JANUARY 2024

Investment Strategy Focus
New Year, New Optimism

Summary

1. **Lower monthly inflation figures underline lower central bank rates.** Monthly inflation prints have declined sharply over the last 6 months. Central banks should cut interest rates starting in March. Lower deposit and money market rates could boost flows to other asset classes.

2. **Euro area sovereign bonds deliver strong finish to 2023.** Thanks to a sharp fall in bond yields over the last 2 months, euro area bonds delivered a 7% annual return last year. We remain neutral on euro area sovereign bonds at these lower yields, awaiting a better entry point.

3. **Gold poised for further gains after +13% over 2023,** supported by a weaker US dollar, lower long-term interest rates and continued central bank buying. It remains an excellent diversifier from stocks and bonds. Gold could decisively break a new all-time high in the weeks ahead.

4. **Risks remain contained, stay positive on Equities.** Our risk radar shows little cause for concern, with most components still benign. Liquidity and financial conditions support stocks. The Spanish IBEX 35, Italian FTSE MIB, Brazilian Bovespa and Mexican IPC indices lead globally.

5. **Reiterating our top 2024 convictions.** In fixed income, we favour emerging market sovereign bonds. In equities, we highlight Japanese and Latin American stocks. In alternatives, we like precious metals and energy infrastructure funds.

Contents

Asset allocation table 2

Macro: Inflation eases, central banks to change course soon 3

Prefer shorter bond duration; Stay with stocks 4

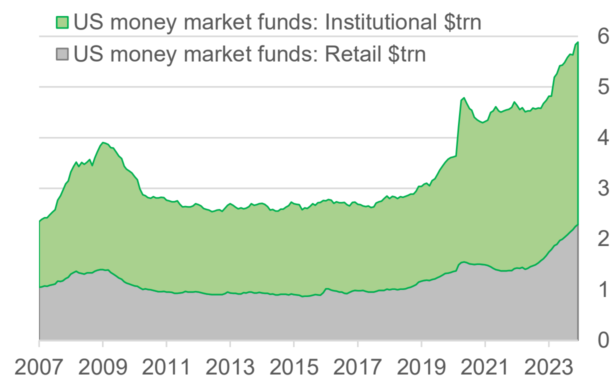
Risk Radar: No particular concerns 5

Asset Class recommendations 6

Economic & FX tables and Team 7

Disclaimer 8

WHAT HAPPENS TO CASH DEPOSITS ONCE CENTRAL BANKS REDUCE RATES?



Source: BNP Paribas, ICI, Bloomberg.

Edmund Shing, PhD

Global CIO

BNP Paribas Wealth Management

Stock market rebound continued in December

EQUITIES, GOLD TOP THE 2023 RANKING

Source: BNP Paribas, Bloomberg. Note: total return indices

LATIN AMERICAN STOCKS RALLY FURTHER

Source: BNP Paribas, Bloomberg. Note: total return indices

Asset Allocation: Stocks, Credit, Bonds, Gold all end 2023 higher

Outlook Summary

	Very underweight	Underweight	Neutral	Overweight	Very Overweight
Equities				+	
Government Bonds			=		
Corporate Credit				+	
Real Estate			=		
Alternatives				+	
Cash		-			

NB. Alternatives include Commodities, Infrastructure and Alternative UCITS/hedge funds

Macro: Inflation eases, central banks to change course soon

Was inflation transitory after all?

Both headline and core inflation rates have slowed sharply over the last 6 months in Europe and the US, while China has even slipped into disinflationary territory (annual core inflation of just 0.6%). Annualising the last 6 months of core inflation prints gives an underlying inflation run-rate of 1.9% for the US (core PCE) and just 0.8% for the eurozone.

Energy remains the key driver of both headline and core inflation over time – in November, euro area energy prices were falling by 11.5% annually thanks to lower oil, natural gas, and electricity prices. We should also take note of sharply slower growth in the US, and an absence of growth in the euro area.

As a result of weaker inflation and growth, the dominating economic narrative has decisively shifted since October from "higher for longer" to expectations of more rate cuts and sooner from the Federal Reserve and ECB in 2024. Today, interest rate futures markets price 6 rate cuts by the Fed and ECB by December, giving a December 2024 reference rate of 4% in the US, and 2.5% in the eurozone. Given the much higher starting point for rates in the US (5.5%) versus the eurozone (4%), we would expect more rate cuts from the Fed than from the ECB over this rate-cutting cycle.

