INVESTMENT STRATEGY

Equity Focus: How much gas is left in the tank?

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The bank for a changing world

Let your profits run – but don‘t chase the rally

Key Points

- **Year-end rally**: as we had expected, markets eventually took off for a year-end rally which has unwound the full downward trend of the previous three months. Other than seasonality and positioning, the driving force has been an almost perfectly composed set of economic data. Almost all releases since late October have been about as friendly as the market could have asked for. e.g. 150k payrolls are strong enough for a soft landing but weak enough to keep the Fed at bay regarding further hikes. The 0.2% rise in CPI should give the Fed further comfort in their successful fight against inflation and there is no longer the need to fight a future easing of financial conditions.
- **How much gas is left in the tank?** Based on history, the recent recovery is by no means unusual. Albeit a bit faster than history suggests, it is quite common for the market to see a meaningful recovery after a 10%+ correction. We still like the technical set-up for the rest of 2023, implying that there is some gas left in the tank. At the same time, it's worth keeping in mind that a serious amount of short exposure has already been covered and, compared with the picture a month ago, there's less upside potential left.
- Valuation is not on the side of the bulls either. Although we doubt that it will matter in the short term, it is likely to cap returns further down the road. Our economic expectations of slower inflation and slower growth (in the US) should constitute some further headwinds.

Main recommendations

(+) **Upgraded EU Tech to Positive.** The sector is well positioned to capture the growth potential of B"B application growth while valuations are low.

European Utilities showed some relative strength this earnings season leading to substantial positive earnings revisions. Valuations are low and positioning is light. We see room for further upside, especially if rates continue to fall.

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

(+) **Country-wise, we maintain our Positive stance on the eurozone, UK, Japan and Latin America**

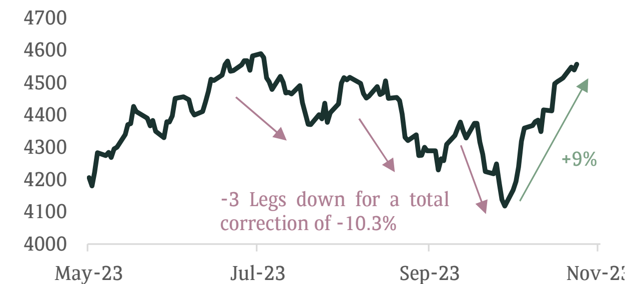
(-) Be cautious/selective with expensive market segments, such as Consumer Staples, some large-cap US tech stocks and some Consumer Cyclicals: pricing power is weakening and operating profits are under pressure from rising costs. Some very high P/E ratios are difficult to justify.

(!) **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

EQUALISING THREE LEGS LOWER IN THE S&P



Source: BNP Paribas, Bloomberg

NOT AN UNUSUAL MOVE SO FAR

*Period from index started falling -10%+ and starts to rise +9% during the selloff; Median of 63 selloffs since World War II

Source: Deutsche Bank

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Contents

Equity Outlook

Index & Macro Observations

Asian Equity View

Sector Views

Equity outlook

3 FACTORS TO WATCH IN 2024: LIQUIDITY, VALUATIONS, EARNINGS

Rising global liquidity and looser financial conditions are key motors for stocks. Another supportive factor may arise from corporate share buybacks which are likely to be the greatest source of demand for stocks in the near term. As there is a lack of new issues coming to market, this net shrinkage of equity supply suggests a moderately supportive backdrop for stocks.

