Document for professional investors
Written on November 23rd, 2023

Outlook for 2024

Multiple risks… just as many opportunities

Coming on the heels of 2023, a year that turned out favourable for the financial markets despite a disruptive international environment, 2024 promises to usher in a new era, according to the experts at Ostrum Asset Management (Ostrum AM), an affiliate of Natixis Investment Managers. Investors will thus have to adapt to a new market configuration, one where the lenders have the power, with interest rates set to remain above 2% for a prolonged period.

2024 is shaping up to be a year filled with investment opportunities, served by active management of risks that should in principle be contained but are nevertheless on the rise: duration risks, credit risks and volatility risks, not to mention risks associated with climate change.

In today’s polarised world, where inflation, monetary policies and sovereign ratings all have yet to be stabilised, the experts at Ostrum AM see opportunities arising in 2024.

FIXED INCOME: yields are expected to change course, the short end of the curve to outperform and swap spreads to continue normalising for interest rates.

Themes	Our 2024 scenario
DURATION	Interest rate trend inflexion expected
CURVE	Short-term segment outperformance
INTEREST RATE VOLATILITY	Volatility concentrated in the long-term segment of the curve
ISSUES	A sharp increase in US Treasuries issues
COUNTRY SPREADS	Risk in Italy. Potential further appreciation in Greece
SWAP SPREADS	Further normalization

CREDIT: 10-year high in yields for Investment Grade and High Yield credit, on both sides of the Atlantic, and attractive returns starting with the short-term segment.

Themes	Our 2024 scenario
SPREADS	Carry is king
EXPECTED PERFORMANCES	Positive performances for IG and HY
HY vs IG	IG: fair value / HY attractive with yields over 7.5% Limited default rate expected in 2024
SELECTIVITY IS VITAL	Credit “traps” are more frequent in IG / HY [15% of HY € is distressed]
FINANCIALS vs CORPORATES	Financials still “better value” than corporates
SENIOR vs SUBORDINATED & HYBRIDS	AT1 and corporate hybrids appear “good value” (YTW close to YTM: general extension risk appears overplayed in our view)
SECTORS	Top-down: defensives yes, but relatively expensive vs cyclicals
GO GREEN !	• 21% of € IG primary issues and 13% of € HY are green bonds • Greenium*, which used to be around 5 bps in € IG, is now almost zero • The sustainable bonds market in Europe is attracting more and more investors vs issues in freefall in the US (-55%)

*Greenium: yield of a sustainable bond compared to a traditional bond of the same maturity.

EQUITIES: profits expected to dip in Europe during the first half, but also an opportunity to get back into the European equity market amid low valuations. Internationally, extreme valuation gaps are expected to normalise.

Themes	Our 2024 scenario
DIRECTIONAL	V-shaped profile in a year of limited performance
PROFITS	Forecasts too high as profits will be hit by the slowdown and disinflation
VALUATION	A relatively comfortable situation pricing-in the current lackluster cycle
ALLOCATION	A defensive profile for the next six months, no real style bias
INTERNATIONAL EQUITIES	Catch-up by more defensive and better-value stocks

MARKETS – a global economy running at three different speeds and risks associated with public finances

According to **Axel Botte, Head of Market Strategy**, the global economic situation will stay mixed, with the global economy running at three different speeds.

Growth in the United States

Economic activity has proved resilient in the US, fuelled by solid consumer spending and an expansionist monetary policy which offset the Fed's monetary tightening moves. Job creations have slowed, but the labour market is still in a good place. The US should see growth of around 2% in 2024.

Stagnation in the eurozone

Meanwhile, the eurozone economy is stagnating, hindered by a lack of consumer spending despite disinflation. Inflation should continue to gradually slow in 2024. Interest rate hikes are significantly slowing credit demand and growth in the eurozone. The decrease in the household savings rate should nevertheless boost it back to its potential by the end of next year. The eurozone should post average annual growth of 0.5% in 2024, with inflation gradually returning to around 2.5% by year-end.

Structural obstacles in China

China's growth is still hampered by US sanctions, which have reduced foreign investments and tech transfers, the real estate market and the need to restructure local government debt. Even so, we see an improvement in household consumption on the horizon, which will mitigate the scope of the structural slowdown in China.