US and European domestic manufacturing is already in recession according to PMI surveys, while consumption is slowing. The twin supports to households from falling energy costs and wage growth that is finally higher than overall inflation should underpin household spending going forwards. Lower interest rates are a further support.

A huge easing in financial conditions

Over the last 2 months, US financial conditions indices eased to their loosest since August 2022. Long-term interest rates fell sharply, credit spreads tightened, and financial market volatility receded. This is not only a relatively immediate boon to financial markets but is also a boost to the real economy over time.

Financial markets price in too many rate cuts?

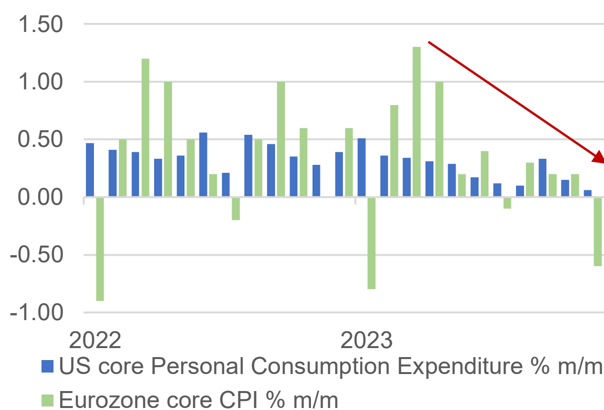
Since mid-October, the US 2-year Treasury bond yield has dropped from 5.2% to 4.3%. This reflects growing expectations of a Federal Reserve monetary policy pivot. Rather than keeping interest rates high to curb inflation, they will now focus on supporting faltering economic momentum by cutting rates rapidly.

At the same time, long-term interest rates have declined by around 1% over the same period to under 4% on the US 10-year Treasury yield and around 2% on the German 10-year Bund yield. Lower long-term inflation expectations and real yields have contributed equally to this dramatic fall in long-term rates. But the obvious question is:

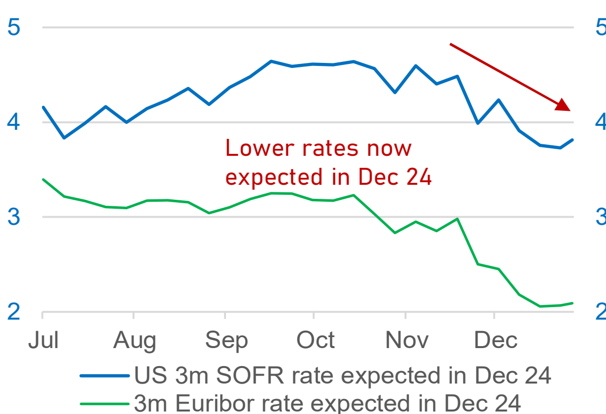
Have financial markets priced too aggressive a move in central bank and long-term interest rates over the last 2-3 months?

In my opinion, it is likely that the markets are today pricing in too many 2024 rate cuts in Europe. We expect just 3 ECB rate cuts in 2024. As a result, long-term bond yields could well drift higher in the near term, as some of this sharp decline unwinds. **Hence, we remain neutral on euro area sovereign bonds at these levels, awaiting a better entry point.**

UNDERLYING INFLATION COOLS RAPIDLY



MORE CENTRAL BANK RATE CUTS EXPECTED



Source: BNP Paribas, Bloomberg.

Prefer shorter bond duration; Stay with stocks

Prefer shorter US bond duration

The decline in bond yields has surprised many investors both in terms of speed and magnitude. And the Fed did little to stop it at the FOMC December meeting, which further exacerbated the trend.

After falling by 57 bps in November, the US 10-year yield fell again by 47 bps in December (36 bps and 42 bps respectively for the German 10-year yield), leading to an impressive total return over the last two months for government bonds: +7% in the US and +6% in Germany.

Such a rally is unlikely to continue in our view in the next few months. Issuers traditionally frontload their refinancing needs and the beginning of the year is associated with an elevated level of bond supply.