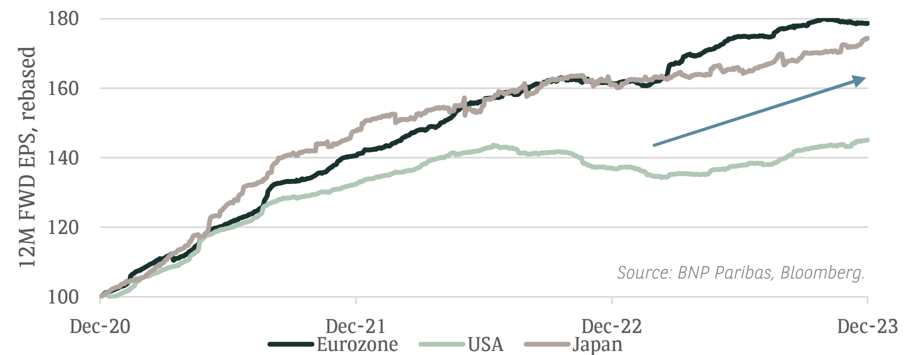
In general, valuations remain relatively cheap versus history for US (excluding megacaps), European, UK, Japanese and emerging market stocks across a number of metrics such as P/E. However higher valuations will require lower long-term interest rates, i.e. falling 10-year bond yields.

Earnings momentum will be key, particularly given the lack of growth in the eurozone and our expectation for a US economic slowdown in 1H24. Up to now, decade-high inflation rates have allowed companies to expand profit margins as they have enjoyed pricing power, while strong consumer demand has also supported top-line growth. As consumers are growing less confident and as headline inflation recedes to more normalised levels, these two indicates weakening earnings ahead. Up to now, these potential drags have not impacted forward earnings estimates. But this could still change, if the economic outlook worsens. **US stocks have traditionally gained** approximately 13% over the six months following a Fed pause. Since the Fed last raised rates to 5.5% at the end of July, US stocks have not progressed. Until the end of January 2024, global stocks may benefit from greater certainty over the end of the central bank rate hiking cycle, based on the typical pattern following a Fed pause.

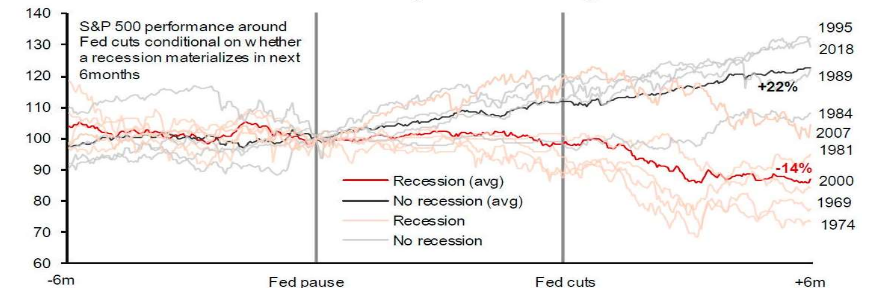
The real question for stocks in 2024 is the length and depth of a US recession. In the event of a recession, any bear market typically begins roughly one month after the first Fed rate cut, as the economic downturn becomes evident. We see the Fed starting to cut policy rates in June, suggesting that the crunch time for stocks will likely be 2H24. Note that the more severe a recession, the deeper the drawdown for equities. As we expect only a modest US recession in 2024, we look for a relatively small increase in unemployment. This, in turn, would imply a relatively modest headwind to 2024 corporate earnings, and thus a correspondingly lower risk to stock market momentum over 2H24. All of this suggests that **we should not rush to downgrade our Positive stance on global stocks for now.**

We see reasons to stick to our Positive stance...