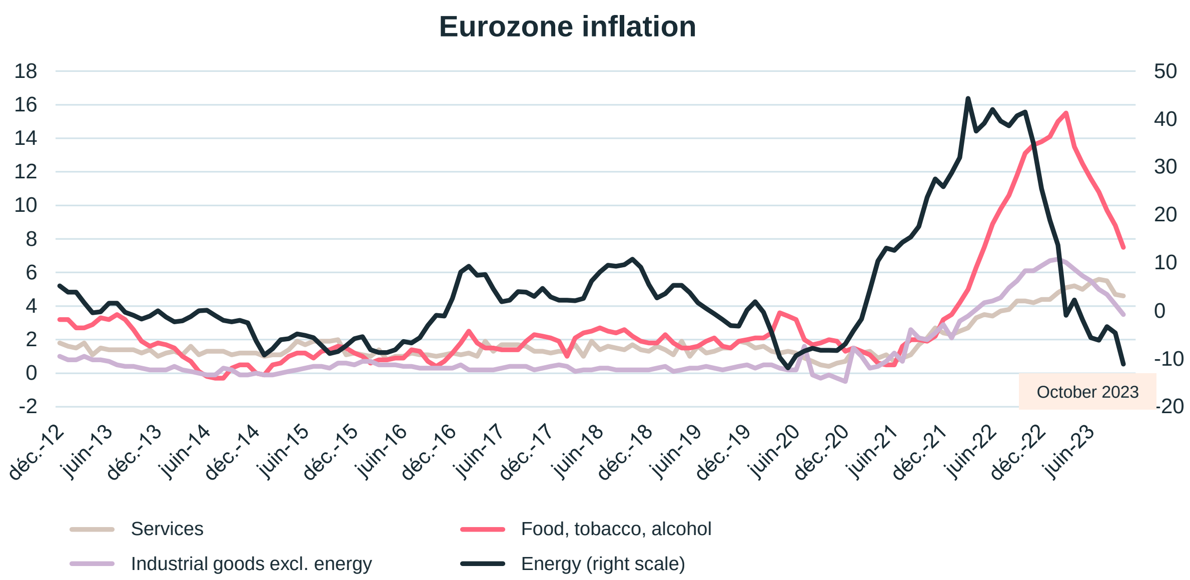
Forecasts		2023				2024				Annual average	
Growth / Inflation		**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**2023**	**2024**
GDP (rolling data)	Eurozone	0.0	0.2	-0.1	0.0	0.1	0.2	0.3	0.4	0.5	0.5
Inflation	Eurozone	8.0	6.2	5.0	3.3	3.2	3.0	2.8	2.5	5.6	2.9
GDP (annualized rolling data)	United States	2.2	2.1	4.9	1.1	1.0	2.0	2.3	2.5	2.4	2.0
Inflation	United States	5.8	4.1	3.6	3.1	2.4	2.3	2.0	2.4	4.2	2.3
GDP (rolling data)	China	2.3	0.5	1.3	1.3	1.3	1.3	1.3	1.3	5.3	5.0
Inflation	China	1.3	0.6	0.0	0.8	1.4	1.6	1.9	1.9	0.7	1.7

Source: Ostrum AM, October 2023

Disinflation dependent on reduced margins

Disinflation is in progress in the eurozone, but getting back to the 2% target is not a given. Inflation slowed to 2.9% in October versus 4.2% in September, thanks to the energy sector. Core inflation is still high at 4.2%, however, as opposed to 4.5%. According to the ECB, half of the observed acceleration in inflation can be attributed to the improvement in profit margins, especially in the service industry. Wage hikes are likely incompatible with reduced inflation in service prices or a rapid return to the 2% target.

Prices of goods have normalised in the US, however, and becoming moderate in the eurozone. Meanwhile, China is exporting a little deflation on goods.

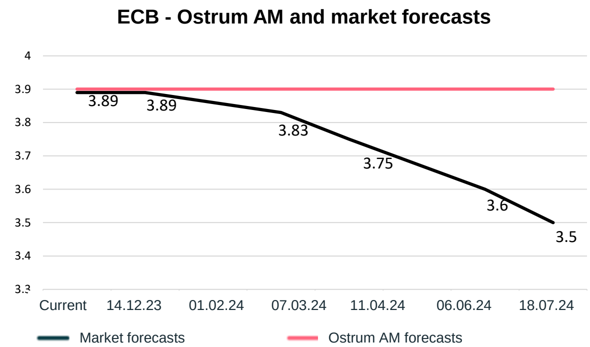


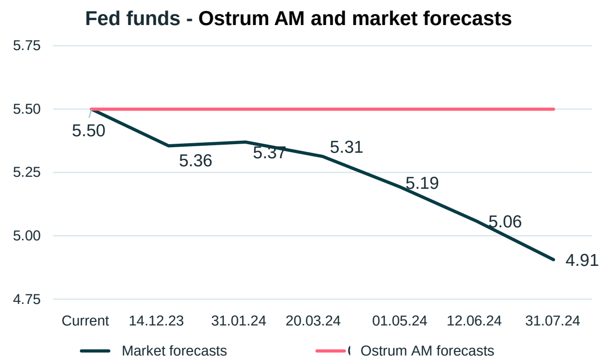
Source: Ostrum AM, October 2023

Monetary easing: watch out for market impatience

After 10 consecutive rate hikes (+450 bp overall) aimed at driving the deposit rate to a record high of 4%, the ECB left its rates unchanged on 26 October. Christine Lagarde reiterated that rates need to be kept at this restrictive level for some time in order to combat inflation, expected to stay "too high for too long".

The market does not believe status quo will be maintained in the first half; hence the upward pressure on bond yields. Rather, the markets see rates declining as from Q2 for both the Fed (US central bank) and the ECB (European Central Bank). As for Ostrum AM, we are not expecting any change before Q2 2024 and are betting on two 25-bp rate cuts in the third and fourth quarters.





Source: Ostrum AM, October 2023

Monetary policy will grow more restrictive through a balance sheet reduction of roughly €850bn in 2024, TLTRO[1] repayments (€500bn) and APP[1] instruments (€350bn).

