2023 Investment Themes - September update

BNP PARIBAS
WEALTH MANAGEMENT

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world

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A surprisingly strong year for stocks, so far

Avoided recession so far this year, but what is to come next?

2023 recession fears recede

The biggest surprise in 2023 to date has been the absence of a widely-forecast US economic recession, after the Federal Reserve raised benchmark interest rates at a speed and scale not seen in nearly 50 years since the stagflation 1970s.

Europe has not been quite as fortunate, with European Central Bank rate hikes and painfully high headline inflation translating into a sharp slowdown in economic activity. This is evident in the falls in eurozone composite PMI to well under the 50 breakeven level, highlighting a contraction in overall activity levels. We continue to believe that any recession will be modest in both depth and duration.

Thinking more about rate cuts now

With a) inflation in steady decline across both developed and Emerging Markets, and b) economic activity adjusting to higher interest rates, central banks can look to end their rate hiking cycles and contemplate rate cuts in 2024. This process has already begun in Brazil, which were early to increase interest rates in January 2021 in response to rising inflation.

Stocks rise, bonds struggle

The surprising resilience of the global economy and the ability of companies to maintain their profitability by passing through price rises has resulted in better than expected earnings momentum for US, European and Japanese companies. This has been key in the strength of stock markets since October 2022 with the MSCI World Index gaining nearly 15% in US dollars and 11% in euros since the start of 2023.

In contrast, government bonds have struggled against a backdrop of sharply higher cash interest rates, delivering a -1% return in US dollars and -2% in euros over this period as investors have flocked to benefit from decade-high money market interest rates.

Potential reversal of longstanding trends

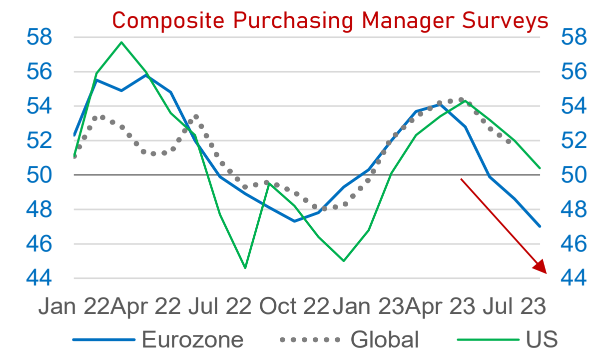
Over the last 12 months, we have already observed the reversal of a number of longstanding trends in (dormant) inflation and (zero) interest rates. But there are still others that could also reverse soon and damage investor portfolios. The technology-driven 13-year outperformance of US stocks over versus the rest of the world is very long, and finally showing signs of exhaustion. Given that the MSCI World Index is today 68% weighted to the US, any prolonged reversal of this trend in favour of Europe, Japan and Emerging Markets could be painful for global investors.

Equally, the predominance of stocks and bonds in a typical diversified portfolio could prove difficult over the next few years if our expectation of continued scarcity of raw materials proves correct. Note that global bonds have delivered zero returns since 2016 in US dollars; in contrast, commodities have returned a cumulative +48%.

Highlighting 3 investment themes

In this update, we revisit 3 of our 2023 investment themes: "When consistent losers become winners" examines the potential for long-term underperforming asset classes (Latin American equities, Emerging Market bonds and silver) to benefit from a robust "mean reversion" effect. We also offer fresh angles on two other themes: reinforcing the security of inputs and technology (raw materials, cybersecurity), and looking at the most attractive ways to lock in historically elevated income yields in the fixed income universe.

GLOBAL ECONOMIC ACTIVITY WEAKENS IN A COORDINATED FASHION



Source: Bloomberg BNP Paribas WM

01

When consistent losers become winners

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THEME 1

When consistent losers become winners

History underlines that persistent underperformance over 2-3 consecutive years from either country stock markets or asset classes can subsequently lead to impressive double-digit returns during the following year. We have identified three asset classes that fell both in 2021 and then again in 2022 from commodities, fixed income, and equities.

Silver fell by 36% from February 2021 to September 2022, and still remains over 50% below its 2011 highs. Local currency Emerging Market sovereign bonds declined by 32% between January 2021 and October 2022, and today offer a 6.5% yield. Thirdly, Latin America stocks retreated 23% from January 2021 to July 2022, having not participated in the impressive 2021 global stock market rally. In each case, we see a combination of attractive valuations and positive catalysts.

OUR RECOMMENDATIONS

We prefer a variety of equity, bond and commodity-based solutions for this theme: direct lines, funds, structured solutions and trackers. This “reversion to the mean” theme has several sub-themes:

- Silver – both exposure to the underlying commodity (including via precious metals funds/trackers) and also to silver commodity producers.
- Emerging Market sovereign bonds - in both local currency and hard currency (US dollar).
- Latin American equities – focusing on both Brazil and Mexico.