Through# ...though? most 2023 EPS forecasts have increased



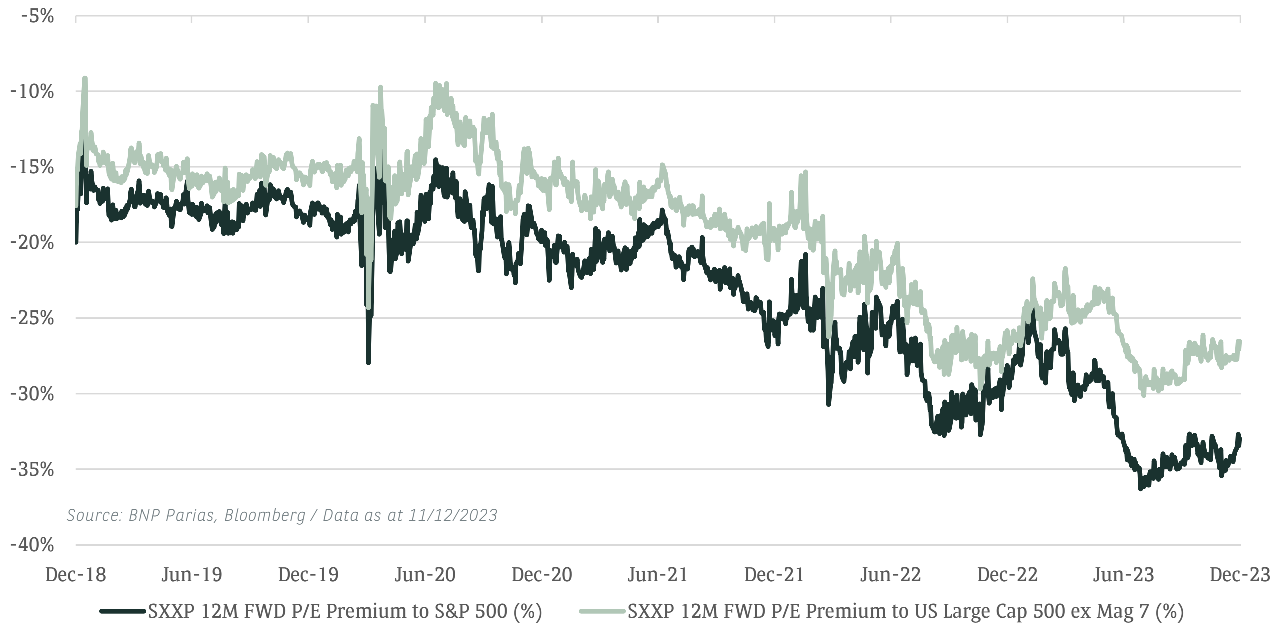
Fed pause is good for stocks over 6 months; then the recession call is key



Source: FTSE Russel, Factset, HSBC.

US vs. EU valuations

MORE THAN JUST THE MAGNIFICIENT 7



Even if excluding the Magnificent 7 makes a difference to the magnitude of relative valuation differences between EU and US equities, the impact does not change the picture in a material way. If the Mag 7 are stripped out of valuations, then Europe goes from trading at a 33% PE discount to the US, to a 27% discount, which is still close to record lows.

Japan - Still ignored by (too) many

TAKE ADVANTAGE OF AN INTERESTING INVESTMENT CASE WHICH IS NOT (YET) PRICED IN BY THE MARKET

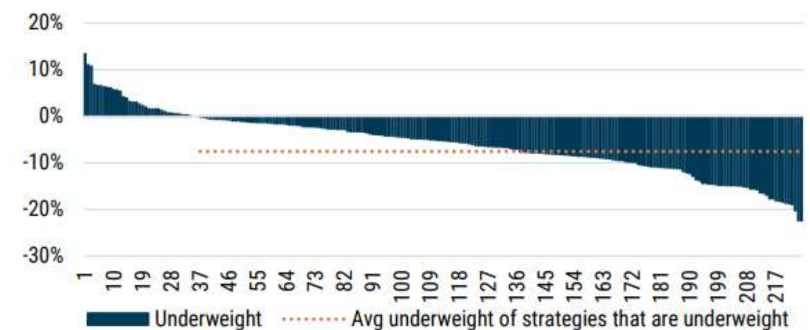
There was little reason for investors to care about buying Japanese stocks during decades past. Japan had weaker relative fundamentals and was reluctant to carry out corporate reforms during most of the 1990s and 2000s.

This is now changing in a meaningful way. Improving fundamentals and governance reforms (which are even encouraged by the Tokyo Stock Exchange) are increasingly hard to ignore. Policymakers continue to push for more competitive and capital-efficient companies, resulting in strong EPS growth and increasing distributions of excess capital.

And yet, most international equity strategies seem to not care as they remain materially underweight Japanese equities. Of 225 actively-managed strategies in the eVestment database, listing the MSCI EAFE (DM ex-US) as their benchmark, 84% are underweight Japan by an average of 7.5% as the chart indicates.

We take this as an additional positive for our constructive stance on Japanese Equities and reiterate our OVERWEIGHT rating.