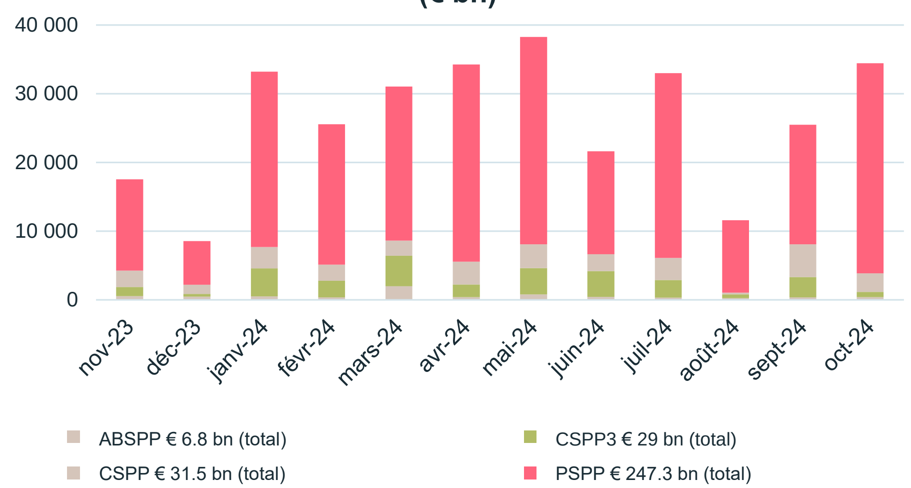
Operation	Value date	Maturity	Allocated amount (bn)	Remaining amount (bn)	% Reimbursed
MRO	8-nov.-23	15-nov.-23	6.9		
LTRO	26-oct.-23	31-janv.-24	0.5	0.5	0%
LTRO	28-sept.-23	21-déc.-23	1.9	1.9	0%
LTRO	31-août-23	30-nov.-23	2.2	2.2	0%
TLTRO III	22-déc.-21	18-déc.-24	52.0	42.4	18%
TLTRO III	29-sept.-21	25-sept.-24	97.6	89.7	8%
TLTRO III	24-juin-21	26-juin-24	109.8	64.2	42%
TLTRO III	24-mars-21	27-mars-24	330.5	257.6	22%
TLTRO III	16-déc.-20	20-déc.-23	50.4	37.3	26%

MRO = Main Refinancing Operations, LTRO = Long Term Refinancing Operations, OT = other type of operation

Source: Ostrum AM, BCE, October 2023

The ECB wants to keep the flexibility offered by the PEPP[1], with reinvestments to be continued over the course of 2024. The decrease in the liquidity surplus is conducive to higher money market rates, which should approach the level of the deposit rate. The amortisation of the APP[1] generates the need for additional financing for borrowers and reconstitutes a bond term premium.

BCE : APP 12-months repayment schedule (€ bn)

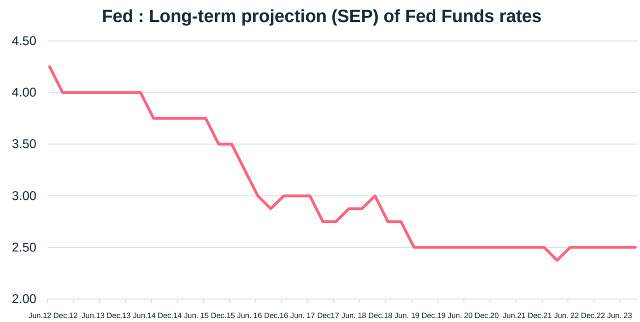


Source: Ostrum AM, BCE, October 2023

1 TLTRO: *Targeted longer-term refinancing operations*. APP: *Asset Purchase Programme*. PEPP: *Pandemic Emergency Purchase Programme*.

Meanwhile, the Fed needs to revisit the idea of interest rate neutrality in 2024. The "neutral" rate will be higher.

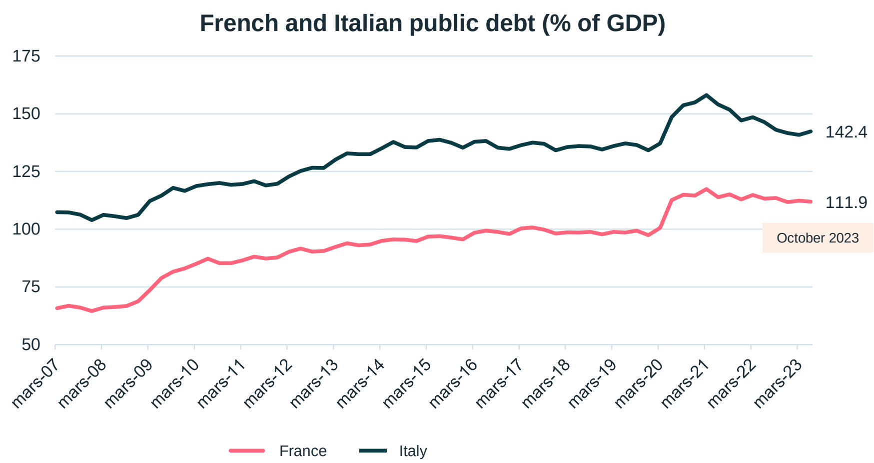
Inflation has fallen, but there are risks of seeing it climb again associated with the real estate market. Ultimately, a less cooperative world is taking shape, one with higher inflation. The 2.5% target level will be up for discussion in 2024, limiting the easing of the Fed Funds rate to 50 bp in 2024. The Fed wants to avoid making cuts too early, due to the persistent risks surrounding price stability.



