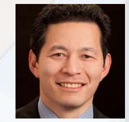
INVESTMENT STRATEGY

Equity Focus: stock markets mark a pause and rotate

October 2023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BNP PARIBAS WEALTH MANAGEMENT

The bank for a changing world

In short: take profits on US Mega Cap Tech stocks

Key Points

- **Seasonal tailwinds**: seasonality is changing from a headwind to a tailwind for equites. Historically, Q4 yields superior returns for stocks.
- **High rates are weighing on valuations**: good news have become bad news again. Investors seem to be increasingly concerned that better data points may compel the Fed to keep raising rates, or at least not cut them from today's elevated levels anytime soon. The resulting rising yields are putting pressure on P/E ratios while keeping credit spreads broadly unaffected.
- **Shadows of the past:** valuations and earnings expectations for the "Magnificent 7" stocks remain extremely optimistic for many years into the future. This seems eerily similar to the Tech-Media-Telecom stock market bubble of 2000. It´s worth recalling that it took more than two decades of the 2000s "FAANG" cohort to recover the losses from the March 2020 peak.
- **EPS/Price decorrelation**: during the last two years European equites outperformed their US counterparts noticeably on an EPS basis. This is by no means reflected in the relative price performance. We expect this to revert on the back of economic sentiment which seems to be at a turning point on both sides of the Atlantic.
- On a regional basis, we maintain our Positive stance on global stocks, favouring the eurozone, UK, Japan and Latin America.

Main recommendations

Energy stocks still offer catch-up potential. Oil prices has risen by almost 40% since early July. This move was barely followed by Energy stocks. Keep in mind that consensus oil price forecasts are still below current levels, increasing the possibility for EPS upgrades for oil stocks. We thus see further upside for the sector.

Stay diversified including in some cheap and solid cyclical stocks (Energy, European Financials).

Country-wise, Japan, Europe and Latin America look more attractive than the US.

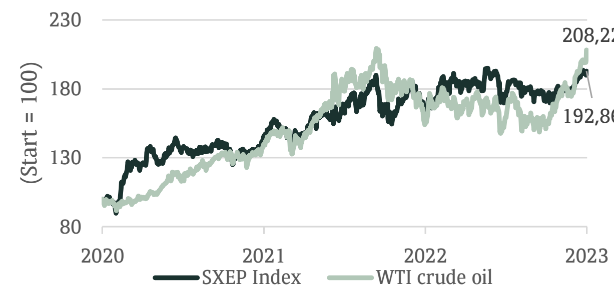
Be cautious/selective with expensive market segments, such as Consumer Staples, some large-cap US tech stocks and some Consumer Cyclicals: pricing power is weakening and operating profits are under pressure from rising costs. Some very high P/E ratios are difficult to justify.

The key risks are that the US Federal Reserve or the ECB could raise interest rates more than expected, triggering a sharper economic slowdown or even a recession. Liquidity is likely to fall in the coming months, especially in the US.

Our position this month

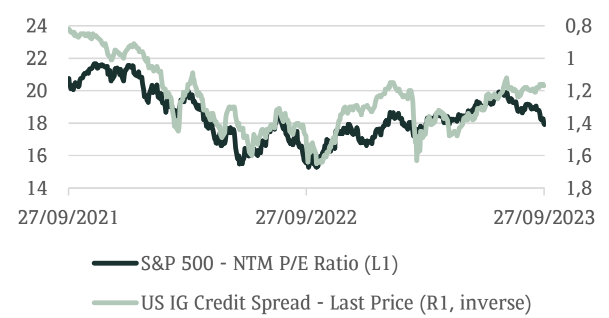
Change in our position since last month

OIL STOCKS LAGGING "THEIR" COMMODITY



Source: BNP Paribas, Bloomberg

CREDIT SPREADS OUTPERFORMED VALUATIONS



Source: BNP Paribas, Bloomberg.

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1. Equities outlook (i)

MORE THAN MEETS THE EYE: LOOK FOR UNDEROWNED EQUITIES

August and September lived up to tradition as being among the weakest months for equities. Luckily, **seasonal patterns are providing a glimpse of hope for investors**. Since 1900, US equities have managed to return 3.6% during Q4 on average. In fact, a good prevailing year seems to provide a special boost during the final quarter of the year. In the years during which the S&P500 rose more than 10% until the end of Q3, the Q4 performance has been even better, showing an average gain of 4.6%.

This phenomenon is no coincidence since there are several reasons which help to explain the pattern of a strong finish:

1.**Fresh money**: fresh funds are usually invested at the beginning of a quarter, e.g., via $401k in plans in the US

2.**Window Dressing**: 31 October marks the fiscal year-end for 24% of all US-based mutual funds (31 December for 21%), representing assets of $925bn and $3,491bn respectively. There is zero tolerance to show a large cash pile and underinvestment to major trendy themes like AI in the reporting during a year with significant market gains.

