INDOSUEZ
WEALTH MANAGEMENT

GLOBAL OUTLOOK 2024

SEARCHING FOR A NEW INFLATION REGIME

Architects of Wealth

• Searching for a new inflation regime

Global Outlook 2024

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01 | Editorial

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Chief Investment Officer

SEARCHING FOR A NEW INFLATION REGIME

Dear Reader,

2022 was a year of shocks on inflation and central banks' interest rates, and while 2023 has seen volatility in bonds, the year has been marked by the unexpected resilience of the US economy. A US recession seemed inevitable as the Federal Reserve (Fed) engineered the fastest tightening cycle in four decades. The US GDP forecast for 2023 stood at 0.3% in January and is likely to end at 2.3% for the year. Throughout, we never fell into the pessimistic camp, moving from a mild contraction to a stabilisation of growth around 1.2% for 2024. The US consumer, thanks to excess savings, wage growth above inflation and a very supportive employment market, remained very resilient throughout the year.

TOWARDS A NEW EQUILIBRIUM

After the Great Financial Crisis of 2008, an era of low inflation, low to negative interest rates, and predictable central bank policy opened and seemed to last forever. To quote German economist Rüdiger Dornbusch: "In economics things take longer to happen than you think they will, and then they happen faster than you thought they could". The brutal adjustment that took place after the COVID-19 crisis saw a massive return of inflation and central banks rushing to combat this abrupt transition they had not seen coming. This led to an astonishing 520 rate hikes throughout the world in the last 24 months.

Amidst these changes, the biggest victim in financial markets for the third year running has been the bond market. US Treasuries, especially long dated bonds, have become risky assets whose price return characteristics suddenly look like equities. For example, the financial instrument TLT tracking 20 year Treasuries has lost more than half of its value since 2020. A government bond issued in 2020 by Austria with 100-year maturity and a 0.75% coupon, lost as much as 70% in 2023.

However, this represents a great investment opportunity. Fixed income now offers much needed attractive yields. Investors have channelled large amounts of money to take advantage of this situation: the TLT mentioned above saw its assets doubled over the same timeframe. However, the medium part of the curve around five years remains a sweet spot of attractive yield and lower price volatility.

THE ONE TRILLION COST

Looking towards 2024, the massive amount of government debt will become a focal point of attention. At the time of writing, the US is running a deficit close to USD 34 trillion, costing it USD 1 trillion a year or 14% of the Federal budget[1]. This is clearly not sustainable, and interest rates will soon find a ceiling, if they have not found one already. While the notion of a form of protection for equity investors through the so called "Fed put", a new form of a Fed put this time on bonds might emerge. Whether it takes the form of Quantitative Easing (QE), Yield Curve Control (YCC) like in Japan, or emergency intervention like the Bank of England in 2022, central banks are never short of options, especially when it comes to stabilising financial markets.

The disinflation process is under way, but it won't be linear. A return to low inflation is out of the picture, as institutions would prefer a continual fine dose of inflation.

This is an inconvenient truth that central banks often avoid publicising. Indeed, "engineering a higher nominal GDP growth through a higher structural level of inflation is a proven way to get rid of high levels of debt", according to market strategist Russell Nappier. Governments will have to engineer a level of nominal growth and of inflation that is consistently somewhat higher than interest rates in order to shrink the debt to GDP ratio. Since mid-2020, US nominal GDP growth has gone up by 40%. This also explains why developed market equities, especially in the US, have continued to perform well, as margins remain resilient and companies' sales are tracking inflation, thus growing on a nominal basis and offering some form of inflation insulation. In essence, we have to move away from high inflation, avoid stagflation, and reach a reflation regime.

This is the topic we will cover in this Global Outlook edition with our experts. Understanding the implications of a new inflation (and growth) regime, which is set to reshape strategic asset allocation, wherein both bonds and equities settle into a healthier balance after years of zero interest rates.

A last word on Environmental, Social and Governance (ESG). The needs of the energy transition have never been more relevant, as "2023 is virtually certain to be the warmest year on record"[2]. Sustainable finance, however, is under attack as performances on many sustainable solutions have disappointed. "ESG bashing" is becoming more commonplace, but we should avoid falling too deeply in the pessimistic camp. Indeed, climate inaction would be twice as costly as the investments needed to make the transition to carbon neutrality by 2050. This offers a clear and compelling investment opportunity.

I hope you will enjoy reading this special edition.

1 - Understanding the National Debt | US Treasury Fiscal Data: https://fiscaldata.treasury.gov/americas-finance-guide/national-debt/
2 - Copernicus: October 2023 - Exceptional temperature anomalies; 2023 virtually certain to be warmest year on record: https://climate.copernicus.eu/copernicus-october-2023-exceptional-temperature-anomalies-2023-virtually-certain-be-warmest-year

02 | Key messages

Delphine DI PIZIO TIGER
Global Head of Asset Management

FOCUS

Searching for a new inflation regime

- Higher inflation regime. Inflation descent is confirmed but supply and demand factors suggest higher structural levels compared to the past, where inflation will remain above central banks' targets. Greenflation is exerting upward pressure on inflation, counterbalanced by the increase in the use of Artificial Intelligence (AI), which could contribute to improved productivity and hence lower prices.
- Bonds are back. Bonds are becoming, once again, an asset class offering a return that is not only positive, but also potentially higher than inflation. Credit markets deliver value, especially in the investment grade category. With a real yield of 2%, inflation-linked bonds offer a good carry and a hedge against higher inflation or lower-than-expected growth.
- For equities, earnings can continue to grow as they benefit from resilient margins in a world of higher nominal growth.

FIXED INCOME

This time it's for real

- The Federal Reserve (Fed) to maintain positive real rates. As core inflation comes down further, lower short-term rates will follow. The Fed is unlikely to maintain real policy rate above 2% which means three or four cuts in 2024.
- The European Central Bank (ECB) dilemma: on the one hand, decelerating inflation but still above the 2% target and on the other hand, weak growth with some countries close to recession. The rate cycle has reached its peak, normalisation can start later in 2024 but at a slower pace than the Fed.
- Debt sustainability will become a hot topic in 2024, but as far as interest charges are concerned, two thirds of 2024 refinancing needs are already in the form of Treasury bills, with the treasury paying an interest rate of around 5.4%.
- Investment grade as the "sweet spot". We are constructive on high quality issuers as investors allocate more into fixed income thanks to higher rates.

EQUITIES

A new cycle of opportunities for equities

- We remain constructive on equities for 2024.
- Three key themes: AI, energy transition and deglobalisation. AI will remain a megatrend led by the "Magnificent 7" due to their immunity to rising rates, substantial cash reserves and huge investment in research and development (R&D). A decrease in interest rates would represent an opportunity to increase exposure to Green Transition thematic. Industrial and manufacturing domains could benefit from deglobalisation.
- US dominance to continue. Key players in AI and more broadly the Growth companies are mainly in the US, which should continue to drive the earnings growth over the next years. The Euro Area is global cycle Value play which could prove attractive in case of a rebound in global activity. Preference for broader approach on Emerging Markets, especially Asia, excluding China, look attractive for 2024.

FOREX

The dollar king could bend, but will not break

- A shallow depreciation. We expect the dollar to depreciate slightly in 2024, as lower federal interest rates and a weak global economy may favour high-beta currencies.
- The euro could regain some colours. Avoiding a recession in Europe will fuel risk appetite for the euro.
- Gold, buy on dips. The inflationary environment and higher real rates are major headwinds for gold, but strong support remains, led by the Fed normalisation and central bank demand.
- No major change expected for JPY. As the Bank of Japan will very gradually adjust its monetary policy.

SUSTAINABLE FINANCE

Inaction is not an option

- Greenflation. The energy transition requires massive investment in new technologies and infrastructure, and could lead to green inflation in the short-term.
- Inaction is not an option. By 2070, the cost of climate inaction will be two times more than the investments needed to make the transition to carbon neutrality by 2050.
- Environmental, Social, and Governance (ESG) offers opportunities for 2024. After a difficult year for the global energy transition sector, the headwinds are beginning to fade. Investors have begun to discount the impact of rising interest rates. Valuations are once again attractive with investment opportunities in areas such as clean transport, renewable energies and environmental technologies.

PRIVATE MARKETS

Entering a new cycle

- Not all managers are created equal. A new environment of higher inflation and rates should emphasise differentiation between investment managers on their ability to generate value through operational improvements rather than through financial engineering.
- 2024: a new set of opportunities. Private Equity funds will benefit from attractive entry prices into what we believe will be a buyer's market. Large pools of small and medium-sized companies will remain a very attractive segment. Distressed credit and structured capital strategies will be attractive ways to play the private credit market, which should benefit from the current environment.
- Leveraging on its long-term vision, away from public market volatility, we strongly believe the asset class carries the tools to continue to deliver outperformance.

MACRO ECONOMICS

On the road to equilibrium

- Soft landing in 2024. We expect the US and the Euro Area to grow at below potential growth level, avoiding a recession. The disinflation process should continue with inflation ending the year just above central banks' targets. Developed economies will benefit from a continued improvement in household real incomes.
- Asia driving global growth. Slowdown in property market continues to weigh on Chinese economic outlook, with a growth set to remain below its historical norms. India should be buoyed by positive demographics, reform *momentum* and reduced sensitivity to external shocks. Smaller Asian economies could recover in 2024, benefiting from the recovery in the global manufacturing cycle and the continued normalisation in tourism.
- Risks to watch. An increasingly polarised world with a proliferation of geopolitical tensions present risks especially on the energy front. The presidential elections in the US and the potential comeback of Donald Trump could exacerbate these risks. Government debt sustainability will also be a focus of attention, notably in Europe.

