SEPTEMBER 2024

Investment Strategy Focus

No change in course despite August turbulence

Summary

1. **Economic focus switches to unemployment:** the rising US unemployment rate (up at 4.3%) has become the focus for policymakers, as the global economy softens and inflation recedes. Take profits on short-term US bonds with the US 2-year Treasury bond yield falling to 3.9%. We remain strategically positive on US Treasuries.
2. **More US rate cuts in 2024**: following the Fed's annual Jackson Hole symposium, expect 2 Fed rate cuts this year. Interest rate markets now expect a 3.2% Fed Funds rate in 12 months. Rate cuts in the absence of recession help stocks, gold.
3. **Weaker energy price outlook fuels global disinflation:** softer Chinese oil demand has driven Brent crude under USD 80/barrel, lowering headline inflation rates, while goods prices remain close to zero. Cut oil recommendation to Neutral, new expected 12-month Brent crude range of USD 75-85/barrel.
4. **US dollar tumbles as markets expect more Fed rate cuts:** the US broad dollar index has weakened by 4% since the beginning of July on lower expected interest rates, with the euro, sterling and yen all gaining ground. A key driver for the gold price breaching USD 2500; we maintain our USD 2600 12-month gold target.
5. **Sector rotation out of Tech, into Health care:** mega-cap technology stocks are no longer leading the global stock market. Rather, Health care and listed Real Estate are leading. We prefer US stock exposure in the form of equal-weighted S&P 500 or small-/mid-cap indices, plus a regional bias to Emerging Markets ex China.

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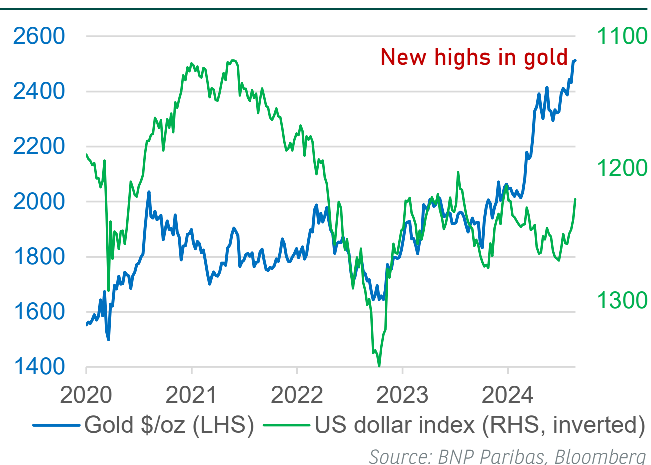
GOLD TOUCHES NEW ALL-TIME HIGH ABOVE USD 2500/OUNCE



Source: BNP Paribas, Bloomberg

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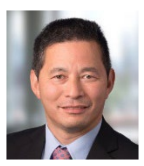


The bank for a changing world

Macro, Market Views

Asset class	View	Comments
Macro		– Monthly inflation prints continue to decline on a bumpy path as they descend towards 2%. – We expect the Fed to cut rates twice this year. The ECB should lead the rate-cutting cycle with 2 further rate cuts this year. – GDP growth should slow in the US over H2 but should rebound in the eurozone and China. Election-related volatility could persist to November.
Rates	=	– Large Treasury bond issuance should prevent an imminent sharp decline in US bond yields. Our 12-month US 10-year Treasury yield target now 4.0% – We prefer intermediate maturities in EUR (<10 years) and short maturities in the US for the time being (3-5 years). – EM sovereign bonds (local currency and USD) still offer attractive 6%+ yields.
Credit	+	– EUR spreads offer further potential to tighten more than US spreads in our view. – Prefer maturities up to 7 years in the US and up to 10 years in the eurozone. – For higher yield (at higher risk), consider the US "fallen angels" strategy and Euro subordinated financial bonds.
Equities	+	– Key drivers include falling inflation, lower long-term interest rates, improving macro liquidity, and easing energy prices. – Favour eurozone, UK, Japan, Brazil markets post multi-year highs. – We like EU Mid/Small Caps. Positive on Health care, Industrials and Mining & construction materials. We also like EU financials, tech and REITs.
Real Estate	=	– Lagged impact from higher interest rates to fade after further falls in commercial real estate valuations in Q1 2024. We see European real estate prices slowly stabilising, with rental yields now more attractive. – Industrial/logistics exposure preferred for healthy yields, higher expected rental growth on robust underlying demand growth. – Listed REIT exposure preferred given low price/book values, 6% dividend yield
Commod-ities	+/=	– We cut our price range for Brent crude oil to USD 75-85 on weaker global oil demand and an expected reduction of OPEC+ production quota cuts into 2025, reducing our stance on Oil to Neutral – Gold: Positive view as EM central banks should continue strategic purchases and Asian households remain buyers. Gold could reach USD 2600/oz next year.
Alternative UCITS/ Private Assets	=	– We favour relative value equity, credit and event-driven funds for their robust risk-adjusted returns at low volatility. – Private equity buyout funds are a preferred private asset subclass, given robust long-term returns and an abundance of public market opportunities
FX		– EUR/USD target is USD 1.12 (value of 1 euro) in 12 months, on narrowing US vs. EU interest rate gap in 2025.

