Completed on 29/11/2022

2023 OUTLOOK

A moderate recession is likely, opportunities among fixed-income markets and relative caution in European equities

After a particularly turbulent year in 2022, Ostrum Asset Management's (Ostrum AM) experts are expecting a moderate recession in 2023. However, investors may be able to capitalise on investment opportunities and attractive entry levels in the markets, particularly in fixed-income and credit. With the ongoing energy crisis in Europe, extreme caution is required in stock picking. Philippe Waechter, Chief Economist, Stéphane Déo, Head of Market Strategy, Alexandre Caminade, CIO Core Fixed Income & Liquid Alternatives, Philippe Berthelot, CIO Fixed Income and Frédéric Leguay, Head of Equity Investments, present their views on the economy and on which markets and investment strategies to prioritise in order to find value in 2023.

MACROECONOMY - High probability of a recession, but of low intensity

- A less dynamic cycle and high recession risk
- Three key issues: demand drivers; monetary policies & inflation; the energy crisis in the eurozone

ASSET ALLOCATION - Caution and diversification

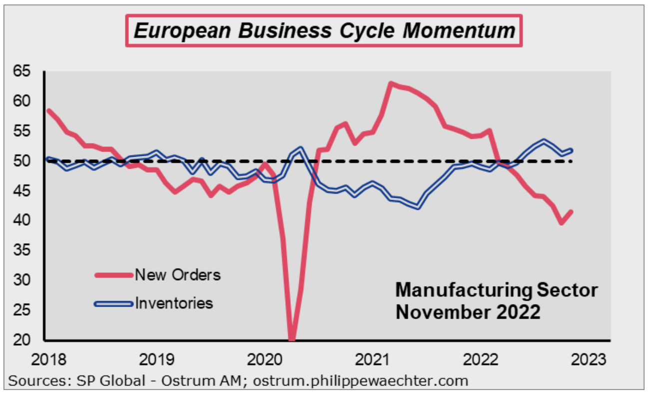
- Anticipating greater interest rate stability and lower volatility
- Une situation favourable for fixed-income and credit investments

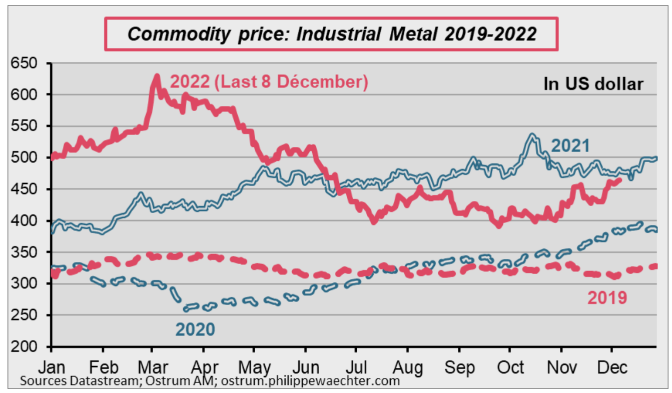
ASSET MANAGEMENT - Finding value in 2023

- **FIXED INCOME - Attractive investment levels in 2023**
    - Interest for sovereign debt on one hand, for supranationals and agencies on the other hand to benefit from swap spreads
    - Opportunities among sustainable bonds, given the improvement in the green issue premium
- **CREDIT - Opportunities in investment grade and high yield**
    - Highest yield in 10 years in investment grade and high yield credit, in Europe and the US
    - Selectivity required, with a careful assessment of initial investment levels
- **EUROPEAN EQUITIES - Caution and selectivity in the face of volatility**
    - Limited short-term potential upside from current valuation levels
    - Prioritise visibility and valuation spreads within the same sector

MACROECONOMY - High probability of a recession, but of low intensity

According to our Chief Economist, Philippe Waechter, the cycle is less dynamic. The major inflationary shock that we are experiencing has weighed on spending power and monetary policies have been toughened. The combined effect of these two factors has had a recessionary impact on economic activity, which is having to adjust to a relatively different context from previously.

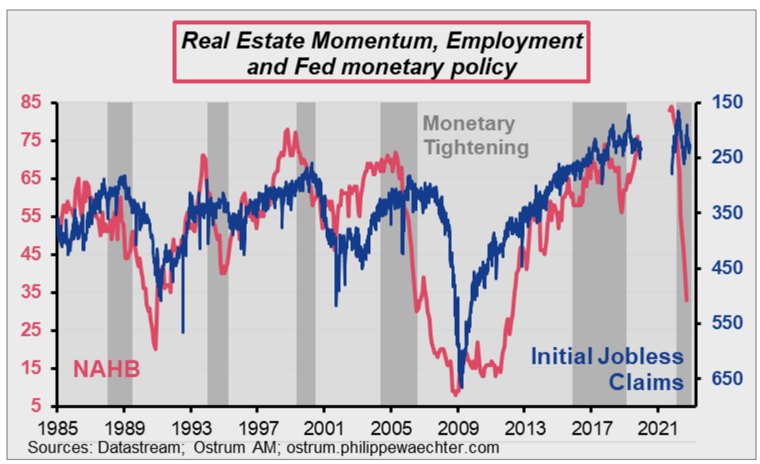




Economic cycle dynamics: a slowdown

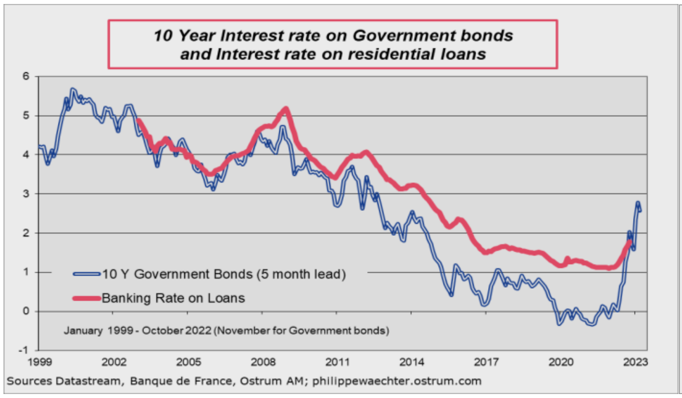
Demand drivers will be a key issue in 2023. Ostrum AM believes that the three main growth drivers, i.e. the US, China and the eurozone, will not see any sharp acceleration in domestic demand.

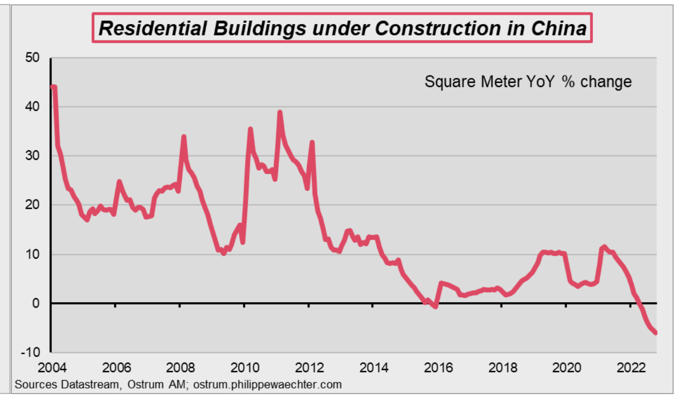
This is due to real estate risk, which is discernible in all three regions. Transactions are slowing sharply in the US, while construction volume is contracting in China and the market is becoming less liquid in Europe, as interest rates rise. Meanwhile, prices are starting to fall in western America and in the largest cities in China. This is not yet the case in the eurozone. A negative wealth effect is to be feared in 2023, which would weigh on consumer spending.