ALLOCATION 2024

Navigating in calmer seas

- More constructive on equities. Higher growth/inflation profile than over the past decade will be more favourable to corporate earnings. We maintain our preference for US equities. Despite attractive valuation we remain cautious on Euro Area equities. We reduced our conviction in China at the end of 2023 by reallocating to broader Emerging Markets exposure.
- Opportunities in Emerging Markets. Given the positive growth differential compared to developed economies, Emerging Markets look attractive on both debt and equities, but a diversified approach must prevail as assessing the country specific risk premium is becoming more challenging.
- Seize the yield. The rise in long rates over the last two years offers attractive entry points. We prefer being exposed to short-term sovereign debt, which need to be supplemented by good quality corporate bonds.
- Yield is once again a positive factor in performance. Cash is not an alternative, as it underperforms short-term bonds over the long-term.

03 | Focus

INFLATION AND THE LONG-TERM INVESTOR

Nicolas MOUGEOT
Head of Investment Strategy
& Sustainability

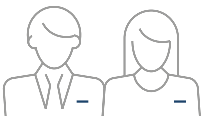
Yasser TALBI
Fixed Income
Portfolio Manager

Inflation has reshaped not only the economy but also the investment landscape. Nicolas Mougeot and Yasser Talbi discuss whether inflation is here to stay, what further actions could be undertaken by central banks and how this could affect investment choices in the longer run.

THE PAST TWO YEARS HAVE BEEN MARKED BY HIGHER INFLATION. IS IT TRANSITORY?

Yasser Talbi: Since the pandemic, supply chain issues, fiscal spending first coupled with accommodative monetary policy followed by a more open stance despite a higher policy rate, all helped fuel the inflation dynamics. Even after the supply chain normalisation, fiscal support helped nominal spending and thus nominal growth. A less rate sensitive economy muted some of the central bank efforts to cool demand. This particular set up created a positive wealth shock that keeps supporting the US consumer (Chart 1).

Wage growth has also played a part in this dynamic. According to the Atlanta Federal Reserve (Fed) wage growth tracker, it is still hovering around 5%. While we are seeing signs of normalisation of the US labour market, workers in some industries are still obtaining further wage increases thanks to strikes.



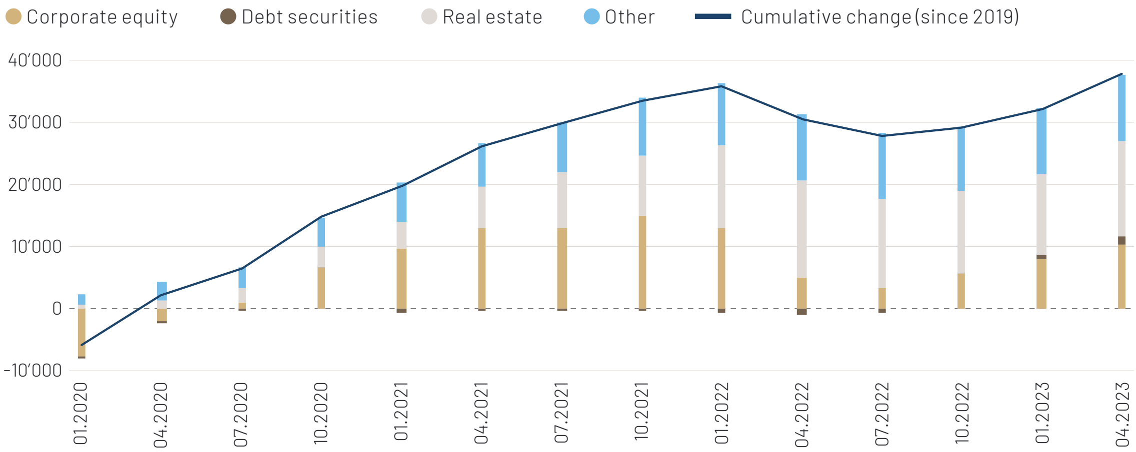
5%:
WAGE GROWTH
remains high
in the US

In the long run, supply and demand factors seem to point to inflation staying above central banks' targets and being more volatile than in the past. The current disinflation dynamic will bring us close to the target in 2024. Can it stay there?

Nicolas Mougeot: We also need to account for long-term forces that affect prices such as deglobalisation, greenflation[3] and innovation. First, trade globalisation has grown since the Uruguay Round which led to the creation of the World Trade Organisation (WTO) in 1994. Indeed, it helped companies in developed countries to push prices lower by delocalising goods manufacturing to developing countries. The "reshoring" topic emerged in 2020 as COVID-19 crisis highlighted the limitations of a globalised economy. However, the jury is still out on whether we are truly moving towards a deglobalisation trend: if exchanges have stalled between the US and China, India's exports to US have actually boomed post-COVID.

If we see a multi-polarisation of the world rather than significant reshoring, this could limit the long-term inflationary pressure that would be created by weaker global exchanges.

CHART 1: CUMULATIVE CHANGE IN HOUSEHOLD NET WORTH BY QUARTER, USD, BILLION



Source: Bloomberg, Indosuez Wealth Management.

3 - Refers to a rise in prices of raw materials and energy as a result of the green transition.

Could AI be the X-FACTOR for inflation?

Second, as discussed in our "Greenflation and opportunities" section (page 22), the energy transition could temporarily bring higher energy prices as the world adapts to the switch from fossil to renewable energies. However, this so-called greenflation could be tempered by a third and major deflationary factor, innovation. Major innovations have always brought in higher productivity and thus lower prices. 2023 was marked by the rise of Artificial Intelligence (AI), with ChatGPT showing how impactful AI could be in improving productivity. Yet, historically, the impact of innovation has taken years to materialise. Will AI's impact manifest more suddenly than that of cars and telephones in the previous century? Potentially, as its adoption has been much faster than any other new technology in the past, with some experts predicting it could add USD 15 trillion to global GDP by 2030.

WHAT ARE THE IMPLICATIONS FOR INVESTORS?

NM: Despite their poor 2022 performance, equities have so far withstood inflation relatively well. A chief reason for their endurance is that earnings are in nominal terms giving companies the ability to adjust shareholder returns (dividend and buyback) upwardly as inflation goes up. This is true as long as inflation does not spiral: CEOs and investors alike prefer predictable cash-flows and predictability gets tougher as inflation gets higher and more volatile.

YT: As for the bond market, the recent repricing in the second half of 2023, especially on the long end helped rebuild a risk premium buffer in the asset class, usually referred to as Term Premia. Inflation was not the driver this time. Continued issuance of long-term debt by the US treasury will likely help keep that premium higher than the last decade while also pressuring other risk premiums in the market.

A stronger nominal growth, larger deficits and a positive disinflation dynamic contributed to higher real rates in the US. Real yields are the yield on inflation linked bonds. Their performance is made of inflation accrual, coupon payments and the change in real yield if the security is not held to maturity. These bonds have suffered due to their duration component, but we believe that a real yield above 2% provides a compelling yield for medium-term investors, good carry and protection in case of lower than expected growth or higher inflation.

Another segment of the fixed income market that provides value is the credit market. Even though credit spreads are not at their widest, in the investment grade market they provide a buffer against government bonds, a lower correlation to equities and lower volatility.

HIGHER BOND YIELD implies HIGHER EXPECTED RETURNS for balanced portfolios

NM: Higher inflation could reshape strategic asset allocation. For years, many investors over-allocated into risky assets as it was the only option to obtain positive return in an environment characterised by zero interest rate. The fact that cash and bonds are once again becoming an asset class paying a return that is not only positive but also potentially above inflation could reshuffle investor's long-term allocation. As shown by Chart 2, higher bond yields have increased the expected return of a 60% equity/40% bond US portfolio by almost 2% *per annum*. We should therefore see institutional investors such as pension funds and insurance companies re-allocating into fixed income.

Another factor in favour of bonds is that they should regain the macro-hedging characteristics they lost these past few years. First, as inflation rose, both bonds and equity prices fell. But at current yield levels, bonds could provide a strong hedge against an economic slowdown or a recession which would force central banks to lower interest rates.

WILL ALTERNATIVE STILL PLAY A ROLE IN GLOBAL ASSET ALLOCATION?

NM: The short answer is yes. Alternative investments, from private equity to infrastructure or real estate, will still bring a desirable diversification but may face various impacts from higher rates and inflation. While higher interest rates are currently negatively impacting real estate's valuation, infrastructure may offer an attractive solution for investors seeking an inflation hedge as infrastructure's cash-flows are usually tied to inflation. Furthermore, the liquidity premium that those alternative investments can offer could also rise as some investors are shifting back to more liquid solutions given the higher bond yields. Patience is a virtue: there should therefore be some attractive investment opportunities across the alternative spectrum for those investors who can wait.

CHART 2: USD 60-40 LONG-TERM EXPECTED RETURNS, %

Note: Expected return in the next 10-year period in USD of a 60% Equity-40% bond portfolio. Equity returns proxied by S&P 500's earnings yield + 2% (as long-term inflation proxy) and bond returns proxied by the yield of the Bloomberg US Corporate Total Return Value Unhedged USD Index.

Source: Bloomberg, Indosuez Wealth Management.

2024: THE YEAR OF BONDS, THIS TIME IT'S FOR REAL

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The fixed income market has proven volatile in 2023, with higher yields and spreads tightening. By March, a banking crisis unfolded, and fears of the 2008 meltdown resurfaces. The US recession was a done deal. None of those negative outcomes realised. Looking into 2024, higher yields cushion the investment horizon for the fixed income investor. Falling rates and mild spreads predict decent performances in 2024.

CENTRAL BANKS

Is Quantitative Tightening (QT) here to stay in the US? Can the European Central Bank (ECB) afford to reduce its balance sheet?

