JULY UPDATE

Investment themes 2023

BNP PARIBAS
WEALTH MANAGEMENT

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INTRODUCTION

Why be more optimistic today?

Fears of economic recession are widespread, and have been for some time.

Manufacturing activity has weakened, but the momentum has improved

■ As the goods demand that had been turbocharged by reopening post-COVID lockdowns in 2021-22 has calmed, manufacturing activity globally has inevitably dipped.

■ At a global level, manufacturing activity looks a lot healthier. The JP Morgan Global Composite PMI output component remains robust at 54.4, well above 50 and thus still signalling positive manufacturing growth around the world.

Inflation is falling in US and Europe, but not in China

■ Inflation rates are falling in each of these geographies, and are likely to fall even faster over the next six months. Moreover, China simply does not have the same economic cycle and has no issue with inflation – China's core CPI is only 0.6% year-on-year as of May, allowing the Chinese authorities to try to stimulate the economy via lower interest rates, in particular to boost domestic growth.

■ This fall in inflation is exactly what Western central banks have wanted to engineer with their programme of higher interest rates, and it seems to be working, albeit more slowly than we might have hoped.

Should we be more optimistic then?

■ Statistically speaking, a "soft landing" where central banks raise interest rates to slow inflation and growth, but manage to curb inflation without triggering economic recession, is a rare beast. So we should not expect this to occur, in the normal course of events.

■ However, we have all been surprised by the resilience of the global economy in the face of a concerted campaign of higher benchmark interest rates in most countries.

■ Inflation is coming down, but growth has not (yet) evaporated. In the US, the Atlanta Fed GDPNow indicator points to a 1.8% GDP growth forecast (annualised) for Q2 this year, a decent rate of growth given the huge hike in interest rates over the past 12 months.

Perhaps then, the chance of achieving one of these rare "priced by stock soft landings" has improved, and this is being priced into financial markets in Europe, Japan and the US.

Macro support for our investment themes

■ We expect modest continued stimulus from the Chinese government and central bank to support Chinese demand as they target 5% growth for 2023. This should support Chinese stocks.

■ The avalanche of investment spending on renewable energy infrastructure in the wake of the energy crisis and unprecedented government support in both the US and Europe should drive our Cleantech theme.

■ In turn, this increased energy transition-related spending should propel demand for critical battery metals, which we highlight as a key investment opportunity within our Scarcity & Security theme.

■ The boom in Artificial Intelligence-related spending, following the runaway success of OpenAI's ChatGPT chatbot, and the ongoing growth of the cloud computing model should together fuel strong growth in cybersecurity spending.

■ Lastly, this new era of higher inflation and higher interest rates is finally delivering the most attractive fixed income sources of investment income for 15 years, which we highlight in our New Income Opportunties theme.

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.

Three promising regions and asset classes that performed poorly both in 2021 and 2022 are: i) Chinese equities; ii) Emerging Market sovereign bonds, and iii) Silver. In each case, we see strong fundamental drivers to underpin a sustainable rebound this year.

KEY CATALYSTS

Energy transition, Chinese stimulus, stronger Emerging Market currencies

We admit that thus far in 2023, the Chinese post-reopening economic rebound has been patchy. But we expect Chinese authorities to enact further stimulus measures to support the property market and to nudge Chinese growth back towards the official 5% target for 2023. Global investment in the energy transition and the growth in electric vehicle demand are key drivers for relevant Chinese companies.

We see the energy transition as a key demand driver for silver, given its key role in the manufacture of solar panels, which are experiencing exponential growth in demand. Emerging Market central banks are in a good position to cut reference interest rates sooner than those in developed markets as they were quicker to initially raise rates in response to rising inflation. We continue to recommend exposure to EM sovereign bonds, given a 7.4% yield for the Bloomberg EM Bond (local currency) index and the potential for Emerging Market currency appreciation as inflation rates fall.

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.

RIDE
THE CLEANTECH INVESTMENT WAVE

The US Inflation Reduction Act represents nearly USD 400 billion of government spending on clean energy. Europe is also incentivising investment in both solar and wind power, and associated battery storage. Today, solar power is the cheapest source of new renewable electricity, due to more efficient solar panel designs.