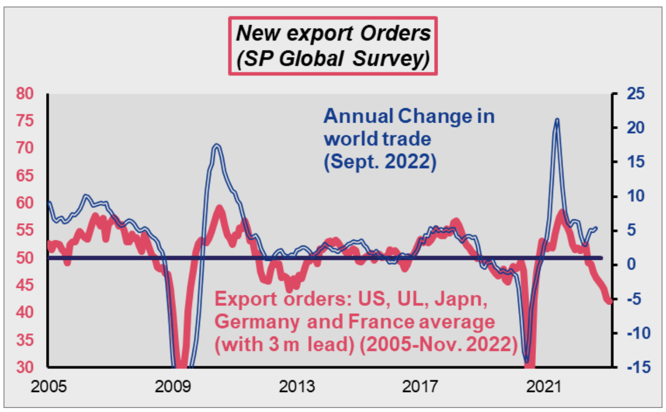
Given that the US real estate market serves as a leading indicator for the economic cycle, construction index data and any downturn in transactions are particularly important factors.

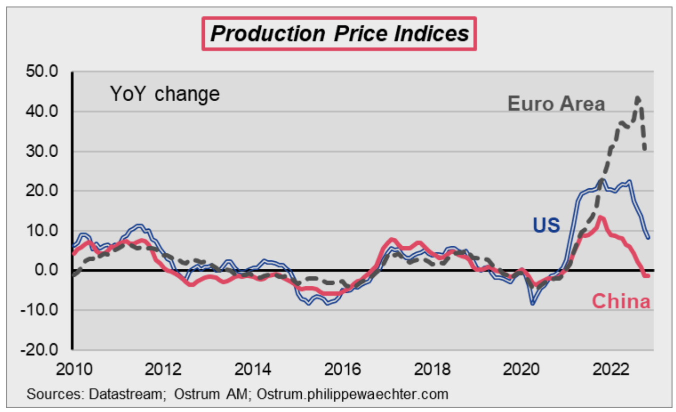
The question of rising interest rates will remain a major issue. Mortgage rates are increasing sharply across the board. There has only been a partial adjustment in France, compared to government bond yields.





Global trade, which is also flagging, is not playing a counter-cyclical role and will not be a source of dynamic momentum in 2023. Countries which are highly dependent on international commerce, such as Germany, are likely to be hit particularly hard. An analysis of production price pace is a reliable indicator of the level of delocalisation risk incurred by European industry.





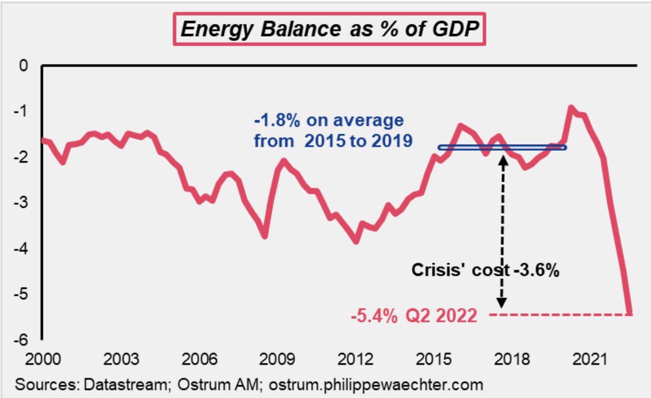
Inflation, monetary policies and the energy crisis

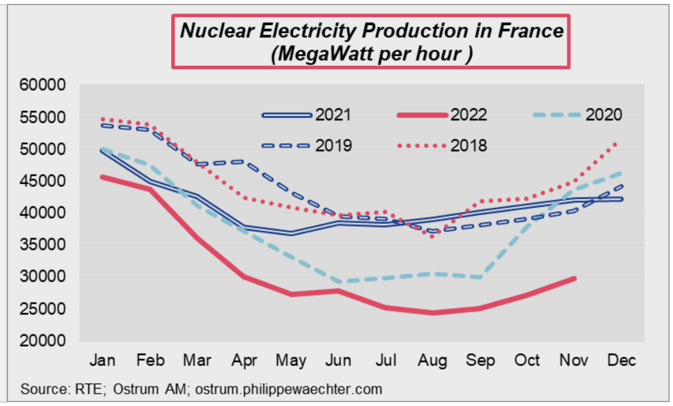
Monetary policy is expected to remain restrictive throughout 2023 in order prevent resurgent inflation. This implies strong recession risk in 2023, before returning to a more normal situation in 2024.

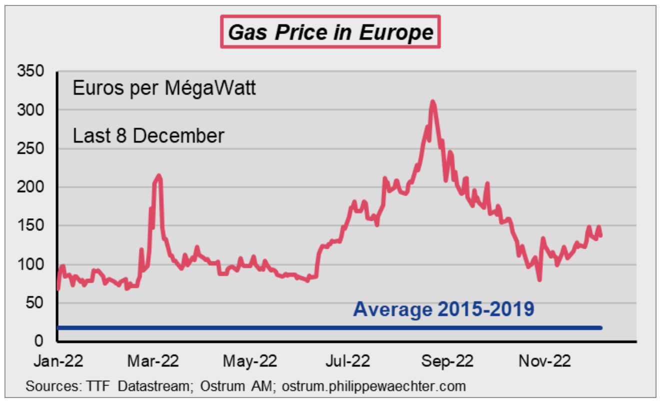
This is particularly the case as **the depth of the energy crisis is specific to the eurozone**, reflecting:

- Higher provisioning costs, weighing on the European economy (2.7 GDP points at the end of the second quarter of 2022), with the associated recessionary aspect
- Insufficient nuclear production in France, questioning our capacity to produce more electricity
- Expensive gas imports, requiring long-term gas supply contracts to reduce price volatility

This equation will have to be resolved in 2023 to enable the economy to take off again.



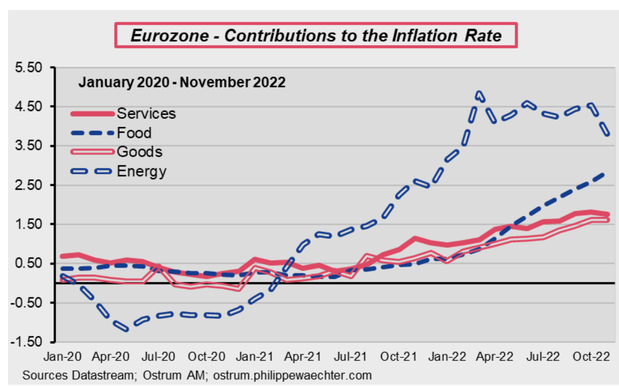




Focus on inflation

Inflation slowed to 10% in November in the eurozone. Energy was the main factor, with a sharply lower contribution. The contribution from services remained stable, with goods rising marginally. Food is the only sector continuing to increase sharply. The lower contribution from energy reflects the fall in the oil price and more moderate gas prices. It is too early to foresee inflation coming to an end, as there is still a strong knock-on effect on goods and services. This explains why the ECB will maintain its restrictive stance. The inflationary spiral must not be allowed to be rekindled. Two key points must therefore be observed carefully:

- The gas price. Although the price has been moderated, tensions are not going to spontaneously abate as the market remains unbalanced. The main aim should be to stabilise gas prices.
- The other key point concerns food prices, which have an immediate strong influence on behaviour. Everyone observes food prices daily. This is a key issue, as many people are impacted in terms of their budget and also their health.