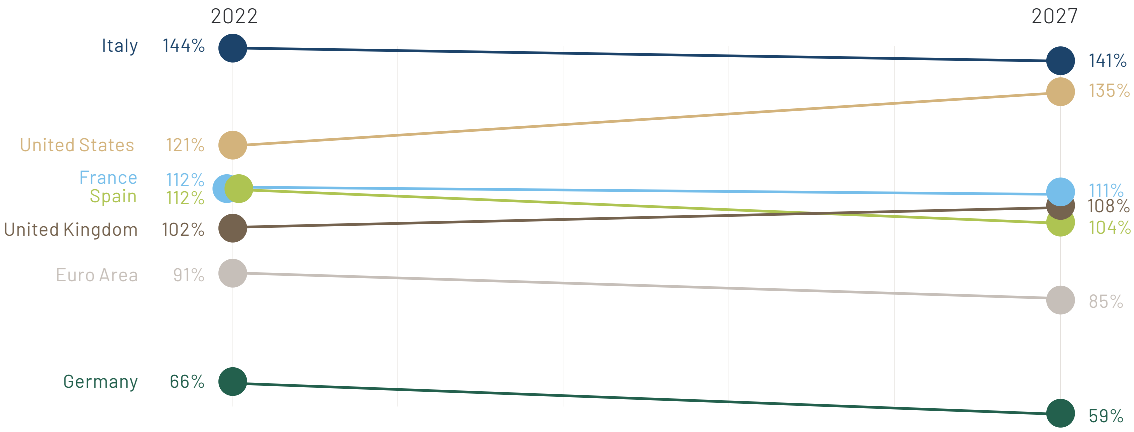
The Federal Reserve (Fed) manages both the cost of money and a portion of the liquidity in the financial system. The pace of reduction, or QT of its balance sheet, takes into account the Reverse Repo (reverse repurchase agreement) amount. According to a research paper[4] published by the Richmond Fed, it will take two years to normalise the Fed's balance sheet. Hence, QT is here to stay but there are many options on their side to smooth financial conditions if needed.

As for Fed funds, the Fed intends to maintain positive real policy rates along the yield curve. Mechanically, if core inflation comes down further, lower short-term rates will follow, as the Fed is unlikely to maintain areal policy rate above 2% which means three or four cuts in 2024. However, any durable cutting cycle will depend on a recession unfolding.

In Europe, the ECB faces a dilemma: on the one hand, a decelerating inflation that remains above the 2% target and on the other hand, weak growth with some countries close to recession. The level of public debt (Chart 3) in several countries plays an important role as well. Most of us remember the sovereign crisis in the early 2010s, when the debt/GDP ratios ended up below the actual levels except for Greece.

Indeed, the ECB wants to avoid the "redenomination risk"[5] rhetoric. The only tool at its disposal is its balance sheet, or the Transmission Protection Instrument (TPI) on which no information has yet been disclosed. The window to reduce the holdings at a rapid pace is closing.

CHART 3: PUBLIC DEBT, % OF GDP



Source: Amundi, Indosuez Wealth Management.

4 - Fed Balance Sheet Normalization and the Minimum Level of Ample Reserves: https://www.richmondfed.org/publications/research/economic_brief/2023/eb_23-07
5 - Redenomination is the recalibration of a country's currency, typically due to hyperinflation and currency devaluation, whereby an old currency is exchanged for a new one at a fixed rate.

US federal deficit expected at
USD 1.8 TRILLION
in 2024

The rate cycle has reached its peak and has weighed on economic activity as most financing is done via the banking channel in Europe. Strong disinflation opens up room for the ECB to cut rates in 2024 but disparities in inflation between countries, coupled with the ECB reaction function uncertainty, lead us to anticipate an initial cut later in 2024. With an adverse scenario of an earlier cut, much more in line with central banks historical behaviour.

REAL RATES: FINALLY HIGHER

We must again differentiate between Europe and the US to examine real rates.

In Europe, the growth outlook stands far below its potential. Elevated total debt (public and private) and a worsening demographic picture compound this, which means real rates must stay close to 0%.

In the US, however, real rates stick to the long-term growth potential (Chart 4). Since the pandemic, many have argued that the neutral rate[6] is higher than in the past 15 years due to the fiscal impulse. Is the fiscal trajectory sustainable? Probably not, but it is hard to imagine the government would halt spending leading up to a presidential election year.

What about debt sustainability? It will surely become a heated issue, but the rise in interest expense will not sharply affect the budget, as two-thirds of next year's refinancing needs are already in Treasury Bills with the treasury paying interest around 5.4%.

INVESTMENT IMPLICATIONS

The US yield curve has been inverted since mid-2022 due to both an aggressive tightening by the Fed and a market starved for duration as the US treasury refinanced its deficit with bills. A normalisation is a central scenario for 2024, as short-term rates will benefit from the gradual loosening in the Fed's policy, and long-term rates are already at their long-term fair value as described above.

In this context, the curve inversion in the absence of recession is the only argument to refrain from being fully invested on the fixed income market, especially on the long part of the curve. On the other side of the coin, largely positive real rates, with a potential for capital gains on a weakening economy both support holding or increasing your investments in this asset class. Inflation linked bonds in the US also provide a compelling case for medium-term investors.

CHART 4: 5-YEAR US REAL YIELD, %

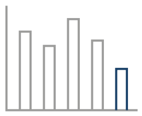
Source: Bloomberg, Indosuez Wealth Management.

6 - The neutral rate is the short-term interest rate that would prevail when the economy is at full employment and stable inflation: the rate at which monetary policy is neither contractionary nor expansionary.

CREDIT

2023 has been a good year for credit markets with positive excess returns across the board. It even outperformed equities on a risk-adjusted basis.

We look towards 2024 with a similar view as 2023: constructive on high quality issuers as investors allocate more into fixed income thanks to higher rates. Despite a gentle deterioration in fundamentals and ratings, we still anticipate some spread compression in high quality credit. However, less so on the high yield (HY) market, even though defaults will stay contained.



Fewer new issues expected in 2024

Investment grade (IG) credit is in the sweet spot as a gradual debt refinancing wave will weigh on the weaker and more cyclical segments of the high yield market. Spreads may drift a touch wider on recession risks, but this will be more than offset by strong carry, lower government bond volatility and lower yields. Net supply will be very low (EUR 11 billion according to J.P. Morgan forecasts), as issuers have limited new funding requirements. The HY market was the unexpected star performer in 2023, and returns in 2024 should remain healthy thanks to a high carry, while defaults will stay within their historical range. Spreads will price in more recession risk, but low prices limit the downside risk for the well-managed balance sheets of this riskier segment.

The asset class provides diversified portfolios high carry, high expected returns and de-correlated investments thanks to higher yields. Hence, this is a must-have in a well-balanced global portfolio.

EMERGING MARKETS: NOT ONLY A CHINA STORY?

After a decade of poor returns, one might be surprised to hear that one of the top performing fixed income markets since the start of the Fed hiking cycle has been Emerging Markets (EM) local currency debt (+8.6% since 17.03.2022)[7]. Special plaudits go to local bonds denominated in Brazilian real and Mexican peso which have delivered returns of +28% and +27% respectively. This outperformance is even more impressive when you consider that the 10-year US Treasury yield has surged from 2.2% to 4.6% and US investment grade credit has lost nearly 10% over the same period.

What changed? Long story short, credibility and carry matter. This time most EM central banks started hiking interest rates well before their Developed Market (DM) counterparts to combat inflation. For example, in Brazil, the central bank hiked from 2% in 2020 to 13.75% by early 2023 and Mexico hiked from 4% to 11.25%. Throw in some improvements in the balance of payments plus an investment boom in parts of Latin America from the "near-shoring" of US supply chains, and you have the recipe for a strong rebound in the asset class.

The key question is: can this *momentum* continue? On this, we want to paint a more balanced picture. On the one hand, interest rate cutting cycles have already started in numerous EM economies and the interest rate differential versus the US dollar has compressed from the highs. Asia local bonds in particular offer little premium over developed markets and are clearly more exposed to a slowing Chinese economy. On the other hand, if we do end up in a world with higher US nominal growth then certain local currency markets in Latin America are worth a closer look – especially those with orthodox central banks that are still offering real yields[8] in excess of 5% - such as Brazil, Mexico and Colombia. Moreover, stretched US dollar valuations combined with historically large fiscal deficits outside of a recession could also provide some optimism for EM investors.

We also find selective opportunities in hard currency EM corporate bonds from the larger EM countries like Brazil, Mexico, Colombia, Chile, Indonesia and India. In particular, we look for the "hidden gems" – companies that are dominant in their respective markets with rock-solid capital structures. These are companies that would be rated several notches higher if they were domiciled in developed markets and pay a hefty yield premium due to their postcode.

7 - J.P. Morgan GBI-EM Diversified Unhedged - JGENDVUL Index.
8 - Real yield = central bank rate minus anticipated inflation.

A NEW CYCLE OF OPPORTUNITIES

Nicolas GAZIN
Global Head of Equity Solutions

Laura Corrieras
Equity Portfolio Manager

The economy has evolved in unexpected and unusual ways in 2023. Despite a significant 525 basis points (bps)[9] increase in rates by the Federal Reserve (Fed) since March 2022 in response to soaring inflation, the US Gross Domestic Product (GDP) demonstrated solid resilience and the equity markets returned overall positive performance. However, inflation above 3% with rising interest rates are historically not positive for equities.

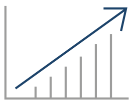
Why and how can equity markets benefit from a new regime of higher growth/inflation?

EQUITY MARKETS

We can gather that currently elevated levels of inflation and growth are attributed in part to past stimulus measures and pandemic recovery. However, this also reflects structural shifts in the economy. Two conflicting forces are at play: inflationary pressures supported by the energy transition and deglobalisation trends, set against deflationary pressures from the Capital Expenditure (CapEx) boom and AI development in the long run.

This clash could support economic growth cyclically and suggests a possible inflection point towards a more reflationary environment than we have seen since the financial crisis. This environment is positive for equities as long as inflation remains under control (the best scenario for equities is inflation between 2% and 3%).

Nevertheless, this scenario also implies that the neutral rate of interest could be higher than in the past. This would force investors to be more selective in stock picking and should favour the future leaders of these long-term secular trends that will shape the next decade.