Market volatility returns in August

The winds of change blow in financial markets

Financial markets have undergone several key changes in long-term trends over July and August this year, triggered by inflections in economic and interest rate momentum. Extreme investor positioning has fuelled a sharp bout of profit-taking in mega-cap tech and the US dollar following substantial gains over the first half of this year.

In currency markets, the Japanese yen has reversed course after weakening almost continuously against the US dollar since the end of 2020. From a July peak of JPY 162 per 1 US dollar, the yen has staged a sharp reversal in this trend in strengthening by 10% to JPY 144 as the Bank of Japan began to raise its benchmark overnight interest rate from -0.1% to 0.25% at the beginning of August.

This in turn sparked a sharp correction in stock markets at the beginning of August, led by a 20% drop in the Japanese Nikkei 225 index and an 8% drop in the Nasdaq 100 benchmark over 3 days. This return of volatility was marked by a surge in the VIX volatility index to a peak reading of over 60 on 5 August, a level only breached twice since 2008 during the last 16 years, during the Global Financial Crisis and then again during the COVID pandemic.

Stock markets recover by end-August

Helped by a substantial fall in both short- and long-term bond yields from the end of May and a relatively robust Q2 earnings season, global stocks have since recovered 9% to return to their mid-July all-time high (in US dollar terms).

Seasonality remains unfavourable in September

There are many potential sources of market volatility in the near term, ranging from the US Presidential election campaign to rising unemployment rates. Seasonal effects also remain unfavourable for stock markets, with September historically being the worst month of the year on average for the S&P 500 index with a -0.7% monthly average return over the last 20 years.

At the same time, investors should bear in mind that from early October we will enter what is typically the most favourable period of the year for stocks, which then lasts until May of the following year.

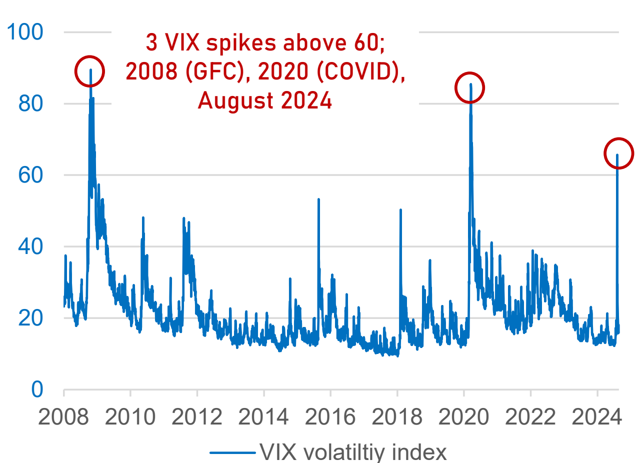
Recession to come, or not?

The one factor that can trigger a more serious correction in stock, credit and commodity markets is a rising risk of global economic recession, led by the US.

For now, this risk remains limited despite the rise in the unemployment rate, with the Atlanta Fed's GDPNow forecast for Q3 2024 running at an annualised 2% rate. This is below the 3.0% growth rate reported for Q2, but close to the 2.5% consensus GDP growth estimate expected for 2024 as a whole.

Key to watch is the unemployment rate, and its effect on US consumer spending. For now, consumer spending seems robust with retail sales growing at over 3% on a nominal basis. Most importantly, while the unemployment rate is increasing, total employment continues to grow, and the level of company layoffs remains low.

US VIX INDEX POSTS A HISTORIC SPIKE IN VOLATILITY ON 5 AUGUST



Source: Bloomberg.