GDP growth and inflation summary & outlook

The cycle is currently relatively undynamic. It is driven in Europe by public intervention. The cost-of-living crisis is weighing on consumer spending across the board. Capex is due to decline in Europe according to the ECB survey of company financing needs. The real estate market is fragile and risks triggering a negative wealth effect in the US, China, Europe and the UK. Meanwhile, these factors are slowing global trade, which is not playing a contra-cyclical role. A global recession is likely towards the end of 2022.

Nominal tensions are declining rapidly in China and the US, in line with the downturn in the economic cycle. In the eurozone, the energy crisis and its knock-on effects have extended the inflationary period. Lastly, the central banks are expected to maintain their monetary grip throughout 2023, even if inflation inverts.

Ostrum AM forecasts on 15/12/2022

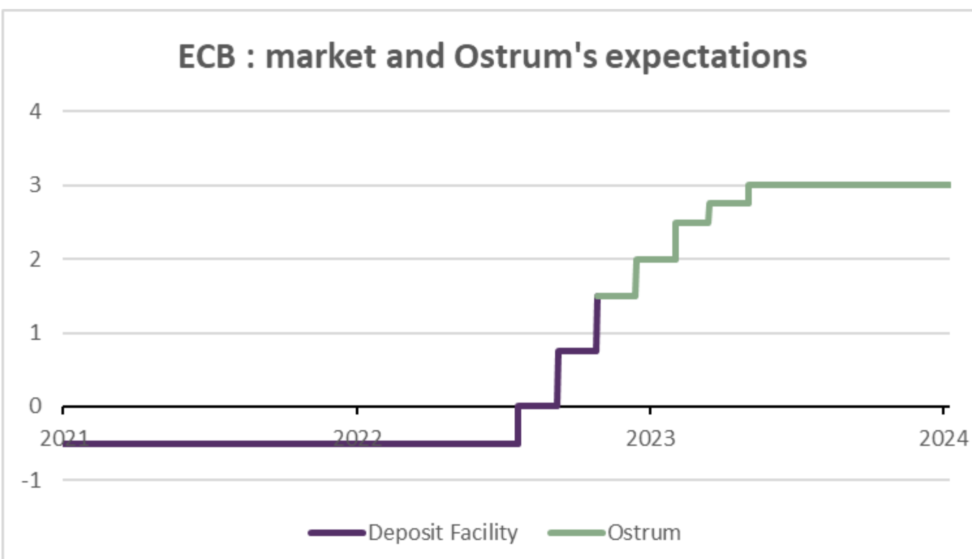
		2023 expectations							
		Growth (yearly average)				Inflation (CPI)			
	2022	Bloomberg Consensus		Ostrum		Bloomberg Consensus		Ostrum	
	Consensus	Forecast	3 month change	Forecast	Gap to consensus	Forecast	3 month change	Forecast	Gap to consensus
USA	1.8	0.4	-0.5 ↓	0.5	0.1	4.3	0.6 ↑	3.5	-0.8
Euro Area	3.2	-0.1	-0.6 ↓	0.4	0.5	6.0	1.5 ↑	4.5	-1.5
UK	4.3	-1.0	-1.0 ↓	-0.2	0.8	7.1	0.6 ↑	6.0	-1.1
Japan	1.4	1.3	-0.3 ↓	1.3	0.1	1.8	0.5 ↑	1.8	0.0
China	3.0	4.9	-0.4 ↓	4.0	-0.9	2.3	0.0 →	1.5	-0.8

Source : Bloomberg & Ostrum

ASSET ALLOCATION - Caution and diversification

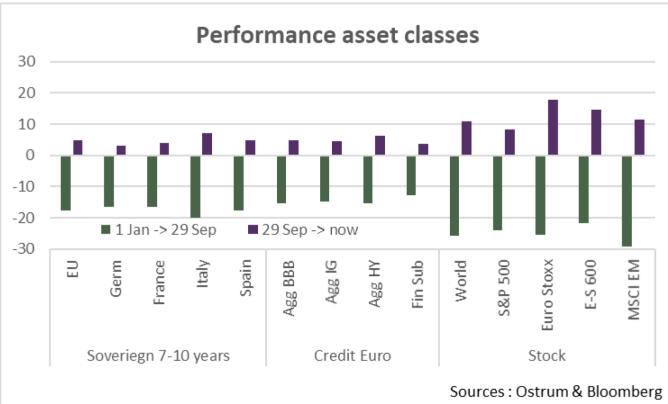
According to our Head of Market Strategy, Stéphane Déo, 2023 should see greater interest rate stability on both sides of the Atlantic. Following a period of extremely rapid global monetary tightening, the central banks are now slowing the pace of their rate hike cycle. The Fed and the ECB are expected to increase rates by 50 basis points at their next committee meetings in December 2022, with Fed funds reaching 4.75% and ECB deposits at 3%.

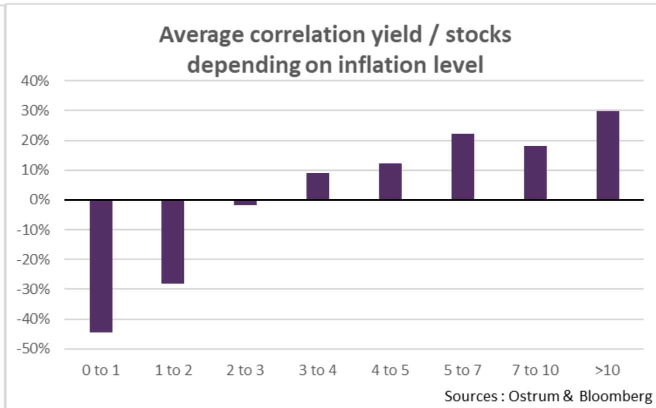
Inflation inertia should encourage the central banks to maintain these rates at least until the end of the year. As a result, 2023 would be a year of much more stable interest rates and a completely flat yield curve.



Source: Ostrum AM, November 2022. The analyses and opinions represent the point of view of the referenced author at the date indicated and are liable to change. They should not be interpreted as having any contractual value.

During the first three quarters of 2022, all asset classes delivered disappointing performances, reducing diversification opportunities for investors. This correlation persisted during the rally at the end of September after the EuroSTOXX index had hit its lows. The strong correlation between equities and bonds, which is to expected during periods of high inflation, should continue for some time, obliging investors to remain highly cautious in their asset allocations and seek other sources of diversification.





For Ostrum AM, 2023 will be a year dominated by interest rates, due to an expected drop in volatility, with central bank rates reaching a plateau and yields also restored after a long period in negative territory, and with credit spreads returning to more reasonable levels, after sentiment turned excessively pessimistic in 2022.