RISKS

- The US Federal Reserve raises its benchmark Fed Funds rate well beyond the expected 5.5% peak rate, which could result in a deeper global economic slowdown than expected.
- An intensification of geopolitical tensions between the US and China could undermine the expected Chinese economic recovery and investor confidence in Emerging Market (including Chinese) assets.

Long-term underperformance creates value, potential for a robust recovery

Historic evidence from country stock markets over more than 100 years, and from asset class performance over 30 years highlights that country equities and asset classes typically rebound strongly after 2 or 3 poor years. In fact, 2022 was a dreadful year for nearly all stock markets and asset classes. In this theme, we focus on country stock markets and asset classes that also performed poorly in 2021 and 2022. These assets thus become potential candidates which would allow investors to benefit from this powerful mean reversion effect.

Within equities, Latin American stocks lagged the MSCI World Index from the beginning of 2021 until mid-July 2022. Within bonds, Emerging Market US dollar bond prices fell by 28% from January 2021 to October 2022. In commodities, silver fell 36% from August 2020 to October 2022, versus a 66% rise for the Bloomberg Commodity Index.

Silver has lagged gold and other commodities

Commodities were one of the very few asset classes to give positive returns both in 2021 and also last year, buoyed by rising prices for energy and battery metals, such as nickel. Silver was a rare exception, down 25% since August 2020 while the Bloomberg Commodity Index has soared by 58%. We believe that the silver price will be boosted by a number of factors, including continued geopolitical tensions, a weaker US dollar, rebounding Chinese/Indian household jewellery demand and stronger industrial demand for solar panels and electronics.

Emerging Market bonds offer elevated yields

Bond markets suffered everywhere in 2022 – but Emerging Market US dollar sovereign bonds also suffered in 2021, with bond prices falling 5% in 2021 before shedding a further 22% to the recent October lows. The yield on the Bloomberg Emerging Market Aggregate Bond Index has almost doubled from 3.5% at the beginning of 2021 to 6.3% as at 25 August 2023.

Since 2010, Emerging Market bonds had closely tracked US high yield bonds, both returning an annual average of 6+% to the end of 2020. However since the beginning of 2021, US high yield bonds delivered -4% to February 2023, while EM USD bonds lagged by -19% over this period. Since March 2023, Emerging Market local currency bonds have delivered a +3% return versus -2% for US Treasuries.

Mexico and Brazil in a global sweet spot

In contrast to central banks of developed economies, the Brazilian and Mexican central banks were quick to raise interest rates to combat higher inflation post 2020. The central bank of Brazil began to raise benchmark rates in March 2021, while their Mexican counterpart began to increase overnight interest rates in June – both well before the US Federal Reserve or the European Central Bank. Today, they are in a good position to reduce rates as their inflation rates have already eased to under 4% in Brazil and under 5% in Mexico. They both benefit from stronger currencies, rising energy prices and cheap stocks with attractive dividend yields. Since July 2022, Latin American stocks have recovered versus the US.

