For professional investors - Marketing Communication - October 2022

EQUITY OUTLOOK

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The second shoe

The path ahead for global equities is clear; it's the timing that is uncertain. Inflation is sticky and well above target in the US and in Europe. Central banks are determined to bring it back down to target, which will likely require a recession. In Europe, a recession is likely anyway, simply due to the energy shock.

Predictably, equities have fallen this year and we anticipate further declines as recession draws nearer. Talk of a soft landing is now as dated as that of 'transitory' inflation. The declines in the US have, so far, been driven primarily by the increase in policy rate expectations and the subsequent impact on multiples (the first shoe), rather than forecasts of lower earnings (the second shoe). In fact, estimates (excluding commodities) have dropped by just 2% in the US since the spring. In Europe, they have — surprisingly — risen, boosted by depreciating currencies and rising estimates for financials alongside higher policy rates (see Exhibit 1).

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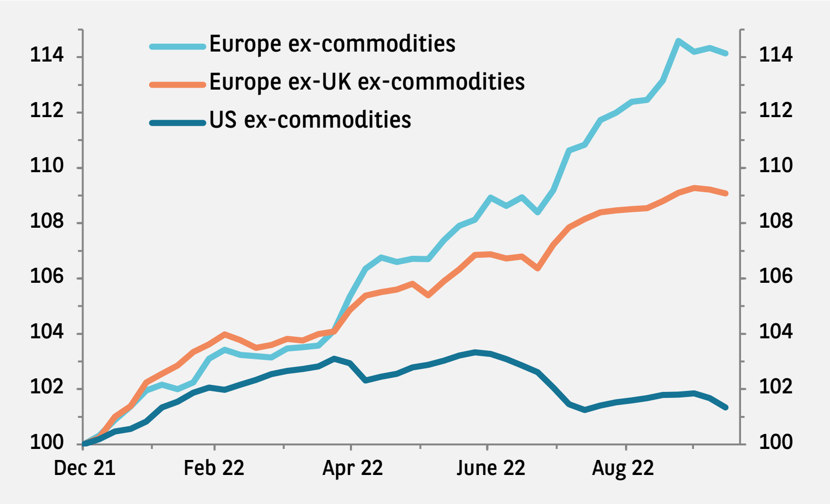
Exhibit 1

Resilient earnings despite headwinds

Next-twelve-month EPS



Data as at 14 Oct. 2022. Sources: FactSet, BNP Paribas Asset Management.

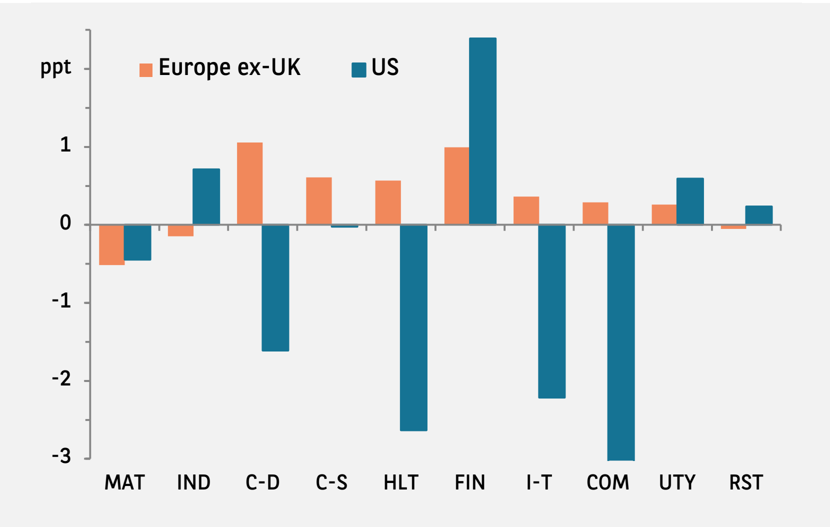
The greater rise in earnings expectations for European corporates, in contrast to those in the US, is striking. Both regions are facing higher interest rates but European equities are less sensitive given the greater value orientation of the market and the non-tech composition of its growth sector. On the other hand, Europe has the additional burden of extremely high energy prices. Nonetheless, earnings estimates have risen for most every sector while in the US they have broadly been declining, particularly for growth sectors such as technology, internet retail and media & entertainment (see Exhibit 2).