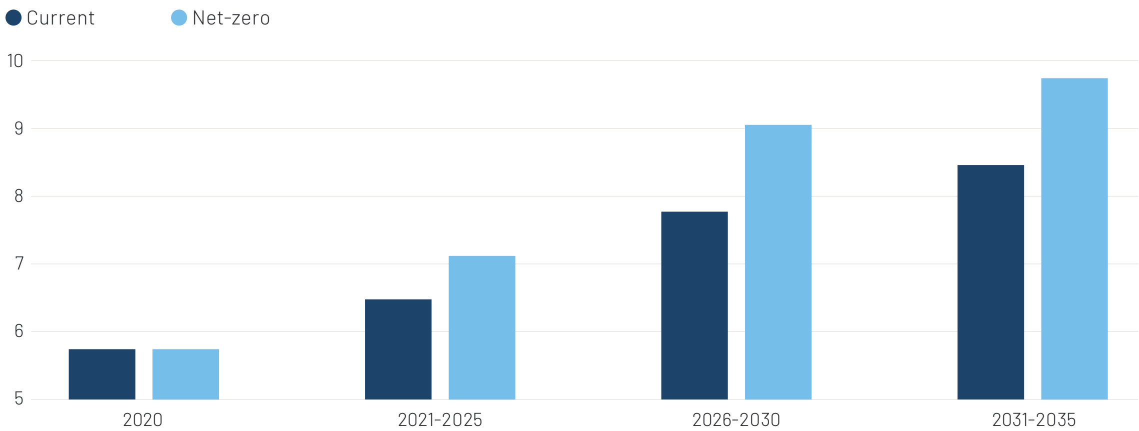
Additional
USD 17 TRILLION
of global investments through 2035

WHO ARE THE FUTURE WINNERS OF THESE MEGATRENDS?

GREEN ENERGY TRANSITION

The energy transition necessitates an additional USD 17 trillion of global investments through 2035 (Chart 5) to meet the Paris Accord net-zero requirements, which might boost GDP and increase inflation before any productivity benefits materialise.

CHART 5: ESTIMATED GLOBAL INVESTMENT REQUIRED TO REACH GOALS, ANNUAL SPENDING, USD TRILLION



Source: McKinsey, Indosuez Wealth Management.

9 - Fed Funds Rates jumped from 0.25% in March 2022 to 5.5% in November 2023.

While the long-term trend in this sector is undeniable, the short-term landscape presents challenges given the level of interest rates. The entire sector grapples with fears regarding financing needs and project returns appear less attractive, resulting in profit-taking on renewable players.

However, we are probably close to a market bottom with an excess of outflows, as valuations are now more rationale and many government plans, such as the Inflation Reduction Act (IRA) in the United States, support long-term growth of renewable companies. Despite short-term headwinds, we remain positive on the transition towards a low-carbon economy. If interest rates were to fall in 2024, this would be a good opportunity to increase the exposure on key sub-segments such as renewable and alternative energy, resources efficiency, electrical vehicles or clean tech.

7

MAGNIFICENT 7:
immune to rising interest rates

SECURITY AND DEGLOBALISATION

A multi-polar world argues for spending to de-risk access to critical resources and securing supply chain.

The aftermath of the COVID-19 crisis and geopolitical uncertainties has spurred initiatives of reshoring, nearshoring, and deglobalisation. As the geopolitical context is becoming more strained (Ukraine/Russia, US/China, Middle East), states are likely to increase their military spending.

These initiatives coupled with significant investments and tax-cut plans may have inflationary effects in the short run. In the US for example, the CHIPS Act[10] was passed to support semiconductor production through a USD 52.7 billion envelope for companies relocating production or ordering from US manufacturers.

This deglobalisation trend can be observed in all sectors, from healthcare (repatriation of the production of certain drugs) to aerospace and defence (the industrial sovereignty is at stake). Therefore, numerous sectors stand to benefit significantly from these strategic investments, particularly within industrial and manufacturing domains, encompassing areas such as research and consulting services, electronic equipment or cybersecurity among others.

ARTIFICIAL INTELLIGENCE (AI)

The confluence of factors such as a constrained labour supply and a decade of insufficient investments require companies to raise their CapEx, especially in technology.

The AI race is on!

According to certain studies, approximately two-thirds of existing jobs face exposure to some degree of AI automation, and generative AI could substitute up to a quarter of current work. Potential productivity gains and labour market impacts are huge.

PricewaterhouseCoopers estimates that AI will enhance GDP by 26.1% in China and 14.5% in North America by 2030, constituting nearly 70% of the global impact.

We all know the biggest players in AI, the “Magnificent 7”[11]: Microsoft, Alphabet, Amazon, leaders in cloud computing; Nvidia in graphics processing units (GPUs); or Meta for its database.

This situation is particularly advantageous for growth companies more broadly, endowed with substantial cash reserves (Chart 6, page 19) that generate more interest income given higher yields. These actors can invest in research and development (R&D) to stay ahead of the competition without the need for financing. They are immune to rising interest rates and are winners in every way.

There are also many other actors essential to the AI chain, and others whose business areas stand to be rattled by AI. Intuitively, generative AI will benefit the IT sector and especially software companies and semiconductors, but there are plenty of opportunities for transformation in FinTech, life sciences, robotisation, communication and transportation, notably autonomous cars with Tesla’ supercomputer Dojo.

10 - The CHIPS Act is a US federal law that provides funding and incentives to increase domestic semiconductor production and research.
11 - The “Magnificent 7”: Apple, Alphabet, Microsoft, Amazon, Meta, Tesla and Nvidia.

IMPLICATIONS FOR EQUITIES

We are probably now entering a new cycle. Some structural megatrends and the changing mix of policy require large investments spending, lifting growth structurally and supporting inflation levels.

This scenario could likely benefit US companies. Firstly, the key players in AI are centred in the United States, which should continue to drive the earnings growth over the next years (for 2024 the earnings-per-share (EPS) growth of the "Magnificent 7" is forecast at +21%, double that of the S&P 500). Moreover, most of Growth companies are cash rich, the longer refinancing rates stay higher, the greater their cash-generating capacity. And counter-intuitively a high rate environment favours Growth stocks which have better credit ratings and lower debt levels than cyclicals.

In Europe, equities are very attractive in terms of valuation, and continue to trade at a record discount to US ones. The Euro Area is a global cycle Value play with a cyclical bias, and could outperform in 2024 if we see an inflexion point in growth leading indicators such as the Purchasing Managers' Index (PMI). Among Value, energy segment is both a hedge in case of deterioration of the geopolitical environment and inflation resurgence.

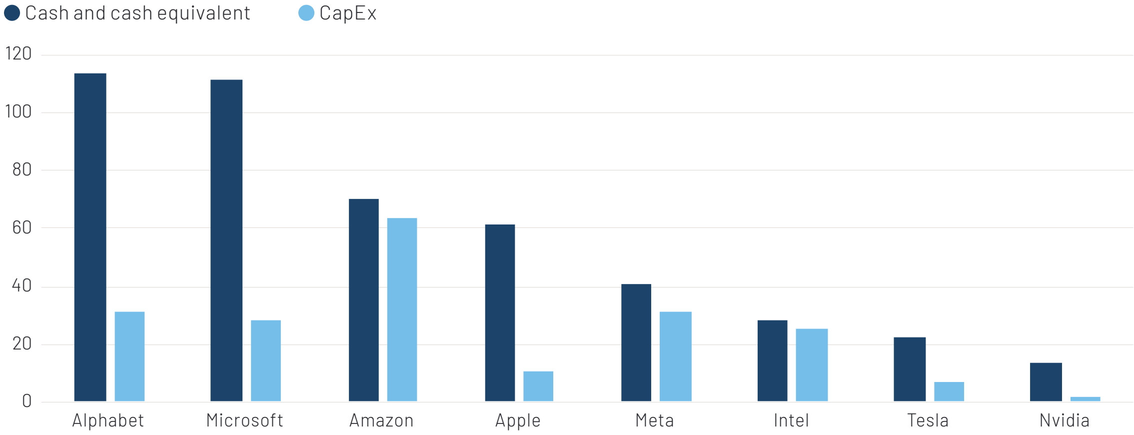
In China, the medium-term outlook is more balanced. Concerns remain significant, with the lack of confidence by private sector, the insufficient domestic demand and stress in real estate continuing. However, Chinese authorities have recently accelerated the stimulus measures (monetary easing and support to the property sector), which could boost consumer confidence and support the economy. Thus, we remain constructive on the platform economy and electrical vehicles sectors in China that look attractive at this point.

We prefer to have a broader approach on Emerging Markets (EM) rather than a strong focus on China.

Asia, excluding China, looks attractive for 2024 given receding risks in the US (lower inflation) and a weaker US dollar which should be positive for Asian markets. Technology leaders from Taiwan and South Korea are essential to the global AI supply chain. Domestic demand and infrastructure plays in India appear as attractive themes as well as a growing middle class and young population in ASEAN (Association of Southeast Asian Nations). Asia remains a high economic growth area at discounted valuations.

Lastly, a scenario of sustained growth with contained inflation is positive for equities. Investment boom and secular trends should support earnings growth over the next decade, and our experts may identify the future winners of this decade of transformation.

CHART 6: CASH AND CAPEX OF US MEGA CAP, USD BILLION



Note: Alphabet have more than USD 110 billion in net cash (it's more than SANOFI's market capitalisation) which generated over USD 3.4 billion of interest income the last year and could return more in 2023 and beyond.

Source: Bloomberg, Indosuez Wealth Management.

THE DOLLAR'S CHALLENGERS ARE EXPECTED IN THE ARENA

Muriel ABOUD SCHIRMANN
Head of Active Advisory

Maxime GARCIA
Investment Strategist

2023 was marked by the resilience of the dollar and the outperformance of the Swiss franc, the safe-haven "par excellence", while the euro continued its timid recovery. For 2024, a soft landing coupled with a structurally higher inflation regime could well redraw the contours of the foreign exchange market.

USD

The dollar king could bend, but will not break

As far as the dollar is concerned, history has taught us that the early stages of a reflationary environment, if accompanied by a strong and robust economic recovery, lead to an appreciation of the dollar. This was the story of 2022. In 2023, the US economy continued to surprise with its resilience, leading investors to push back their expectations of the end of the Federal Reserve's (Fed) tightening cycle, thereby supporting the greenback. We also note that, in the longer-term, when inflation is well managed by the Fed in periods of reflation (and we believe it is), the impact on the dollar is relatively neutral. Indeed, we are less bearish on the world's reserve currency and do not foresee a sharp depreciation in the first half of the year, since a soft landing would once again prompt investors to postpone their optimistic rate cut expectations, further supporting the currency. However, we still expect the Fed to cut rates in mid-2024, and as the global economy is set for a soft landing, appetite for the high-yielding safe-haven dollar could wane in favour of higher-beta, riskier currencies in the second part of the year. Consequently, we would not be surprised to see a slight depreciation throughout the year.