MSCI EAFE ACTIVE MANAGER OVER/UNDERWEIGHTS TO JAPAN (BY STRATEGY)



Source: eVestment / Data as at 30/06/2023

Emerging Markets (i)

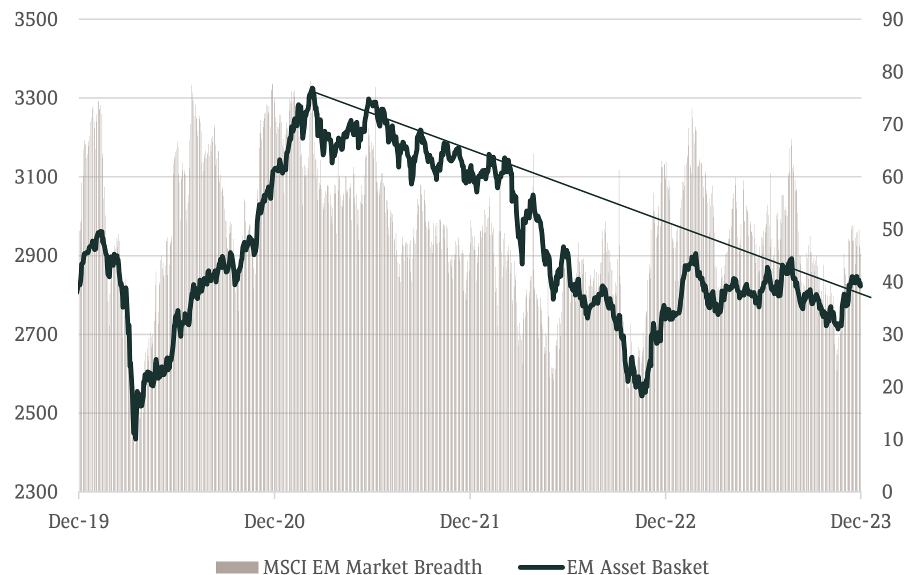
INFLECTION POINT?

Something seems to have happened after the Fed extended its "pause" to 4 months of no change. When looking at the price action in emerging market assets (stocks, bonds, FX) it increasingly looks like the market has made its mind up: the Fed is done.

This is good news, as the key catalyst for Emerging Markets is going to be the Fed. Only when the market truly believes that the Fed has finished its hiking cycle, we will most likely witness the strongest possible upside catalyst for EM assets.

Only then will the market care once again about the strong valuation case for Emerging Market assets, the extreme pessimism on EM (big outflows, light allocations, general bearishness), and the fact that EM central banks as a group have begun to clearly pivot towards rate cuts. Keep in mind how fast the market turned in October 2022 on vague hopes of inflation peaking!

The line in the chart is showing the equally-weighted prices of EM equities, EM local currency bonds and a basket of EM currencies vs. the dollar. The shaded area is a combination of breadth indicators for EM equites. As shown, asset prices started to recover and are looking to break a long-term down trend. This is happening as breadth among EM equities is increasing.



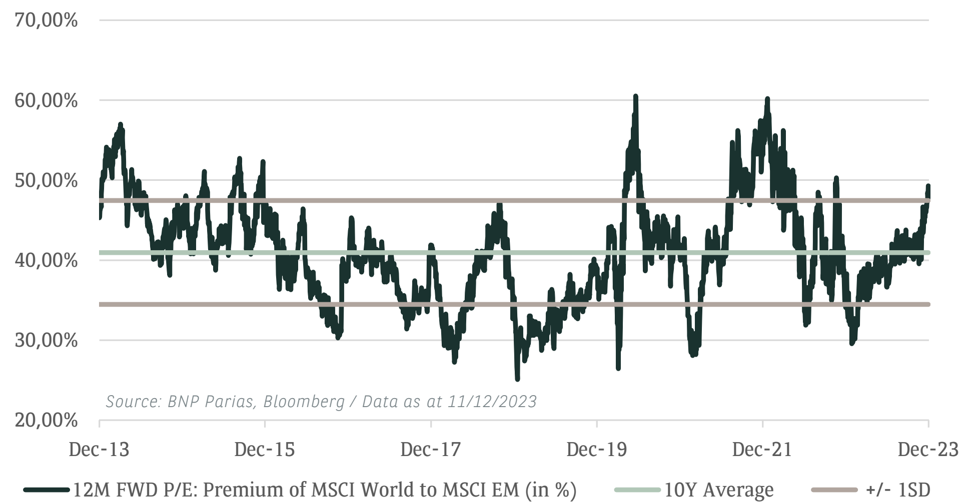
Source: BNP Paribas, Bloomberg / Data as at 10/12/2023