> "European earnings have been surprisingly resilient despite headwinds."

Exhibit 2

US earnings dragged down by tech-related sectors

Contribution to index forward EPS growth since 1 April 2022



Data as at 14 Oct. 2022. Sources: Bloomberg, BNP Paribas Asset Management.

Irrational exuberance?

Even with the negative revisions, earnings growth expectations are still quite positive. Next year earnings are forecast to rise by 10.4% (ex-energy) in the US (4q) and by 7.0% in Europe (full year). These figures could almost be viewed as Pollyanna-ish given the macroeconomic outlook. Equity analysts evidently have not received the recession memo. We would agree that estimates are too high. The slowdown in economic growth and increase in unemployment that will be necessary to bring inflation back to target mean that earnings estimates will at some point have to fall (and equity prices along with them).

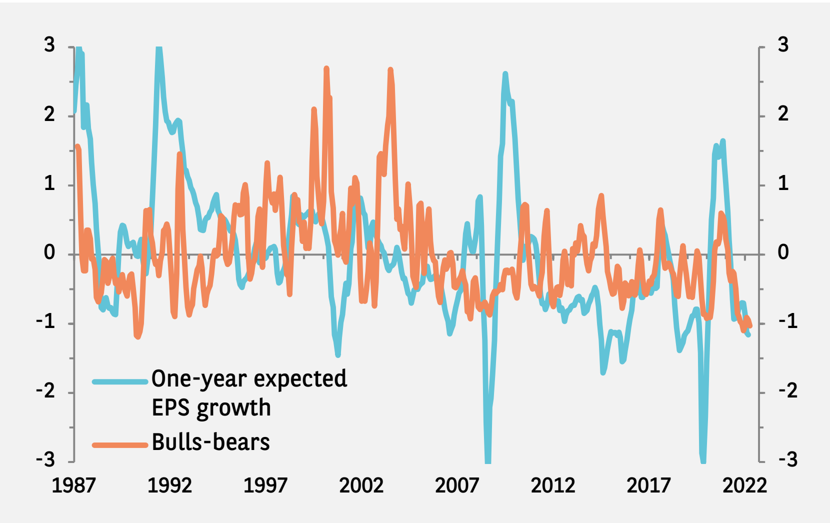
The evident optimism of analysts stands in stark contrast to the pessimism of most investors and businesspeople: A recent survey showed 91% of CEOs expecting a recession on the horizon; the bulls-to-bears ratio is near all-time lows. Expectations for earnings growth simultaneously with forecasts of recession is not necessarily cognitive dissonance, however. Growth forecasts are positively biased. Since 1987, the average one-year growth forecast has been 13.8%. There have only been three months over the entire period when the forecast was actually negative (notably, one of those months was February 2009, just before the market rebound). Forecasts today, while positive, are nonetheless low relative to history, so the pessimism towards equities is in fact broad-based (see Exhibit 3).

> "Earnings estimates (and equity prices) will at some point have to fall."

Exhibit 3

Earnings growth expectations are also pessimistic

Bulls-to-bears ratio and earnings growth forecast z-score



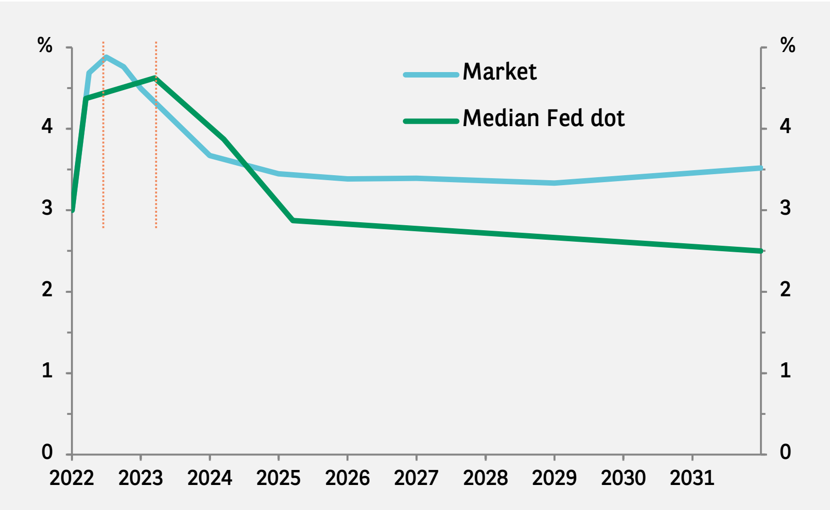
Data as at 17 Oct. 2022. Sources: Bloomberg, BNP Paribas Asset Management.