EUR

More steam to come?

The outperformance of the US economy in 2023 and the "higher for longer" mantra have weighed on the euro. Nevertheless, we believe that the European economy will recover from the energy shock and regain a better balance with the rest of the world, with our growth scenario in line with market consensus, which should slowly support the currency's recovery. We also do not subscribe to the market's scenario of 100 bps of cuts in 2024. This should be a positive driver for the euro through 2024. Still, we do not deny that certain risks remain, in particular if macroeconomic dynamics fail to meet consensus, in which case investor appetite for the single currency would remain sluggish.

GOLD

Buy on dips

An environment of higher inflation can be positive for gold, as investors seek to preserve their wealth and protect their purchasing power. Nevertheless, the opportunity cost of holding the yellow metal, which is a non-yielding asset, is affected by rising real interest rates. As a result, gold's upside potential is limited, at least until the major central banks begin to normalise the pace of their monetary policy and real interest rates start to fall.

However, the conflict in the Middle East reminds us of the appeal of gold's safe-haven status. In addition, the demand from central banks to diversify their foreign exchange reserves should continue to be a supportive factor: in the first nine months of 2023, they have bought 800 tonnes of gold (Chart 7), +14% year-on-year (according to the World Gold Council report).

CHF

Between floor and ceiling

The Swiss franc remains an attractive hedge, as it could outperform if the macroeconomic and geopolitical risks materialise. It also benefits from the Swiss National Bank's (SNB) willingness to intervene in the foreign exchange market, with a central bank reducing its USD and EUR foreign exchange reserves, which represents a ceiling on the price of EUR/CHF. However, its valuation is close to its all-time highs against the euro and the dollar, which somewhat limits its upside potential. We also note that the currency currently has a negative carry, acting as a floor for EUR/CHF and USD/CHF, at least until the European Central Bank (ECB) and Fed cut rates. Finally, the appetite for CHF as a safe-haven asset may well diminish if we do indeed avoid a recession in the Euro Area, in line with our scenario.

This argument is also reinforced by our analysis of past reflationary episodes, where the yen and the Swiss franc tend to underperform to the extent that investment flows are directed towards regions with better growth prospects and higher interest rates.

JPY

No major change expected

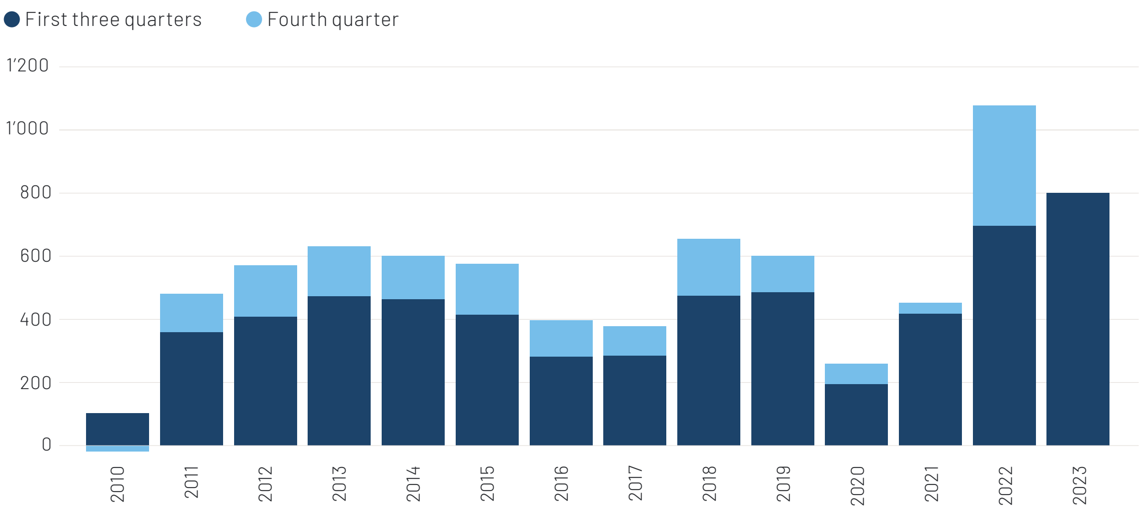
The yen continues to be penalised by its rate differential with the other major economies. On the one hand, a Bank of Japan intervention could well be on the cards as we continue to close in on historic lows. On the other hand, with the government's tax cut aimed at pulling Japan completely out of deflation coming into effect in June 2024, the Bank of Japan will likely not change its policies on the premise that the economy has exited from deflation beforehand. We therefore expect minor and incremental changes to the Bank of Japan monetary policy. While reflationary episodes are generally unfavourable for the yen, a level close to historic lows and an interest rate differential that will gradually reduce as the Fed normalises its policy could support the yen, particularly during the second semester of 2024.

AUD

China business cycle matters less

Finally, the reflationary environment tends to benefit major commodity exporters, such as the Australian dollar, as higher commodity prices boost trade balances and economic performance. We also note that Australia will be a key country in the global energy transition due to its large metal reserves. Consequently, greenflation should be a positive driver for the Australian dollar.

CHART 7: CENTRAL BANKS HAVE ANOTHER COLOSSAL YEAR OF BUYING GOLD, TONNES



Source: Metals Focus, Refinitiv GFMS, World Gold Council, Indosuez Wealth Management.

GREENFLATION AND OPPORTUNITIES

Fabrice DE SOUSA
Portfolio Manager

Inflation has been a key concern for investors, economists and consumers in recent years. We all know that monetary policies or supply and demand shocks affect it. The climate and energy transition, as a crucial response to climate change, is reshaping the global economy and creating a new phenomenon: greenflation.

Is the transition from fossil fuels to more sustainable energy driving inflation? What about the cost of inaction? Does the impact of rising interest rates question the investment opportunities associated with this energy transition?

NEW environmental STANDARDS require MASSIVE INVESTMENTS

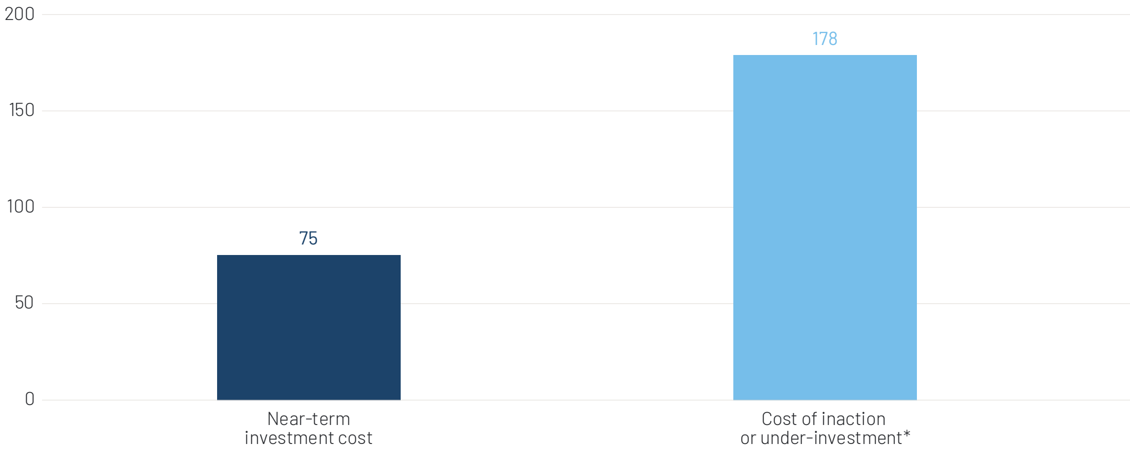
INFLATION AND ENERGY TRANSITION

The energy transition involves a shift from fossil fuels to cleaner and renewable energy sources, as well as more sustainable production practices. This change requires massive investment in new technologies and infrastructures to modernise and adapt the existing frameworks around new environmental standards. Developments related to the energy transition, for example, through the development of wind farms, solar power stations or smart grids, require significant investments, increasing production costs in these sectors. This will automatically drive up the costs of renewable energy in the short-term.

The amount of capital required to develop renewable energies increases their sensitivity to interest rates volatility (a key factor in calculating project profitability), delaying the adoption of clean technologies and slowing down investment in decarbonisation. In addition, existing fossil fuel power plants have years of life ahead of them. Early decommissioning of these power plants for the energy transition could result in a global loss estimated at USD 1'400 billion, directly impacting energy bills for consumers.

Furthermore, the growing demand for green technologies is putting pressure on raw materials, such as rare metals used in batteries or solar panels, which cause high price volatility.

CHART 8: ESTIMATED COSTS OF UNMITIGATED CLIMATE CHANGE BETWEEN 2023-2070, USD TRILLION



*Estimated value of global costs of climate change effects like extreme heat, weather disasters, and rising sea levels across all sectors.

Source: BofA Global Research, Deloitte: Wood Mackenzie, Indosuez Wealth Management.

47%
MORE
investments in solar and wind projects in 2023

IS INACTION AN OPTION?

Faced with these colossal financing requirements to ensure the energy transition and their impacts on prices and therefore on inflation, the question that is immediately asked is: 'What if we do nothing?' According to some studies, by 2070, the cost of climate inaction, especially by the increase of natural disasters, will be two times more than the investments needed to make the transition to carbon neutrality by 2050 (Chart 8, page 22).

ENERGY TRANSITION PROVIDES OPPORTUNITIES

Despite the announcement of ambitious investment plans, such as the European Green Deal[12] and the Inflation Reduction Act (IRA) in the United States, companies linked to renewable energies have posted chaotic stock market returns in the second half of 2023, affected in particular by the increase in interest rates. Does this mean that this investment theme no longer offers opportunities?

The answer is clearly no.