Source : Ostrum AM, Bloomberg, octobre 2023

Public finances: a major source of financial risks

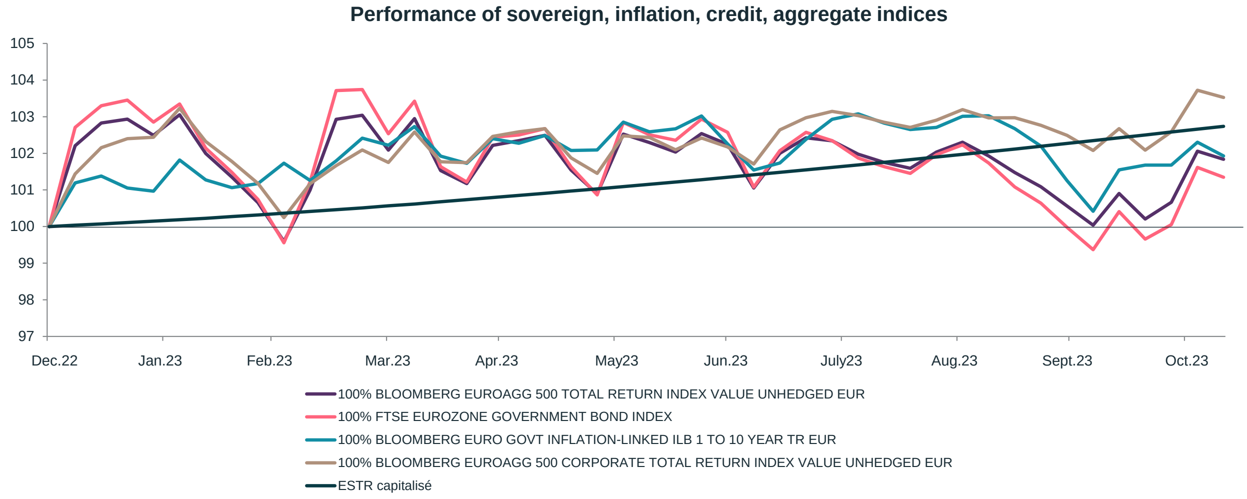
Weak growth in Europe, coupled with the massive use of fiscal stimulus in the US, once again raise the question of the sustainability of public debt. Sovereign ratings are under pressure. The US had its rating downgraded first by Fitch (AA+), then by Moody's (long-term outlook). The federal deficit is sitting at 7% of GDP. Ratings for France (AA) and Italy (BBB-) may be called into question as deficit limits are reintroduced for the eurozone in 2024. This promises to be a key issue during the European elections.



Source: Ostrum AM, Bloomberg, October 2023

FIXED INCOME – A record year for sovereign issues on the horizon

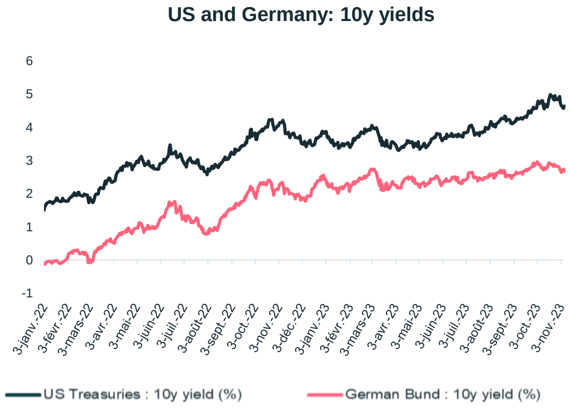
Alexandre Caminade, Head of Core and Liquid Alternative Fixed Income Strategies, stressed that the bond markets delivered a positive performance in 2023, both in terms of sovereigns as well as inflation and aggregates, while nevertheless hovering at below-money market levels.

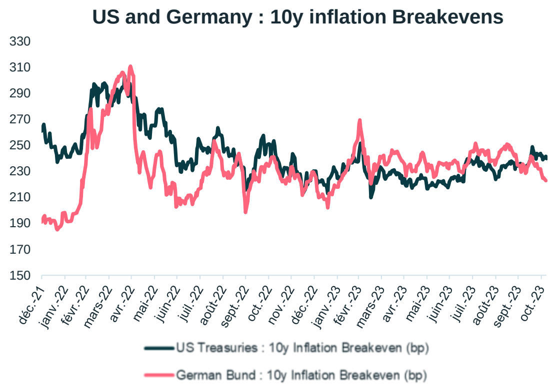


Source : Ostrum AM, Bloomberg, 07.11.2023

Yields expected to change course

We see a potential for yields to fall in 2024. The 5% levels already observed on the US 10-year (and 3% on the Bund) should not be exceeded. Gradual disinflation and the monetary tightening effect should keep inflation expectations contained.



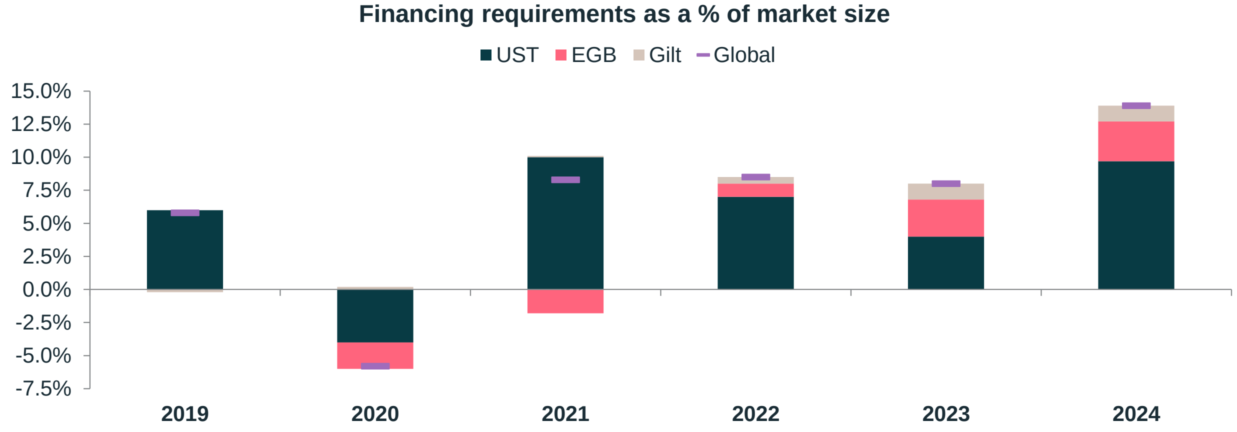


Source : Ostrum AM, Bloomberg, 07.11.2023

A record year for sovereign issues and normalisation of yield curves

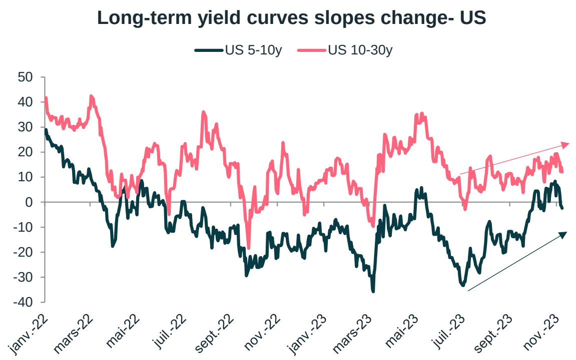
For 2024, the markets will have to deal with an unprecedented rise in net bond issues.