2023 asset allocation

Sovereign	-	Neutral	+
United States			X
Bund			X
OAT			X
Emergent			X

Credit	-	Neutral	+
Investment Grade			X
High Yield			X

Equities	-	Neutral	+
EUR	X		
United States	X		

Relative views	-	Neutral	+
Shares vs. Sovereign	X		
Equity vs. Credit	X		
Credit vs. Sovereign			X
EUR vs. US shares			X

Source: Ostrum AM & Bloomberg, 15.12.2022. The analyses and opinions represent the point of view of the referenced author at the date indicated and are liable to change. They should not be interpreted as having any contractual value.

Summary of our views

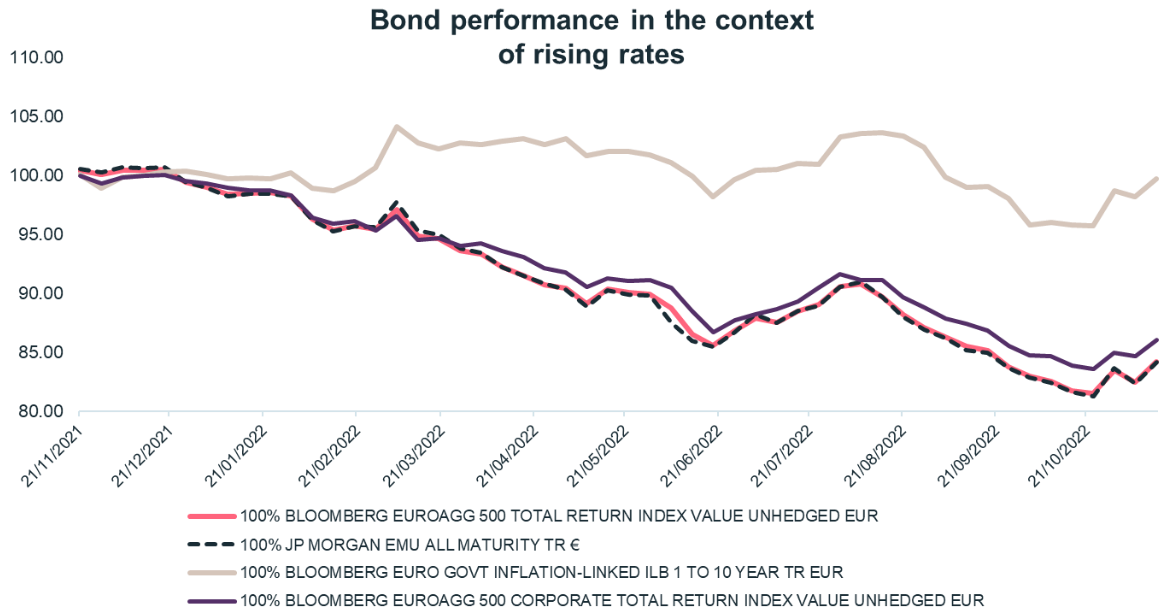
Sovereigns		15/12/2022	Outlook Dec. 2023
United States	Fed Funds	4.50	5.00
	10 years	3.45	4.50
Great Britain	10 years	3.24	
Japan	10 years	0.26	
Eurozone	ECB, deposits	2.00	3.00
Germany	10 years	2.08	3.00
	30 years	1.89	2.90
France	10 years	2.59	3.60
	Spread	51	60
Italy	10 years	4.17	5.75
	Spread	208	275
Spain	10 years	3.16	4.28
	Spread	108	128
Portugal	10 years	3.07	4.05
	Spread	99	105

Credit / Spreds	15/12/2022	Outlook Dec. 2023
Euro inflation swap 10 years	2.51	2.50
Libor OAS Spread		
Investment grade	99	
High Yield	420	
OAS spreads vs sovereigns		
Investment grade	167	160
High yield BB	358	370
EMBI Spread	460	450
Forex		
EUR/USD	1.06	1.00/1.05
Equities		
Euro Stoxx	3836	3800
Commodities/Volatility		
Brent Oil Price	81.54	100

Source: Ostrum AM & Bloomberg, 15.12.2022. The analyses and opinions represent the point of view of the referenced author at the date indicated and are liable to change. They should not be interpreted as having any contractual value.

FIXED INCOME - Attractive investment entry levels in 2023

In the opinion of our Core Fixed Income & Liquid Alternatives CIO, Alexandre Caminade, 2022 was the worst year in the past two decades for the fixed income markets. In 2023, investors could capitalise on attractive investment levels to set up exposure to interest rate trends, probably during the second quarter. This will be the case once record new issue volumes have been placed in the markets and the rate hike cycle, initiated by the Fed and the ECB, has been completed.



Source: Ostrum AM and Bloomberg as of 15.11.2022. *The analyses and opinions represent the point of view of the referenced author at the date indicated and are liable to change. They should not be interpreted as having any contractual value.*

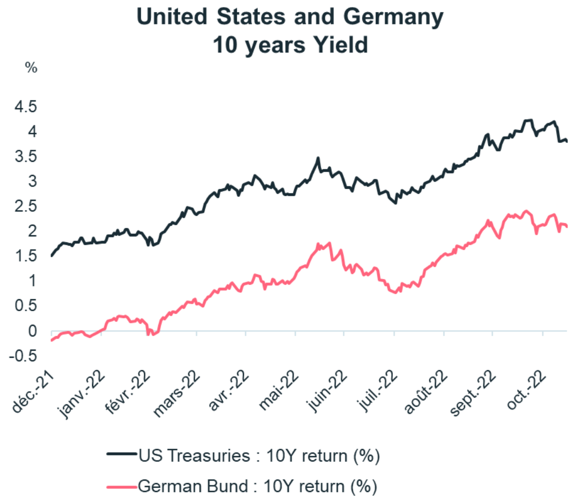
This situation stems from two key factors: inflation and intervention by the central banks. As the central banks had underestimated the tenacity of the inflationary trend, they were obliged to accelerate their monetary tightening cycle and adopt a restrictive stance. This policy drove long-term rates higher during 2022 and stabilised inflation outlook during the second half of the year, following a sharp rise during the first half.

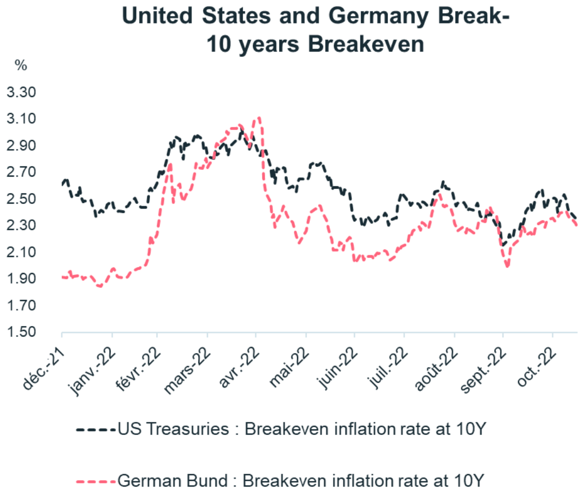
Breakeven inflation rate stabilisation and a further rise in nominal rates

We believe that inflation outlook is unlikely to increase, given that the central banks are expected to maintain their refinancing rates in restrictive territory in 2023. Inflation, particularly core inflation, is likely to effectively remain above target levels.