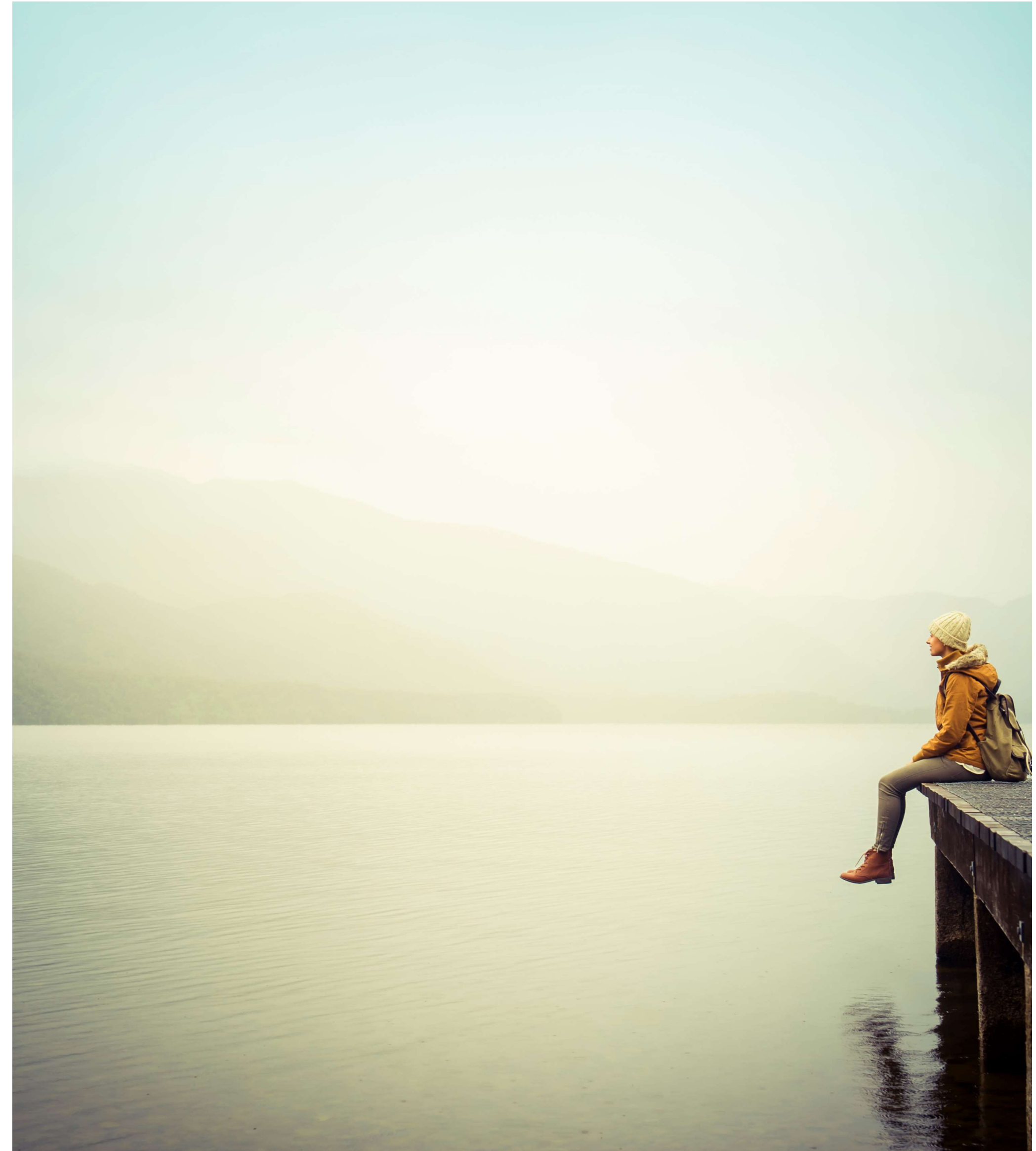
SILVER HAS DRAMATICALLY LAGGED GOLD SINCE 2011 PEAK

LATIN AMERICAN STOCKS BEAT US

Sources: Cambria, BNP Paribas, Bloomberg

02

Scarcity and Security are the new watchwords



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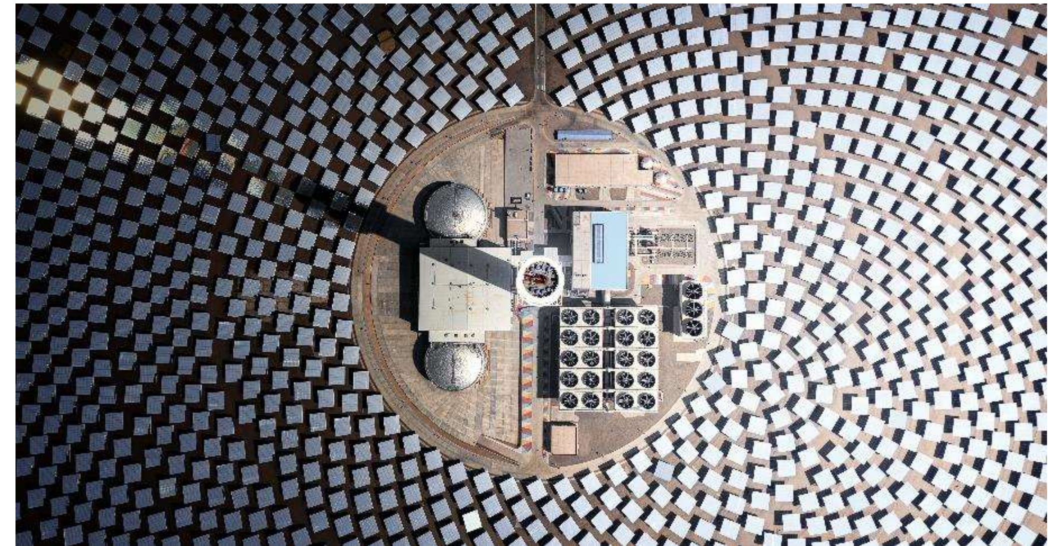
THEME 2

Scarcity and Energy Security

In today's world of heightened geopolitical tensions and emerging shortages of energy and other commodities, new trends of energy & raw materials security, nearshoring of goods production and technological security have emerged. The increasing prevalence of global weather volatility in the form of floods and droughts highlights once again the focus on food and water security.

The need for greater energy security remains a key driver behind both clean energy and energy conservation investment in Europe. Replacing Russian pipeline natural gas and reducing overall gas & electricity demand are near-term priorities, especially in Europe. The circular economy is an important tool in decreasing indirect energy consumption in the production/provision of goods and services.



