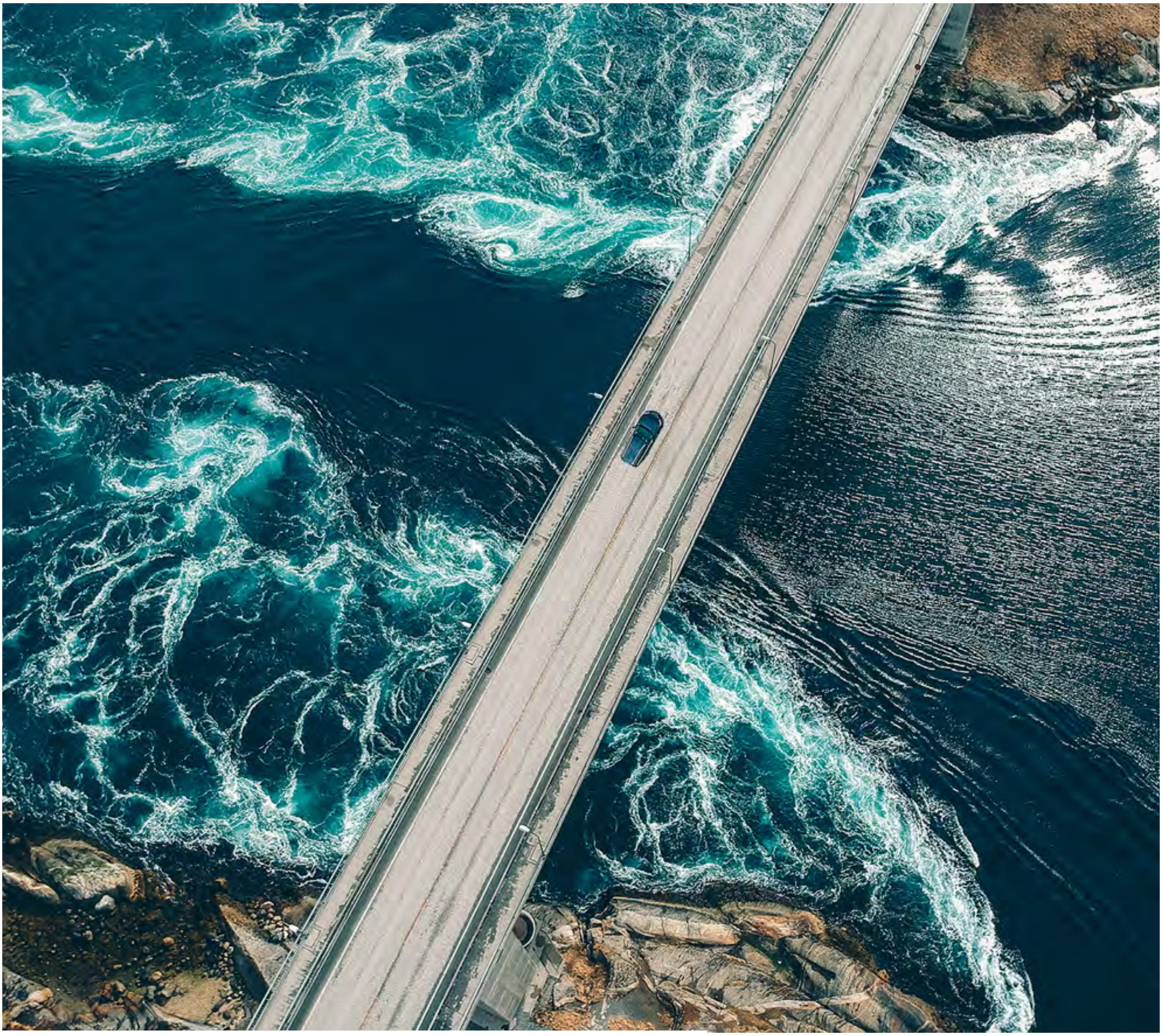
Investment themes 2023



BNP PARIBAS
WEALTH MANAGEMENT

The bank for a changing world

INTRODUCTION

The accumulation of economic and geopolitical uncertainties, together with poor performance by stocks, bonds and credit, has left both retail and professional investors feeling extremely gloomy about the future.

But it is precisely at times of pervasive pessimism that we should recall the lessons of history. In the past, extreme lows in investor sentiment have preceded strong positive performance by stocks, credit and private equity.

Reasons for hope

In the US, in spite of the sharp rise in interest rates, domestic demand continues to hold up surprisingly well, in part thanks to the abnormally high cash savings accumulated by households over 2020-21 which are now being spent.