3. **Buybacks**: according to Goldman Sachs, November–December is the strongest two-month period of corporate buybacks. The impact this year is estimated to be roughly $5bn of daily demand.

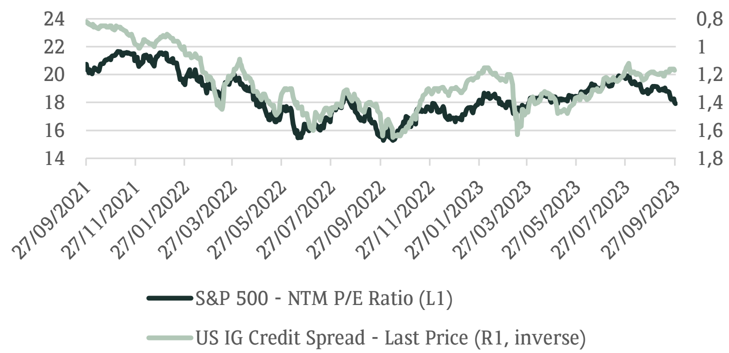
On the other hand, still solid economic data are ironically providing some tailwinds for equity valuations via the rates channel. Not too long ago, investors were desperately waiting for better data points that may suggest the US economy could withstand higher rates and eventually avoid a recession. Fast forward to today and the consensus appears to be convinced that the runway for a soft landing of the US economy is well in sight. A view which we disagree as we still forecast a mild recession next year. However, with data coming in strongly, markets appear to be concerned now that better data points may prevent the Fed from continuing to raise rates, or at least not cut them anytime soon.

What's interesting about this rate debate, however, is that the pressure from rates may come down more on stock valuations than corporate fundamentals.

That's because the move up in longer-term rates has been a reaction to better growth and thus inflation outlook. And better growth has positive implications for corporate earnings, especially those companies with clean balance sheets. Thus, fundamentals (aka credit risk) rather benefit from this. In theory, higher earnings should help equity valuations as well. Simultaneously though, higher rates raise the discount rate on stocks and may more significantly impact the valuation of companies generating cash flows further in the future. That is why the mega-cap Tech stocks started to underperform recently while credit spreads stayed stable. The discount effect outweighs any positive effect on earnings from a stronger economy.

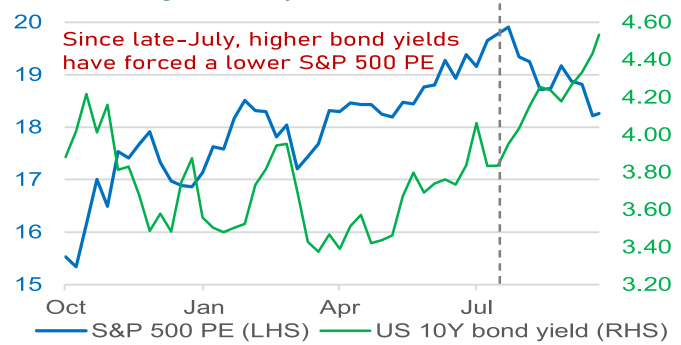
Current preference for cheap and lagging countries and sectors

CREDIT SPREADS OUTPERFORMED VALUATIONS



Source: BNP Paribas, Bloomberg.

Higher bond yields, lower S&P PE



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

1. Equities outlook (ii)

We would also like to remind investors about the shadows of the past. Valuations and earnings expectations for US mega Cap Tech Stocks remain extremely optimistic for many years into the future. This seems eerily like the Tech-Media-Telecom stock market bubble from 1999-2000. A time when all things related to the Internet and the Millennium Bug were the key market narrative driving the mega-cap tech stocks of the day to record highs. Back then, these stocks included Microsoft, Cisco, Intel, NTT and Nokia, to name the biggest 5 TMT stocks at the end of 1999. By early 2000, each of these stocks had performed extraordinarily well, on average +160% from the beginning of 1999 to March 2000, just 15 months later.

Today, the FAANG stocks have risen by 200% from March 2020 to November 2021 thanks to the narrative about working from home, a roughly similar period as for the Year 2000 TMT stocks**. The FAANG stocks then returned to this November 2021 peak in mid July this year, on the back of all the buzz about Artificial Intelligence. But their share prices have since started to fade.** The experience of the dot.com bubble burst may serve as a cautionary tale of staying invested in technology-driven bubbles for too long. Post the technology stock peak in March 2000, these mega-cap TMT stocks had still not recovered to the average March 2000 share price level by the beginning of 2020, so 20 years later.

Conclusion: Yes, stay invested in stocks for the long term, BUT consider avoiding (or at least lowering) exposure to potentially overvalued -cap technology stocks at this point, in case we see a repeat of the post-2000 experience. Believe that the FAANGs may be close to the peak also limits any potential for above average performance on the index level due to their high weight. We rather expect outperformance to come from under-owned areas of the market with more rotations below the surface. We currently find plenty of interesting places outside the FAANG realm for equity investors to invest. These areas include, among others, European equities as well as Japan. We invite you to discover our views in greater detail below.

