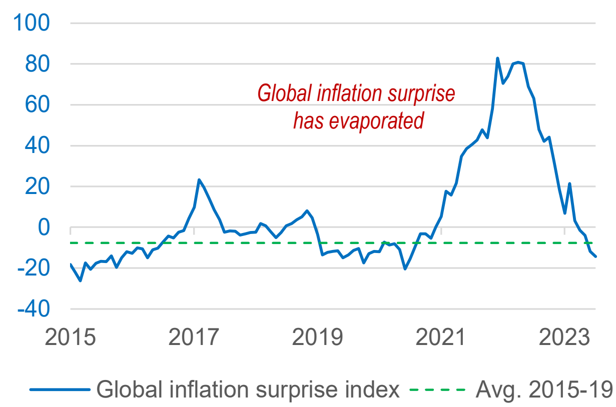
Key components of inflation, such as housing costs, energy costs, and food are all easing. We are also starting to import deflation in goods, notably from China. With emerging weakening in employment markets, wage growth will likely slow, which in turn should slow inflation in the services sector.

RECORD RISE IN REFERENCE INTEREST RATES FROM ZERO TO 20-YEAR HIGHS



Source: BNP Paribas, Bloomberg.

NO EVIDENCE OF A SECOND INFLATION SURPRISE, SO FAR...



Source: BNP Paribas, Bloomberg.

INVESTMENT CONCLUSION

1. Economic activity has or is slowing quite markedly, including the key employment markets.
2. Inflation will continue to trend lower in these key economies, with potentially a catch-up on the downside in the UK and the eurozone.
3. This could be better news for bond investors. Remember, lower inflation (and in particular lower inflation expectations) are good news for bond investors, and typically lead to lower yields and higher prices.

Macro Trends: Stagnation

Just how bad is the European economy?

Higher US bond yields reflect in part the surprisingly strong growth posted in the States this year, combined with a tight employment market. This is now resulting in pressure for higher pay and benefits, as per the UAW union strike in US car factories.

Europe is not at all in this situation. Despite successfully navigating the winter gas crisis and despite record levels of employment, household and industrial confidence has evaporated due to a combination of stubbornly high inflation rates and sharply higher borrowing costs.

The weakness in European household consumption stands in stark contrast to the US situation, where excess savings and high wage growth have supported consumption at high levels – at least for now. Even more importantly, US CPI sits at 3.7% as of August, far lower than the eurozone's 5.2% rate. US employees are thus seeing improving purchasing power after inflation, while this is not yet the case in Europe.

Note too the powerful fiscal stimulus being injected into the US economy by the Biden administration, a powerful driver of increased corporate investment.

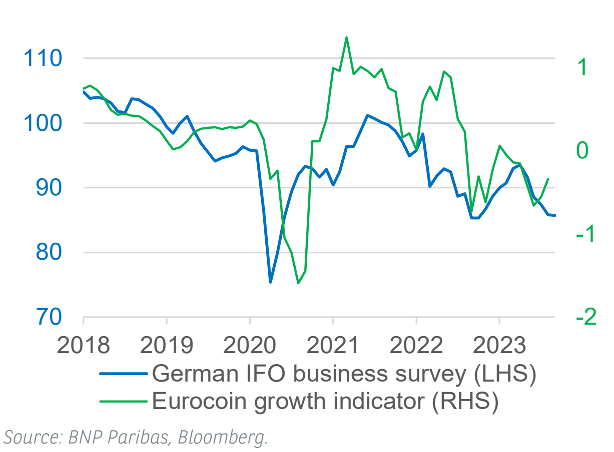
Economic stability in view

It seems clear that the transmission of higher ECB interest rates into the European economy has been more immediately effective than for the Federal Reserve in the US. New mortgage and housing activity has collapsed, as have new business loan volumes. Inflation continues to impact households more in Europe, while there is no huge stimulus to boost investment as is the case Stateside.

But, more timely economic activity signals suggest that the worst may already be past in Europe. Indicators of current economic activity such as the German IFO survey and Eurocoin both suggest stability or even a modest economic recovery over August and September. Economic surprise indices suggest improving momentum in the global economy, which is typically then followed by the eurozone.

This emerging stability or even rebound remains contingent on stability in both short- and long-term interest rates, and a continued decline in headline inflation in Europe. We are optimistic that we will see these two trends emerge through to year end, which should then allow Europe to just escape recession.

IFO, EUROCOIN INDICATORS SUGGEST ACTIVITY IS STABILISING IN AUGUST-SEPT.



