SEPTEMBER 2023

Investment Strategy Focus
Bonds at a TIPping point?

Summary

1. **Buying opportunity in US government bonds:** the Fed probably reached its terminal rate and should hold its target rate steady at 5.5% until Q1 2024. The recent sell-off in US Treasury bonds offers long-term investors a good entry point. We favour US Treasury Inflation Protected bonds (TIPS) given elevated real yields.
2. **Recent US dollar movements are exaggerated**: we still expect the Fed to start cutting its benchmark interest rate in late Q1 next year as economic momentum softens. Cumulative rate cuts from peak to trough should be much bigger for the Fed than for most other central banks. This should be a key driver of US dollar weakness, once the uncertainty around the Fed's interest rate path reduces.
3. **Small stock market correction in August**, but no breakdown in the upwards trends in Euro, Japanese, US and Latin American stock markets. We maintain our Positive stance on global stocks, favouring the Eurozone, UK, Japan and Latin America on a regional basis.
4. **Healthcare sector is a key quality defensive sector** that has consistently outperformed other defensive sectors, and benefits from the ageing population megatrend. We continue to rate Healthcare as Positive.

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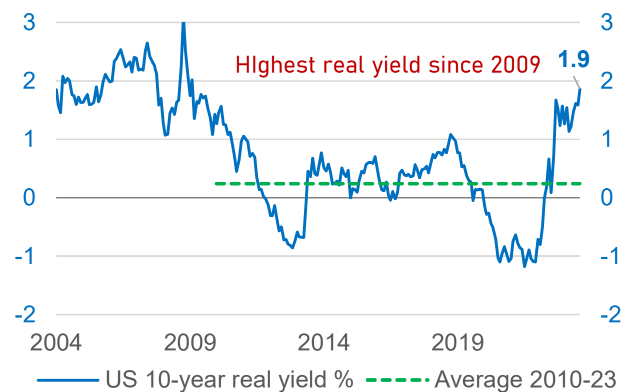
US 10Y TREASURY INFLATION-PROTECTED BONDS AT HIGHEST YIELD SINCE 2009



Source: BNP Paribas, Bloomberg

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The bank for a changing world

Key Calls: a summer pause in financial markets

EUROZONE BANKS CLOSE TO HIGHS

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

BRAZIL AND MEXICO BEAT US STOCKS

Source: BNP Paribas, Bloomberg. Note: indices in US dollars

Asset Allocation: buy US inflation-protected bonds

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

Markets overexcited by signs of a soft landing

Too much US macro optimism

Economic indicators have shown signs of resilience, especially in the US. Forward-looking indicators, such as PMIs and regional surveys, however continue pointing towards a challenging outlook for the manufacturing sector and more recently for the service sector (especially in Europe). We still expect the effects of higher interest rates to weigh on activity as there are often big time lags and mortgages rates have started rising again. Household demand resisted quite well over the recent months. That can be explained, to a large extent, by the substantial excess savings accumulated after the Covid stimulus period (especially in the US). We expect these financial buffers to be largely used, offering less support for consumption growth. In the eurozone, the business surveys showed that the service sector is also expecting weaker activity. The downside remains limited, however, as the strong employment data suggest a resilience of consumer demand.

China's economy has not yet bottomed out and the property sector still poses the biggest risk to our economic forecasts. China's three major demand-side growth engines all slowed down recently: 1) External trade. 2) Consumption & investment. This risk was increased by the lack of commitment to credit support to private developers at the July Politburo meeting. Although the government shows no intention of bailing out developers, we think systemic risk in the financial system is limited. Indeed, the market has priced in a large extent of negativity in the property sector. 3) Bank loan exposure to property developers is only 3% of banks' total loan book and the shadow banking transformation has progressed since 2017.

Japan sees healthy growth (for once)

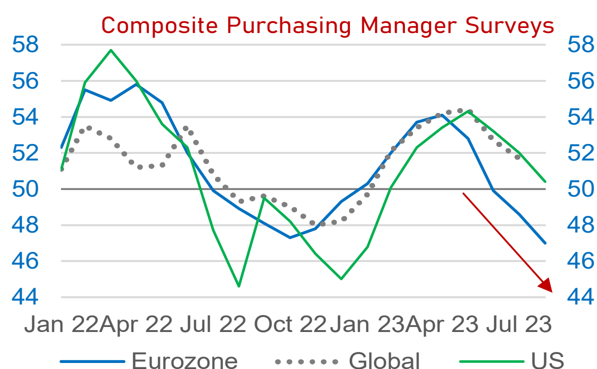
The bright spot on the macro front is Japan with an economy growing at a healthy 3.7% in the first quarter (annualised). We see the potential for an acceleration in consumer demand based on accumulated savings and an improved real wage growth outlook. The sharp depreciation of the yen against most currencies should also offer a key support for exports.