Current preference for cheap and lagging countries and sectors

IS THE MEGA-CAP TECH RALLY FADING AGAIN?

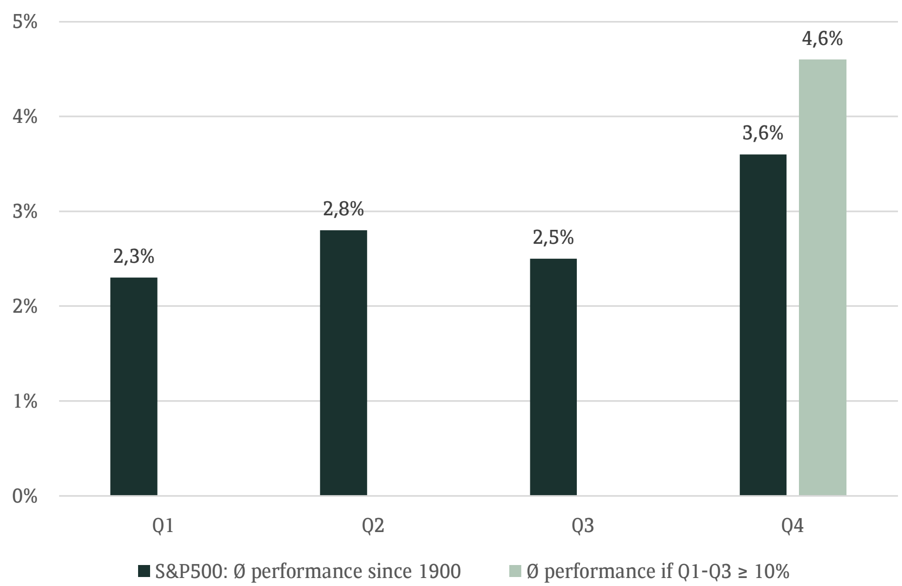
Source: BNP Paribas, Bloomberg.

Warning: Look at the painful collapse post 2000

Source: BNP Paribas, Bloomberg

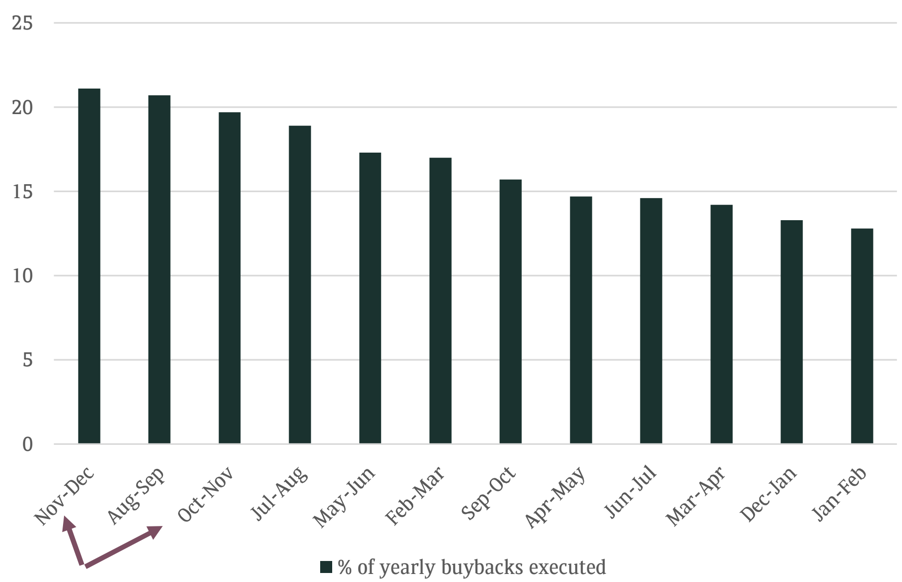
2. Seasonality: Up to a strong finish

Q4 is historically the best quarter. Even more so if the YtD performance was strong