Pining for the pivot

The broad outline of the path for the economy and markets is clear: Rising policy rates until inflation slows, and then a pivot by central banks to cut rates to support growth. The timing is far less clear. After the latest Federal Open Market Committee (FOMC) meeting, fed funds forecasts — both by the market and from the Fed itself — have at least reached an appropriately high level (see Exhibit 4). We have long felt policy rates needed to rise beyond 4% if the Fed is to achieve its objectives.

“There is a big difference in views about the timing of the Fed pivot.”

Exhibit 4
Market is forecasting the pivot much sooner
Fed funds forecasts



Data as at 18 Oct. 2022. Sources: Bloomberg, BNP Paribas Asset Management.

This increase has removed one of the key threats to the market. As policy rates ratcheted higher, real rates surged and equity valuations fell. This particular dynamic at least should no longer continue to drive markets down.

There still remains the gap between when the market expects a pivot to occur and when the Fed says it will. Markets are forecasting it in six to nine months, whereas the Fed’s ‘dot plot’ does not foresee it until 2024. This mismatch may be less of a risk, however. There are two scenarios where the market’s view turns out to be the right one: Either the Fed is able to cut rates because inflation has begun to decelerate more quickly than expected (good), or is forced to cut rates because growth has slowed more than expected or markets are falling significantly (bad). In either case, equities are likely to react positively to the Fed lowering rates. If, on the other hand, the Fed is able to stick to its plan, it would essentially be status quo and so should not require an adjustment in equity prices.

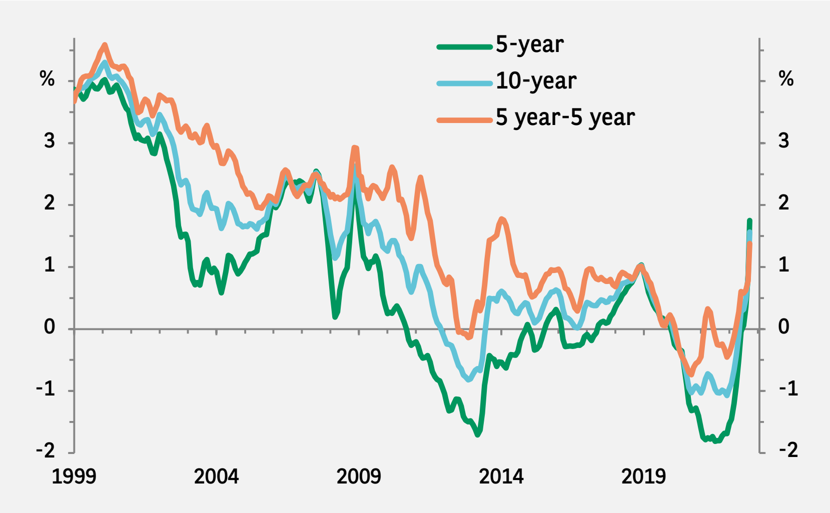
Rates reset

With fed funds estimates now at what we believe are appropriate levels, real rates may have topped out. The increase in yields over the last year has been dramatic, from a low of -1.8% for five-year yields to about 1.8% today. Current levels are now though near or above the highs since the global financial crisis (see Exhibit 5).

Exhibit 5

US real yields have mostly normalised

Three-month moving average



Data as at 18 Oct. 2022. Sources: Bloomberg, BNP Paribas Asset Management.

> "Real yields have mostly normalised, removing a threat for the markets."