It is not certain that this supply will be easily absorbed at current yields. Hence, we think the risks are skewed to higher bond yields in the near term. As a result, we believe interest rate sensitivity should be reduced so we now switch our preference towards short-term US Treasuries. The Bloomberg US government bond index with bonds maturing between 1 and 3 years shows a yield of 4.4%.

We believe US Treasuries remain attractive and offer better value than German government bonds. The current US Treasury yield (4.1% as of 29/12/2023) remains well above the average of the last 20 years (2.4%). By comparison, the spread is smaller for German government bonds and the current level is lower: 2.3%, while the 20-year average is 1.5%.

Edouard Desbonnets

January could be trickier for stocks, but no change in strategic positive preference for equities

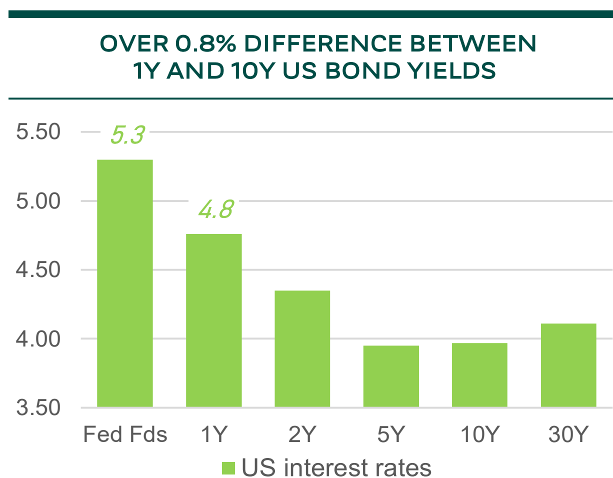
Since the end of October, abundant liquidity and dramatically improved financial conditions have propelled US stocks to a 16% rebound, and eurozone stocks to a 13% rebound to the beginning of January. Key benchmark US and European stock indices have returned close to their all-time high marks reached at the end of 2021. After such an impressive rally in such a short timespan, it is only natural to think of taking at least some profits.

But, even though any rise in long-term bond yields could temporarily halt the advance in stocks, I would not rush to cut stock exposure (except in the Magnificent Seven US mega-cap technology stocks).

2023 fund flows massively favoured money market and bond funds and ETFs, while stock funds received relatively limited inflows by comparison. We could well see a rebalancing towards stocks in January, as retail investors chase recent performance. In addition, companies themselves continue to be a source of demand for stocks as they continue their existing stock buyback programmes.

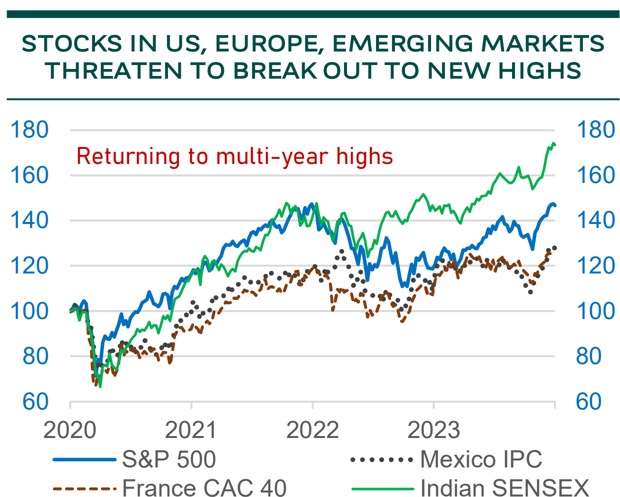
Seasonal patterns remain favourable for stocks up to May, while a number of key benchmark stock indices around the world (including the S&P 500, the Euro STOXX 50, the French CAC 40, the Japanese Nikkei 225, the Mexican PIC, and the Indian Sensex) returned close to multi-year or all-time highs. Should these indices establish new multi-year highs, there is a strong possibility of further upside momentum, as frequently occurs post key breakouts.

OVER 0.8% DIFFERENCE BETWEEN 1Y AND 10Y US BOND YIELDS



Source: BNP Paribas, Bloomberg.