Source: BNP Paribas, Bloomberg

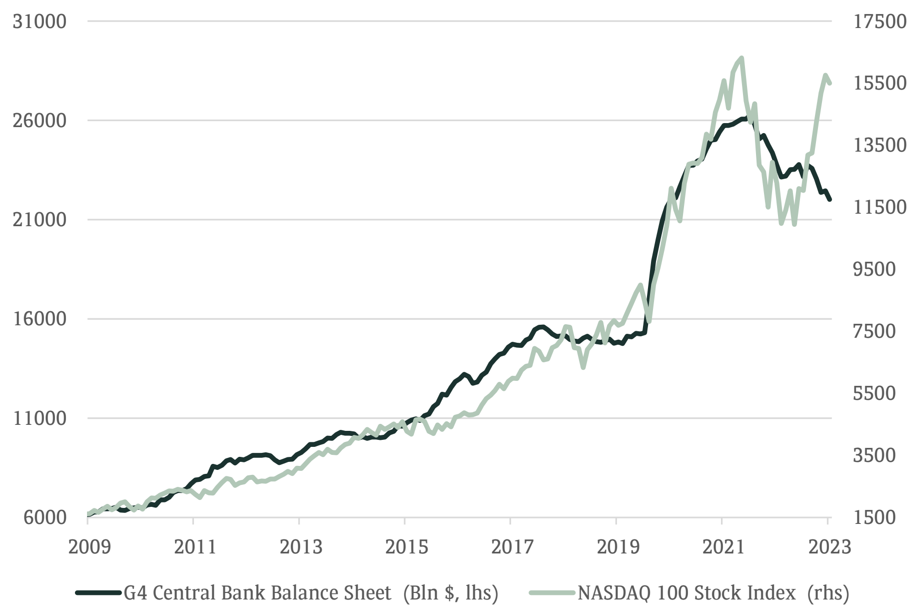
Q4 is high tide for buybacks, providing further support



Source: BNP Paribas, Goldman Sachs

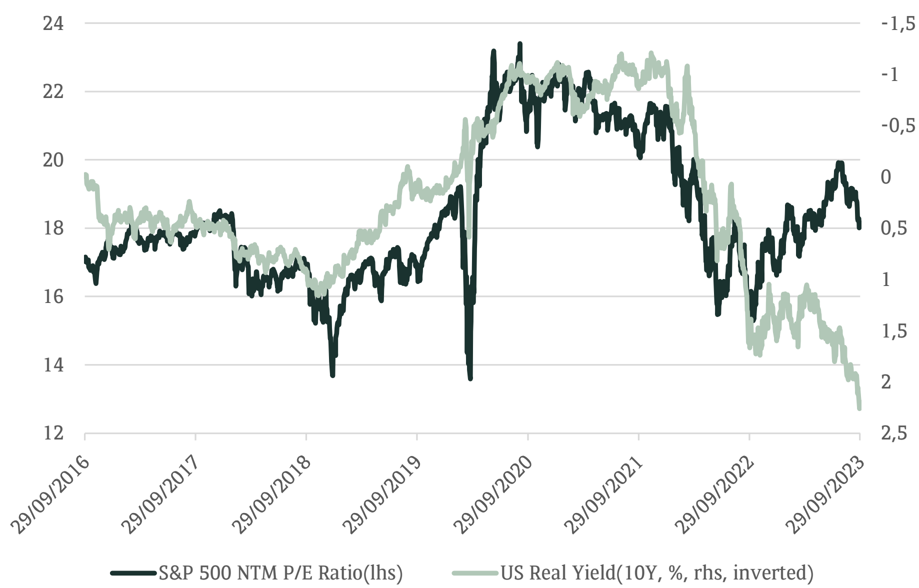
3. Defying gravity......for now

If technology stocks benefitted from QE, they should not get away unscathed from QT



Source: BNP Paribas, Bloomberg

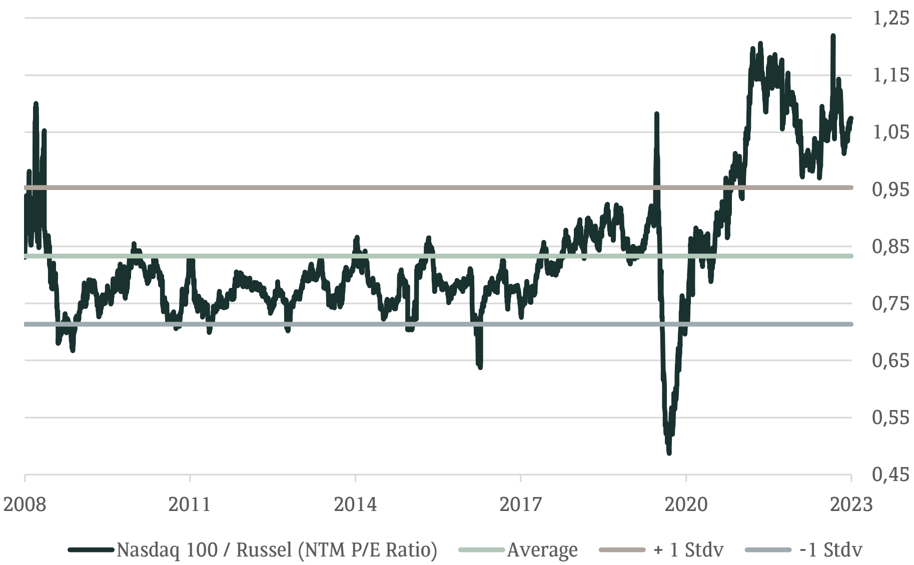
There is still some downside based on the current level of real yields