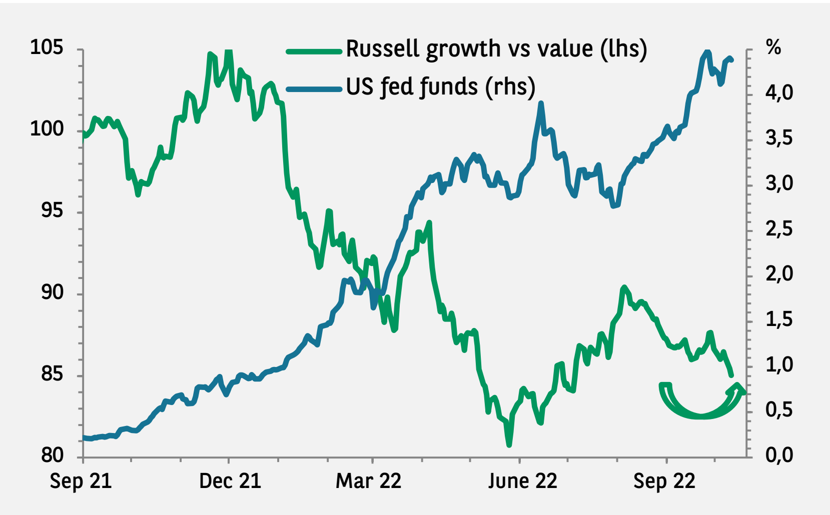
Yields are nonetheless still below longer-run averages and one could argue they need to rise by another 100bp to truly normalise. This may yet happen, though lower economic growth rates would argue for lower real yields than in the past. In any event, any additional gains are likely to be a far slower (multi-year) process as central banks only gradually unwind quantitative easing and run down their balance sheets.

This scenario suggests that the underperformance of growth stocks may be coming to an end. Most of the underperformance this year has been driven by rising discount rates and falling multiples (see Exhibit 6), though the return to pre-pandemic patterns of consumption has also had an impact on some of the big lockdown winners such as Amazon.

Exhibit 6

Stable fed funds forecasts should support growth stocks

One-year fed funds forecasts and Russell 1000 Growth vs Value indices



Data as at 18 Oct. 2022. Sources: Bloomberg, BNP Paribas Asset Management.

If rates tread water from here, the relative earnings growth advantage that the growth style has over value should start to tell (consensus estimates are for 11% YoY EPS gains in 2023 for growth vs. 7% for value). While equities broadly are not yet cheap, the fall in growth stock prices has left the z-score of the relative multiple of the Russel 1000 Growth index vs. the Value index at -0.6. Once the pivot in policy rates occurs, the outperformance of growth should accelerate as discount rates fall and value stocks are hindered by lower energy prices and lower nominal interest rates.

“If policy rates tread water from here, growth stocks should do better vs value.”

Earnings tea leaves

The current 3q earnings season will be sifted for clues to the outlook. Given recession forecasts, investors are wondering whether profit warnings will multiply. The recent announcement from FedEx seemed to confirm that sentiment. In fact, guidance of late has not been particularly negative, though companies do seem to be becoming more cautious.

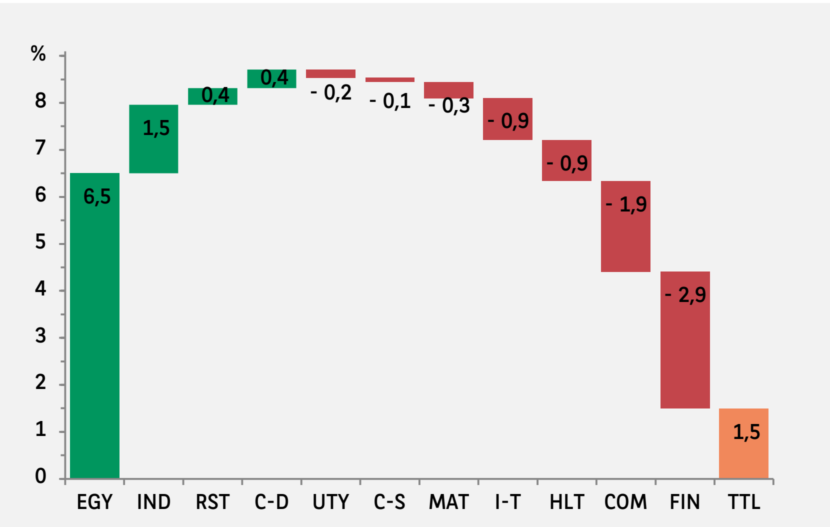
We are optimistic on the prospects for the earnings season. It is true that the return to pre-pandemic consumption patterns has tripped up not only internet commerce companies but also companies that, like FedEx, are linked to it. Retailers, too, have not stocked the kinds of goods consumers want now and had stocked many they did not want as much anymore. These missteps have an impact on earnings but are not a signal of accelerating weakness in demand. In fact, most of the anecdotes we hear from companies are positive, with demand so robust that companies struggle to meet it.