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:

- Efficiency, reuse, and recycling: investment in circular economy leaders.
- Energy Efficiency: beneficiaries of the US Inflation Reduction Act and European equivalents, boosting investment in renewable energy generation, infrastructure and storage, including solar energy, industrial battery storage and critical battery metal production, and biomethane collection..
- Water recycling and Technologies for water efficiency, recycling and desalinisation.
- Cybersecurity and Safety: cybersecurity, personal and industrial safety.
- Focus on local production of energy, goods & services.

RISKS

- Production costs and thus the price of the energy transition are rising sharply. Without strong government support, the transition could slow down, given that many countries are heavily indebted and the cost of debt rocketed in 2022. Very tricky fiscal and societal choices must be made.
- Today it is still difficult to source essential materials and components. This is particularly the case for areas in which demand is growing rapidly (e.g. lithium), because supply is struggling to keep up with the pace of demand. This could hamper the transition.
- Generally speaking, energy is a cyclical sector. Energy prices fluctuate considerably in tandem with economic growth, but also with geopolitical events that are often unpredictable and uncontrollable. Return on investments can therefore be highly volatile and sometimes lower than expected.

Energy efficiency, renewables back in focus

Natural gas and electricity costs that remain far above pre-2022 levels in Europe underline the economic necessity to invest in alternative means of electricity generation to reduce dependence on gas- and coal-fired power stations. The need to increase European energy security is also driving lower gas and electricity consumption, which has been largely achieved to date without a corresponding fall in industrial production.

According to the International Energy Agency, low-emission sources are expected to cover almost all of the growth in global electricity demand by 2025 (solar, wind, biomass, nuclear), with China accounting for more than 45% of the growth in renewable generation over 2023-25. This should take the share of renewables in the global power generation mix from 29% in 2022 to 35% by 2025.

In the US, the Energy Information Administration estimates that 54% of all new US electric-generating capacity in 2023 will be solar. Battery storage should also more than double this year, often installed in combination with new solar or wind projects. The acceleration in energy conservation and energy efficiency/transition growth trends is thus clear in the US and Europe but also in China and India. We continue to favour investment in energy efficiency and energy transition funds.

The circular economy plays an important energy-saving role

The circular economy ("repair-reuse-recycle") remains an excellent indirect way to reduce energy consumption in the production of goods and services, through more productive use of assets (e.g. via the sharing economy) and by prolonging the effective life of goods (thus diminishing the demand for virgin raw materials, for instance).

Interest in the circular economy continues to gather speed, and this is increasingly reflected in financial performance too – with the ECPI Circular Economy Index continuing to outperform the MSCI ACWI Index since early 2020. We believe that increasingly restrictive environmental regulations will continue to drive circular economy growth, particularly in industries such as household appliances and consumer electronics as well as battery recycling.

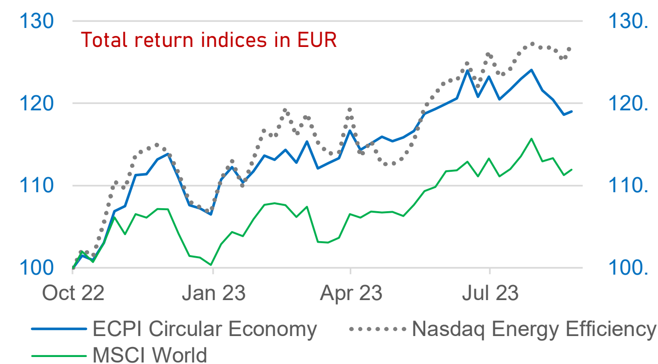
Critical battery metals in increasing demand

Exponential growth in renewable energy and electric vehicles will drive increasing demand for underlying critical battery metals, such as copper, tin, nickel and lithium. In addition, Latin American- and Asian-producing countries have begun to place new restrictions on the ownership of production and the export of these battery metals. Together, these factors should lead to higher prices for these metals over time, given a lack of new supply in the near future.

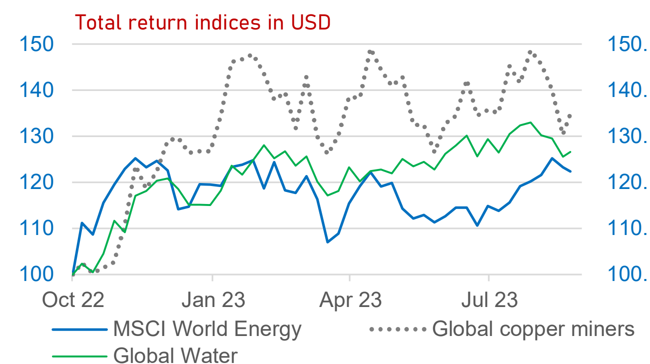
Cybersecurity essential in cloud computing

The growth in adoption of cloud computing as a more efficient form of technology infrastructure, and the increase in large-scale IT network hacks and ransomware attacks are fuelling growing demand for cybersecurity solutions and services. Over 2023 to date, the cybersecurity theme has performed well, with the Wisdomtree Team8 Cybersecurity Index gaining 28% in US dollar terms.