Source: BNP Paribas, Bloomberg

4. US Small Caps – close to the bottom?

The valuation premium of technology vs small cap stocks is close to a 15-year high



Source: BNP Paribas, Bloomberg

Stdv = Standard Deviation

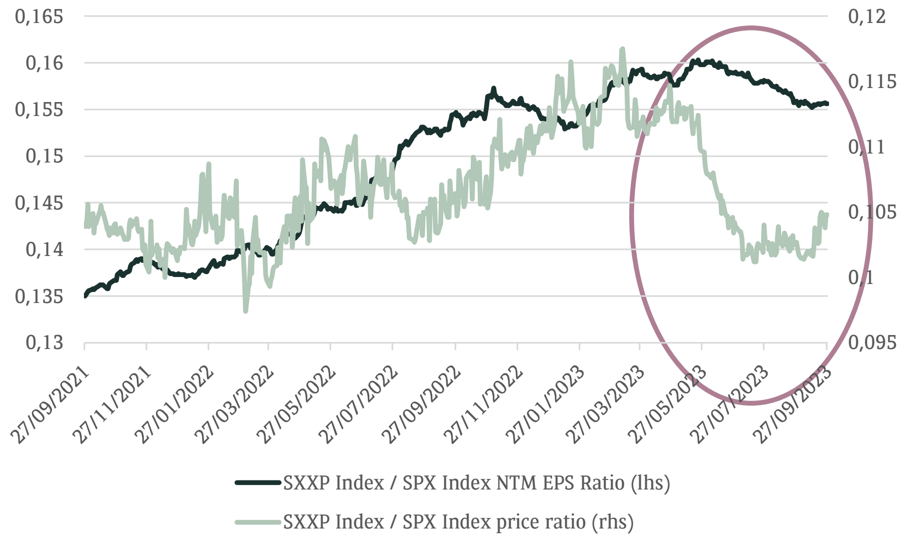
An RSI below 30 has done a good job at picking near-term tactical troughs

Source: BNP Paribas, Bloomberg

RSI = Relative Strenght Indicator / Value below 30 / above 70 indicates somthing is oversold / -bought

5. Europe: stronger earnings, weaker prices

US/EU equity performance recently decorrelated from EPS trends, leaving potential for European equities to catch up



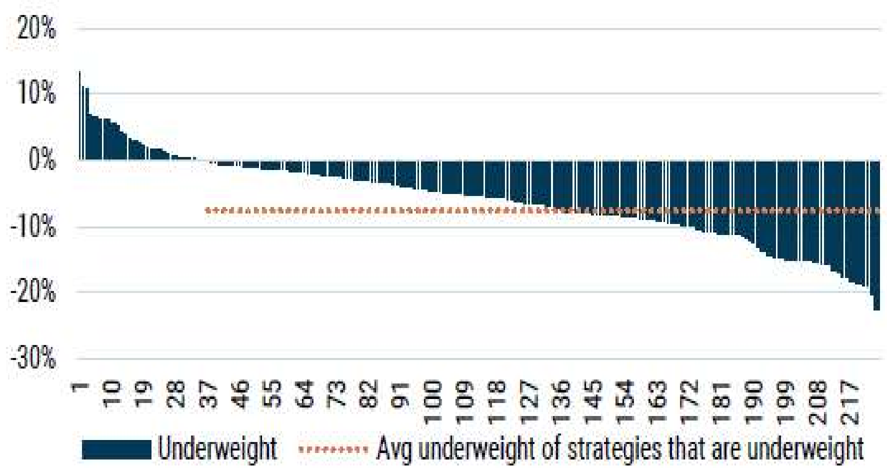
Source: BNP Paribas, Bloomberg

A changing economic sentiment may accelerate any potential re-rating of EU-equities

Source: BNP Paribas, Bloomberg

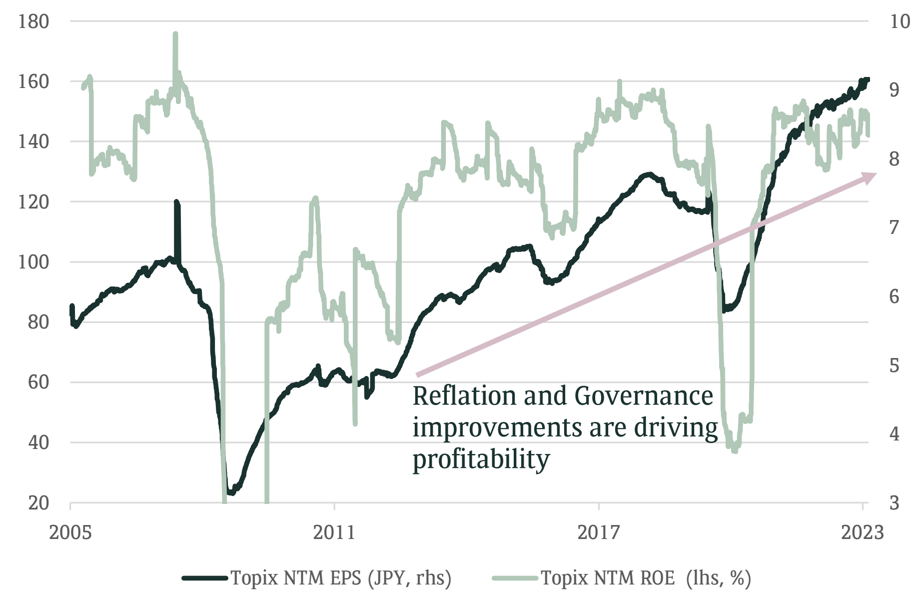
6. Japan: still underowned despite structurally improving fundamentals