Emerging Markets (ii)

A HISTORIC UNDERPERFORMANCE LEAVES EM EQUITIES LOOKING CHEAP VS DM EQUITIES

A 14% YTD outperformance has pushed DM equites to a 22Y relative high in USD terms

The rally leaves DM equities trading at a 47% PE premium to EM, 1 standard deviation above the 10Y average



Asian Equities view

CHINA AUTHORITIES TO RAMP UP PROPERTY MEASURES

Asian Equities Rebounded As Dollar & Yields Declined

ASIA COUNTRY PREFERENCE

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

- Asian equity markets had a strong month in November (except for China A-shares), thanks to a decline in US yields and the greenback from peak levels.
- Sentiment on China remains weak despite newsflow that China authorities will ramp up support to the property developers, including a list of 50 developers eligible for a raft of financing, and the authorities may allow financial institutions to offer unsecured short-term loans to qualified developers for the first time.
- However, the key for any meaningful and sustainable improvement in Chinese developers' liquidity situation is a property sales recovery, which will require the revival of domestic confidence.
- Next to watch in China: the Central Economic Work conference in mid-December that will set the economic policy direction for 2024. We will be watching to see if some stronger and coordinated fiscal, monetary and housing stimulus will be announced after the meeting.

ASIAN EQUITIES REMAIN SENSITIVE TO USD & US YIELDS

		1-month (%)	YTD (%)	2022 (%)	Forward PE (x)	Trailing PB (x)	Dividend Yield (%) 2023f	EPS Growth (%) 2023f	EPS Growth (%) 2024f	ROE (%) 2023f
	Asia Ex-Japan	6.8	0.2	-21.5	12.1	1.5	3.0	0.2	20.8	9.9
North Asia	China	2.8	-9.7	-22.4	9.5	1.3	3.6	13.7	15.5	10.4
North Asia	China A-shares	-1.5	-9.1	-21.6	11.9	1.9	3.1	12.7	14.0	11.6
North Asia	Hong Kong	2.5	-19.8	-7.8	11.7	0.9	4.2	2.6	12.7	6.6
North Asia	South Korea	10.4	16.2	-26.4	10.8	1.0	2.2	-34.0	68.5	6.0
North Asia	Taiwan	8.5	21.9	-24.7	15.1	2.4	3.4	-19.4	18.5	13.9
South Asia	India	5.3	10.0	1.6	19.8	3.7	1.3	23.0	13.6	14.5
South Asia	Indonesia	3.7	-1.6	10.4	13.1	2.2	5.0	35.6	8.3	14.6
South Asia	Malaysia	0.2	-3.7	-4.3	13.4	1.4	4.0	8.5	8.4	9.1
South Asia	Philippines	7.1	-1.4	-7.3	11.4	1.7	2.2	24.2	9.1	12.7
South Asia	Singapore	0.7	-5.0	4.4	11.3	1.3	5.3	39.8	1.9	10.0
South Asia	Thailand	0.7	-14.8	6.3	15.8	1.7	2.8	-15.4	16.4	8.3

Source: Datastream, BNP Paribas (WM) as at 29 Nov 2023

Sector Allocations – Overview

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

- **No changes this month**
- **Our EU Tech upgrade was extremely well timed as the sector rallied ~ 17% since the upgrade.**
- **Other key calls (EU Real Estate & EU Utilities) are also working well while Energy is lagging.**
  - We provide an updated view on those sectors within the new "Thoughts and Convictions" section on the next page.