STOCK MARKET SEASONALITY: EURO STOXX 50 IMPROVES FROM OCTOBER

Source: forecaster.biz

Weaker activity and continued disinflation

Guy Ertz

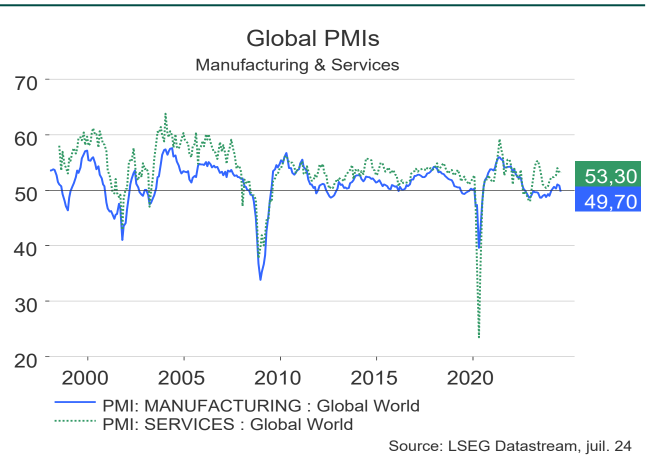
Leading indicators such as business surveys suggest a weakening of economic activity after a period of gradual recovery in industrialised countries. However, consumer demand remains relatively resilient as inflation is falling and central banks are expected to cut rates. Companies have reduced the number of job vacancies but are not laying off on a large scale. This is key because they have realised over the past two years that qualified workers are scarce. Rising employment supports household consumption (two-thirds of total demand), which in turn should support growth going forward. Overall, surveys suggest that companies are more cautious, but generally do not suggest recession fears. China has shown signs of recovery as confirmed by recent data on intra-Asian trade. Measures to boost activity in the property sector have had little effect so far. Domestic credit growth has been slowing this year despite monetary policy easing. In the short term, the authorities will probably strengthen their industrial policy while introducing measures to gradually stimulate domestic demand. We may see some upside surprises.

Global inflation has been on a downward trend since late 2022. It was first driven by falling goods prices as the strong post-COVID demand reversed and demand shifted towards services. Service prices and housing-related components have been much stickier, largely explaining why the normalisation process in core inflation is slower. Now, cooling wage inflation suggests more inflation normalisation. The recent rise in container shipping costs is a concern but the impact on core CPI inflation should be small and shouldn't derail the disinflation trend. The recent weakness in oil & gas prices is positive news.

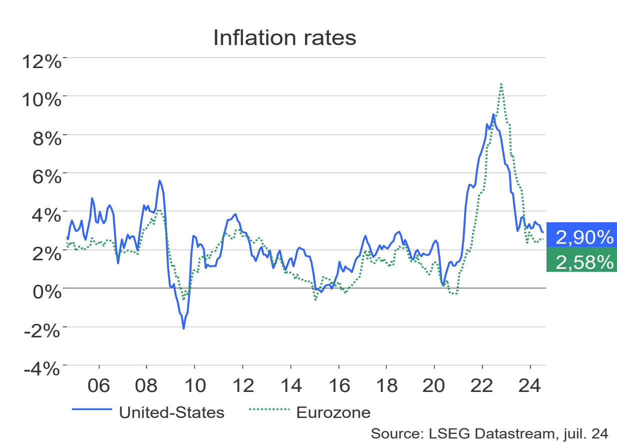
In the US, consumer price inflation is slowing, in line with the cooling of job creation. After three months of sluggish growth, the CPI index fell in June, month-on-month, for the first time in two years. Core CPI inflation rose only by 0.1% over the month, clearly decelerating. Core inflation year-on-year for June was 3.3%. A few volatile categories explain this deceleration, with a -5% month-on-month decline in airfares and a -2.5% decline in hotel prices. Auto insurance rebounded as largely expected, but inflation in non-shelter services cooled, with recreation services and transportation services excluding auto insurance and airfares contracting and inflation in medical care services also printing lower. Rent for primary residence and owners' equivalent rent recorded their weakest monthly gains since July 2021 and April 2021, respectively. July core PCE inflation, the Fed's favourite measure, confirmed this with 0.2% month-on-month and 2.5% on a yearly basis. The recent rise in producer price inflation needs to be monitored. The Fed is expected to cut rates twice this year followed by further cuts next year and in 2026.