MSCI EAFE Active Managers over/underweights to Japan (by strategy)



Source: GMO, eVestment

A changing economic sentiment may accelerate any potential re-rating of EU-equities

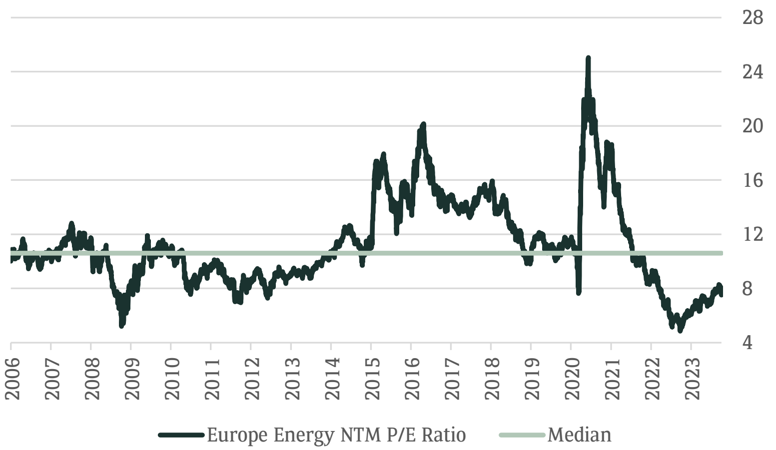


Source: BNP Paribas, Bloomberg

7. Energy: still trading cheap vs long term demand expectations

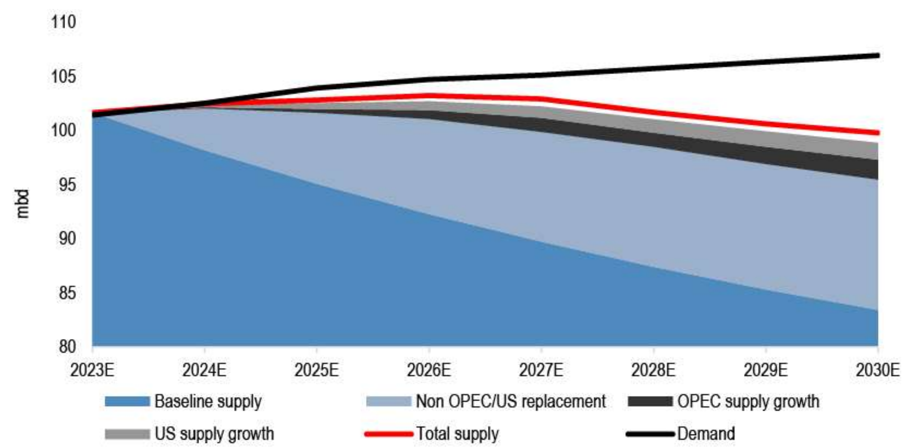
Energy (+) underperformed the broader market as well as oil prices in 2023. Since June, Brent has been up ~ 20% while the SXEP has risen by only ~8%. We feel that energy stocks offer interesting long-term prospects given a constructive view on oil supply/demand dynamics. The primary drivers of our structural view are: i) higher for longer rates are tempering the flow of capital into new projects and/or maintenance investments; ii) as companies return more cash to shareholders via buybacks, the cost of equity is rising, resulting in elevated cash break-evens. This is pushing the marginal cost of oil higher; iv) institutional- and policy-led pressures are driving an accelerated transition away from fossil fuels; and iv) demand may not shrink as fast as expected since the global population is expected to grow by ~ 600m by 2030. The majority of this growth will be in regions which are still heavily dependent on fossil fuels and are unlikely to decarbonise any time soon. Thus, we see the stars aligning for a prolonged period of healthy margins for energy companies due to increasing supply/demand imbalances.