Nominal rates are expected to continue increasing during the first quarter of 2023 for three reasons:

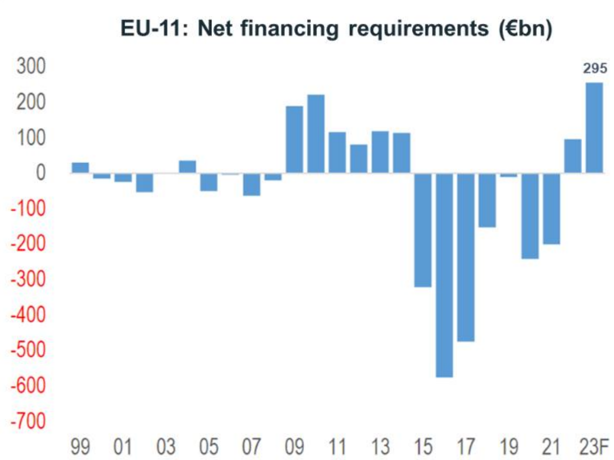
- The Fed and the ECB should continue raising their rates, albeit at a slower pace, to reach a final level of around 5% for the Fed and 3% for the ECB.
- Inflation, particularly core inflation, will remain high, especially in early 2023.

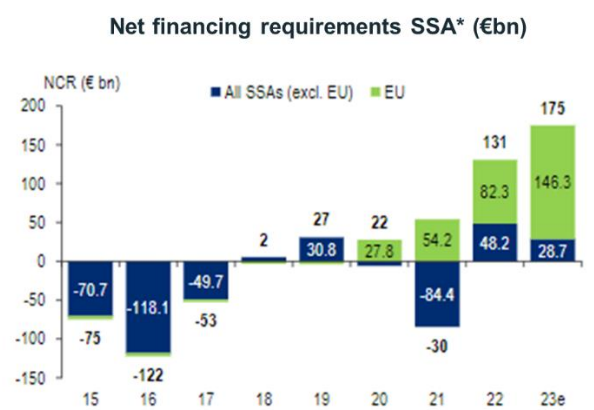




Source: Ostrum AM and Bloomberg as of 15.11.2022.

- Lastly, net European government financing requirements in 2023, which have never been so high over the past two decades, will be concentrated mainly in the first part of the year.

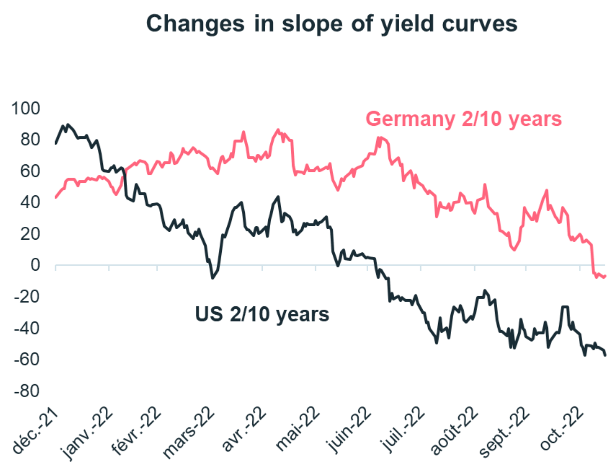


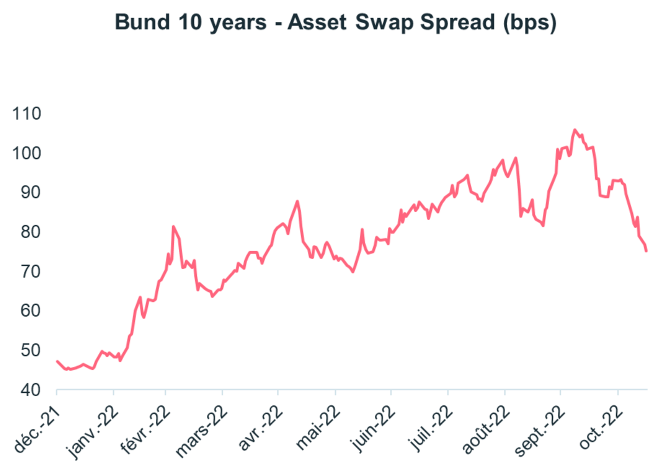


Source: Ostrum AM and Citigroup as of November 2022. * SSA: Sovereigns & supranational organization

Yield curves to steepen again

We are expecting yield curves to steepen again by the end of 2023, after flattening significantly during 2022. Interest rate cuts by the Fed and the ECB in 2024 are possible, which would drive short-term rates lower, while new issue volumes are expected to weigh on the longer-dated segment of the yield curves.



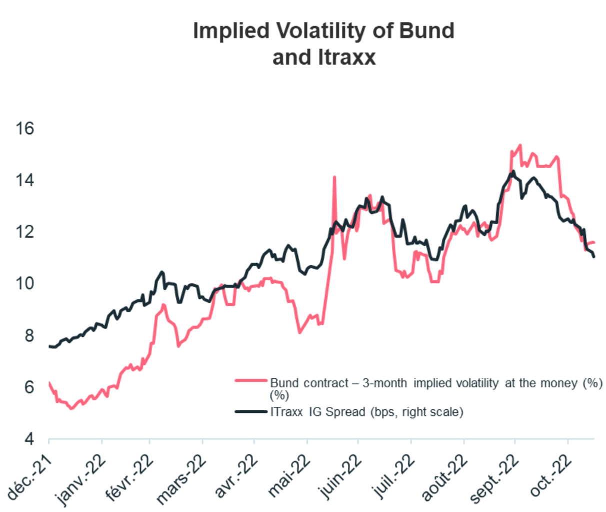


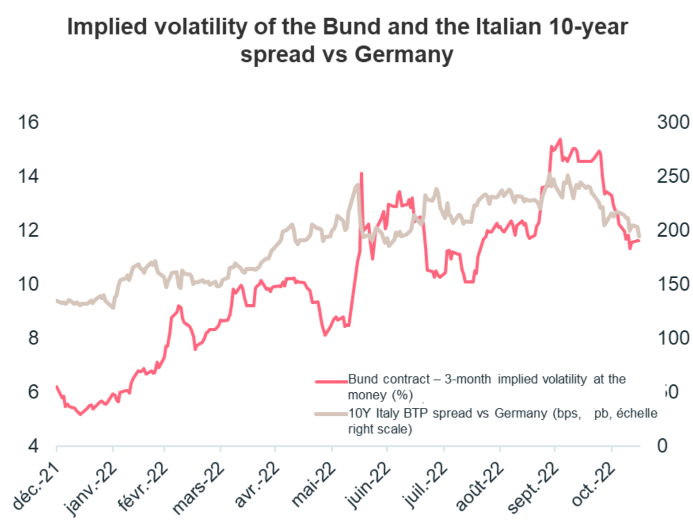
Source: Ostrum AM and Bloomberg as of 15.11.2022.

Yield strategies among the so-called spread assets

The so-called spread assets could perform well in 2023. We are expecting interest rate volatility, a determining factor in 2022 spread trends, to stabilise due to improved visibility in monetary policy outlook.