ENERGY EFFICIENCY, CIRCULAR ECONOMY THEMES CONTINUE TO LEAD



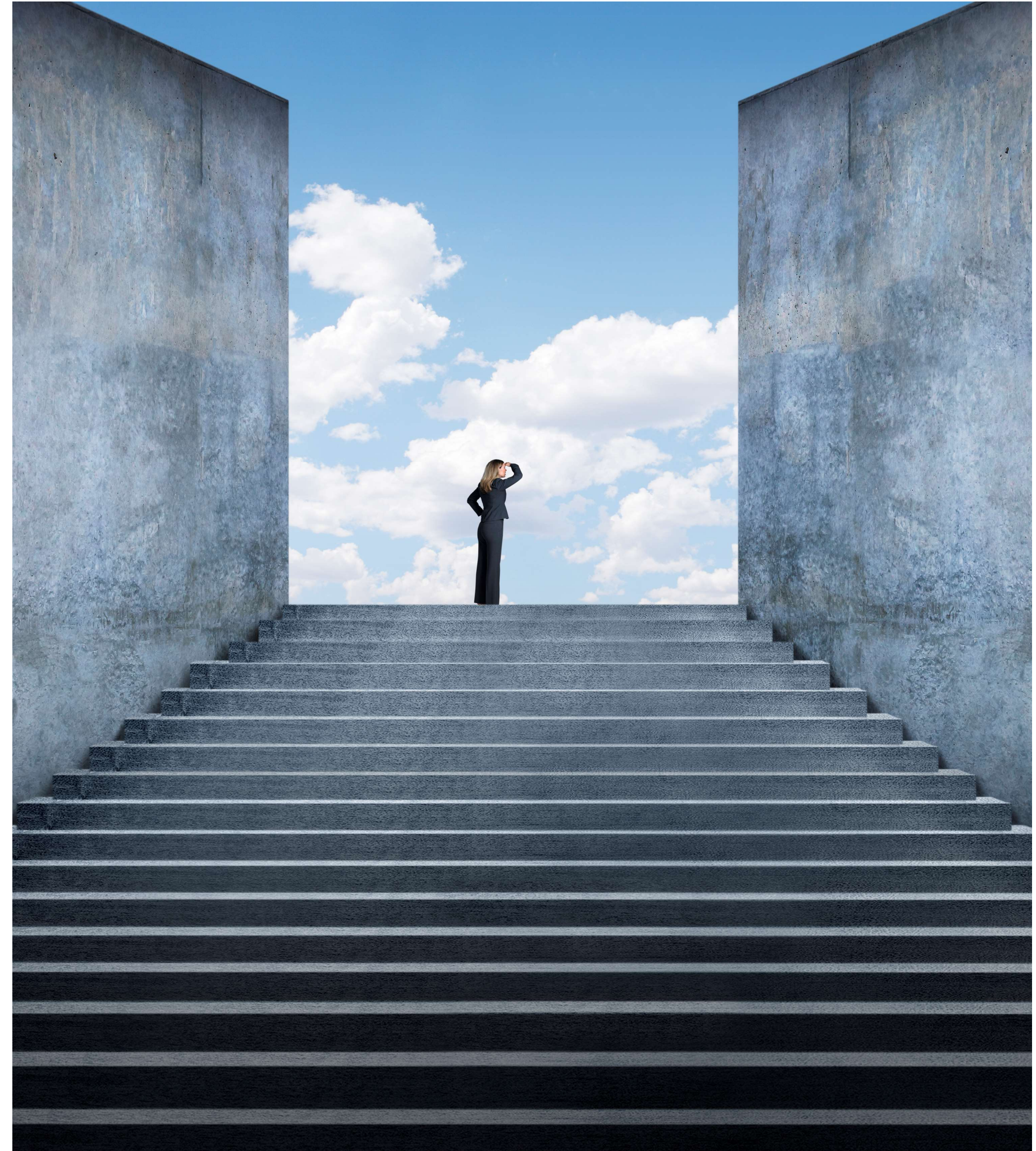
FOCUS ON CONSTRAINED COPPER, ENERGY AND WATER PRODUCTION



Source: BNP Paribas, Bloomberg

03

New income opportunities: from TINA to TARA



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Bonds are Back

The dramatic surge in bond yields that has followed the interest rate hiking cycles of central banks have finally created some opportunities in the fixed-income space for investors with a lower appetite for risk. We have made the jump from an era of TINA (There Is No Alternative) to TARA (There Are Reasonable Alternatives).