The need for energy security remains a key driver behind European clean energy and energy conservation investment. The circular economy is an important tool in decreasing indirect energy consumption in the production/provision of goods and services.

OUR RECOMMENDATIONS

- **Global renewable energy growth led by solar.** In 2023, solar power will account for two-thirds of the projected increase in global renewable energy generation. This comes in response to higher electricity prices, particularly in Europe. Heavy investment in electricity network infrastructure and large-scale energy storage in order to connect new solar panel and wind power installations to the power grid is also being made, boosting suppliers of industrial power management and transmission systems and components.
- **Recycling, Reuse and Repair grows in importance.** With the exponential growth in demand for solar panels and electric vehicles, the need to recycle used batteries and panels becomes ever more urgent. This remains a key plank of investments in the circular economy – the principle of focusing on the reuse, repair and recycling of goods and services to reduce our materials and energy footprint.

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 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.

The treble tides of COVID-19, conflict and climate change have laid bare the fragile nature of the global world order, and of the economy. Prior long-term underinvestment in commodities supply should also drive commodities prices higher over time.

In today's world of heightened geopolitical tensions, and increasing 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.

SCARCITY AND SECURITY ARE THE NEW WATCHWORDS

OUR RECOMMENDATIONS

- **Critical battery metals in the demand spotlight.** Exponential growth in renewable energy and electric vehicle demand 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 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 20% in euro terms.

KEY RISKS

- **A major global recession would likely create severe demand destruction for energy and raw materials,** driving 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.

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 a lower appetite for risk. We are now moving from an era of TINA (There Is No Alternative) to TARA (There Are Reasonable Alternatives).

OUR RECOMMENDATIONS

- **Cash-like funds have attracted investor inflows.** 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.

- **Locking in high interest rates beyond early 2024.** We thus recommend that risk-averse investors lock in the highest yields available for at least 14 years via short-term US investment grade corporate bonds (ca. 5.5% yield), Eurozone IG corporate bonds (4.7% yield) and Emerging Market sovereign bonds. (7.4% yield). Long-short credit arbitrage hedge/alternative UCITS funds are also attractive to capture pockets of value in fixed income – the HFR credit arbitrage index has gained 4% in US dollars since end-November 2022.

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.
- **Credit risk.** 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.

The current slowdown in demand, easing of supply chain pressures and cooling of commodity prices are calming inflation pressures. These, 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.