In the eurozone, July headline inflation stabilised at around 2.5% while core inflation was slightly higher at 2.8%. Lower energy and food inflation are contributing to the disinflation process. Headline inflation should fall to 2% in the third quarter. Continued stickiness in the more wage-sensitive parts of the inflation basket, such as services, could somewhat delay disinflation for the core measure. The trend remains in place and continues to suggest further rate cuts by the ECB. We expect 2 more rate cuts this year and 3 more next year.

PMI BUSINESS SURVEYS AT WORLD LEVEL



KEY INFLATION MEASURES



Critical macro and market factors to follow

Macro: all about unemployment and rates

We believe that investors should concentrate on two key questions for the next few months:

1) How big is the risk of US and global economic recession over the next 12 months?

2) Will global liquidity remain sufficiently strong to drive financial markets higher in the coming months?

What critical macro factors should we monitor in answer to the first question? We already know that the US bond yield curve has been inverted for a long time now, signalling a potential recession to come. But perhaps of greater importance today is the state of employment markets, given the impact of employment on consumer spending.

The starting point is favourable, with both US and euro area unemployment rates today close to or at historic lows at 4.3% and 6.4%, respectively. However, the US rate has risen steadily from the early 2023 low of 3.5%, while in the process triggering a positive recession reading on the Sahm rule. This Sahm rule is an unemployment-based indicator of the early onset of economic recession.

But setting against this positive Sahm rule recession signal is the fact that US companies are not laying off more employees, as one would expect in the early stages of recession. The JOLTS layoffs and discharges rate remains stuck at its post-pandemic low of just 0.2%. In fact, the rise in the unemployment rate is largely due to a substantial increase in the size of the total US labour force.

There are over 3 million more people in the US civilian labour force today (168 million) than at the start of 2020. According to US nonfarm payroll data, the total number of employees continues to increase in July. We see a similar trend in the eurozone, with total employment still rising and 7 million more employed in June than before the pandemic.

This may change in the coming months. A negative inflection in employment trends would represent a rising recession risk. But this is not yet evident.

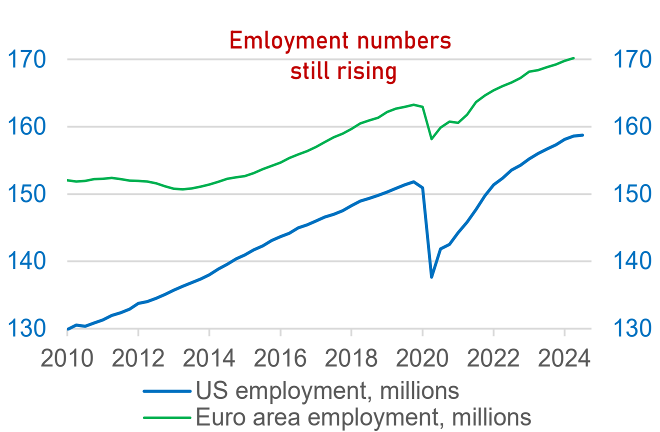
Lower interest rates boost liquidity

Aside from the perceived recession risk, the second factor dominating financial markets is interest rates and their impact on global liquidity. Aside from the Bank of Japan, major central banks have entered a rate-cutting cycle. This has dragged both short- and long-term bond yields substantially lower since April.

Given the recent upturn in the size of G4 central bank balance sheets and loosening bank lending standards, we should expect global liquidity and credit conditions to improve over the coming months. This should support global financial markets, in particular stocks, commodities and corporate bonds as we move into the final months of 2024.

Conclusion: further deterioration in the US unemployment rate could warrant a more defensive asset allocation stance. But an expected improvement in global liquidity and credit conditions remains a key supporting factor for stocks, corporate credit and commodities.

JOB CREATION REMAINS ROBUST IN THE US AND EURO AREA



Source: Bloomberg.

GROWING GLOBAL MONEY SUPPLY REFLECTS IMPROVING LIQUIDITY

Source: BNP Paribas, Bloomberg.