We are effectively observing a close correlation between spread trends and interest rate volatility, as demonstrated by the relative trends between volatility among German 10-year yields (Bunds) and credit spreads, represented by the Itraxx Main index reflecting the investment grade credit market. The same phenomenon is observable in the relative volatility trend between the Bund and Italian sovereign spreads.



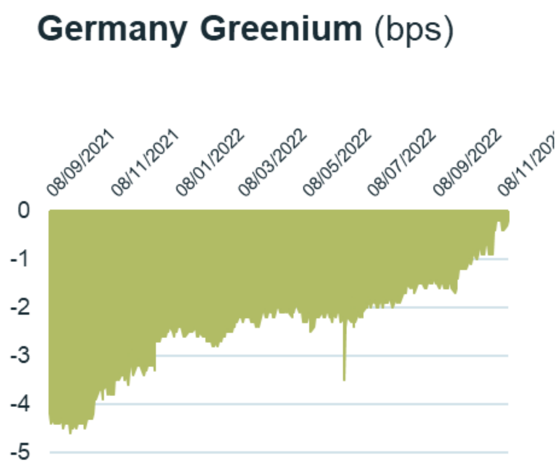


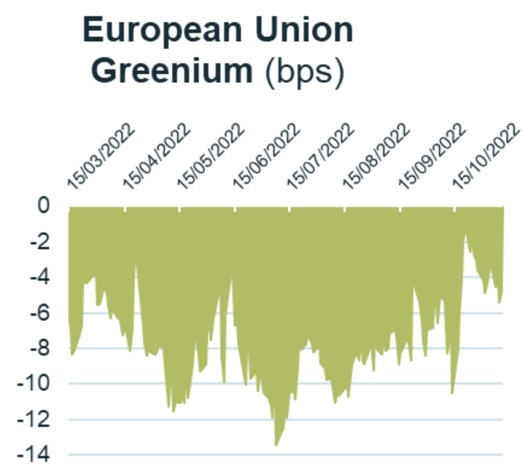
Source: Ostrum AM and Bloomberg as of 15.11.2022.

We are expecting volatility to decline sharply in 2023, due to improved visibility in monetary policy outlook, which should increase risk appetite. In this context, among spread assets and within aggregate type investments, we are prioritising supranationals, agencies and investment grade credit. These strategies also capitalise on swap spreads, which remain at extremely high levels, as illustrated above.

Value to be found in sustainable bonds

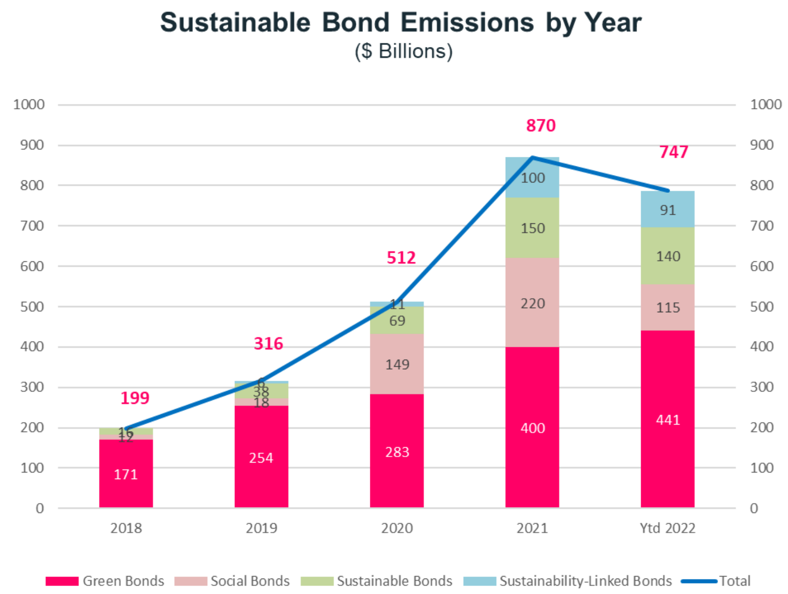
Sustainable bonds also appear to harbour potential upside opportunity. Firstly, green issue premiums have improved, offering better investment conditions to investors. This is particularly the case for sovereign and agency issues, particularly in Germany.





Source: Ostrum AM and Bloomberg as of 15.11.2022.

Secondly, we are expecting sustainable bond issue volumes next year to match the levels reached in 2021, at slightly above 830 billion euros.



Source: Ostrum AM and Bloomberg as of 15.11.2022.

CREDIT - Opportunities in investment grade and high yield

According to our Fixed Income CIO, Philippe Berthelot, 2022 was the worst year for the bond market since 1994. However, 2023 is being heralded as an excellent year for fixed income investments in general, including credit, in line with our view of a moderate recession or soft landing.

Default rates will remain low

Although we are not anticipating default rates to surge in the credit market, a moderate increase towards average historic levels is expected, from current levels at close to zero.

Expected default rates for 2023, close to the historic average at around 3.3% or even 4%, support the scenario of a moderate recession. Monitoring default rates is indispensable, as this factor is one of the adjustment variables determining medium/long-term spreads. At Ostrum AM, we use our proprietary top-down forecast model developed by our strategists. This model is complemented by a bottom-up approach applied by our team of credit analysts, covering an investment universe of around 400 European and UK high yield issuers, excluding financials. Our analysis currently identifies a relatively limited number of issuers which could potentially default.

Ostrum AM *default rate* *[bonds only, weighted by issuers]*	Jun 2023
EUROPE Bottom-up	**3.3%**
EUROPE Top-down	**4.0%**

- Bottom-up methodology based on the most fragile issuers in the Ice BOfA ML index HPCO (excluding financial and including CCC ratings), i.e. 14 candidates for default on 421 issuers at the end of 2022
- Top Down fault prediction based on a proprietary model developed by Ostrum AM

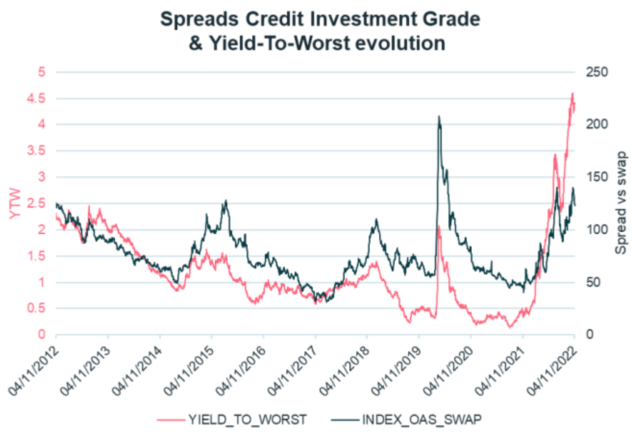
In conclusion, the credit market is unlikely to be impacted by default rates. We believe that the markets have been extremely pessimistic in terms of outlook, or at least have priced-in a default premium, which is unjustified at this stage, under our forecasts.