Gradual inflation normalisation

Inflation pressures are fading in most countries. We expect stable headline inflation and a moderate decline in core inflation in August. Underlying pressures should continue to fade for goods price inflation. This is supported by the recent collapse in producer prices thanks to decreasing supply chain constraints. House prices and rents should also be less of an inflationary source. Inflation in China is very low which should lead to lower inflation in the western economies.

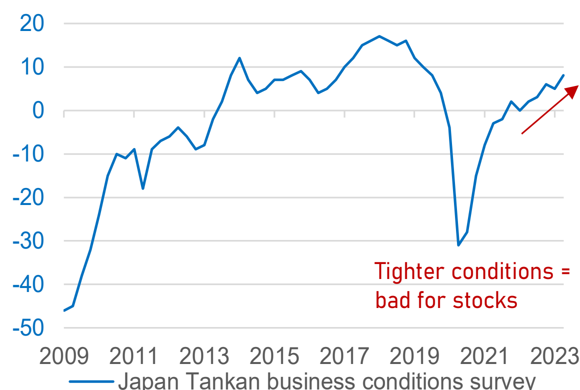
Our current forecasts anticipate a further decline in core inflation in the coming months. We expect headline inflation to end the year below 3% and below 4% for core inflation in both the US and the eurozone. Core inflation should remain the key metric for the ECB. Wage growth needs to be monitored closely. We see clear signs that the job market is cooling, albeit from extreme levels. This will be important for bringing down services and core inflation durably.

FALLING PMI SURVEYS UNDERLINE SLOWING ECONOMIC ACTIVITY



Source: BNP Paribas, Bloomberg

JAPANESE BUSINESS SENTIMENT CONTINUES TO IMPROVE



Source: BNP Paribas, Bloomberg

Central banks and Fixed Income Outlook

A likely end to Federal Reserve rate hikes

The Fed has probably reached its terminal rate and should hold its target rate steady at 5.5% until Q1 2024.

In the eurozone, we expect one more rate hike by the ECB with a terminal rate of 4% (deposit rate).

Bond yields moved higher (see chart below). Indeed, recent stronger-than-expected economic data in the US and signs of sticky inflation in the eurozone and the UK have generated expectations that central banks could delay rate cuts, or even consider additional rate hikes.

Other drivers include:

1. Upward revisions in the borrowing needs of the US Treasury, and
2. The fact that the markets are expecting more normalisation of the monetary policy by the Bank of Japan.

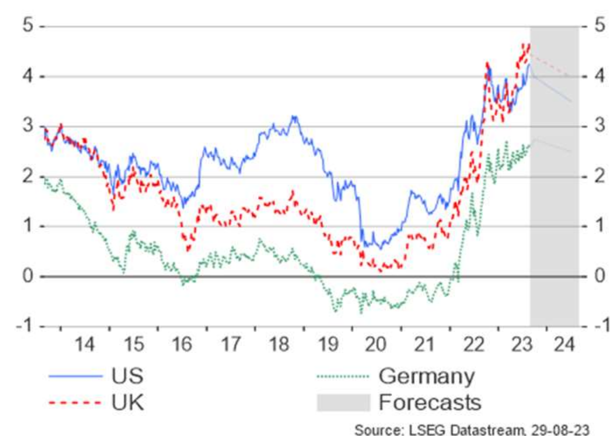
New buying opportunities in US Treasuries

We see new opportunities in US government bonds including maturities of up to 10 years. US long-term rates are expected to be close to peak as the central bank has probably reached the end of its monetary tightening and economic activity is expected to slow. **Our 12-month target for US 10-year bond yields remains 3.5%**, well below the current 4.2% level.

Long-term real yields (excluding inflation) are close to 2%, which we judge attractive. We prefer US inflation-linked bonds (TIPS) which offer protection against an unexpected rebound in inflation. The main driver of the expected fall in yields should be real yields rather than long-term expected inflation - which should favour inflation-linked bonds.