September's key recommendations

Bonds: unlikely to see yields fall much further

Easing of inflation, weaker economic momentum and clearer central bank direction on future interest rate cuts have been the three factors behind the sharp decline in bond yields since the end of May. This fall in yields has been most pronounced in the US, the 2-year Treasury yield down by 1.1% over this period to 3.9%, and the 10-year Treasury yield easing 0.9% to 3.8% at the time of writing. The average 10-year eurozone government bond yield has fallen a more modest 0.3% to 3.0%

As investment grade (IG) corporate bond spreads have stayed broadly stable over the past months, this fall in government bond yields has been replicated in credit markets. Currently, US IG corporate bonds offer an average 4.9% yield, while their eurozone equivalents yield 3.5%. These yields are the lowest seen since September 2022. Consequently, investors have benefited from a 7% return in US IG credit, a 3% return in eurozone IG credit and a 7% return from emerging market US dollar bonds since the end of April.

For now, the best of the bond returns appears to be behind us, in the absence of economic recession. Interest rate futures markets price in a 2% fall in the Fed Funds and a 1.4% decline in the ECB deposit rate over the next 12 months. This seems aggressive to us, and we expect more modest central bank rate-cutting cycles than this pricing suggests.

Previous Fed rate-cutting cycles have been positive for gold, and for stocks (if recession is avoided). According to Calamos Investments, US small-caps have historically outperformed on Fed rate cuts.

Stocks: favour continued momentum in Health care, listed Real Estate

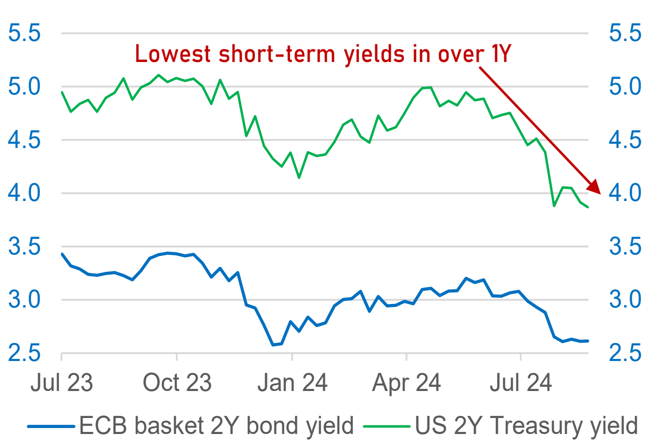
While the global technology sector has stuttered since the end of July, other sectors have assumed overall stock market leadership in the form of the Health care, Real Estate and Insurance sectors. There has also been a rotation away from the largest US stocks towards smaller-cap stocks of late. While the Magnificent 7 remain 11% below early July peak, the equal-weight S&P 500 and the S&P Mid 400 indices have continued to fresh all-time highs. **We continue to recommend taking profits in US technology and rotate into equal-weight and mid/small-cap US S&P indices.**

At the sector level, **we reiterate our positive view on Health care, listed Real Estate and European insurance.** Health care has benefited from a positive earnings season, powered not only by type 2 diabetes drugs but also promising new cancer treatments.

Listed real estate has been a prime beneficiary of lower long-term interest rates alongside US Utilities, while the insurance sector continues to benefit from positive pricing power and a positive market-to-market effect thanks to gains on bond and credit portfolios.

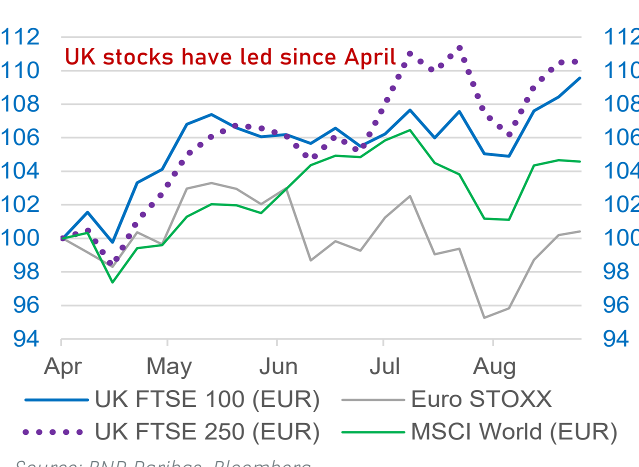
At the regional level, the UK stock market continues to hover at around all-time highs, with international investors benefiting from a 3% gain in sterling vs. the euro and a +4% advance vs. the US dollar year-to-date. **The improving domestic economy, cheap valuation and corporate takeover activity remain key reasons behind our positive stance on UK large- and mid-cap stocks.**

SHORT-TERM BOND YIELDS REFLECT EXPECTED CENTRAL BANK CUTS



Source: Bloomberg.