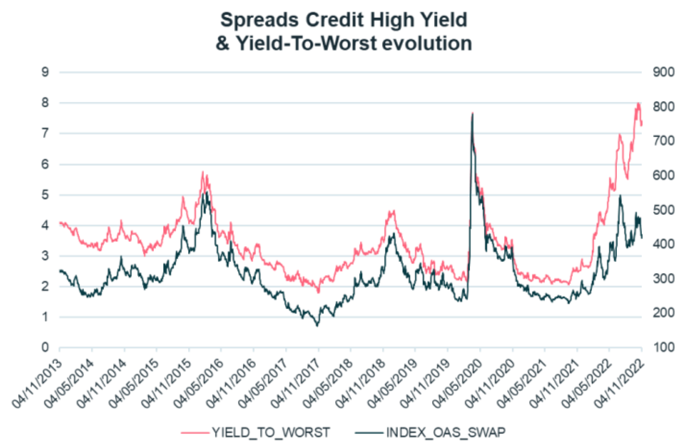
Investment grade and high yield credit yields at their highest level in a decade

Credit indicators will undoubtedly deteriorate slightly in terms of leverage and interest cover ratios, as well as cashflow generation, although significant negative newsflow is already priced-into current valuations.

In terms of attractivity, yields are at 10-year highs in the investment grade and high yield segments, in Europe and in the US.

Investors must remain highly selective in investment grade credit, due to this segment's sensitivity to interest rate hikes. On the other hand, high yield credit enjoys its own momentum, as it is less correlated to interest rates, offers an interesting return with a limited default rates, although yields are expected to decrease. Both segments present unprecedented investment opportunities compared to the past decade, with almost 4% for investment grade euro credit and over 8% for high yield euro credit. A careful assessment of investment entry levels is required to deliver satisfactory performances.





Source: Ostrum & Bloomberg, 31.10.2022. Indices Bofa ML Euro BB-B constrained index and "Bloomberg Barclays Euro Aggregate Corporate"

Sector views

The rising interest rate trend in Europe, combined with our view of narrowing swap spreads during 2023 should benefit the banking sector, notably senior and subordinated debt (T2 bonds), including additional tier-1 and contingent convertible bonds (cocos). Concerning corporate debt, at Ostrum AM we believe that generalised extension risk for hybrids appears exaggerated and significant value can be captured through selective investments.

Certain property managers / listed real estate investment trusts, which have been hit particularly hard in 2022, are also worth considering. The telecoms sector, which has proven highly resilient until now, currently appears to be slightly overpriced.

Lasty, high yield credit, which is less correlated to interest rates, deserves a heavier strategic allocation, in the light of our default rates forecasts, but remaining highly selective in the choice of issuers.

YTM* / L OAS	31/12/21	04/11/22	Difference
10 Y Tsy	1.51%	4.16%	+265
10 Y Bund	-0.18%	2.27%	+245
€ IG	50 bp	119 bp	+69
€HY	284 bp	478 bp	+194
US IG	114bp	192 bp	+78
US HY	320 bp	497 bp	+177

Source: Ostrum AM, Bloomberg as of 04/11/22. * YTM: Yield-To-Maturity.

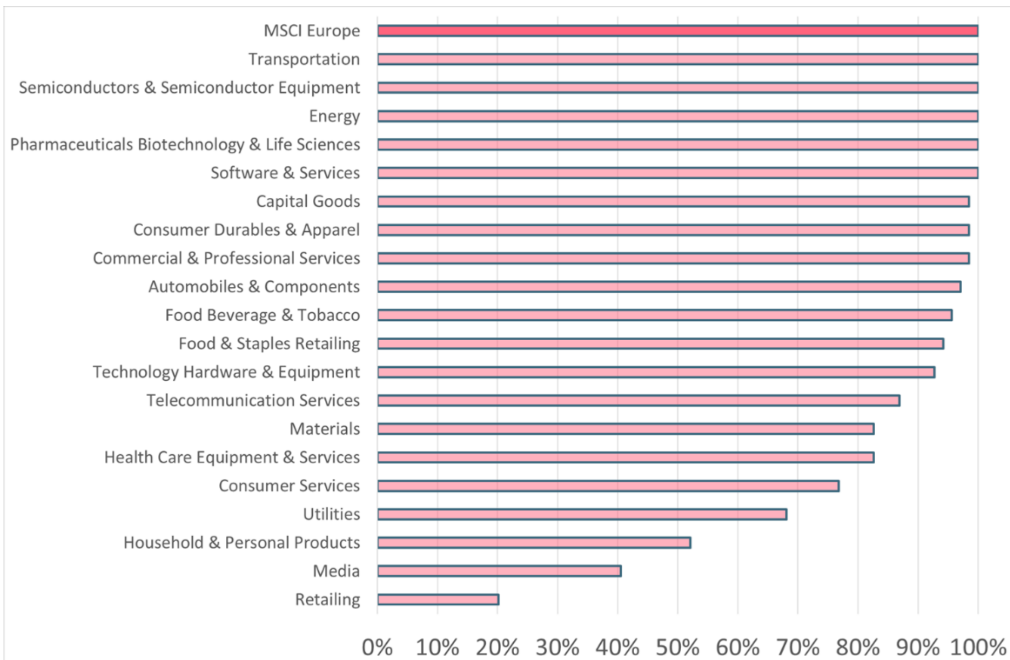
EUROPEAN EQUITIES - Caution and selectivity in the face of volatility

According to our Head of Equity Investments, Frédéric Leguay, 2023 will be a year for potential investments in the European equities market, but with a high degree of caution and on a selective basis. Corporate earnings are effectively expected to fall in 2023, contracting by around 10%, reflecting our moderate slowdown scenario. Margins will be squeezed by the global macroeconomic situation, despite companies proving their resilience in 2022, by delivering higher profits and regularly beating consensus market forecasts.

Corporate margins at their highs

Margins are currently at an extremely high level in most business sectors, compared to the past 17 years (2005-2022). Companies have effectively benefited from supply shortages, which have made it easier to pass-on higher costs, and also capitalised on the weak euro, which has boosted their competitivity and their profits.

Operating Margins in Europe at 30 June 2022
Percentiles over the period 31 March 2005 - 30 June 2022

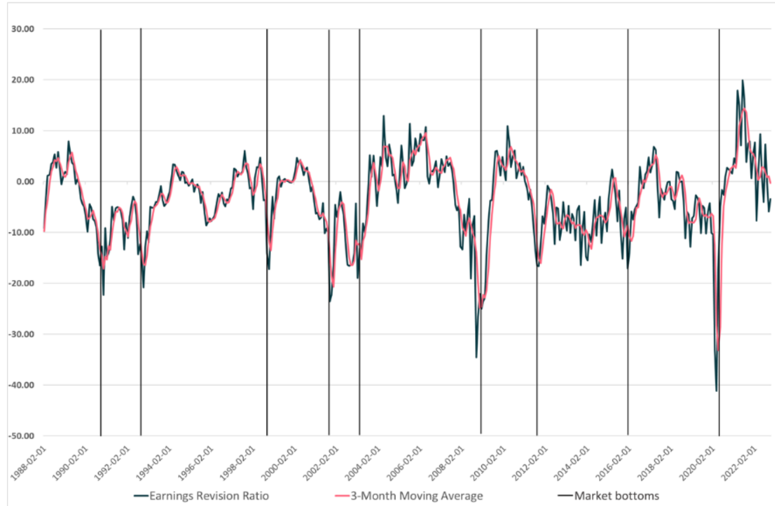


Wait and see

Investors are not reassured by the current global economic context, which accounts for the high level of equity market volatility in 2022. The global economy will slow down significantly in response to the more restrictive monetary policies. Companies will therefore have to defend their margins in a context of slowing demand and supply normalisation.