Sector Allocations – analysis and convictions

Overall view on Equities	Region	Sector / Style in Focus	View	Comments
+	Global (+)	Energy	+	The sector suffered from the recent correction in oil prices, which we deem temporarily though. Our mid-term outlook remains bullish as demand growth seems to be underestimated. The expected rebound toward the USD85-95 range should provide some tailwinds. Valuations are cheap. e.g. in the US the sectors' relative P/E valuation vs. the S&P 500 has ranked in the 5th percentile since 1990.
		Materials	+	The Materials sector was unable to withstand the price correction in many metals. With the US being more likely to narrowly miss a recession, PMIs should start to recover sooner which should help metals. More demand support is expected from the energy transition. Thus, we especially like exposure to those metals/miners (e.g. copper miners).
		Healthcare/ Biotech	+	The sector is currently experiencing some notably dispersion which is mainly driven by the impact of anti-obesity drugs (AOM). While certain companies have soared on the back of extremely positive assumptions regarding the AOM total addressable market (TAM), others have suffered as their TAM is expected to shrink on the back of an overall improved health. We consider this as overdone and would expect a correction as demographic trends continue to point to structural growth for the entire sector.
		Consumer Staples	-	We expect ongoing margin headwinds as input costs have gone up. At the same time consumers are still suffering from higher interest rates/inflation and are thus trading down, i.e. buying less expensive brands.
	US (=)	Technology	=	The Technology sector is still heavily dominated by too expensive mega cap names. We prefer to look at subsectors with structural growth trends such as Cybersecurity and Semiconductors.
	Europe (+)	Technology	+	The majority of European Software companies are active in the application layer of the AI value chain. We expect growing demand as AI enables users to overcome traditional software limitations when it comes to process automation. This potential does not seem to be fully priced in.
		Utilities	+	The sector experienced relative strength during the last earnings season which led to some upgrades in FY23 guidance. The sector's earnings revisions are second only to Banks with relative EPS revisions at a 4-year high. Valuations vs. the market have normalised and recently hit a ~20-year low versus the rest of the defensive universe. Utilities are also amongst the biggest beneficiaries of lower government bond yields.
		Real Estate	+	Despite the recent rally, EU Real Estate is still trading > 40% below both its pre- and post COVID highs. Valuations are still looking cheap, and we see room for recent asset price writedowns to reverse. Keep in mind that the sector was trading at a price/book ratio of ~ 1 during 2010 - 2020, while today it is only 0.66. Due to structural trends (lacklustre new building activity, demographics etc.) we´re especially constructive on residential RE. Otherwise, we like Logistics and Data Centres while being a bit more cautious on Offices and Retail RE.

Risen from the ashes

EUROPEAN BANKS SHOW A STRONG COMEBACK VS US PEERS – STILL LOOKING CHEAP THOUGH

Due to the high weighting of Banks in Europe, the region's relative performance vs. the US has historically been closely linked to the wellbeing of the financial sector. Over the past 15 months, the tide has turned. European banks, driven by improving interest income prospects thanks to rising rates, have massively outperformed their US peers. Despite the outperformance of EU banks, it is worth noting that they are still the second-cheapest sector vs. history in Europe compared with US peers, trading over 2 standard deviations below the 10 year average of the 12M FWD P/E ratio.

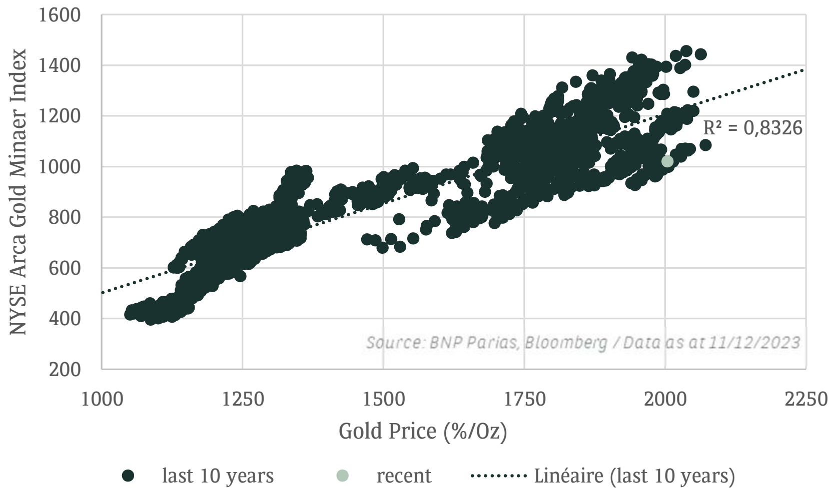
A golden opportunity?