Moreover, we have already had a significant lowering of earnings expectations for the third quarter. The MSCI USA index is expected to post just a 1.5% gain in Q3, and 75% of that is from the energy sector (see Exhibit 7). Excluding commodities, EPS is actually expected to drop by 6% year-on-year. With such low expectations we would not be surprised to see results still beat forecasts. The reaction of equity markets will depend much more on the outlooks companies provide, but with demand robust, we do not foresee companies significantly lowering guidance until the slowdown in demand is more apparent.

Exhibit 7

Energy accounts for the bulk of earnings growth

Contribution to US 3Q 2022 MSCI US EPS YoY EPS growth



Data as at 14 Oct. 2022. Sources: FactSet, BNP Paribas Asset Management.

China and emerging markets

The underperformance of emerging markets (EM) this year has been almost entirely driven by China (which accounts for 30% of the index market capitalisation). The MSCI EM index declined by 28% up to 17 October 2022 (total return in USD), while the MSCI World index is down by a bit less (23%). China, however, has dropped by 34%, while the rest of emerging markets has declined by 25%, that is, the same as MSCI World. EM ex-China equities have even been gaining ground over the last couple of months (see Exhibit 8).

Exhibit 8

Emerging market equity underperformance driven by China

Relatitve performance of EM indices vs MSCI World

Data as at 17 Oct. 22. Sources: Bloomberg, BNP Paribas Asset Management.

This comparative resilience is all the more surprising when one considers the strength of the US dollar and the increase in US interest rates, two factors which normally result in more significant underperformance. Foreign fund flows have been negative as investors opt for the comparative safety of US assets at a much higher return than was available before.

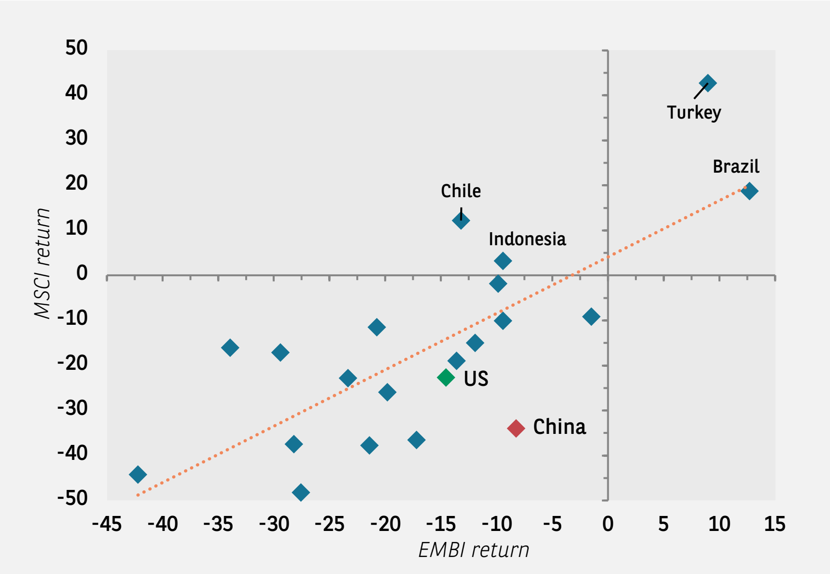
Macroeconomic factors have been key for the performance of emerging market equities even more than is typically the case. The correlation between equity market returns and USD sovereign debt returns has been notable this year (see Exhibit 9). The government bond returns reflect the need for central banks to raise their own policy rates to match the Fed's moves, pushing up bond yields. Though most countries do not face the same inflationary pressures as the US, increasing food prices weigh more heavily due to the greater weight food has in EM inflation indices. Currency weakness is a function of current account deficits, with energy importers particularly at risk.