In the eurozone, we do not yet recommend government bonds. The ECB should hike one more time and yields are still close to our 12-month target. **We remain positive on European and US investment grade corporate bonds with a duration of up to 5 years. We like Emerging Market sovereign bonds (both local and hard currency).**

RISING GOVERNMENT BOND YIELDS



Source: LSEG Datastream, 29-08-23

US INFLATION-PROTECTED BONDS HAVE OUTPERFORMED GLOBAL SOVEREIGN BONDS

Source: BNP Paribas, Bloomberg

INVESTMENT CONCLUSION

In the Fixed Income space, we prefer:

- **US Treasuries, in particular Treasury Inflation Protected bonds (TIPS);**
- **UK gilts;**
- **Euro and US investment-grade corporate bonds;**
- **Emerging Market sovereign bonds in local and hard currency**

FX Outlook: no change in primary US dollar downtrend

Higher US rates temporarily help USD

The US dollar has been gaining momentum in recent weeks. The move was quite broad-based, as can be seen by the evolution of the dollar index DXY.

The key supportive US dollar factor was increasing expectations that the Fed could be forced to make more rate hikes, or at least wait longer before starting to cut rates.

We think that these movements are exaggerated, and we still assume that the Fed has reached its terminal rate. Furthermore, we still expect the Fed to start cutting its benchmark interest rate in late Q1 next year.

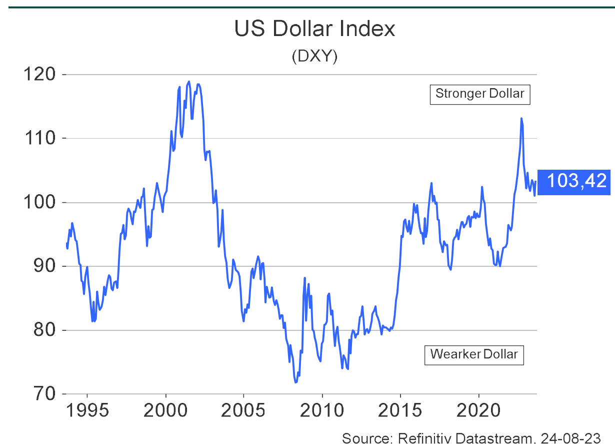
The cumulative rate cuts from peak to trough should be much bigger for the Fed than for most other central banks. This should be a key driver of US dollar weakness, once uncertainty around the Fed's interest rate path reduces.

Weaker Chinese renminbi, Japanese yen

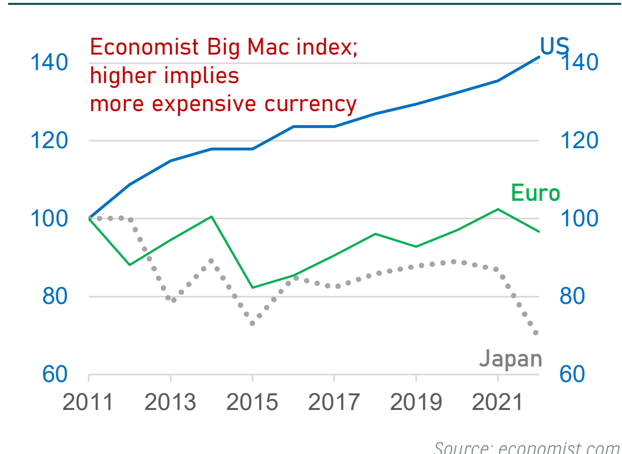
The recent decrease in Chinese policy rates has further increased the interest rate differential with the US and accentuated the depreciation of the CNY. The scope for further cuts is, however, limited while the US Fed is expected to cut rates from late Q1 onwards. Given the recent weakness of the Chinese currency, we increase our 3-month target from 6.9 to 7.2 and our 12-month target from 6.5 to 6.8.

We have also changed our targets for the Japanese currency. In July, the Bank of Japan allowed the 10-year yields to rise to 1% from 0.5% previously. The rate difference relative to the US is likely to keep the yen weak over the coming months. Once the Fed will start cutting rates in late Q1 2024, the yen should gradually recover. Given the recent stronger weakness of the yen, we increase our USD/JPY 3-month target from 138 to 140 and our 12-month target from 128 to 134.

DOLLAR STILL STRONG



US DOLLAR EXPENSIVE ON ECONOMIST BIG MAC INDEX, YEN IS CHEAP



Source: economist.com

INVESTMENT CONCLUSION

We think that recent US dollar movements are exaggerated, and we still assume that the Fed has reached its terminal rate. We still expect the Fed to start cutting its benchmark interest rate in late Q1 next year. The cumulative rate cuts from peak to trough should be much bigger for the Fed than for most other central banks. This should be a key driver of US dollar weakness, once uncertainty around the Fed's interest rate path fades.