UK STOCKS POST STRONG RETURNS IN EUROS SINCE APRIL



Source: BNP Paribas, Bloomberg.

Summary of our main recommendations, by asset class

	Current Recom	Prior Recom	Constituents	We like	We avoid	Comments
Equities	+	+	Markets	UK, Japan, eurozone, Brazil, China, S. Korea Singapore and Indonesia		Buoyant global liquidity continues to support stock markets. 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, Industrials, Materials, EU Financials & Technology	Consumer Discretionary, Consumer Staples, Travel & Leisure	**European banks** should benefit from surprisingly resilient consumption, rising Net Interest Margins & elevated ECB deposit rate. **Health care** has benefited from a strong earnings season and promising drug pipelines.
			Styles/ Themes	Quality, Megatrend themes		Circular Economy, Electrification, Security, Deep Value themes
Bonds	=	=	Govies	Favour US 5-7 year duration. Prefer inflation-indexed bonds		Our 10-year bond yield targets are 4.0% in the US and 2.25% in Germany in one year. Favour US inflation-linked bonds.
	+	+	Credit	US, Euro IG credit		We favour investment grade Credit, focusing on EU credit (especially financials) on the back of decade-high yields and strong balance sheets.
	+	+	EM bonds	USD and local currency		Attracted by high yields versus US high yield, solid economic prospects
Cash	-	-				
Commodities	+/=	+		Gold Oil Industrial metals		Oil (=) Weaker global oil demand and the prospect of a steady reduction in OPEC+ production cuts should keep Brent prices in the USD 75-85 range. Base metals (+) The outlook for the manufacturing sector is improving. Cyclical demand will meet structural while supply remains constrained. Gold (+) we remain positive on the medium-term for geopolitical reasons, 12-month range = USD 2600.
Forex			EUR/USD			Our EUR/USD target is USD 1.12 (value of 1 euro) in 12 months.
Real Estate	=	=		Health Care, logistics/ warehouses		Unlisted real estate faces enduring headwinds from slowing economies and much higher financing rates. Prefer listed real estate.
Alternative UCITS				Long/Short Equity, Credit and Relative Value, Trend-following		Relative value alternative UCITS funds have beaten bond/credit indices since the start of 2023, offering lower risk returns, at low volatility.
Infrastructure	+	+		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 %	2023	2024	2025
United States	2,5	2,6	1,9
Japan	1,7	-0,2	0,7
Eurozone	**0,5**	**0,8**	**1,6**
Germany	-0,1	0,1	1,3
France	1,1	1,3	1,4
Italy	1,0	1,0	1,4
Emerging			
China	5,2	5,2	4,3
India*	8,2	6,9	6,7
Brazil	2,9	2,2	2,0

* Fiscal year

Source : BNP Paribas, Bloomberg - 03/09/2024

BNP Paribas Forecasts			
CPI Inflation %	2023	2024	2025
United States	4,1	2,9	2,3
Japan	3,3	2,6	2,4
Eurozone	**5,4**	**2,4**	**2,0**
Germany	6,1	2,4	2,2
France	5,7	2,5	1,1
Italy	6,0	1,2	2,0
Emerging			
China	0,2	-0,1	1,2
India*	5,4	4,7	4,3
Brazil	4,6	4,2	4,0

* Fiscal year

Source : BNP Paribas, Bloomberg - 03/09/2024

	Country		02/09/2024	months	months
Against euro	United States	EUR / USD	1,11	1,10	1,12
	United Kingdom	EUR / GBP	0,84	0,84	0,86
	Switzerland	EUR / CHF	0,94	0,98	0,98
	Japan	EUR / JPY	160,95	160	157
	Sweden	EUR / SEK	11,34	11,00	11,00
	Norway	EUR / NOK	11,64	11,30	10,80
Against dollar	Japan	USD / JPY	145,39	145	140
	Canada	USD / CAD	1,35	1,32	1,30
	Australia	AUD / USD	0,68	0,68	0,70
	New Zealand	NZD / USD	0,63	0,60	0,63
	Brazil	USD / BRL	5,64	5,00	5,00
	India	USD / INR	83,87	82,0	82,0
	China	USD / CNY	7,11	7,20	7,20

Source: : BNP Paribas, Refinitiv Datastream. As at 2 September 2024

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