STOCKS IN US, EUROPE, EMERGING MARKETS THREATEN TO BREAK OUT TO NEW HIGHS



Source: BNP Paribas,. Bloomberg

Risk Radar: No particular concerns

Economic, financial market indicators stay benign

In our proprietary Risk Radar model, we monitor 9 key economic and financial market indicators that have historically given advance warning of rising risk to the global economy and financial markets.

Typically, when between 3 and 5 of these indicators are triggered (amber risk zone), this suggests that investors should watch markets more carefully, and be prepared to take a more defensive position in their portfolios.

At 6 indicators triggered and above (red risk zone), investors should definitely sell down stocks and credit and retreat to safe havens like cash, gold and government bonds. This risk radar peaked last at a reading of 5 out of 9 components in June and September 2022.

Currently, only 2 out of 9 indicators signal any concern, the US yield curve (which remains inverted, i.e. short-term yields higher than long-term yields) and the rising trend in US unemployment (the unemployment rate rising and above its own trailing 12-month moving average).

This suggests that the overall level of risk remains relatively low, supporting our positive stance on stocks and corporate credit.

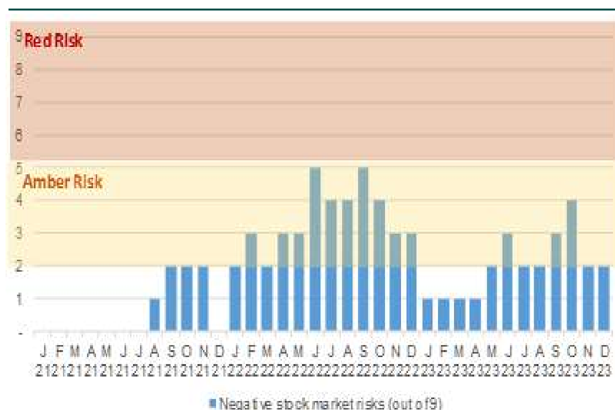
3 top convictions: Latin America, EM bonds, Gold

Equities: Latin American stocks. High commodity exposure (energy, metals), robust nominal growth and appreciating currencies are three drivers of outperformance by Brazilian and Mexican stocks. Valuations remain cheap (8x P/E for Brazilian, 13x P/E for Mexican stocks) and dividend yields are attractive, while strong Brazilian real and Mexican peso momentum also helps US dollar and euro-based performance. *Latin American equity funds, ETFs.*

Fixed income: Emerging market sovereign bonds (local currency). An attractive gross yield of 6.5%, stronger EM currencies against a weaker US dollar, and emerging market central banks which are already cutting reference rates as inflation pressure weakens are all favourable factors for emerging market sovereign bonds. *Emerging market local currency sovereign bond funds, ETFs.*

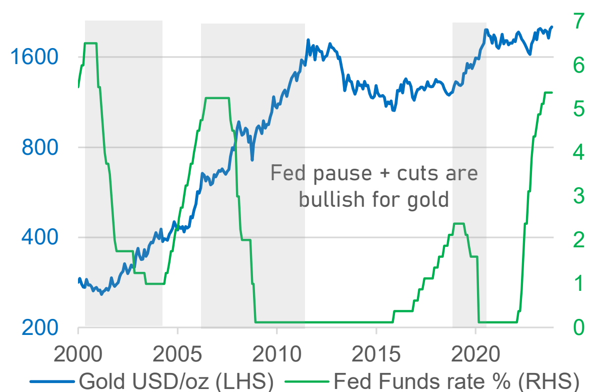
Alternatives: Precious metals (gold, silver). Boosted by i) continued central bank buying, ii) lower bond yields, iii) a weaker US dollar and iv) global geopolitical tensions, gold has just reached a new all-time high. Gold has typically performed very well in the past during Fed rate-cutting periods. We like the diversification benefits of precious metals, which today are ever more valuable in a balanced portfolio. *Physical gold, silver, precious metals miners.*

BNPP WM RISK RADAR: LOW OVERALL RISK



Source: BNP Paribas

THREE IMPRESSIVE RALLIES IN GOLD DURING FED RATE PAUSE/CUTTING CYCLES



Source: BNP Paribas. Bloomberg.
Note: Shaded areas are Fed rate pause/cut periods