Oil stocks are still trading well below long-term averages



Source: BNP Paribas, Bloomberg

Oil supply deficit could growth as high as 7.1 million b/d in 2030, driving upside risks to oil prices

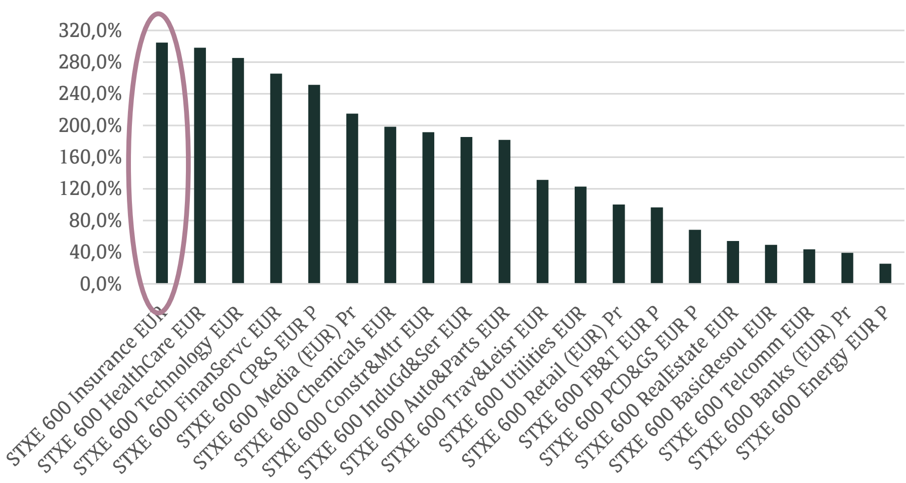


Source: J.P. Morgan Commodities

8. Insurance: Underrated Champions

Insurance (+) companies are often deemed to be boring. While this may be true for most of their business, investors should still get excited about the sector from an investment perspective. We feel Insurance companies have among the most underappreciated business models. On average, the companies are enjoying above-average pricing power which allows them to pay constantly growing dividends. Accordingly, the European Insurance sector has been the best-performing sector in over the last 12 years in Europe. Today, **the sector offers a dividend yield of 6% with share buybacks adding ~1% pt** making this an attractive income sector relative to the European market. **The sector's premium to the broader European market dividend yield is currently 2 pts**, one standard deviation above median levels over the past decade. Thus, the sector offers an attractive capital return yield premium despite the recent rise in risk free yields. In fact, it is even benefitting from rising rates as they make certain products more attractive to clients.

The best-performing sector (12/30/10 – 09/30/23) thanks to.....



Source: BNP Paribas, Bloomberg

....strong pricing power and above-average dividend payouts

Source: BNP Paribas, Morgan Stanley

9. Asian Equities view

Asian Equities decline as USD strengthens

CONCERNS OVER CHINA ECONOMIC OUTLOOK REMAIN

ASIA COUNTRY PREFERENCE

+	=	−
	COUNTRY	
China Singapore South Korea Indonesia	India, Taiwan, Thailand Malaysia Philippines	-

- Asian equity market corrected in September, in line with the global markets. Markets remained nervous that high oil prices might keep interest rates higher for longer, as central banks fight high inflation expectations.
- Hong Kong/China stocks remained disappointed against the backdrop of surge in US yields and the dollar following a relatively hawkish Fed meeting and lingering concerns over China's domestic growth.
- We have been seeing some stabilisation of economic data in China. However, market sentiment remains very weak. We still expect more targeted easing measures to come through. Autos, consumer durables, technology and tourism are potential policy beneficiaries.

ASIAN EQUITIES REMAIN SENSITIVE TO CHINESE ECONOMIC DEVELOPMENT & US YIELDS OUTLOOK

		1-month (%)	YTD (%)	2022 (%)	Forward PE (x)	Trailing PB (x)	Dividend Yield (%) 2023f	EPS Growth (%) 2023f	EPS Growth (%) 2024f	ROE (%) 2023f
	Asia Ex-Japan	-3.9	-3.4	-21.5	12.6	1.5	3.0	0.8	21.4	9.9
North Asia	China	-5.0	-10.1	-22.4	9.8	1.3	3.5	16.4	15.5	10.7
	China A-shares	-2.0	-4.7	-21.6	12.4	2.0	3.0	15.9	14.2	12.2
	Hong Kong	-8.1	-21.7	-7.8	11.8	1.0	4.3	5.0	14.2	6.6
	South Korea	-3.3	13.2	-26.4	12.1	1.0	2.2	-35.2	69.7	6.0
	Taiwan	-2.7	13.7	-24.7	15.2	2.3	3.5	-21.8	22.2	12.7
South Asia	India	1.3	6.7	1.6	20.7	3.8	1.3	21.9	14.6	14.4
	Indonesia	-1.7	1.0	10.4	14.0	2.4	4.7	34.3	9.9	15.0
	Malaysia	-1.1	-4.1	-4.3	13.6	1.4	3.9	7.2	10.2	9.1
	Philippines	3.3	-2.1	-7.3	11.3	1.7	2.2	23.0	9.4	12.9
	Singapore	0.5	-0.8	4.4	11.5	1.3	5.0	42.1	1.8	10.0
	Thailand	-5.2	-10.8	6.3	16.8	1.8	2.7	-11.3	14.7	8.8

Source: Datastream, BNP Paribas (WM) as of 29 Sep 2023

Do you have insurance?