In Europe, we have already seen an impressively rapid response to the energy crisis, with a substantial reduction in energy demand by both industry and households. This reduction is one reason for the sharp retracement in gas and electricity prices of late. The level of employment in Europe hit an all-time high in Q2 2022 of 213 million. More people gainfully employed support more resilient domestic demand.

In Asia, inflation remains under control, while countries with extensive commodities exposure and youthful populations like Indonesia, India and Vietnam remain attractive long term.

Five new investment themes for 2023

Firstly, investors looking for generous and secure yields are spoilt for choice today. Secondly, the elevated market volatility regime that we see today is not about to change.

Thirdly, we have entered a new era of structurally higher inflation and greater uncertainty than in previous decades. Fourthly, inflation and interest rates will decline from current decade highs.

Finally, persistently high energy costs will encourage accelerated investment in energy transition and efficiency.

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2022 has been a year of surprises for investors, ranging from the aftermath of COVID-related disruptions in global supply chains to conflict in Ukraine and an associated European energy crisis. In addition, the global economy has seen an unprecedented swing from massive government and central bank boosts to the global economy in 2021, to a sharp reversal towards higher policy interest rates from global central banks in 2022 as inflation rates have spiked to decade highs.

The resulting slowdown in economic demand, easing of supply chain pressures and cooling of commodity prices should calm inflation pressures. This in turn should lead to lower long-term bond yields. We believe that long-term investors should look beyond the peak in inflation and policy rates to the investment opportunities that lower inflation and long-term rates can offer.

LOOKING THROUGH THE INFLATION AND RATES PEAK

In anticipation of lower inflation and long-term rates in 2023

OUR RECOMMENDATIONS

This theme focuses on Equities and Fixed Income.

Peaking yields: spreads and yields on investment grade credit have reached multi-year highs and now offer attractive opportunities.

- **Quality stocks** with strong cash flow and solid balance sheets should allow companies to increase margins by taking advantage of easing input costs.
- **Pricing power** is key: high net worth individuals (HNWIs) are less affected by rising living costs, in that they can comfortably continue spending on luxury goods.
- **Increased Capex** to adapt to a new labour market: labour, especially in the US, is scarce and expensive, forcing businesses to ramp up Capex in digitalisation and automation in a bid to remain competitive. Security investments are needed to mitigate risks from cybercrime.
- **Emerging Markets** tend to benefit from a weaker dollar: we expect the greenback to weaken in 2023 that should provide EM equities with tailwinds.

KEY RISKS

- **If inflation** remains at high levels for longer, central banks would be forced to keep hiking rates beyond expectations, thus pushing bond yields higher. This would probably have a negative impact on equity and bond prices.
- **Further disruption** in supply chains could hurt input prices and squeeze profit margins, in turn having a negative effect on equity prices.

SEIZING NEW INCOME OPPORTUNITIES FROM TINA TO TARA

After years of loose monetary and fiscal policies when both volatility and risk were gradually suppressed, bond yields fell to nearly 0% or even below zero. Investors had no choice but to invest in equities to find reasonable returns. That was the era of TINA: There Is No Alternative (to equities).

Those days are now past.

The transition to TARA (There Are Reasonable Alternatives) has been painful for bondholders, but necessary. The recent dramatic surge in bond yields and the widening of credit spreads have finally created some opportunities in the fixed income space for investors with a lower appetite for risk.

OUR RECOMMENDATIONS

A cross-asset theme: Bonds and Equities:

- **US government bonds for USD-based investors and long-term UK government bonds** as yields are at decade highs.
- **Investment Grade corporate bonds in the US** for USD-based investors following the rise in both bond yields and credit spreads.
- **Investment Grade corporate bonds in the eurozone,** with a preference for short-term bonds issued by companies with solid balance sheets.

Opportunities also exist in corporate hybrids, Tier 2 bank bonds, and Contingent Convertible (CoCo) bonds.

- **Unconstrained bond funds**
- **Equities, with a focus on solid companies** that deliver growing dividends.
- **Income-focused structured products.**

KEY RISKS

- **Interest rate risk.** Inflation has proved difficult to predict. A slower-than-expected decline in inflation will force the Federal Reserve and the European Central Bank to keep hiking rates, pushing bond yields higher and bond prices lower. This is the so-called interest rate risk i.e., the potentially negative impact of the change in market interest rates on the bond price.
- **Credit risk.** Aggressive central banks may push economies into recession. Long-term bond yields would drop but corporate credit spreads would widen materially, and corporate bankruptcies would increase. The credit risk is the capacity of an issuer to honour its commitments: downgrades of an issue or an issuer's rating may lead to a drop in the value of associated bonds.