Summary of our main recommendations, by asset class

	Current Recom	Prior Recom	Constituents	We like	We avoid	Comments
EQUITIES	+	+	Markets	UK, Japan, eurozone, Latin America, China, S. Korea Singapore and Indonesia		Look through a temporary dip to the recovery beyond. Key drivers include falling US inflation, lower long-term interest rates, improving macro liquidity, and easing energy prices. Build stock exposure gradually on market consolidations.
			Sectors	Global Health Care, Energy, Materials, EU Financials & Technology		**Energy & Materials** to benefit from rebounding Chinese activity, low base metals inventories. **European banks** should benefit from surprisingly resilient consumption, rising Net Interest Margins & rising ECB deposit rate.
			Styles/ Themes	Quality, Megatrend themes		Circular Economy, Electrification, Security, Income Growth themes
BONDS	=	=	Govies	Favour US short duration. Prefer inflation-indexed bonds		Our 10-year bond yield targets are 3.75% in the US and 2.5% in Germany in one year. Favour US and UK inflation-linked bonds.
	+	+	Credit	US, Euro IG credit		We favour investment grade Credit, focusing on US credit on the back of decade-high yields and strong balance sheets.
	+	+	EM bonds	USD and local currency		
CASH	-	-				
COMMO-DITIES	+	+		Gold Oil Industrial metals		Oil (+) Brent should remain in the USD 80-95 range due to gas/oil substitution & the progressive ban on Russian oil. Base metals (+) boosted by China's reopening in the short term, and energy transition demand in the longer term. Gold (+) is our preferred safe haven, weaker USD & stable LT rates should help, 12-month exp. range = USD 1900-2150.
FOREX			EUR/USD			Our EUR/USD target is USD 1.15 (value of 1 euro) in 12 months. Target change for Chinese CNY and Japanese JPY – less potential for rebound.
REAL ESTATE	=	=		Health Care, UK commercial		Unlisted real estate faces enduring headwinds from slowing economies and much higher financing rates. Prefer listed real estate.
ALTERNATIVE UCITS				Long/Short Equity and Relative Value		
INFRA STRUCTURE	+	+		Energy, transportation, water		Excellent long-term returns expected from private and listed infrastructure given long-term underinvestment.

Economic, FX forecast tables

BNP Paribas Forecasts			
GDP Growth %	2023	2024	2025
United States	2,4	0,9	1,3
Japan	2,1	0,8	0,9
United Kingdom	0,5	0,0	1,1
Eurozone	**0,5**	**0,6**	**1,6**
Germany	-0,1	0,3	1,3
France	0,8	0,6	1,4
Italy	0,7	0,9	1,5
Emerging			
China	5,2	4,5	4,3
India*	7,5	7,0	6,5
Brazil	3,1	1,8	1,8

* Fiscal year

Source: BNP Paribas - 20/12/2023

BNP Paribas Forecasts			
CPI Inflation %	2023	2024	2025
United States	4,1	2,6	2,3
Japan	3,2	2,4	1,9
United Kingdom	7,4	2,5	2,1
Eurozone	**5,5**	**2,0**	**2,0**
Germany	6,1	2,4	2,1
France	5,7	2,4	1,8
Italy	6,1	1,7	1,8
Emerging			
China	0,4	1,5	1,7
India*	5,8	5,7	4,5
Brazil	4,6	3,6	3,9

* Fiscal year

Source: BNP Paribas - 20/12/2023

	Country		Spot 02/01/2024	Target 3 months	Target 12 months
Against euro	United States	EUR / USD	1,09	1,06	1,15
	United Kingdom	EUR / GBP	0,87	0,86	0,86
	Switzerland	EUR / CHF	0,93	0,95	0,98
	Japan	EUR / JPY	155,33	154	154
	Sweden	EUR / SEK	11,16	11,00	11,00
	Norway	EUR / NOK	11,30	11,30	10,80
Against dollar	Japan	USD / JPY	141,94	145	134
	Canada	USD / CAD	1,33	1,32	1,30
	Australia	AUD / USD	0,68	0,68	0,70
	New Zealand	NZD / USD	0,63	0,60	0,63
	Brazil	USD / BRL	4,90	5,00	5,00
	India	USD / INR	83,32	82,0	82,0
	China	USD / CNY	7,13	7,20	6,80

Source: BNP Paribas, Refinitiv Datastream. As at 2 January 2023

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