GOLD MINERS HAVE NOT YET FULLY REFLECTED THE RECENT RISE OF GOLD

Gold has recently hit a new all-time high. While gold has risen by 12% during the last year, gold miners have only gained a mere 3.25%.

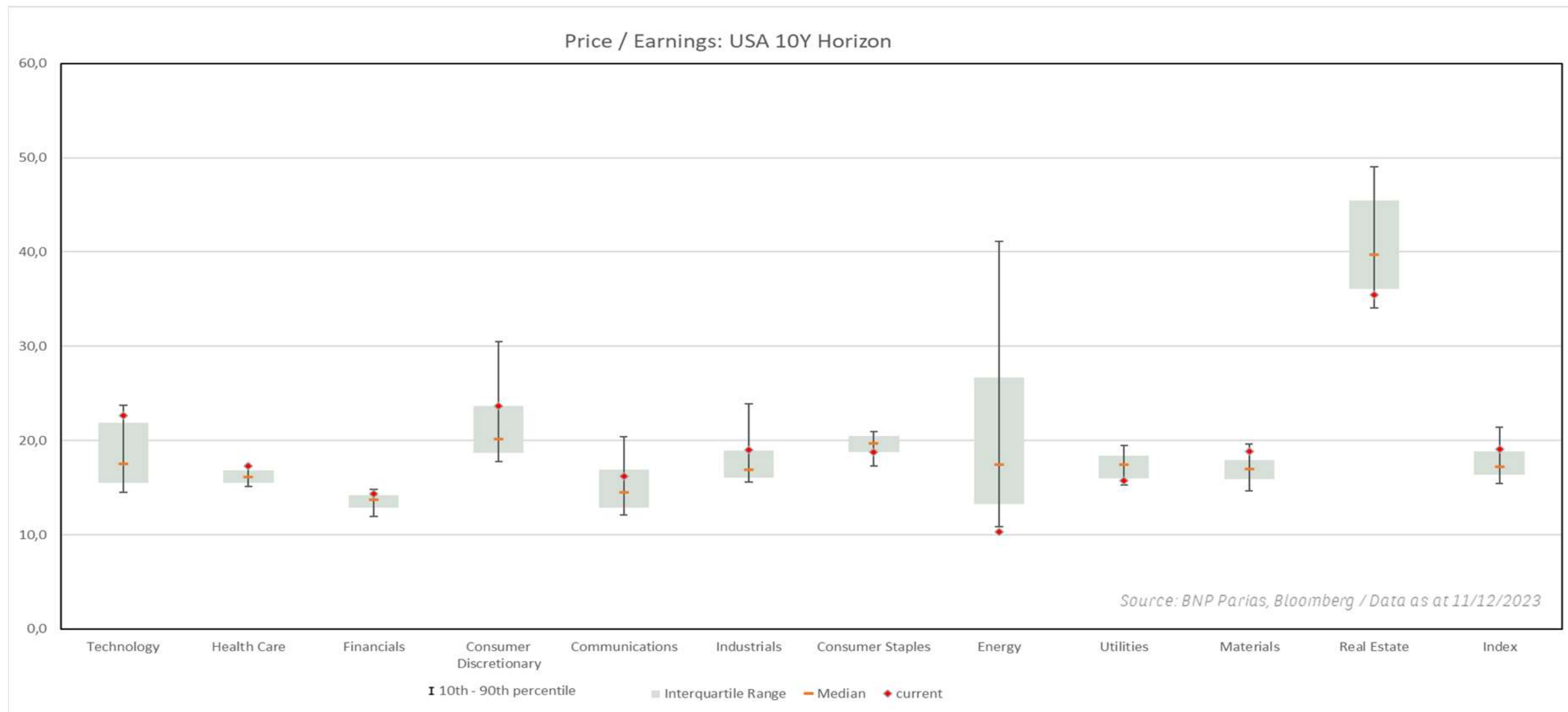
Higher gold prices though should lift earnings of gold miners, eventually providing some tailwinds for the respective stocks. During the last 10 years, the price of gold was a reliable determiner for the price of gold miners.