Today, the cash and fixed-income asset classes offer the highest yields seen in the last 10-15 years thanks to the post-COVID surge in global inflation, which has prompted a break in the interest rate regime from the prior Zero Interest Rate Policy era that persisted from 2009 to 2022.

Given the likelihood that inflation rates will settle in future at a higher level than experienced in the years post the Global Financial Crisis, we favour investment in inflation-protected sovereign bonds, given today's elevated real yields.

OUR RECOMMENDATIONS

Investable sub-themes of this secure income theme include:

- Sovereign bonds: US and UK government bonds with maturities of around 5 years, with a preference for Treasury Inflation Protected bonds (TIPs) and index-linked gilts:
- Corporate credit: investment grade corporate bonds in the US for USD-based investors: investment grade corporate bonds in the eurozone, with a preference for bonds issued by companies with solid balance sheets
- Emerging Market local currency sovereign bonds;
- Income-focused structured products;
- Equities: with a focus on solid companies that deliver growing dividends

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.
- Liquidity risk is the risk that an investor will be unable to sell a bond before maturity, or will only sell it at a much lower price than expected.
- Currency risk is the risk of making a loss due to the fluctuation of the currency used for the bond issue, in comparison with the investor's reference currency.

Cash-like funds have attracted investors

Thanks to a rapid and aggressive series of interest rate hikes by central banks in the US, UK and eurozone over the last 12 months, cash-like instruments, such as money market funds and term deposits have attracted huge inflows from risk-averse savers as reference interest rates reach their highest levels since 2007-08.

While this makes sense in the short term given the relatively attractive cash yields on offer, investors should consider the growing reinvestment risk. Once inflation rates fall sufficiently (by early/mid-2024), central banks will begin to reduce benchmark interest rates to support economic activity. At this point, yields on money market funds and other cash instruments will inevitably fall.

Falls in inflation rates pick up pace

Since peaking at over 9% in mid-2022, US headline inflation more than halved to 3.2% in July this year. According to Truflation, the real-time CPI inflation measure is even lower, as low as 2.7% (as of 24 August). In the eurozone, a similar but lagged pattern of inflation peak and decline is evident – from an October 2022 peak of over 10%, eurozone CPI dropped to 5.3% in July. Longer-term inflation expectations, derived from bond markets, remain in line with history: the US 5-year, 5-year forward inflation breakeven rate is just 2.4%, while the German equivalent inflation breakeven is 2.5%.

Global growth is slowing – rate cuts in 2024?

While the prevailing consensus interest rate scenario remains "higher for longer" given the persistence of above-target inflation rates in the US and Europe, money markets price US Federal Reserve rate cuts starting in Q1 2024, with the European Central Bank expected to follow suit by mid-year. This suggests that current cash interest rates will decline in 2024 as central banks react to slower growth and inflation dynamics, cutting returns to investors in cash and cash-like investments.

We believe that conservative investors should look to lock in the current high levels of yield available via investment in sovereign and corporate bonds. Indeed, 10-year government bond yields of over 4% are today available in the US and UK. Around 6% is offered in US investment-grade corporate credit and Emerging Market local currency sovereign bonds.

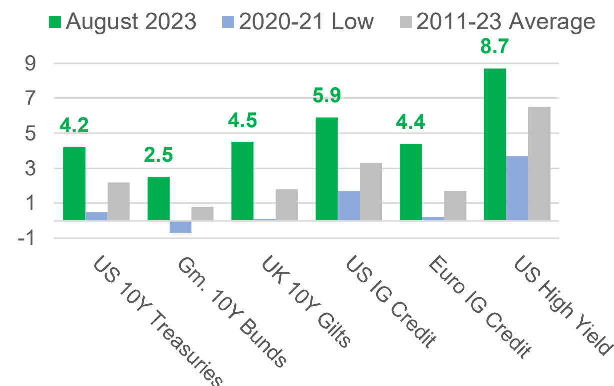
Long-short credit arbitrage hedge/alternative UCITS funds are also attractive to capture pockets of value in fixed income – the Eurekahedge Structured Credit Hedge Fund Index has gained over 4% in US dollars since end-2022.

The benefits of long-term inflation protection

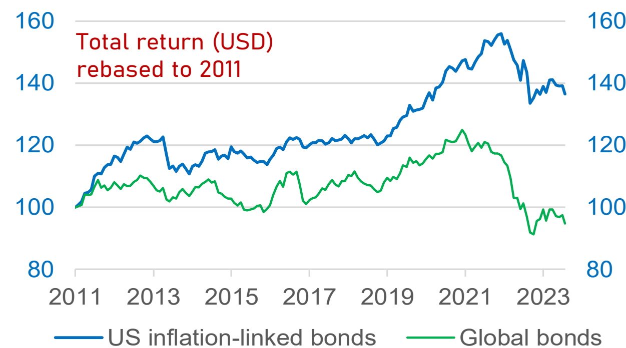
The return of extreme inflation volatility of a sort not experienced since the 1970s has reminded investors of the benefits of assets with built-in inflation protection, either explicit or implicit. Commodities, such as oil and gold, are assets with an implicit form of inflation hedging.