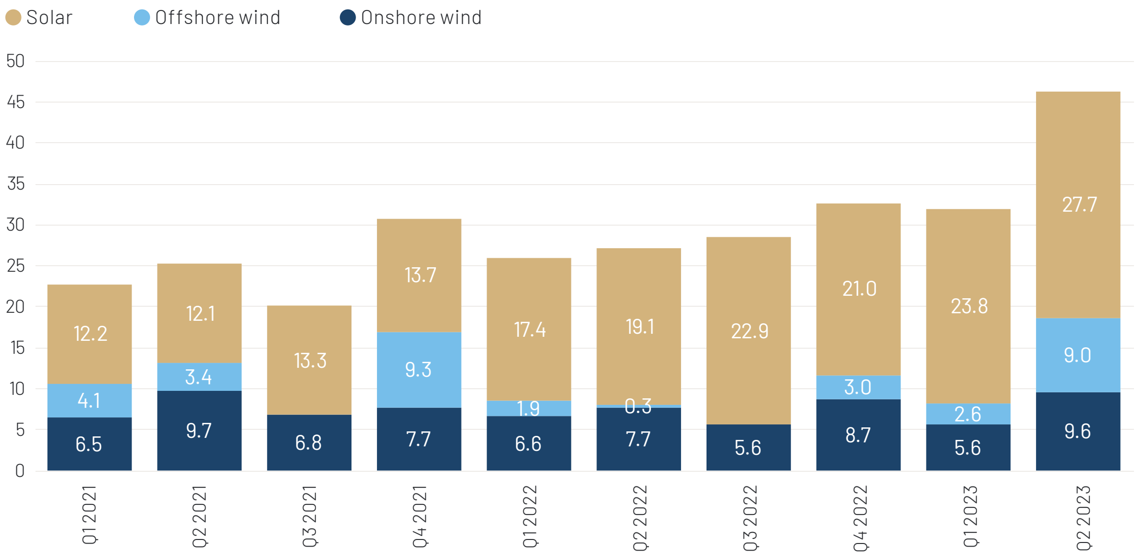
Despite these challenges, the climate and energy transition is not an option. It is crucial to reduce greenhouse gas emissions and promote sustainability. Moreover, in a world beset by geopolitical tensions, energy independence is becoming a national security issue.

Investments in new solar and wind projects in Europe, the Middle East and Africa (Chart 9) reached USD 78 billion in the first half of 2023, 47% higher than in the same period last year. The main drivers of this impressive growth are the continued development of solar projects in the region, particularly in Spain, and onshore wind power plants.

If renewable energy growth rates are impressive in Europe, they are even more so in China. If we compare the first six months of 2023 with the first half of 2022, the pace of installations in China has more than doubled. According to BloombergNEF estimates, 413GW of new solar power capacity should be installed worldwide in 2023, largely thanks to China, which alone accounts for more than the rest of the world (58% of new capacity).

As mentioned above, cost increases, supply chain issues, monetary tightening and interest rate hikes have had a significant impact on the renewables sector. For example, at the end of October the S&P Global Clean Energy Index had lost -34% since the beginning of 2023 (in USD, total return). Today, the valuations of companies linked to this thematic came back to attractive levels, especially at the dawn of the huge investment plans being deployed to finance this transition.

CHART 9: ESTIMATED INVESTMENTS IN NEW SOLAR AND WIND PROJECTS IN EMEA, USD BILLION



Note: The chart includes disclosed and undisclosed values. Multipliers are used to estimate the value of a deal that is captured in our asset finance database but for which the monetary value is not disclosed. It is estimated using either recent averages or CapEx figures within the Levelised Cost of Electricity tableau tool. EMEA stands for Europe, Middle East and Africa.

Source: BloombergNEF, Indosuez Wealth Management.

12 - The main goal of the European Green Deal is Climate neutrality by the year of 2050 (decarbonise their energy system by aiming to achieve net-zero greenhouse gas emissions by 2050).

Moreover, the main headwind for this theme is now fading. Investors have largely discounted the impact of rising rates on valuations of renewable energy companies. Over 2024, we are anticipating an inflexion in US monetary policy.

Valuations are once again attractive, rate cuts are looming and massive investments to finance the energy transition will provide real supports to the theme and offer clear investment opportunities for investors. Below are a few areas to watch (not exhaustive):

Renewable energy
Solar, wind and hydro energies are growing fast and lie at the heart of the energy transition.

Energy Storage
Energy storage systems, such as batteries, are an essential link in optimising the benefits of renewable energies, which are intermittent by nature.

Clean transport
Electric vehicles (EV) and sustainable mobility solutions are expanding rapidly. Carmakers focusing on EV and charging infrastructure are benefiting from the electrification.

Energy efficiency
Reducing energy consumption is a priority. This transition to greater sobriety necessarily involves companies offering solutions to improve energy efficiency in buildings and industries.

Environmental Technologies
Companies developing technologies for decarbonisation, recycling and water management are also potential investment candidates.

CONCLUSION

The climate and energy transition may lead to greenflation in the short-term due to high initial costs. However, the costs of inaction in the long-term would be much higher than the short-term investments needed to achieve the net-zero objectives. In addition, the energy transition represents a major opportunity for investors aware of the long-term challenges and benefits. By investing in companies and sectors related to climate transition, investors can not only contribute to the global effort to fight climate change, but also benefit from potential financial returns as the world moves towards a cleaner and more sustainable future.

ARE PRIVATE MARKETS ENTERING A NEW CYCLE?

Remy POMATHIOS
Head of Private Markets Investments

Matthieu ROUMAGNAC
Head of Real Assets Investments

Private Markets have become an asset class of their own covering investments into Private Equity, Private Credit, Private Real Estate and Private Infrastructure. Democratisation of the asset class and the rise of interest rates are reshaping the industry while confirming that not all managers are created equal.

2023 FUNDRAISING is expected to be down **~20% VS. 2022**

LOWER VOLUMES SUPPORT THE FLIGHT TO QUALITY

In 2023, Private Markets' fundraising was severely hit after several record years (Chart 10), on the back of a reduction of distributions inherent to a muted Mergers and Acquisitions (M&A) market and a somewhat cautious attitude of investors towards the asset class.

Distributions returned to investors by Private Markets funds experienced a sharp drop since Q3 2022 as the volume of M&A transactions plummeted. Buyers and sellers have indeed been struggling to reach agreements on price given the continuous rise of the cost of capital and the lack of visibility on the macroeconomic environment. Similar to the 2020 COVID-19 period, we witnessed a significant flight to quality as only the very best assets changed hands.

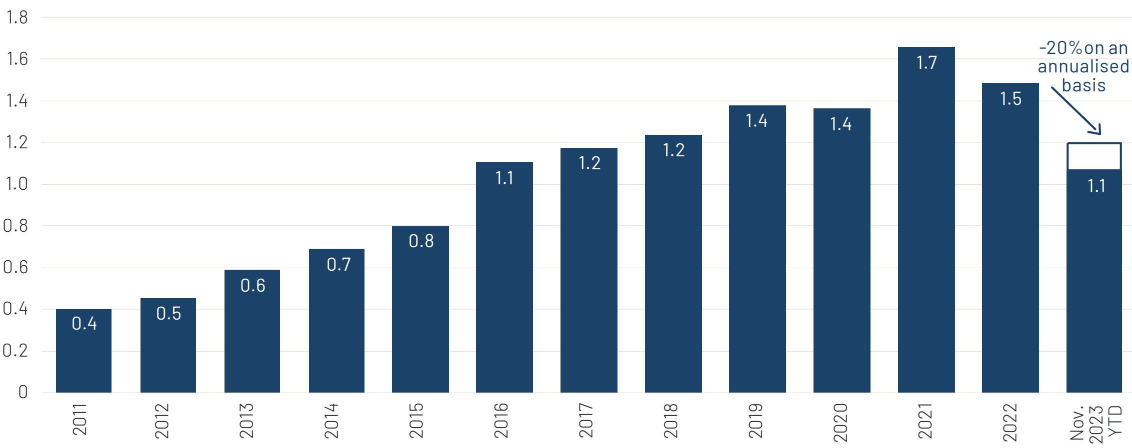
OPERATIONAL TRANSFORMATION IS CENTRAL AGAIN

2023 has also been a turning point for Private Markets as sticky inflation and higher-for-longer interest rates set the foundation for what appears as the "new normal" in the macroeconomic environment.

Over the longer-term, we believe that this new environment could benefit Private Markets investors, as it will differentiate investment managers on their ability to generate value through operational improvements rather than through financial engineering.

As such, selectivity is more important than ever in the Private Markets industry. With private assets facing an increasing number of transformational challenges, notably in the digital and environmental fields, we are strongly convinced that only the managers with deep operational involvement will continue to deliver superior returns.

CHART 10: GLOBAL PRIVATE MARKETS CAPITAL RAISED, USD TRILLION



Source: Preqin Database November 2023, Indosuez Wealth Management.

PRIVATE MARKETS, AN INDUSTRY COMING TO MATURITY

We trust that the most experienced and sophisticated Private Markets managers, with proven operational expertise, will benefit disproportionately from the new paradigm, concentrating fundraising power as well as privileged access to transactions. In our view, a solid investment team is no longer enough and must now be complemented by resources dedicated to support portfolio companies in the implementation of operational initiatives in order to drive value creation.

Therefore, in what could turn into a winner-takes-all scenario, we anticipate a continued acceleration in the consolidation of Private Markets managers. Takeover of managers by larger peers have already started, with several material transactions that occurred in 2023. The consolidation trend is in its initial phase as the asset class will grow further, fuelled by new types of investors including high-net-worth individuals.

2024, A NEW SET OF OPPORTUNITIES?

On the Private Equity side, we see encouraging signs on the M&A market with deal activity regaining *momentum* in Q3 2023. We anticipate transactions to gradually come back in 2024, supporting a recovery in volume of distributions to investors.

We believe that the overall downward adjustment of entry valuations could accelerate throughout 2024 as excessively delayed exits will have to materialise with fund managers under pressure to return capital to their Limited Partners[13].

As such, we are convinced that Private Equity funds will benefit in 2024 from attractive entry prices in what we believe will be a buyers' market.