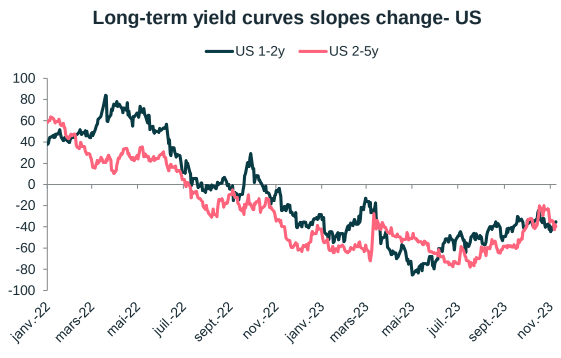
On a global scale, the lion's share of the increase in net issues in 2024 will come from US treasuries. The US Treasury Department must not only finance a federal deficit to the tune of $1,800 billion while extending its debt, but also convince private-sector investors to take up the baton for the Fed.



Source: Citi.

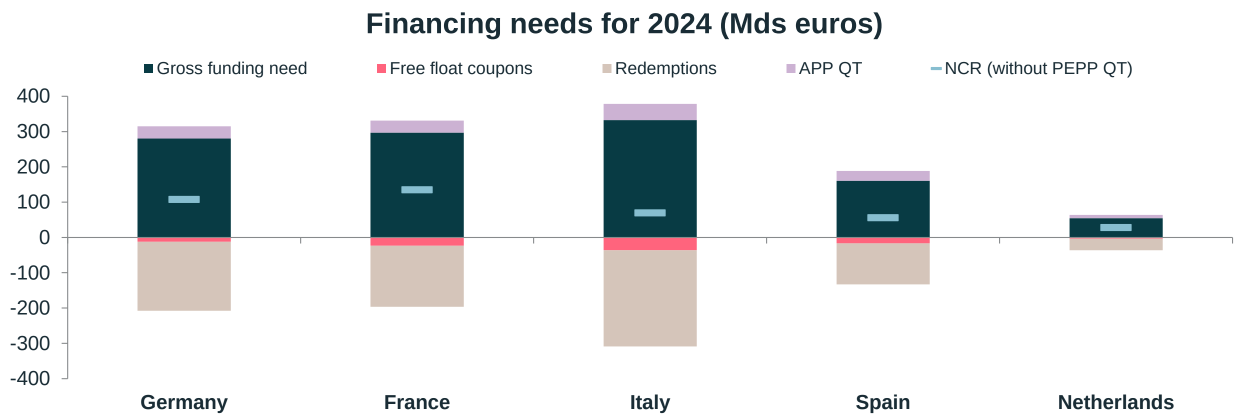
In the US, increased borrowings combined with the easing of Fed rates will likely cause the yield curve to steepen. We have already witnessed the substantial reconstitution of the term premium since the month of September. The long end of the curve should continue to be the most volatile in the first half of the year, followed by a steepening trend at the short end as we get closer to the Fed's first rate cuts.





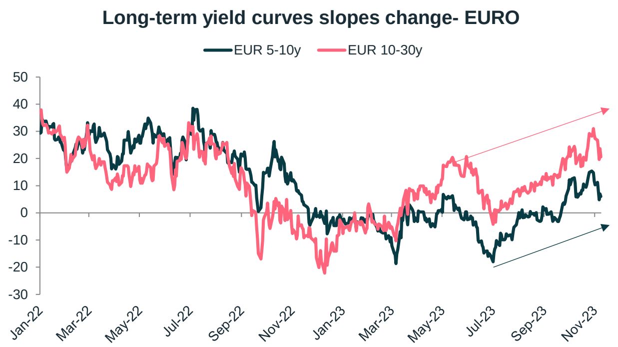
Source : Ostrum AM, Bloomberg, 07.11.2023

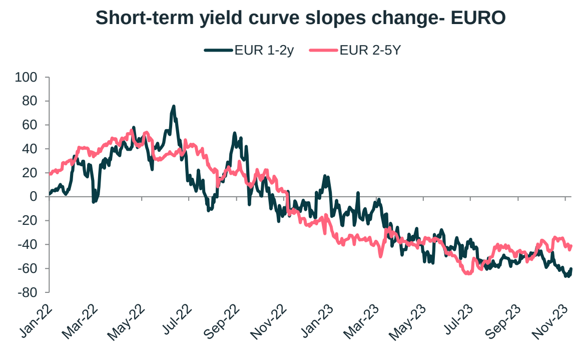
The increase in net sovereign issues is less pronounced in the eurozone. After 2023's Public Sector Purchase Programme (PSPP), the question of not reinvesting the Pandemic Emergency Purchase Programme (PEPP) may be raised. In that case, government net funding requirements adjusted for quantitative tightening (QT) should climb by an additional €15bn to €18bn per month. Despite the weight of investment flows, 10-year returns are not expected to top 5% for the T-Note or 3% for the Bund. Inflation expectations appear to be rooted in the disinflation in progress and the past effect of monetary tightening.