Based on this relationship, the current level of gold is showing at least 10% upside (see lhs graph). It's also worth noting that gold miners have traded substantially higher in the past whenever gold has traded at elevated levels (see rhs graph).



Valuations - US

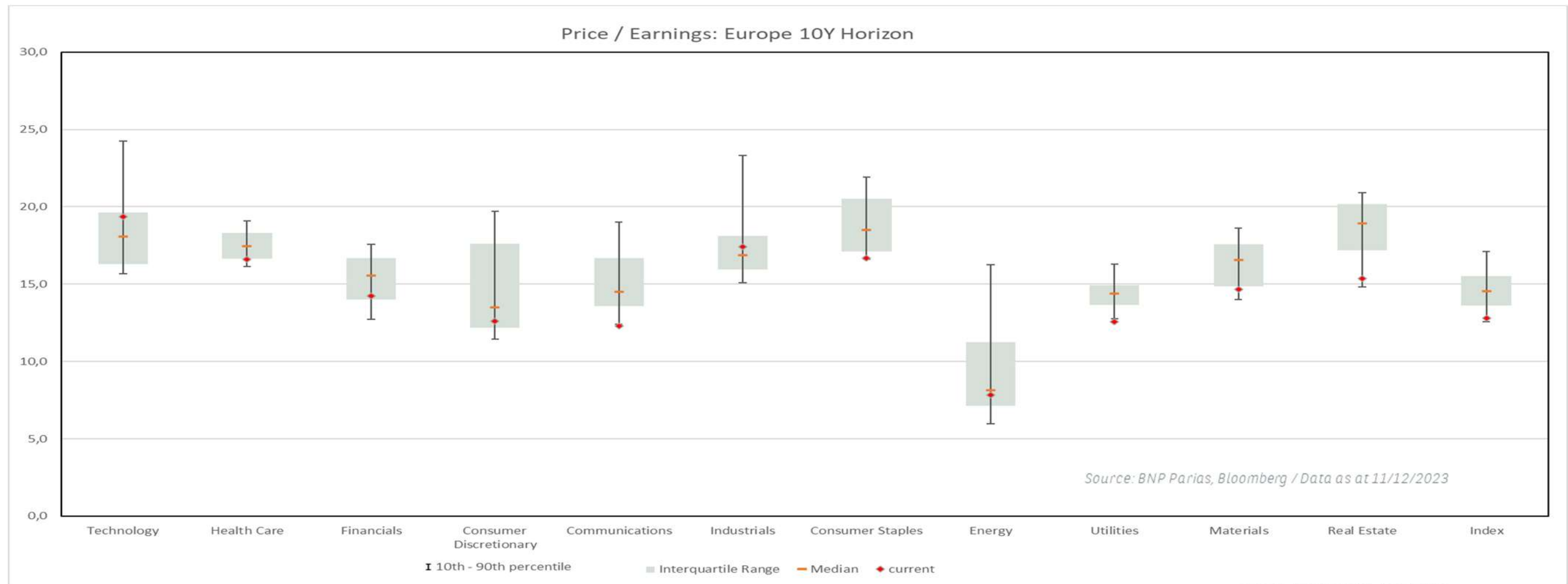
MOST OF THE SECTORS IN THE US ARE AT THE TOP OR EVEN ABOVE THEIR 90TH PERCENTILE



Source: BNP Paribas, Bloomberg

Valuations - EU

EUROPEAN SECTORS CONTINUE TO SCREEN CHEAP VS HISTORY ACROSS THE BOARD



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