Source: BNP Paribas, Bloomberg.

GLOBAL ECONOMIC MOMENTUM IS SLOWLY IMPROVING, EUROZONE FOLLOWS

Source: BNP Paribas, Bloomberg.

Investment Conclusion

In Europe, decade-high interest rates and shrinking purchasing power weigh on current activity, dipping into recession territory. But beware of being over-pessimistic – employment is resilient, the drag from energy prices is fading, and interest rates have peaked.

Inflation continues to slow: weaker household demand, cheaper goods imported from China, cooling food prices and lower household energy costs should combine to drag headline inflation closer to a more comfortable level. Falling inflation should eventually support bond prices.

Bonds: more attractive by the day

US bond temper tantrum

Lately, bond yields have reacted to a) stronger-than-expected US growth and b) the Federal Reserve's repeated "higher for longer" messaging by grinding to new multi-year highs. The US 2-year Treasury yield hit 5.1%, while the 10-year yield has risen to 4.6%.

Long-term yields are rising for simple reasons: firstly, the US government has a large and growing budget deficit to finance, obliging it to borrow more money – i.e. issuing more Treasury bonds in the near-term.

Secondly, the Federal Reserve are no longer buying bonds, but are rather selling them. Thirdly, Chinese and Japanese investors are not buying US Treasuries either, as currency-adjusted yields are no longer attractive to them.

In the absence of these historic US bond investors, domestic investors are the obvious buyers. But these domestic buyers prefer short-term bonds that offer yields at or above 5% to longer-dated paper with lower yields. Hence there remains pressure on longer-dated bond yields to rise closer to the yields on short-dated bonds, flattening the yield curve.

Why we stick to our bullish US bond call

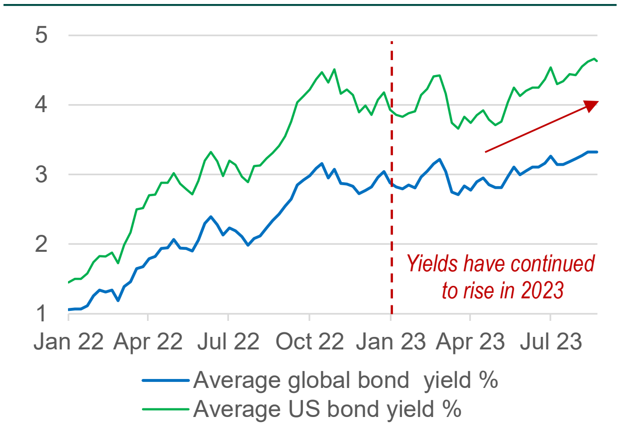
As is always the case, rather than trying to pinpoint the perfect timing to build a bond portfolio (which in any case is impossible to achieve reliably), we aim to identify an attractive entry point on the basis of a long-term investment horizon.

US 10-year treasury yields may rise a little further in the very short-term, but should remain below 5%. In addition, we favour bonds more in the 3-5 year maturity bucket, which carry yields ot 4.7%-4.9%.

Statistically speaking, US bond yields have typically declined following the last hike in interest rates by the US Federal Reserve. We believe that we have already seen that. We expect a moderate decline in 10 year US bond yields over the next 12 months to 3.75%. As a US bond investor today, you can lock in a yield of 4.7% on a 5-year bond, but you also have in our view the potential for moderate price gains to come as well.

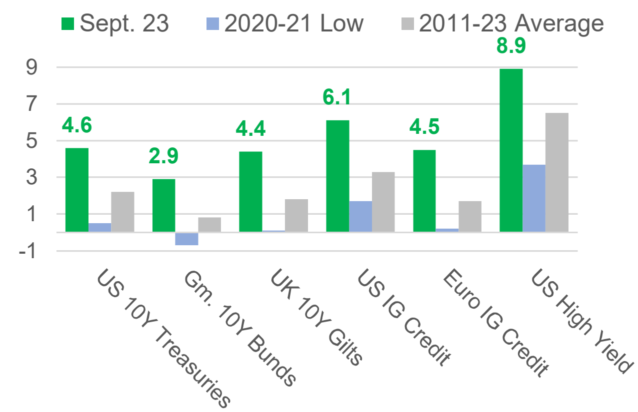
According to JP Morgan, historical returns on US Treasuries have averaged 25%-36% over the 2 years following the final Federal Reserve rate hike in interest rate cycles since 1981.

GOVERNMENT, CORPORATE BONDS RETURN TO ATTRACTIVE YIELDS



Source: BNP Paribas, Bloomberg.