EMBRACING MARKET VOLATILITY

The year 2022 will rank as one of the highest years in decades for volatility in global bond and foreign exchange (FX) markets given the uncertainty around interest rates and the question of when inflation will peak. The era of zero rates and the global central bank "put" are now history. Global central banks are pursing different paths for controlling inflation. In addition, global equities entered a bear market and are experiencing higher volatility amidst mounting fears about the extent of a recession.

This environment is creating enhanced opportunities to utilise structured solutions across asset classes in bonds, FX, equities and commodities. In addition, it provides unique opportunities in global macro and trend-following strategies, gold, as well as higher quality companies with secure and growing dividends.

OUR RECOMMENDATIONS

A cross-asset theme: Foreign Exchange, Bonds, Equities, Commodities and Hedge Funds.

- **Cross-asset structured solutions:** with elevated volatility, it is an advantageous time to create customised structured solutions for investors for better entry points, capturing buffered upside and capital protection.
- **Global Macro/CTA hedge strategies:** for years, negative and zero rates suppressed interest rate volatility. Now, there are clear directions in FX, interest rates, and equities which can be exploited via trend-following strategies.
- **Secure/growing dividends:** in periods of rising or above-average inflation, we focus on a defensive equity strategy including high-quality companies with pricing power as well as those that can raise dividends and benefit from high nominal GDP growth.
- **Gold:** the precious metal is an underperformer during periods of a stronger dollar, higher interest rates and rising real yields as it does not offer a yield or carry. As inflation peaks, the properties of a gold hedge could shine again, driven by the increase in global government debt, recession, and geopolitical uncertainty.

KEY RISKS

- Depending on the structured solutions chosen, an increase, **a decrease, or a change in asset prices** could lead to capital loss.
- There is no guarantee that global macro or trend-following strategies will benefit from the current trends in asset markets. Furthermore, any sudden suppression of **interest rates back to zero** could reduce opportunities.

INVESTING IN A NEW ERA

The last twenty years were marked by several dominant global trends: disinflation, ultra-cheap/free money for borrowers, and the global production of raw materials and goods & services that suppressed prices.

Since 2021, there has been a 180-degree turn. The COVID-19 pandemic, the ensuing economic stimulus and escalating geopolitical tensions have ushered in a new environment of high inflation, largely on the back of a shortage of cheap energy and other commodities, sharply rising interest rates, and a reversal of globalisation in favour of nearshoring. These shifts are not temporary but structural in nature. The new economic era requires a completely different investing mind-set. We see investment opportunities in energy production & infrastructure, food & water security, cybersecurity, reuse/recycling, and in industrial automation.