LOOKING THROUGH THE INFLATION AND RATES PEAK

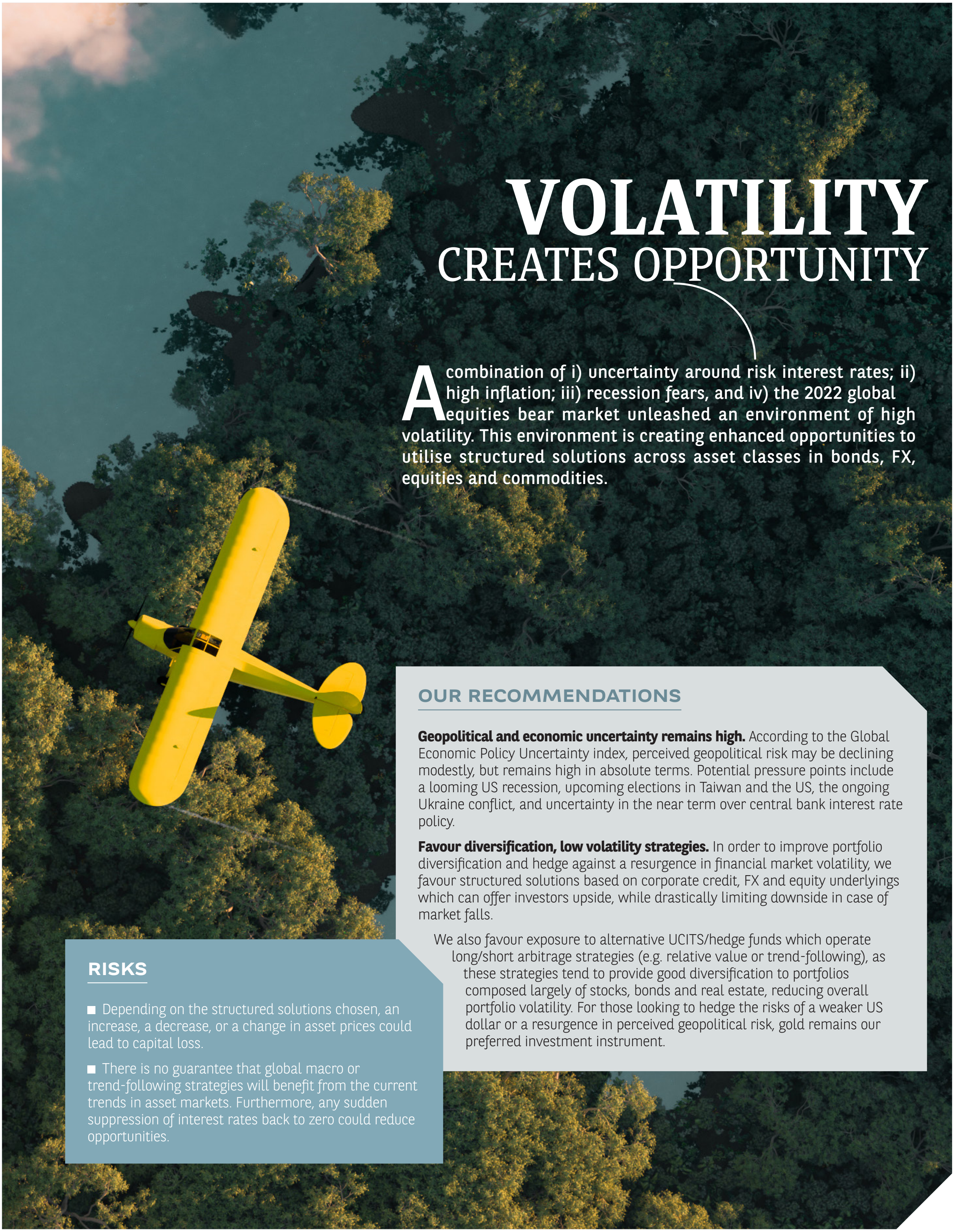
OUR RECOMMENDATIONS

Falls in inflation rates pick up pace. Since peaking at over 9% in mid-2022, US headline inflation more than halved to 4% in May this year. According to Truflation, the real-time CPI inflation measure is even lower, as low as 2.5% (as of 20 June). 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 fell to 6.1% in May. 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 2.2%, while the German equivalent inflation breakeven is 2.5%.

Beneficiaries of lower long-term interest rates. Given our expectation that inflation rates should decline fairly rapidly over the remainder of 2023, we also expect long-term interest rates (bond yields) to decline modestly from current levels over the coming year. While the prices of quality corporate and sovereign bonds should rise as a result, we see better investment leverage to this adjustment in the form of high-quality stocks. The global luxury goods sector is a good example of such a high-quality sector with superior long-term profitability and cash flows.

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.



VOLATILITY
CREATES OPPORTUNITY

A combination of i) uncertainty around risk interest rates; ii) high inflation; iii) recession fears, and iv) the 2022 global equities 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.

OUR RECOMMENDATIONS

Geopolitical and economic uncertainty remains high. According to the Global Economic Policy Uncertainty index, perceived geopolitical risk may be declining modestly, but remains high in absolute terms. Potential pressure points include a looming US recession, upcoming elections in Taiwan and the US, the ongoing Ukraine conflict, and uncertainty in the near term over central bank interest rate policy.

Favour diversification, low volatility strategies. In order to improve portfolio diversification and hedge against a resurgence in financial market volatility, we favour structured solutions based on corporate credit, FX and equity underlyings which can offer investors upside, while drastically limiting downside in case of market falls.

We also favour exposure to alternative UCITS/hedge funds which operate long/short arbitrage strategies (e.g. relative value or trend-following), as these strategies tend to provide good diversification to portfolios composed largely of stocks, bonds and real estate, reducing overall portfolio volatility. For those looking to hedge the risks of a weaker US dollar or a resurgence in perceived geopolitical risk, gold remains our preferred investment instrument.

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.

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