BOND YIELDS ON OFFER TODAY ARE WELL ABOVE HISTORICAL AVERAGE



Source: BNP Paribas, Bloomberg.

INVESTMENT CONCLUSION

The US bond market struggles to absorb huge US treasury bond supply - the Fed and foreign investors are no longer buyers, and domestic buyers prefer short-duration, higher yielding bonds, or even money market funds.

In our view, yields at 10-15 year highs continue to offer an attractive opportunity to the conservative investor to build bond portfolios for the long term.

Equities: just seasonal weakness?

Stocks swoon over summer

August and September are traditionally two of the weakest months of the year for stock markets. 2023 has been no exception to this rule – the MSCI World index has retreated over 6% from its year high hit at the beginning of August, with very few stock markets escaping the drag from higher bond yields.

Some of our preferred stock markets have survived summer relatively well – the Japanese TOPIX even rose 2% over this span, while the UK's FTSE 100 has eased back only 1%. In contrast, the US mega-cap FAANG stocks have given back 12% on profit-taking since their mid-July peak, but remains +63% over the year to date.

For 2023 to date, global stocks still register gains of 13% in euro terms, while the Euro STOXX 50 is still up 11%. If we look further back to October 2022 when this current uptrend began, the Euro STOXX 50 has still gained 27% including dividends and the MSCI World index 12% in euro terms.

Market corrections are always unwelcome, but there is a silver lining – they can prolong the lifespan of a bull market, by cooling animal spirits.

Higher bond yields largely to blame

The current setback in stocks is largely due to two factors:

a. The sharp rise in long bond yields since late July, triggering a compression in stock market P/Es;

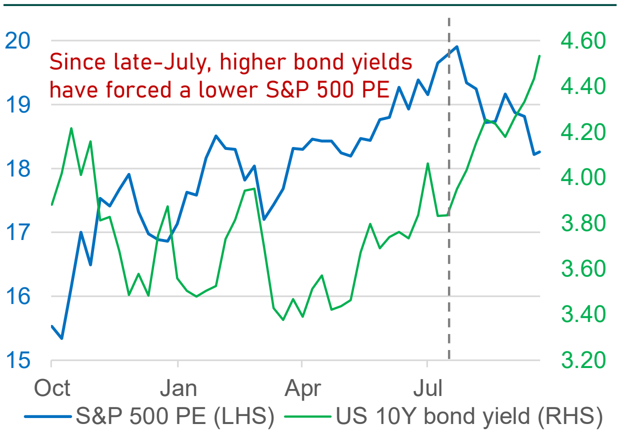
b. Growing concerns over global economic stagnation, prompting a lack of confidence in consensus earnings estimates, which still suggest expected US and European EPS growth in 2024[e].

Further headwinds include the competition from higher cash interest rates in the eurozone, given the ECB's recent decision to raise their deposit rate to 4%.

Thus the catalysts for stock markets should correspondingly be: a) stability or even decline in long bond yields; and b) evidence of stability or even a modest rebound in European and Chinese economic activity, giving greater confidence in EPS estimates.

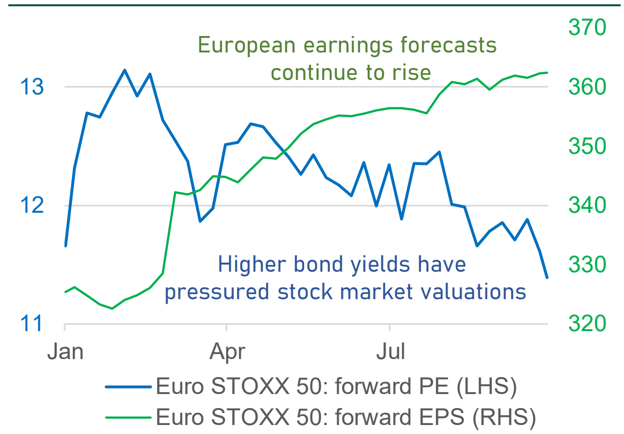
Our risk radar is not giving any warning signs at present; financial conditions indices in Europe and the US are also not showing any particular signs of stress. We thus urge patience in stocks, as we enter a more favourable Q4 period for risk assets.

HIGHER BOND YIELDS, LOWER S&P PE



Source: BNP Paribas, Bloomberg.

EURO STOXX 50 EARNINGS FORECASTS RISE



Source: BNP Paribas, Bloomberg.