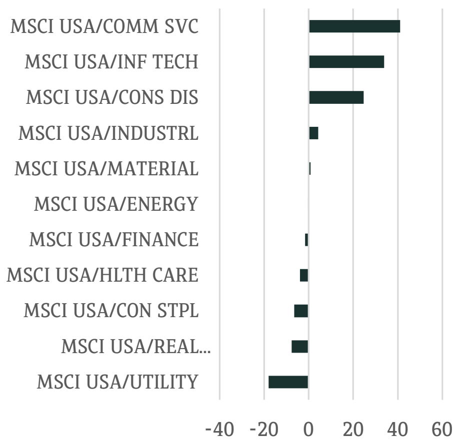
10. Sector allocation: stick to the game plan

RISING YIELDS ARE TAKING THEIR TOLL IN A FALLING MARKET. WE CONTINUE TO PREFER QUALITY AND/OR VALUE SECTORS

Stronger-than-expected economic data resulted in a rise in yields and a delay of future rate cuts from the FED. This brought renewed pressure on rate-sensitive sectors. Interestingly, US Mega Cap Tech no longer seemed to be immune to the rates backdrop as the "Magnificent 7" underperformed in September.

- Summer is typically the most difficult period for equities. **Among the defensive sectors, we maintain our preference for Health Care.** This sector is a long-term outperformer and, among other, fits well with the innovation, ageing population and AI themes.
- **Cautious investors may diversify into other strong, and/or cheap and/or high-dividend stocks,** such as Energy, European Financials and solid Utilities that benefit from the energy transition.
- **We would still avoid expensive tech and consumption stocks. Despite the recent correction, valuations are still demanding.** Besides, the consumer is increasingly reluctant to accept the sharp consumption price rises observed since early 2022.

US sector performance YTD 2023. Technology and cyclicals lead while Utilities and Energy are in the red.

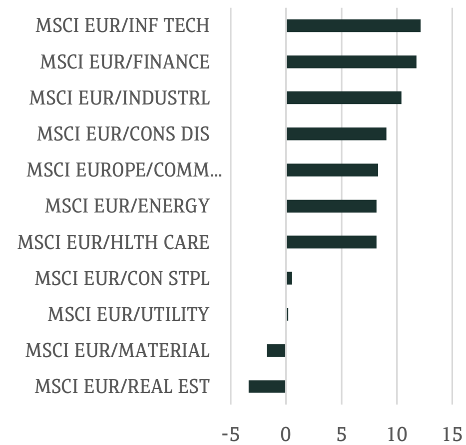


Source: FTSE Russell. Performance as at 30 August 2023

Our recent sector preferences managed to generate some outperformance versus the broader, falling market. We stick to our view to favour, apart from Health Care, the Energy sector as we expected demand to keep recovering, whereas supply would stay constrained. Insurance is becoming increasingly interesting thanks to high payout ratios.

- **Energy was the star performer in the summer,** with oil prices recovering from around USD 70/barrel to around USD 90 today. Oil supply will remain constrained by Saudi Arabia and Russia. On the demand side, the travel recovery, the strong economy in many parts of the world and the development of e-commerce are all supporting oil prices.
- **Insurance companies are offering a pay-out yield of ~ 7%** which sits one standard deviation above long-term averages, making it an interesting income sector.
- **As technology is expensive and facing new issues, remember that there are other vehicles to play** AI, including companies in Health Care, Business Services, Industrials, and even some Financials and Utilities that are expected to enjoy productivity gains!
- Listed European Real Estate is recovering but still suffers from uncertainties about its refinancing, growth and dividends.

European sector performance YTD 2023. Cyclicals and Technology lead while Basic Resources, Real Estate and Energy are down (but recovering).



Source: BNP Paribas Wealth Management, Bloomberg
Performance as at 6 October 2023

11. Sector Preferences

Reco	Sector (Level 1)	Industry (Level 2) +	Industry (Level 2) =	Industry (Level 2) -
+	**Energy**	Energy		
+	**Materials**	Materials		
+	**Health care**	Pharmaceuticals + Biotech Health Care equip. & services		
	Utilities	EU Utilities	US Utilities	
	Financials	EU Banks EU Insurance EU Diversified financials	US Banks US Insurance US Diversified financials	
	Real estate	EU real estate	US real estate	
	Communication Services		Telecoms Media & Social Networks	
	Industrials		Commercial Services Capital Goods Transportation	
	Technology		Technology	
	Consumer Discretionary		Luxury Goods Consumer Services Retail Automobille Leisure	
-	**Consumer Staples**			Food & Beverages Food Retail Household & Personal Care Products

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Edouard DESBONNETS
Investment Advisor, Fixed Income

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