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2023 OUTLOOK: despite a mild recession, opportunities in bond markets and relative caution in European equities

After a particularly turbulent year, the experts at Ostrum Asset Management (Ostrum AM), an affiliate of Natixis Investment Managers, expect a moderate recession in 2023. However, investors could take advantage of investment opportunities and interesting entry points in the various markets, particularly in fixed income and credit. As the energy crisis continues in Europe, the greatest caution will be required in stock selection. Philippe Waechter, Head of Economic Research, Stéphane Déo, Head of Market Strategy, Alexandre Caminade, Head of Core Fixed Income and Liquid Alternatives, Philippe Berthelot, Head of Money Market and Credit Management, and Frédéric Leguay, Head of Equity Management, present their views on the economy, the markets and the investment strategies that should be favoured to find value in 2023.

Economy: high probability of a mild recession

According to **Philippe Waechter, Head of Economic Research**, the cycle is less dynamic. There has been a major inflationary shock that has eroded purchasing power and a tightening of monetary policy. This combination has a recessionary effect on economic activity, which has to settle into a slightly different framework than before. 2023 will have three dimensions. **The first is the source of demand.** Ostrum AM believes that the three major growth drivers, the US, China, and the Eurozone, will not see their domestic demand accelerate sharply. This is due to the real estate risk identified in all three regions. Transactions are slowing sharply in the US; construction is contracting in China and the market is less liquid in Europe. At the same time, prices are starting to soften in the Western US and in China's top cities. This is not yet the case in the Eurozone. A negative wealth effect is to be feared in 2023, which will penalise consumption. **The second aspect is that monetary policy** will have to remain tight throughout 2023 to avoid a resurgence of inflation. **This implies a strong risk of recession in 2023**, before a return to a more normal situation in 2024. The last dimension concerns **the specificity of the euro area on the energy crisis.** It reflects a rise in the cost of supplies, a shortage of nuclear production in France and high-priced gas imports. The first point is a drain on the European economy (2.7 points of GDP at the end of the second quarter), with the associated recessionary aspect, the second concerns France's capacity to produce more electricity and the third is to have long-term contracts on gas supply to reduce the volatility of its price. It is this equation that will have to be solved in 2023 if the economy is to recover.

Asset allocation: caution and diversification

According to **Stéphane Déo, Head of Market Strategy**, 2023 should be characterised by **greater stability in interest rates** on both sides of the Atlantic: After extremely rapid global monetary tightening, the Central Banks are slowing down the pace of their rate hikes. The Fed and the ECB are expected to raise their rates by 50 basis points at their December 2022 meetings, to 4.75% for

Fed funds and 3% for ECB deposits. During the first three quarters of 2022, all assets suffered from disappointing performance, reducing diversification opportunities for investors. A correlation that was still at work during the rebound at the end of September after the Euro Stoxx hit a low. This situation, common in times of high inflation, is likely to persist, **forcing investors to be cautious in their asset allocations and seek other sources of diversification**. For Ostrum AM, 2023 will be the year of fixed income and credit due to an expected decrease in volatility, with cCentral Banks reaching cruising speed, profitability restored after a long period of negative rates and credit spreads returning to more reasonable levels after the excesses of pessimism in 2022.

Fixed income: attractive entry points in 2023

For **Alexandre Caminade, Head of Core Fixed Income and Liquid Alternatives**, 2022 was the worst year for more than 20 years in the bond markets. In 2023, investors could benefit from interesting **entry points** for interest rate exposure, probably in the second quarter, once most record issuance volumes have been placed in the markets and the Fed and ECB rate hike cycle is over. With regard to yield curves, and after a strong flattening movement in 2022, Ostrum AM expects **a steepening by the end of 2023**. The market should anticipate rate cuts by the Fed and the ECB in 2024, which would push short rates down, while issuance volumes should weigh on the longer end of the curves.

Spread assets could do well in 2023. Ostrum AM anticipates that interest rate volatility, a key factor in 2022 on the evolution of spreads, will stabilise, thanks to a better visibility on the trajectory of monetary policies. **Sustainable bonds** also appear to be an interesting opportunity. On the one hand, the "greenium" (issue premiums) has improved, offering better buying conditions to investors. On the other hand, Ostrum AM estimates that next year's expected issuance volumes should not exceed 2021 levels, i.e., just over € 830 billion of issuance.