Stock markets hit summer doldrums, at last

August as a cooling-off period for stocks

It is often the case that the summer months see stock markets marking a pause, even when they have been on a solid march higher, as observed this year.

While US, European, Japanese and emerging stock markets have all dipped this month on low volumes, they all remain substantially higher than in October 2022.

In our view, the resilience of corporate earnings underlies strength in developed market stocks, with profit margins and cash flows still robust and long-term debt financing (via corporate bonds) already secured at low rates.

The time to question our current Positive stance on stocks (held since late November 2022) will be if and when global recession clouds become more apparent. Yes, there is some disappointment in eurozone and Chinese economic activity. However, the US, Japan and Latin America continue to show resilient growth. Thus, I believe that we are not at this decision point just yet for global stocks. But this will only remain true if long-term interest rates stabilise or ease lower.

Healthcare: a quality defensive sector

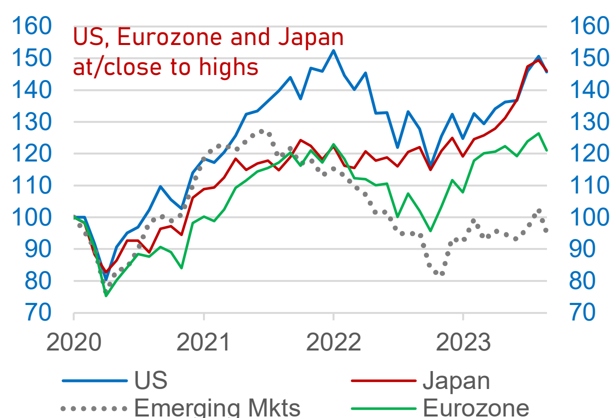
There are few global sectors that have performed as well as Healthcare over the long term. Healthcare includes large pharmaceutical stocks, fast-growing biotech companies, medical device companies and healthcare services.

Over the long term, the MSCI World Healthcare sector has returned nearly 12% on average per year since 2012, nearly 2% better per year than global defensive sectors overall. The sector benefits from high profitability thanks to patent protection, robust healthcare price inflation and steadily growing demand from ageing populations around the world.

Alongside global branded goods companies which tend to exhibit similar characteristics to healthcare, this is a sector which we prefer on a long-term sector allocation basis.

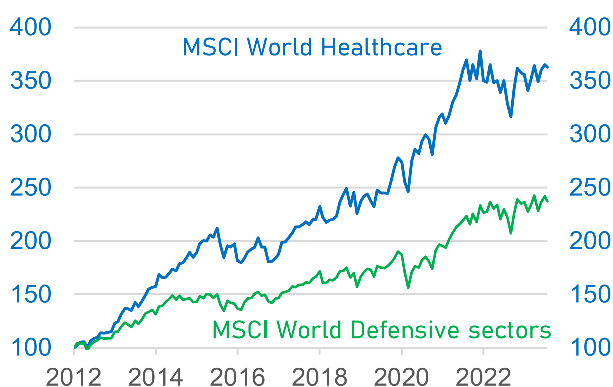
We maintain our Positive stance on Healthcare, with sales growth to continue to come from obesity and weight control drug segments in particular, given the enormous potential addressable market around the world.

US, EUROZONE, AND JAPANESE STOCKS STAY AT OR CLOSE TO MULTI-YEAR PEAK



Source: BNP Paribas, Bloomberg. Note total return indices in local currency

HEALTHCARE CONTINUES TO BE A SUPERIOR QUALITY DEFENSIVE SECTOR



Source: BNP Paribas, Bloomberg. Note: total return indices in US dollars

INVESTMENT CONCLUSION

Despite a small stock market correction in August, there has been no breakdown in the upwards trends in Euro, Japanese, US and Latin American stock markets. We maintain our Positive stance on global stocks, favouring the eurozone, UK, Japan and Latin America on a regional basis. On a sector basis, remember that the Healthcare sector is a key long-term quality defensive sector that has consistently outperformed other defensive sectors, and benefits from the ageing population megatrend. We continue to rate Healthcare as Positive.