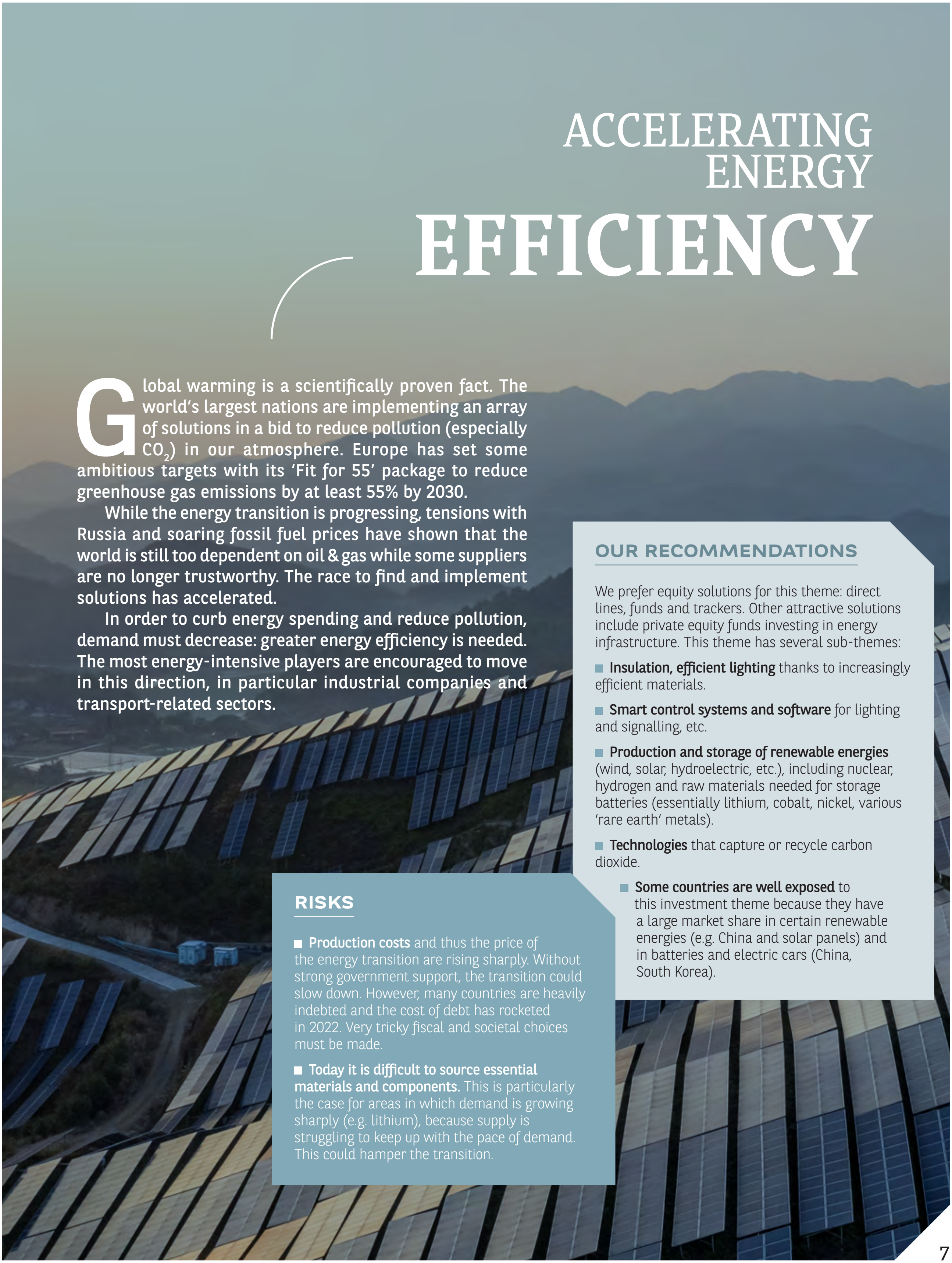
OUR RECOMMENDATIONS

Investable sub-themes of this new era mega theme include:

- **Reuse and recycling of goods & services** via investment in circular economy leaders, plus focus on local production of food & energy, goods & services.
- **Energy security:** energy transportation and storage infrastructure, renewable/biomass energy generation, battery metals & energy storage, the hydrogen economy, oil & gas exploration and production, nuclear power.
- **Food security and alternative food sources:** solutions to combat malnutrition, via more effective water irrigation, fertilisers & technologies to boost crop yields, plus companies which combat food waste. Technologies for water efficiency, recycling and desalinisation.
- **Technology security:** cybersecurity, semiconductors, satellite technology and networks.
- **Nearshoring winners** (e.g. Mexico and Brazil), industrial automation and product lifecycle management software.

KEY RISKS

- **A major global recession** would likely drive severe demand destruction for energy and raw materials, pushing down commodity prices and thus hurting the profits of commodity-producing companies. It is, however, unlikely to jeopardise long-term trends.
- **Investment solutions** for this theme mainly relate to equities. Despite the theme's relevance and attractive expected returns, such solutions are subject to movements in global equity markets.



ACCELERATING ENERGY EFFICIENCY

Global warming is a scientifically proven fact. The world's largest nations are implementing an array of solutions in a bid to reduce pollution (especially CO_2) in our atmosphere. Europe has set some ambitious targets with its 'Fit for 55' package to reduce greenhouse gas emissions by at least 55% by 2030.

While the energy transition is progressing, tensions with Russia and soaring fossil fuel prices have shown that the world is still too dependent on oil & gas while some suppliers are no longer trustworthy. The race to find and implement solutions has accelerated.

In order to curb energy spending and reduce pollution, demand must decrease: greater energy efficiency is needed. The most energy-intensive players are encouraged to move in this direction, in particular industrial companies and transport-related sectors.

OUR RECOMMENDATIONS

We prefer equity solutions for this theme: direct lines, funds and trackers. Other attractive solutions include private equity funds investing in energy infrastructure. This theme has several sub-themes:

- **Insulation, efficient lighting** thanks to increasingly efficient materials.
- **Smart control systems and software** for lighting and signalling, etc.
- **Production and storage of renewable energies** (wind, solar, hydroelectric, etc.), including nuclear, hydrogen and raw materials needed for storage batteries (essentially lithium, cobalt, nickel, various 'rare earth' metals).
- **Technologies** that capture or recycle carbon dioxide.
- **Some countries are well exposed** to this investment theme because they have a large market share in certain renewable energies (e.g. China and solar panels) and in batteries and electric cars (China, South Korea).

RISKS

- **Production costs** and thus the price of the energy transition are rising sharply. Without strong government support, the transition could slow down. However, many countries are heavily indebted and the cost of debt has rocketed in 2022. Very tricky fiscal and societal choices must be made.
- **Today it is difficult to source essential materials and components.** This is particularly the case for areas in which demand is growing sharply (e.g. lithium), because supply is struggling to keep up with the pace of demand. This could hamper the transition.

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