Credit: opportunities in Investment Grade and High Yield

According to **Philippe Berthelot, Head of Money market and Credit Management**, 2022 was an *Annus Horribilis* for the bond market, the worst since 1994. However, 2023 is shaping up to be an *Annus Mirabilis*: the expected default rates for 2023 (around 3.3%, close to historical averages) confirm the scenario of a mild recession. In terms of performance, yields are at a 10-year high on Investment Grade and High Yield credit, both in Europe and the US. More precisely: one has to be very selective on **Investment Grade credit**, because of its sensitivity to Central Bank rate hikes, whereas **High Yield credit** responds to its own dynamics. Both segments present investment opportunities not seen in the last 10 years. The upward trend in interest rates in Europe, combined with our view that swap spreads will narrow during 2023, should benefit the **banking sector**. On the corporate side, the risk of a generalized extension seems exaggerated to Ostrum AM for **hybrids**: a lot of value can be extracted by being selective. Some **listed real estate investment trusts (REITs)**, which suffered a lot in 2022, also deserve some attention. **Telecom stocks**, which have been very resilient so far, look a bit expensive now. Finally, High Yield credit, which is less sensitive to interest rates, deserves an increasing strategic allocation.

Credit is back in 2023: it is interesting, attractive, and remunerative: around 4% for Investment Grade € credit and more than 8% for High Yield € credit: managing risk means being selective with a good evaluation of entry points.

Equities: volatility will encourage caution and selectivity

According to **Frédéric Leguay, Head of Equity Management**, there is no longer any potential for appreciation in the European equity markets, so **patience is required before investing**. The markets have just gained 17%, while inflation seems to be on the decline in the US. Yet the global economy will slow significantly in response to restrictive monetary policies. And companies, whose margins reached their highest level in forty years in 2022, will have to defend them in a context of slowing demand and normalisation of supply. Ostrum AM therefore expects a 10% contraction in the earnings base in Europe, which is in line with its scenario of a small slowdown, but also with investors' expectations. Unfortunately, **valuations offer little potential**, especially if we factor in the abnormally high level of profitability, the likely future rate hikes and the still uncertain geopolitical context. Since 1990, European markets have never bottomed before the results review process has entered its final phase. This time it has not yet started. **2023 will be volatile and will offer further opportunities to position in risky assets**. In the meantime, Ostrum AM favours visibility, in order to absorb the consequences of lower earnings estimates. It should also be noted that valuation differences between stocks in the same sector remain significant and widespread. They can be exploited in order to benefit from a safety margin while waiting for better days, which should come in the second half of next year. In 2023, Ostrum AM favours the **financial sector, visible sectors such as health, telephony, consumer goods and services**. In the first quarter, Ostrum AM should strengthen its position in growth sectors depending on valuations and in the second quarter return to certain stocks that are more sensitive to the cycle.

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Ostrum Asset Management draws on its investment expertise to enhance the impact of its clients' commitments as they act together to support European citizens' life plans, health and retirement.

A European institutional investment management leader¹, Ostrum Asset Management supports its clients in their liability-driven investments, offering both asset management solutions on the back of its long-standing fixed-income and insurance-related management expertise (equity and fixed income), and investment services via its innovative technological platform.

Ostrum Asset Management is a well-established responsible investment advocate² and manages €389 billion³ in assets for large institutional clients – insurers, pension funds, health insurers, corporations – as well as €542 billion³ in assets under administration for professional investors worldwide across all asset classes. Ostrum Asset Management is an affiliate of Natixis Investment Managers.

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1. IPE Top 500 Asset Managers (Investment & Pensions Europe) 2022 ranked Ostrum AM as the 11th largest asset manager, as at 12/31/2021. Any reference to a ranking, a rating or an award provides no guarantee for future performance.
2. Ostrum AM was one of the first French asset manager signatories to the PRI in 2008. More details; www.unpri.org

3. Source: Ostrum Asset Management, consolidated data at end-June 2022. Administered assets include Ostrum AM's assets. The services provided for a given client may concern certain services only.

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1. Cerulli Quantitative Update: Global Markets 2022 ranked Natixis Investment Managers as the 18th largest asset manager in the world based on assets under management as of December 31, 2021.
2. Assets under management ("AUM") of current affiliated entities measured as of June 30, 2022 are \$1,156.7 billion (€1,106.7 billion). AUM, as reported, may include notional assets, assets serviced, gross assets, assets of minority-owned affiliated entities and other types of non-regulatory AUM managed or serviced by firms affiliated with Natixis Investment Managers.
3. A brand of DNCA Finance.

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