But inflation-protected bonds issued by the US, UK and French governments are assets which offer an explicit inflation hedge - the coupons they pay vary as a function of reported inflation rates. Following the rise in government bond yields across the board, we judge these inflation-protected bonds as attractive to investors who seek a consistent post-inflation return.

SOVEREIGN BOND, CORPORATE CREDIT YIELDS SIT AT 10-15 YEAR HIGHS



US INFLATION-LINKED BONDS HAVE BEEN FAR SUPERIOR TO GLOBAL (NOMINAL) BONDS



Sources: Bloomberg, BNP Paribas

04

Our initial 2023 Investment Themes

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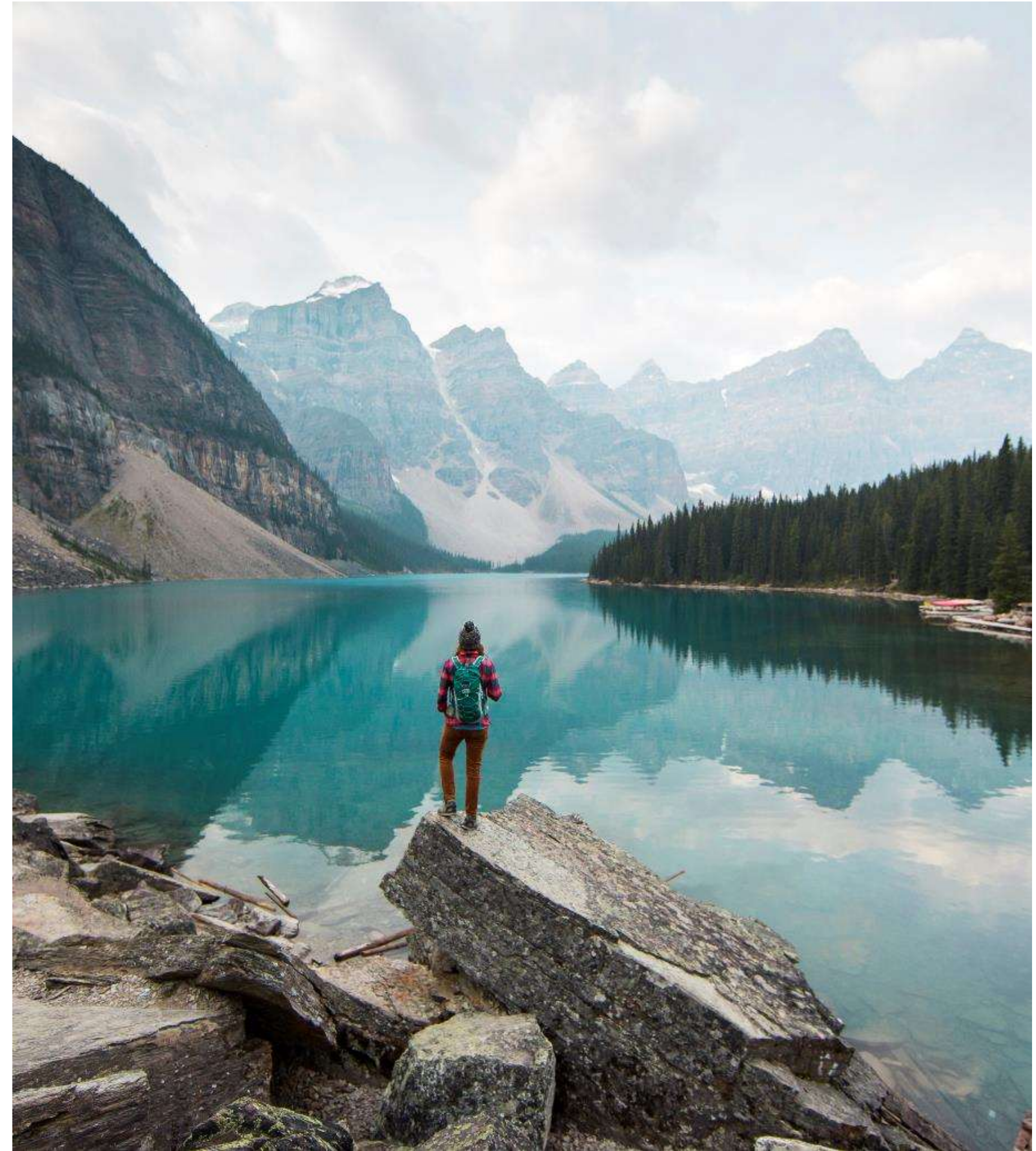
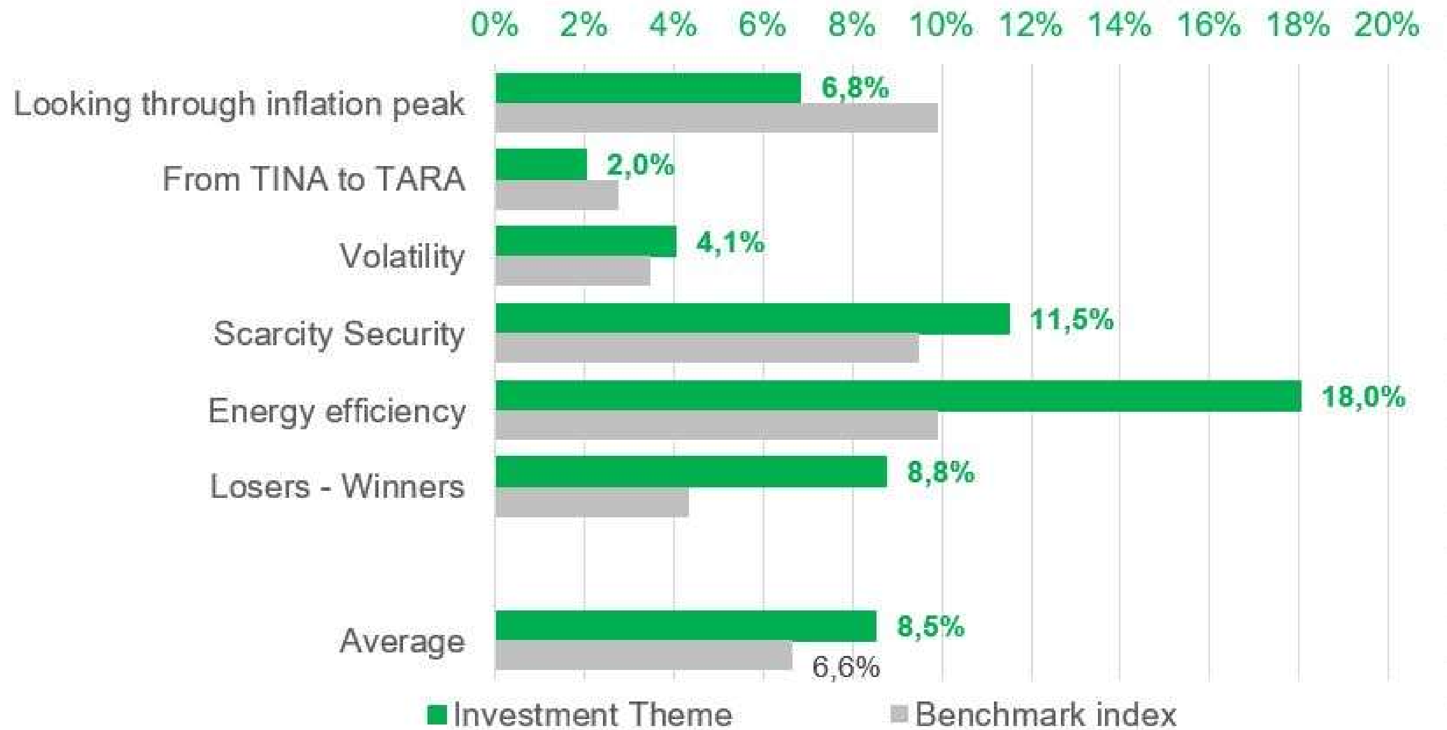