Source : Ostrum AM, Bloomberg, Citi, 07.11.2023

The eurozone curve should be slower to normalise. This is because it is less volatile, with the ECB less inclined to aggressively lower its rates, plus the amount of issues is relatively stable. The long end of the curve is set to remain under pressure due to issues being concentrated in the first half of the year and uncertainty surrounding the quantitative tightening (QT) of the PEPP. The short end should subsequently ease with the prospect of initial ECB rate cuts, but to a lesser extent compared to the US curve.



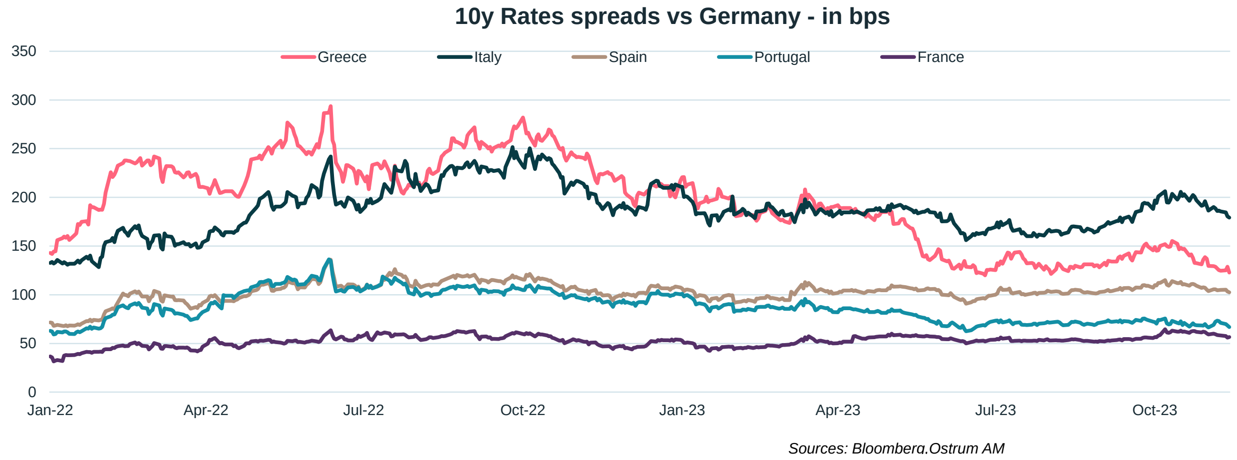


Source : Ostrum AM, Bloomberg, 07.11.2023

Sovereign spreads expected to rise slightly and swap spreads to normalise

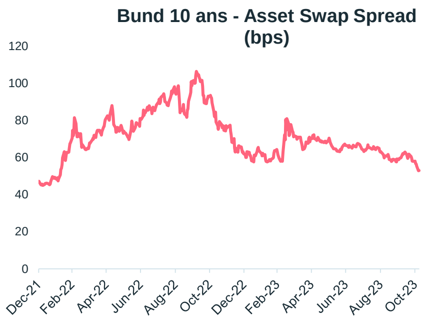
Sovereign spreads should end up increasing somewhat. Italy is in the most fragile position, but other countries (including France) are facing fiscal struggles. Use of household savings protected the Italian BTP in 2023, but the acceleration of quantitative tightening would be bad for the country's debt.

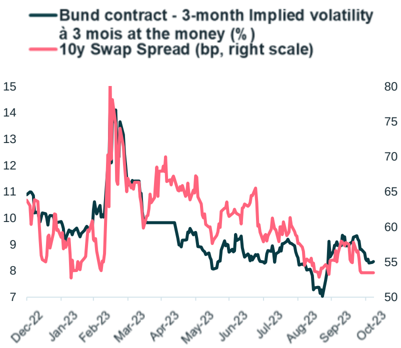
The Greek spread should benefit from another ratings bump to Investment Grade (by Fitch) after the one decided by S&P.

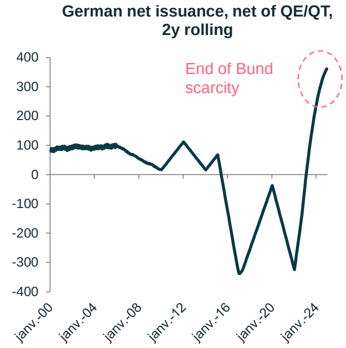


Source : Ostrum AM, Bloomberg, 07.11.2023

The recent tightening of swap spreads should continue, albeit at a slower pace. The unusually high level of swap spreads can be chalked up to demand for risk protection by banks, high volatility and the scarcity of the Bund on the repo market. These factors should diminish significantly in 2024.







Source : Ostrum AM, Bloomberg, 07.11.2023

CREDIT – 2023: a remarkable year. 2024? Repeat performance!

According to **Philippe Berthelot, Head of Credit and Money Market Strategies**, 2024 should be another satisfactory year in terms of performances for bond assets, including credit.

Ostrum AM is leaning towards a soft landing for its central scenario, with a 0.5% GDP increase in 2024. Though admittedly low, it still means growth, while inflation is also expected to steadily decrease in the eurozone.

So where can value be found on the credit market in 2024? Credit should keep 2023 momentum going next year. It remains both attractive and profitable: over 4.3% for EUR-denominated Investment Grade credit and over 7.5% for EUR-denominated High Yield credit.

Credit indicators in green territory

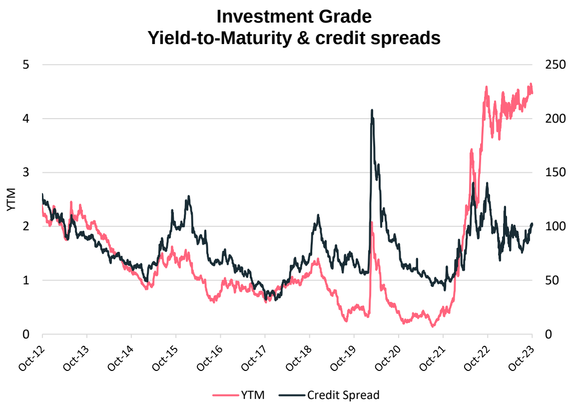
Credit indicators are in green territory, with positive returns, as indicated in the right-hand column of the table. Performance has been robust year-to-date for most bond assets.