Investment Conclusion

Be patient with global stocks, as we expect the current bond tantrum to subside, leading ultimately to lower long bond yields. This in turn will support valuations, which remain cheap versus historical average in the eurozone, UK, US mid-/small-caps, and emerging markets.

Japanese stocks boosted by higher yields, weaker yen, rising profitability: Japan has been the standout stock market over the summer. Financials benefit from higher inflation, bond yields; exporters benefit from a weaker yen. We continue to like Japanese stocks, with a value bias.

Energy Focus: Can Oil Prices Exceed $100?

Oil producers wary of killing the golden goose

World crude oil prices have surged 30% over the last 3 months, thanks to a combination of restricted OPEC+ supply and robust global oil demand.

At USD97/barrel, Brent crude sits over 40% above its 10-year average (of USD68) and is a boon to the coffers of oil-producing nations including OPEC members, and of course the US and Norway.

Could crude oil prices surge even further, to above USD100/barrel in the near term? We see this scenario as unlikely, for a number of reasons:

a. Global economic growth is likely to slow further on the back of slower US activity – the US alone represents close to 20% of world oil demand, so oil demand may thus weaken;

b. OPEC nations such as Saudi Arabia do not want the oil price to go so high as to trigger a global recession, as occurred in 1990 or 2008 - thus hurting final demand and then prices;

c. The high WTI price is incentivizing new shale oil drilling, in time driving higher US production;

d. US natural gas prices remain low, providing a cheaper alternative to heating oil.

Refining capacity is the real bottleneck

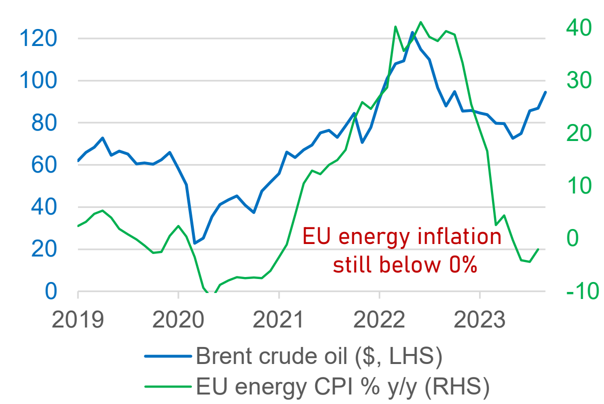
Due to Russian sanctions, refined oil products such as diesel are in relatively short supply in Europe. Given the lack of new refining capacity and robust end demand, oil refining margins (the profit from transforming crude oil into finished oil products) have remained elevated since 2022.

US refining specialist companies have benefited enormously from this tightness in global refining capacity since 2022. In Europe, refining remains largely the preserve of large integrated energy companies who are then the chief beneficiaries of these elevated refining margins. We believe that these superior refining margins will persist over the medium term, supporting energy sector profitability.

Favour the Value investment factor

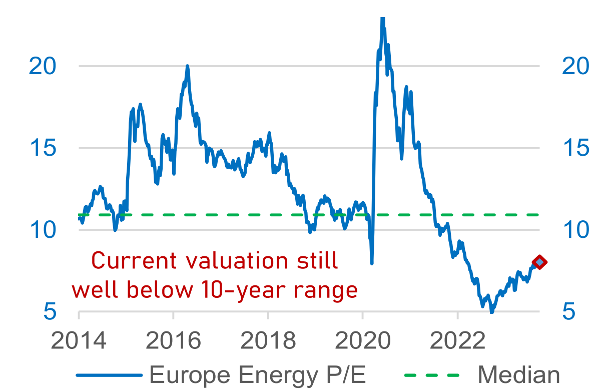
European and global investment funds and ETFs that target the value investment factor (focusing on companies that are cheaper than the overall stock market) tend to outperform at times when inflation is above average. The value factor is typically more heavily weighted towards industries such as energy and financials, sectors that we currently prefer.

OIL PRICE UP, BUT ENERGY INFLATION CALM



Source: BNP Paribas, Bloomberg.

EUROPEAN ENERGY SECTOR STILL CHEAP



Source: BNP Paribas, Bloomberg.

INVESTMENT CONCLUSION

Don't expect oil prices to exceed $100: OPEC+ quota cuts and rising global demand have pushed Brent crude 30% higher from June lows. But even higher oil prices could trigger global recession and hurt oil demand, thus current oil prices are in a sweet spot for OPEC+.

We prefer European and global value factor funds. Over the last 6 months, the BNPP Europe Value index has returned 7%, while the MSCI Europe Growth index has lost 1% – we expect this value outperformance to persist at least through to year end.