Investment Theme	Description
Looking through the inflation and rates peak	The current slowdown in demand, easing of supply chain pressures and cooling of commodity prices is calming inflation pressures. This in turn should lead to lower long-term bond yields later this year. We believe that investors should look beyond the peak in inflation and policy rates to the investment opportunities that lower inflation and long-term rates offer.
Seizing new income opportunities from TINA to TARA	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 lower appetite for risk. We are now moving from an era of TINA (There Is No Alternative) to TARA (There Are Reasonable Alternatives).
Embracing market volatility	A combination of a) uncertainty around risk interest rates b) high inflation, c) recession fears; and d) the global equities 2022 bear market unleashed an environment of high volatility. This environment is creating enhanced opportunities to utilise structured solutions across asset classes in bonds, FX, equities and commodities.
Investing in a new era	The shift to the 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 is not temporary but largely structural in nature. The new economic era requires a completely different investing mind-set.
Accelerating energy efficiency	Tensions with Russia and soaring fossil fuel prices have shown that the world is still too dependent on oil & gas. In order to curb energy spending and reduce pollution, 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.

Performance of our 2023 investment themes



Note: Performance for Themes 1, 4, 5 in EUR, for Themes 2, 3 and 6 in USD.
Performance for themes 1-5 from 9 December 2022 to 24 August 2023, for Theme 6 from 14 March 2023

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