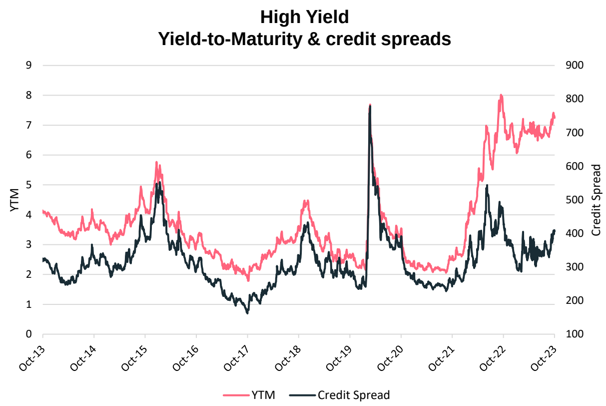
Sectors	Yield (YTW)	Spread (L-OAS)	Total Return in local currencies 2023 YTD
€ Government (ICE BofAML 3-5 Y All Euro Gov. - E2AS)	3.07%	-9bp	+2.00%
€ Investment Grade (ICE BofAML Euro Corporate - ER00)	4.32%	101bp	+3.54%
$ Investment Grade (ICE BofAML US Corp C0A0)	6.05%	162bp	+0.93%
€ High Yield (ICE BofAML Euro HY - HE00)	7.56%	414bp	+6.65%
$ High Yield (ICE BofAML US HY - H0A0)	8.85%	431bp	+7.17%
Global High Yield Short Duration (ICE BofAML US HY – H1UE)	7.66%	324bp	+6.22%
$ COCO (ICE BofAML COCO)	8.80%	437bp	-1.17%
€ Hybrid IG (ICE BofAML Global Hybrid non financial corp index GNEC)	5.92%	240bp	+4.58%

Source: Ostrum & Bloomberg 03.11.2023

Yield on IG and HY credit the highest it's been in a decade

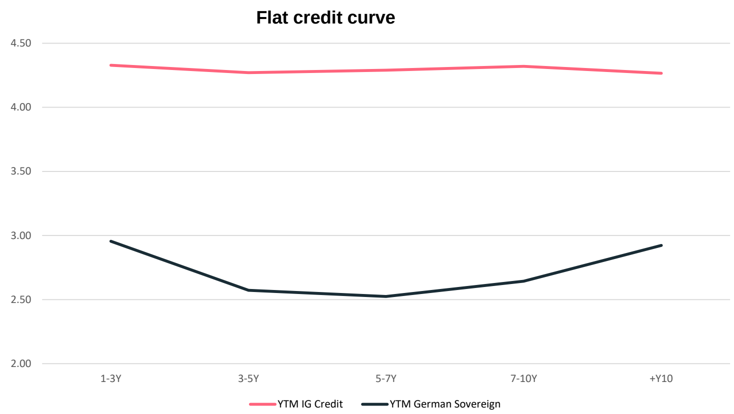
Investment Grade and High Yield credit bonds offer the highest yield for more than 10 years now, driven by an acceptable level of leverage - though slightly on the rise - and a default rate contained at 3.5%, below its historic 20-year average.





Source Ostrum AM, Bloomberg, Octobre 2023. Indices : LECPTREU, HEC4 (indice B-BB).

Returns are attractive starting at the short end, given that the credit curve is virtually flat, thus delivering attractive returns from the 1-3 year segment onward. 2024 will be a time for getting back into longer-dated segments, however, in order to take advantage of expected rate cuts.



Source: Ostrum AM, 03/11/2023.

Default rates up slightly but expected to remain below their historic average

In credit, we see default rates climbing slightly, starting from near-zero levels, but remaining below their historic 20-year average.

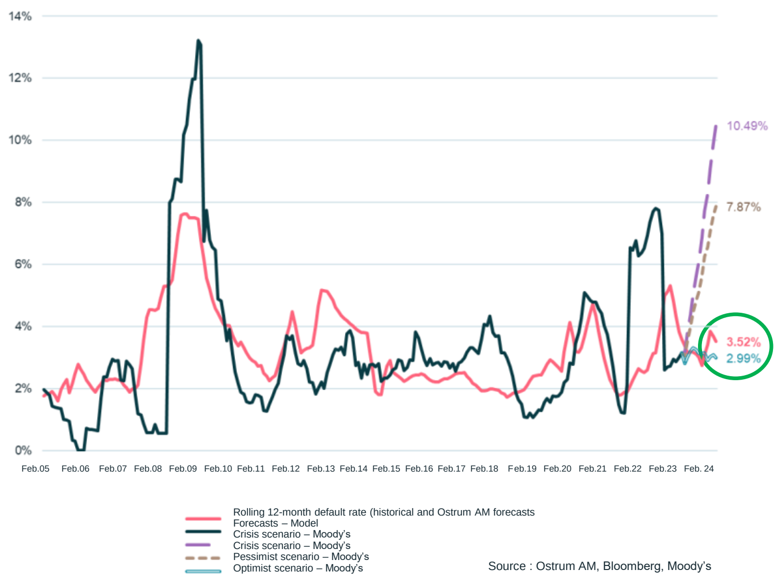
Ostrum AM’s predicted default rate of 3.5% for 2024 confirms the scenario of a weak recession. It is vital to keep track of the default rate as one of the variables that underpins spread levels over the medium/long term. Ostrum AM employs a proprietary top down forecasting model developed by our strategists. Our team of credit analysts also uses a bottom up approach covering an investment universe of some 400 European and UK High Yield issuers (excluding financial companies). For now, this analysis has identified a fairly limited number of issuers (14) liable to default.