China Update

Grace Tam, Chief Investment Adviser, Asia

Lack of clarity in near term economic outlook

The Politburo meeting in late July had reignited hope for immediate measures to revive consumer and business confidence, stronger support for the property market and resolutions to the local government debt problems. However, slow progress in easing measures, coupled with the debt woes of Country Garden (one of China's top property developers) and recent defaults in trust/wealth management products (in shadow banking) dampened the already fragile sentiment further.

The Chinese central bank, the PBoC, cut key policy rates in August, but that was perceived by the market as insufficient when households' risk aversion is increasing, as evidenced by the still high level of household savings (despite re-opening and rate cuts) and declining outstanding residential mortgage given surge in prepayments.

Financial systemic risk is unlikely

Although the government shows no intention to bail out private developers, we think systemic risk in the financial system is limited. This is not a Lehman moment. Why?

1) The market has priced in a large extent of negativity in the property sector, as reflected by sharp decline in property developers' bonds and stocks over the past two years.

2) Bank loan exposure to property developers was RMB 6-7 trillion, only 3% of bank's total loan book.

3) Shadow banking has been transformed since 2017: i) total AUM of trust companies dropped from a peak of RMB 22 trillion in 2017 to RMB15 trillion in Q1 2023; ii) property loans and infrastructure loans used to account for the bulk of trusts' investment, but now, most of their money is invested in bonds and equities; iii) trust companies' links to other parts of the financial system are very limited, so it is unlikely we will see widespread contagion; and iv) trust loans represent only 1% of outstanding total social financing, (a measure of the aggregate volume of funds provided by China's domestic financial system to the private Sector of the real economy within a given timeframe).

Stronger policy support is still the key

Most of the high-frequency economic indicators show no turnaround in sight in China's economic momentum and the economy does not seem to have bottomed out yet. Our base-case scenario is no big-bang stimulus in the near term, but we will continue to see targeted easing measures in a "reactive" rather than "proactive" manner. This would likely be in contrast to what investors have been hoping for, i.e. some stronger and coordinated stimulus that allows market to quantify their positive impact on growth. Beijing aims to rebalance the economy from the old economy that was dependent on increasing leverage in infrastructure and real estate to a new economy with focus on digitalisation and decarbonisation. Authorities would tolerate slower growth to achieve their longer-term goal of "common prosperity". However, any further delay in a decisive response to restore confidence and revive domestic demand would risk a fast deteriorating economy (downward spiral) and in turn, the government would require even much more costly and bigger fiscal expansion (that the government seems reluctant to do now) in the future to recover growth. We also continue to monitor the China currency, CNH, as any sharp weakness could impact the level of monetary easing.

Selective trading opportunities

At the same time, market expectations are very low. Any positive surprise in the actual stimulus measures (not only policy guidance or framework) will see a strong rebound in Chinese equities. However, a sustained rally would depend on whether the market is convinced that the stimulus is big enough to trigger a meaningful turnaround in economic momentum.

INVESTMENT CONCLUSION

Market volatility will remain high. Nevertheless, we see trading opportunities in selective areas with more favourable policy support, such as electric vehicles, consumer staples and durables, internet, technology and tourism which are somewhat shielded from the property downturn.

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 3.5% 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	1,9	0,3
Japan	1,0	2,0	0,9
United Kingdom	4,1	0,5	0,1
Eurozone	**3,4**	**0,5**	**0,6**
Germany	1,9	-0,2	0,6
France	2,6	0,8	0,6
Italy	3,8	0,9	0,8
Emerging			
China	3,0	5,3	4,8
India*	7,2	6,1	6,5
Brazil	2,9	2,5	1,8

* Fiscal year

Source: BNP Paribas - 28/08/2023

BNP Paribas Forecasts

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

* Fiscal year

Source: BNP Paribas - 28/08/2023

	Country	Spot 27/08/2023		Target 3 months	Target 12 months
Against euro	United States	EUR / USD	1,08	1,08	1,15
	United Kingdom	EUR / GBP	0,86	0,86	0,86
	Switzerland	EUR / CHF	0,96	0,98	0,98
	Japan	EUR / JPY	157,87	151	154
	Sweden	EUR / SEK	11,95	11,00	11,00
	Norway	EUR / NOK	11,56	11,30	10,80
Against dollar	Japan	USD / JPY	146,58	140	134
	Canada	USD / CAD	1,36	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	4,89	5,00	5,00
	India	USD / INR	82,66	82,0	82,0
	China	USD / CNY	7,29	7,20	6,80

Source: BNP Paribas, Refinitiv Datastream. As at 28 August 2023

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