In our view, the large reservoir of small-and-medium sized companies will remain a very attractive segment, as these businesses are often more agile and offer a large diversity of value creation levers, while being less dependent on financial markets to generate an exit.

On the private credit side, we observed a strong acceleration in the capital raised in the last 18 months on the back of increasing interest rates.

Investors will, however, have to remain cautious and selective as we believe defaults rates could increase significantly in the next two years due to increased pressure to meet interest coverage ratios.

As a complement to direct lending strategies, we believe distressed credit and structured capital strategies will be attractive ways to play the private credit market, which should benefit from the current environment.

13 - A limited partnership is a form of partnership in which some of the partners contribute only financially and are liable only to the extent of the amount of money that they have invested.

Finally, for infrastructure assets, investments are expected to benefit further from the global funding gap to finance the energy transition and digitalisation of society. We perceive sustained inflation as a clear driver of performance in the years to come, particularly in the real assets space.

After more than fifteen years of low rates and negligible inflation, Private Markets are entering a new chapter. As the economy transforms across the board, with challenges ahead well beyond the impact of higher cost of debt or long-term inflation, so does the Private Markets industry.

Leveraging on its long-term vision, away from public markets volatility, we strongly believe the asset class carries the tools to continue to deliver outperformance.

REAL ESTATE HIGHLIGHTS

Valuation decreases of 10% to 20% on average are at play for over 12 months now, having impacted investment volumes by close to 40% in 2023. Inflation-linked rental growth in 2023 is expected to stabilise in 2024.

The tighter credit conditions and increasing cost of debt are accelerating the downtrend which may continue until mid-2024 opening compelling opportunities for contrarian opportunistic buyers.

However, some sectors have remained resilient and in particular:

- Hotels and "operating assets" having fully recovered versus pre-pandemic years and are being driven by a strong demand/supply imbalance in Europe.
- Retail has shown relative resilience and has continued to provide solid returns.
- Luxury real estate had little impact from the interest rates movement.

As interest rates seem to approach their peak we foresee the following sub-markets to progressively recover and in particular logistics and prime green offices in CBD (Central Business District) areas with low vacancy rates. Residential assets remain a long-term investment play with robust fundamentals.

04 | Macro Economics

ON THE ROAD TO EQUILIBRIUM

Lucas MERIC
Investment Strategist

Despite the recessionary fears that surrounded it for a time, 2023 has ultimately been a year of resilience for the developed economies in the face of the drastic tightening orchestrated by the central banks since 2022. On a very positive note, this resilience was accompanied by strong disinflation, putting the global economy on track for a probable soft landing in 2024.

GLOBAL ECONOMY IS ON TRACK FOR A SOFT LANDING IN 2024

This soft landing can be explained by the normalisation of the major post-pandemic imbalances that have fuelled the disinflation dynamic. In particular, this rebalancing has largely taken place in the goods market, with a marked improvement in supplier delivery times, an adjustment in the labour market without massive job destruction, and a normalisation of the housing component in the United States. Although much of the disinflationary movement has already taken place, we expect it to continue into 2024. Our scenario is illustrated by developed economies that are expected to grow below their potential but without falling into recession, and inflation in the US and Euro Area that will end the year just above the central banks' targets.

INFLATION TO END 2024 just above central bank's targets

In the United States, we expect growth to slow at the start of the year before rising moderately towards its potential growth level in 2025. A recession has been avoided, thanks in particular to the strength of the US consumer, buoyed by continuing gains in purchasing power and with more solid financial balance sheets than before the pandemic. In addition, households and businesses were able to lock-in very attractive rates before the first rate hikes in 2022, justifying relatively low effective rates today (average mortgage interest rate paid being equal to 3.7% while new mortgage rate is at 7.9%). In addition, our expectations of rate cuts by the Federal Reserve (Fed) starting in mid-year 2024 should help to mitigate refinancing risks.

MAJOR HEADWINDS should recede for the Euro Area in 2024

After a year of weak but resilient growth in 2023, the Euro Area should not lag the US in terms of growth in 2024 as much as last year (Table 1). Households will benefit from stronger gains in real income while, unlike their American counterparts, they will still benefit from substantial precautionary savings, which could provide a support to consumption dynamics (Chart 11). At the same time, two major headwinds are set to recede in 2024: the drag from monetary tightening is set to loosen from the first half of the year, with the European Central Bank (ECB) having started to raise rates several months after the Fed, while the manufacturing activity should pick up on the back of a less adverse effect from energy prices and a recovery in the global manufacturing cycle.

ASIA: THE LAND OF GROWTH AND DIVERGENCES

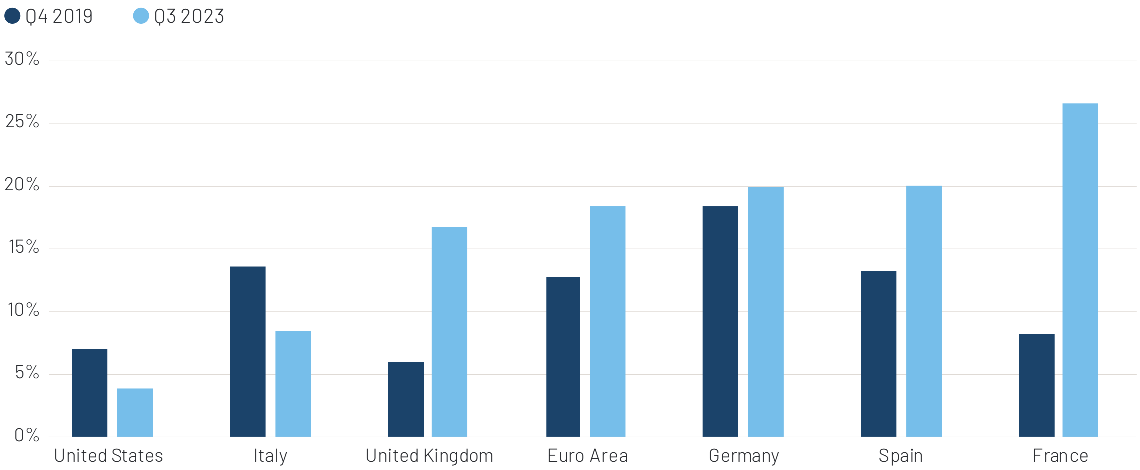
As for China, the year 2023 was disappointing despite the promises of a reopening at the end of 2022, with the economy severely penalised by the slowdown in the property market. In our view, major risks from 2023 on the property sector and local government financing vehicles remain very real and should justify a continuation of accommodative economic policies to support growth. The authorities have sufficient room for manoeuvring, given low inflation and a level of central government debt that is well below that of developed countries. Be that as it may, the Chinese economy is still set to grow well below its historical norms, a symbol of growth that will no longer be driven by property and construction, and which will have to face up to the challenge of a declining demography.

TABLE 1: MACROECONOMIC FORECASTS 2023 - 2024, %

	GDP		INFLATION	
	2023	2024	2023	2024
United States	2.3%	1.2%	4.2%	2.7%
Euro Area	0.5%	0.7%	5.6%	2.9%
China	5.1%	4.5%	0.5%	1.8%
Japan	1.9%	1.1%	3.2%	2.0%
India	6.5%	6.0%	6.2%	5.9%
Brazil	2.6%	1.3%	4.8%	4.0%
World	**3.0%**	**2.7%**	-	-

Source: Indosuez Wealth Management.

CHART 11: SAVINGS ACCUMULATED SINCE 2019 COULD PROTECT EURO AREA CONSUMERS, SAVINGS RATE %



Source: Bloomberg, Indosuez Wealth Management.

Conversely, positive demographics should buoy long-term growth prospects in India, in addition to reform *momentum*, reduced sensitivity to external shocks, potential direct investment inflows, and important forex reserves. However, some challenges might arise in 2024 from supply side constraints and political uncertainty with a general election in the first half of the year. 2024 should also be more supportive for other smaller Asian economies such as South Korea, Taiwan and Vietnam, which should benefit from the recovery in the global manufacturing cycle, the continued normalisation in international tourism and diversification of investments outside China.

Japan could also distinguish itself by extending its incremental adjustment of monetary policy in response to the emergence of a reflationary environment. 2024 could see the Japanese economy start to move more towards consumption-led growth due in particular to an improvement in wage dynamics and aided by accommodative fiscal policy. However, the road to reflation in the Land of the Rising Sun is a long one, and is unlikely to materialise as early as 2024.

The main risks to our soft landing scenario in 2024 include:

- An increasingly polarised world, accompanied by a proliferation of geopolitical risks, such as the Russo-Ukrainian and Israel-Hamas wars, which could have major adverse effects on energy prices, presenting significant risks for Europe in particular. The situation regarding tensions between China on the one hand and the United States/Taiwan on the other is also likely to be the focus of attention. All these geopolitical risks should be exacerbated by the presidential elections in the US and the potential comeback of Donald Trump.
- Government debt is also likely to be an important issue, especially in Europe where a latent risk could remain, particularly on the question of the sustainability of Italian debt in an environment of high interest rates and lower nominal growth. At the same time, the drastic rise in US debt could prove to be more of an issue beyond 2024, which will be a presidential election year and therefore unlikely to see significant budget consolidation.

05 | Asset Allocation

ALLOCATION 2024: NAVIGATING IN CALMER SEAS

Grégory STEINER, CFA
Global Head of Multi Asset

Adrien ROURE
Portfolio Manager

The year 2023, which consensus assumed would be the year of a marked economic slowdown in the advanced economies, justifying investors' cautious positioning at the start of the year, and the return to centre stage of the Chinese economy (in reopening mode), ultimately delivered its share of surprises for strategists.

From a macroeconomic perspective, this resulted in a surprising resilience of the global economy – especially in the United States - forcing central banks to maintain a restrictive bias. While on the financial markets, the statement was that of an extremely high concentration of the performance of stock indices on a few specific names (luxury goods stocks in Europe in the first half of the year and the "Magnificent 7" in the United States). Finally, 2023 saw further exogenous shocks that were as sharp as ever. In particular, the continued rise in long-term interest rates served as a reminder that "there is no free lunch" as evidenced by the vulnerabilities of US regional banks, the impact on both the profitability of some environmental companies and the attractiveness of physical real estate in a more complicated refinancing environment and more structural social changes.