There is therefore no need for haste. Since the end of the 1980s, European markets have never reached their low point before the earnings downgrade cycle has entered into its final phase. So far, it has not yet begun, so there is time to wait and see.

Markets never hit their lows before the earnings review process began



Source: Ostrum, MSCI & Bloomberg, 18.11.2022

Despite the sharp fall in the stock markets until the start of the third quarter of 2022 and following the rally in place since October, equity upside potential remains limited for 2023. Given the abnormally high level of profits, combined with likely interest rate hikes and the geopolitical context remaining uncertain, Ostrum AM believes that further upside from current equity prices can only occur if there is a significant drop in the level of real interest rates, the main driver in market valuations over the past three years. As volatility is likely to remain prevalent in 2023, there will be other opportunities for investors to reinvest in risky assets.

What valuation levels for equity markets?

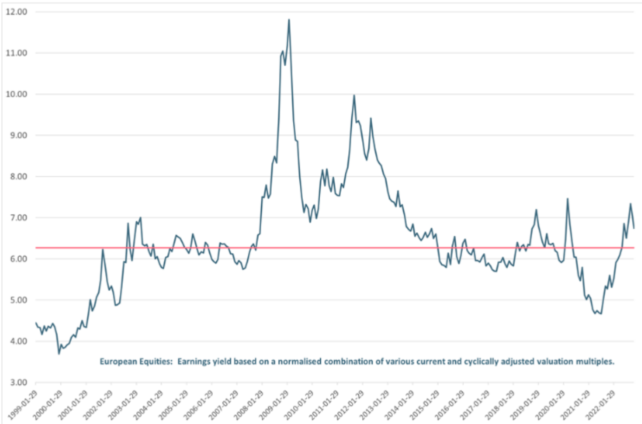
The markets have devalued sharply, particularly until the beginning of the third quarter, with the market PE multiple falling from around 17 times, to closer to 12 today. These multiples are below their long-term average. However, they do not adequately reflect the high level of margins or further expected rate hikes and the specific risks incurred by the current situation.

If we analyse valuations taking into account the abnormally high level of margins and anticipated rate hikes in 2023, we note that expected market yield is close to the very long-term median (left-hand chart, since 2000).

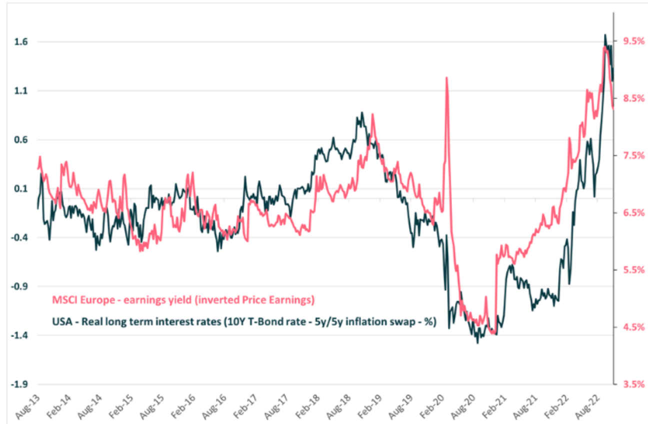
Given the current risk environment, with the energy crisis and the current geopolitical situation, we believe that expected yield, reflecting a slight premium of around 50 basis points compared to normal levels, harbours only limited potential upside over the next few months.

Market performance close to median

(Inverse of a multiple with several standardized valuation measures)



Valuation deeply affected by real rate dynamics



Source: Ostrum, MSCI & Bloomberg, 18.11.2022

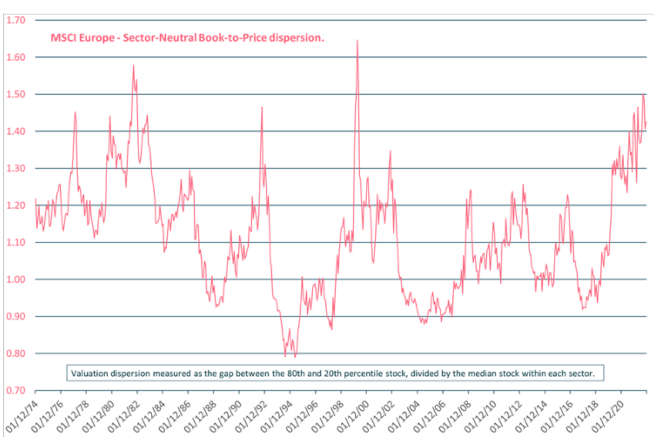
The right-hand chart demonstrates that the level of real interest rates has been the main driver determining market valuations in the US and in Europe over the past two years and we are expecting this situation to persist. We believe that potential upside compared to current levels is relatively limited, with a year-end 2023 target corresponding roughly to current market levels. As 2023 will remain a volatile year, reallocations into risky assets will have to be selective.

What investment opportunities in European equities in 2023?

Aware of the consequences of corporate earnings downgrades, Ostrum AM is prioritising high-visibility business models in the early part of the year. We are avoiding deep cyclical companies which will be impacted more heavily by the forthcoming slowdown. We will also be paying particular attention to company valuations, as there are still very wide valuation spreads between stocks in the same sector at the end of the year, meaning that the most expensive stocks may come under further pressure if long-term rates continue increasing as we are expecting. Conditions should improve during the second half of 2023 however.

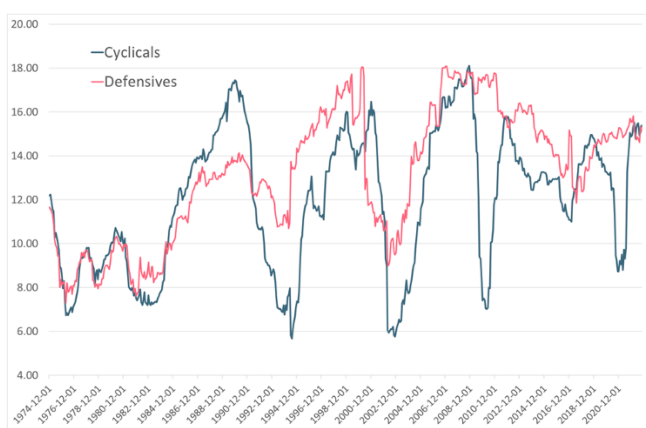
In this context, the sectors that we consider the most likely to prove resilient are financials, along with sectors with clear visibility, such as healthcare, consumer staples and services. During the first half of the year, investors may be able to reallocate into growth sectors, depending on valuations, then reinvest in certain more cyclical stocks once we have greater visibility regarding the end of the slowdown.

Significant differences in valuation between securities in the same sector



Source: Ostrum, MSCI & Bloomberg, 18.11.2022

Too early to reinforce cyclical values Return on equity (%)



Source: Ostrum, MSCI & Bloomberg, 31.10.2022

Additional notes

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