> "The under-performance of EM equities has been almost entirely China.

Exhibit 9

Macro factors are driving emerging market equity returns

Total return of country MSCI and ICE BofA government bond indices



Data as at 17 Oct. 22. Sources: Bloomberg, BNP Paribas Asset Management.

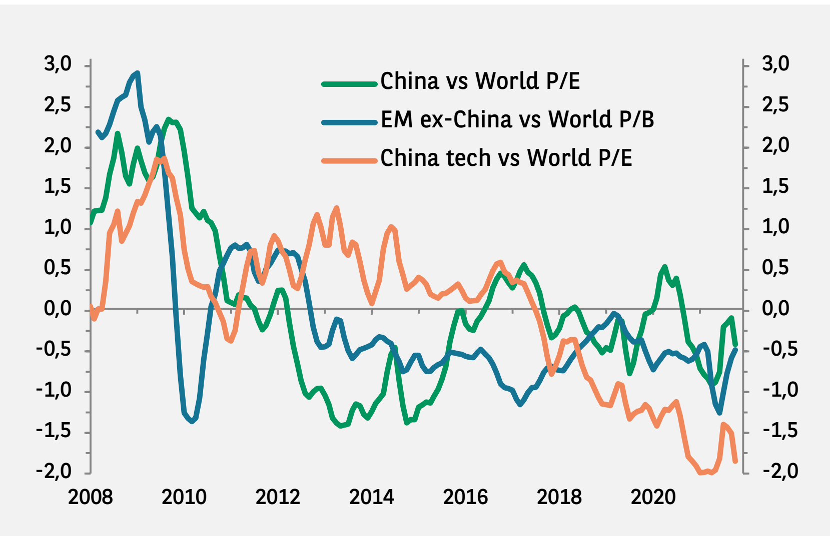
"Emerging market equities have the potential to outperform from here."

With the outlook both for Europe and the US more negative than positive, emerging markets ex-China have the potential to outperform from here. The adjustment to the rise in both the dollar and Treasury yields has largely taken place and we do not anticipate further large gains in either in the near future. While slower growth is a concern for the whole world, emerging markets ex-China do not face the direct impacts of the conflict in Ukraine (eastern Europe excepted), nor will central banks need to hike rates by as much as the Fed given that inflation is not as high or as entrenched. If commodity prices fall next year, those countries that have held up better may lag and vice versa, but in aggregate we see higher earnings growth for emerging markets. Valuations are also in EM's favour (particularly for Chinese technology stocks), though that is rarely a catalyst (see Exhibit 10).

Exhibit 10

Relative valuations favour emerging markets

Forward price-earnings ratios and trailing price-book



Data as at 17 Oct. 22. Sources: FactSet, BNP Paribas Asset Management.

As is the case for the US and Europe, China has unique factors affecting its own outlook, namely the zero-Covid policy and a shaky property market. Neither of these is likely to improve soon. Nonetheless, the country will eventually develop and roll out an effective vaccine, and history has shown us that economies rebound quickly once restrictions are eased. The property market will take longer to sort out, and the long-existing government objective of reorienting growth away from a dependency on investment to domestic consumption has only become more urgent.

But there is a critical difference between China and the West when it comes to China's ability to address these problems: Inflation is low in China (core consumer price inflation is rising by just 0.6% per year), meaning the government and central bank can use both fiscal and monetary policy stimulus to revive economic growth.

"The Chinese government is committed to its GDP growth target."

Conclusion

Equity markets still face challenging months ahead. Despite significant increases in US interest rates, economic growth remains far too strong to achieve the Fed's goal of bringing inflation back to target and a recession will likely be necessary. The only question is how deep it will be. Europe is already facing a recession and substantial uncertainty in the winter ahead. Though the European equity market appears inexpensive, earnings remain at risk.

Relative havens are likely to be growth stocks, particularly once the Fed gets closer to pivoting away from higher to lower interest rates. Emerging markets ex-China appear comparatively well placed by virtue of being further removed from an overheated US economy and the conflict in Ukraine. China boasts attractive valuations and a positive medium-term outlook, but patience will probably be required before the re-rating occurs.

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VIEWPOINT

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