CONSTRUCTIVE on equities for 2024

In our view, the last few quarters represent more of a period of economic transition in which the role of fiscal policy has increased and is likely to gain traction in a world of central bank-led interest rate normalisation and global liquidity withdrawal. This change of perspective is part of a broader transition phase that began in the late 2010's, which encompasses a climate transition incorporating a need for nations' energy self-sufficiency, a technological transition with the progressive generalisation and diffusion of Artificial Intelligence accompanied by long-term productivity gains for companies and a geopolitical transition with a change in the balance of powers and temptations of self-reliance (a theme already mentioned in our Global Outlook 2023, see "The Return of Borders").

For investors, it is necessary to adapt to this "new normal" by rethinking the construction of diversified portfolios. This requires a better balance in the use of available asset classes than in the past. Indeed, after global interest rate rises, bond markets are becoming particularly attractive again (both government and corporate bonds). They complement the portfolio manager's range of assets alongside equity markets, structured products and real assets to offer more limited risks of capital loss than in the past.

EQUITY MARKETS

- Strategically, we continue to be constructive on equities for 2024. Despite the end of abundant liquidity, several sources of growth should continue to support risky assets: a structurally higher growth/inflation profile than in the last decade, generally favourable for corporate earnings, the comeback of technological progress allowing companies to improve their productivity via lower costs and ensuring margin stability at high levels, and the gradual end of monetary tightening policies.
- With this in mind, we believe that US equities are well positioned, particularly those with strong economic fundamentals and abundant cash flows. In the short-term, large growth stocks will continue to be popular with investors. Secondly, if the economic cycle picks up and monetary conditions become significantly more accommodative, investors will have to start to reposition themselves towards small and mid-caps, which have long been ignored by investors.

- We believe Europe would be more challenged in its attempt to cope with the transitions outlined above. Admittedly, growth should improve slightly in 2024, but this hides divergences in growth and inflation at the country level, as well as differing sensitivities to the global trade cycle. Thus, despite valuation levels that seem attractive, we prefer to start the year with a more cautious position on Euro Area equities. Outside of the Euro Area, we believe the United Kingdom could benefit from its defensive nature and quality of hedging in the face of rising energy price pressures.

YIELD
will be an important source of
POSITIVE PERFORMANCE

- Lastly, we maintain our constructive view of emerging market assets. Indeed, these economies should offer a positive growth differential over the developed economies in 2024. A diversified view of both countries and asset classes (equities and debt) must prevail as assessing the country specific risk premium is becoming more and more challenging in this world in transition.
- We strategically reduced our conviction in China at the end of 2023 due to structural factors (falling demographics, persistent deleveraging of the real estate sector) weighing on the long-term outlook for the country. However, we believe that the world's second largest economy will offer more specific investment opportunities in 2024 that are likely to be limited to certain sectors or companies promoted by local authorities.

FIXED INCOME MARKETS

- The rise in long-term rates over the last two years now offers attractive entry points for investors seeking exposure to bond markets. However, despite the expected loosening of financial conditions in 2024 (as the process of disinflation materialises) and in the absence of economic accidents, this transition to a higher nominal growth regime implies the stabilisation of interest rates at higher levels than those seen in the past.
- The market equilibrium that prevailed after the Great Financial Crisis of 2008 has changed with the disappearance of central banks as a marginal buyer on the demand side and a growing need for financing from governments on the supply side, in a context marked by the search for strategic autonomy of nations and the development of the infrastructure necessary for the energy transition. In this environment of high interest rates, greater attention will have to be paid to the quality of issuers and the management of their fiscal policy.
- While the potential for capital returns on bonds may therefore appear to be partially limited, we believe that the yield component will be an important source of positive performance. In contrast, money market, which may seem attractive in the short-term, is not a satisfying alternative in our view over a long period. We prefer being exposed to short-term sovereign debt, which needs to be supplemented by good quality corporate bonds (the latter offering generous yields for limited risk). However, we are more cautious on high yield bonds as many companies will need to refinance their debt and may experience some volatility.
- In addition, we are maintaining an enduring optimistic view on emerging market local currency debt for 2024, whose yield, around 7%, remains attractive while a potential depreciation of the dollar in 2024 would support the asset class. Lastly, emerging countries' central banks seem to have learned the lessons of past crises by better managing the rate hiking cycle, limiting the risk of monetary policy errors.

CURRENCY AND PRECIOUS METALS MARKETS

- The macroeconomic environment that continues to surprise to the upside in the United States compared to the Euro Area could benefit the dollar in the short-term, while its status as a safe haven against rising geopolitical risk may act as an additional support factor. However, several factors lead us to maintain a cautious view on the greenback strategically: the expected end of monetary tightening across the Atlantic, concerns about the sustainability of government debt but also more structurally the phenomenon of diversifying foreign exchange reserves and the creation of bilateral channels between emerging countries with the use of other settlement currencies.
- In a world in transition where geopolitical and climate related financial uncertainties are high, and volatility shocks have become more frequent over time, we believe it is increasingly important to add a selection of hedging assets to allocations. For instance, we believe certain currencies such as the Swiss franc or the Japanese yen add value to a diversified portfolio. Gold also deserves to be considered; beyond holding for wealth management reasons, the yellow metal could benefit from a drop in real yields, central banks continued buying, while offering an attractive hedge against a scenario of stagflation and/or renewed geopolitical stress.

06 | Global presence

OUR STORY

For more than 145 years we have advised entrepreneurs and families around the globe, supporting them with expert financial advice and exceptional personal service.

To this day we serve each and every client as an individual, helping them build, protect and pass on their wealth.

Truly personal service resonates with our clients and, when combined with the financial strength and complimentary expertise of Crédit Agricole Group, one of World's top 10 banks, it results in a unique approach to building value for entrepreneurs and families around the world.

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07 | Glossary

Basis points (bps): 1 basis points = 0.01%.

BLS: Bureau of Labor Statistics.

BNEF: Bloomberg New Energy Finance.

Brent: A type of sweet crude oil, often used as a benchmark for the price of crude oil in Europe.

CBO (Congressional Budget Office): Congressional Budget Office of the United States.

CHIPS Act: The CHIPS Act is a US federal law that provides funding and incentives to increase domestic semiconductor production and research.

CPI (Consumer Price Index): The CPI estimates the general price level faced by a typical household based on an average consumption basket of goods and services. The CPI tends to be the most commonly used measure of price inflation.

Deflation: Deflation is the opposite of inflation. Contrary to inflation, it is characterised by a sustained decrease in general price levels over an extended period.

Duration: Reflects the sensitivity of a bond or bond fund to changes in interest rates. This value is expressed in years. The longer the duration of a bond, the more sensitive its price is to interest rate changes.

EBIT (Earnings Before Interest and Taxes): Refers to earnings generated before any financial interest and taxes are taken into account. It takes earnings and subtracts operating expenses and thus also corresponds to non-operating expenses.

EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortisation): EBITDA takes net income and adds interest, taxes, depreciation and amortisation expenses back to it. It is used to measure a company's operating profitability before non-operating expenses and non-cash charges.

ECB: The European Central Bank, which governs the euro and Euro Area member countries' monetary policy.

Economic Surprises Index: Measures the degree of variation in macro-economic data published versus forecasters' expectations.

EPS: Earnings-per-share.

ESG: Non-financial corporate rating system based on environmental, social and governance criteria. It is used to evaluate the sustainability and ethical impact of an investment in a company.

European Green Deal: The main goal of the European Green Deal is Climate neutrality by the year of 2050 (decarbonise their energy system by aiming to achieve "net-zero greenhouse gas emissions by 2050).

Fed: The US Federal Reserve, i.e. the central bank of the United States.

FOMC (Federal Open Market Committee): The US Federal Reserve's monetary policy body.

GDP (Gross Domestic Product): GDP measures a country's yearly production of goods and services by operators residing within the national territory.

Greenflation: Refers to a rise in prices of raw materials and energy as a result of the green transition.

IMF: The International Monetary Fund.

Inflation breakeven: Level of inflation where nominal bonds have the same return as inflation-linked bonds (of the same maturity and grade). In other words, it is the level of inflation at which it makes no difference if an investor owns a nominal bond or an inflation-linked bond. It therefore represents inflation expectations in a geographic region for a specific maturity.

Nearshoring (regionalisation): Described by the OECD as the decision to relocate previously offshored activities, not necessarily back to the company's home country, but rather to a neighbouring country.

OECD: Organisation for Economic Co-operation and Development.

OPEC: Organization of the Petroleum Exporting Countries; 14 members.

OPEC+: OPEC plus 10 additional countries, notably Russia, Mexico, and Kazakhstan.

PMI: Purchasing Managers' Index.

Policy mix: The economic strategy adopted by a state depending on the economic environment and its objectives, mainly consisting of a combination of monetary and fiscal policy.

Pricing power: Refers to the ability of a company or brand to increase its prices without affecting demand for its products.

Quantitative easing (QE): A monetary policy tool by which the central bank acquires assets such as bonds, in order to inject liquidity into the economy.

Quantitative tightening (QT): A contractionary monetary policy tool applied by central banks to decrease the amount of liquidity or money supply in the economy.

Redenomination: Is the recalibration of a country's currency, typically due to hyperinflation and currency devaluation, whereby an old currency is exchanged for a new one at a fixed rate.

SEC (Securities and Exchange Commission): The SEC is an independent federal agency with responsibility for the orderly functioning of US securities markets.

Soft power: A concept used in international relations.

Spread (or credit spread): A spread is the difference between two assets, typically between interest rates, such as those of corporate bonds over a government bond.

Secular stagnation: Refers to an extended period of little or no economic growth.

SRI: Sustainable and Responsible Investments.

VIX: The index of implied volatility in the S&P 500 Index. It measures market operators' expectations of 30-day volatility, based on index options.

WTO: World Trade Organization.

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