Summary of our main recommendations, by asset class

	Current Recom	Prior Recom	Constituents	We like	We avoid	Comments
EQUITIES	+	+	Markets	UK, Japan, eurozone, Latin America (selective), China, S. Korea Singapore and Indonesia		Look through a temporary dip to the recovery beyond. Key drivers include falling US inflation, lower long-term interest rates, improving macro liquidity, and easing energy prices. Build stock exposure gradually on market consolidations.
			Sectors	Global Health Care, Energy, Materials, EU Financials & Utilities		**Energy & Materials** to benefit from rebounding Chinese activity, low base metals inventories. **European banks** should benefit from surprisingly resilient consumption, rising Net Interest Margins & rising ECB deposit rate.
			Styles/ Themes	Quality, Megatrend themes		Circular Economy, Electrification, Security, Income Growth themes
BONDS	=	=	Govies	We add US govies (maturities up to 10Y). Prefer inflation-indexed bonds		Our 10-year bond yield targets are 3.75% in the US and 2.5% in Germany in one year. Favour US and UK inflation-linked bonds.
	+	+	Credit	US, Euro IG credit		We favour investment grade Credit, focusing on US credit on the back of decade-high yields and strong balance sheets.
	+	+	EM bonds	USD and local currency		
CASH	-	-				
COMMO-DITIES	+	+		Gold Oil Industrial metals		Oil (+) Brent should remain in the USD 80-95 range due to gas/oil substitution & the progressive ban on Russian oil. Base metals (+) boosted by China's reopening in the short term, and energy transition demand in the longer term. Gold (+) is our preferred safe haven, weaker USD & stable LT rates should help, 12-month exp. range = USD 1900-2150.
FOREX			EUR/USD			Our EUR/USD target is USD 1.15 (value of 1 euro) in 12 months. Target change for Chinese CNY and Japanese JPY – less potential for rebound.
REAL ESTATE	=	=		Health Care, UK commercial		Unlisted real estate faces enduring headwinds from slowing economies and much higher financing rates. Prefer listed real estate.
ALTERNATIVE UCITS				Long/Short Equity and Relative Value		
INFRA STRUCTURE	+	+		Energy, transportation, water		Excellent long-term returns expected from private and listed infrastructure given long-term underinvestment.

Economic, FX forecast tables

BNP Paribas Forecasts			
GDP growth %	2022	2023	2024
United States	2,1	2,1	0,3
Japan	1,0	2,0	1,0
United Kingdom	4,1	0,5	0,1
Eurozone	**3,4**	**0,5**	**0,9**
Germany	1,9	-0,3	0,3
France	2,5	0,7	0,5
Italy	3,8	0,9	1,1
Emerging			
China	3,0	5,1	4,5
India*	7,2	6,1	6,0
Brazil	2,9	3,1	1,8

* Fiscal year

Source: BNP Paribas - 25/09/2023

BNP Paribas Forecasts			
CPI inflation %	2022	2023	2024
United States	8,0	4,1	2,2
Japan	2,5	3,2	2,5
United Kingdom	9,1	7,4	2,9
Eurozone	**8,4**	**5,6**	**2,9**
Germany	8,6	6,2	3,0
France	5,9	5,7	2,7
Italy	8,7	6,0	2,0
Emerging			
China	2,0	0,5	2,0
India*	6,7	5,9	5,0
Brazil	9,3	4,7	4,2

* Fiscal year

Source: BNP Paribas - 25/09/2023

	Country		Spot 01/10/2023	Target 3 months	Target 12 months
Against euro	United States	EUR / USD	1,05	1,06	1,15
	United Kingdom	EUR / GBP	0,87	0,86	0,86
	Switzerland	EUR / CHF	0,97	0,98	0,98
	Japan	EUR / JPY	157,12	154	154
	Sweden	EUR / SEK	11,57	11,00	11,00
	Norway	EUR / NOK	11,30	11,30	10,80
Against dollar	Japan	USD / JPY	149,48	145	134
	Canada	USD / CAD	1,35	1,32	1,30
	Australia	AUD / USD	0,64	0,68	0,70
	New Zealand	NZD / USD	0,59	0,60	0,63
	Brazil	USD / BRL	5,03	5,00	5,00
	India	USD / INR	83,23	82,0	82,0
	China	USD / CNY	7,31	7,20	6,80

Source: BNP Paribas, Refinitiv Datastream. As at 1st October 2023

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