Default rate @ *Ostrum AM* *[bonds only, weighted by issuers weight]*	End 2024
EUROPE Bottom-up	3.5%
EUROPE Top-down	3.5%

- Bottom-up methodology based upon the most fragile issuers included in Ice BOfA ML index HPCO (ex-financials, including CCCs names), ie 14 candidates for defaults out of 396 issuers
- Top-Down defaults expectation based upon Ostrum AM in-house model

Source : Ostrum AM, Bloomberg, Creditsights, Moody's. as of 03.11.2023.

Europe – Rolling 12-month default rate



Source : Ostrum AM, Bloomberg, Moody's

Sector views

Based on our prediction of a limited increase in ECB key rates - 50 bp in H2 2024 - and a reduction in swap spreads, we have a positive view of the banking sector. We include the Tier 2 (possibly AT1 as well) subordinated debt segment, which has confirmed its appeal with the impressive success of recent primary market issues.

In corporate bonds, we like the High Beta segment. The vast majority of corporate hybrids have been called by their issuers, meaning very little extension risk has materialised.

We believe High Yield is set to outperform for the third year in a row, but are remaining vigilant nonetheless due to the higher number of distressed issuers. The research conducted by our team of 23 credit analysts is critical to ensuring issuer selection.

Finally, the durable bond market is still going strong in Europe. Green bonds make up 21% of EUR-denominated IG issues and 13% of EUR-denominated HY issues on the primary market. The "greenium" (premium earned on a sustainable bond versus a conventional bond with the same maturity), which previously sat at 5 bp in the EUR-denominated Investment Grade segment, has dwindled to near-zero. It is worth noting that US issues are in free fall (-55%).

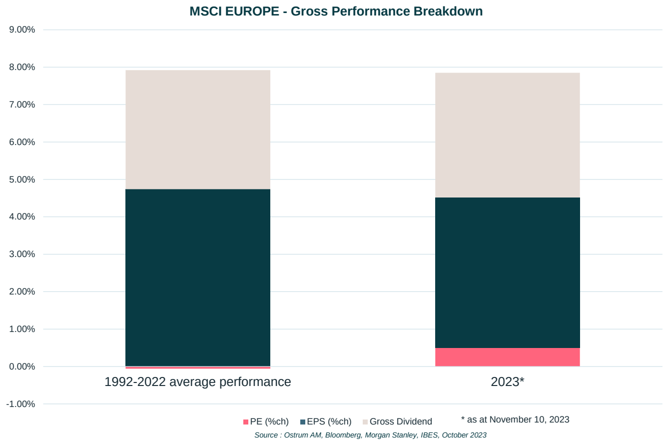
In order to manage risks appropriately, good sector diversification is key, as is being highly selective when it comes to issuers given the expanding number of "credit traps".

EUROPEAN EQUITIES – An opportunity to return to the market in H1

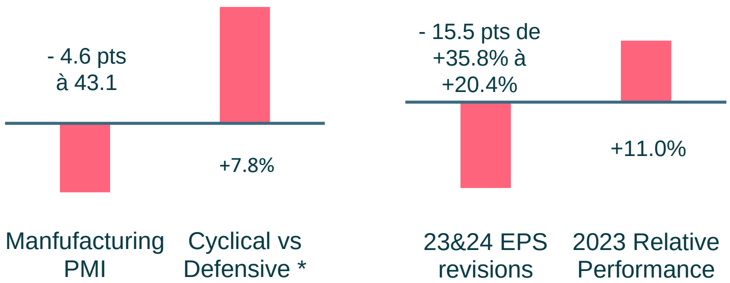
According to **Frédéric Leguay, Head of Insurance Equity Strategies**, after the recent 6% increase, the European equity markets turned in a double-digit performance in 2023 and offer little upside potential in 2024. European markets are expected to hit a low point in Q2 as the earnings revision process draws to an end. Volatility should end up climbing over the period.

Profits poised to slide in H1, presenting an opportunity to return to the market

Thus far, 2023 has ultimately proved to be a relatively normal year for the equity markets in Europe, with a performance in line with the last 30 years.



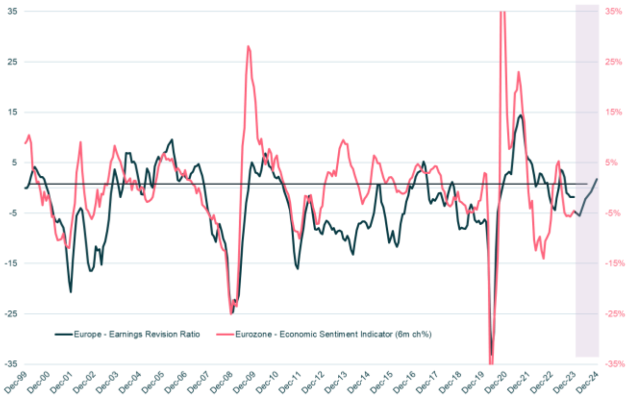
That said, there were some surprises in store. We are currently experiencing the worst crisis in the manufacturing sector after those of the Technologies - Media - Telecommunications (TMT) sector, the 2008 crisis and COVID...and yet, stocks sensitive to the economic cycle have outperformed. Of all the sectors in Europe this year, Technology has seen the strongest downward revisions of its projected earnings for 2024, and even so it has considerably outperformed the market.

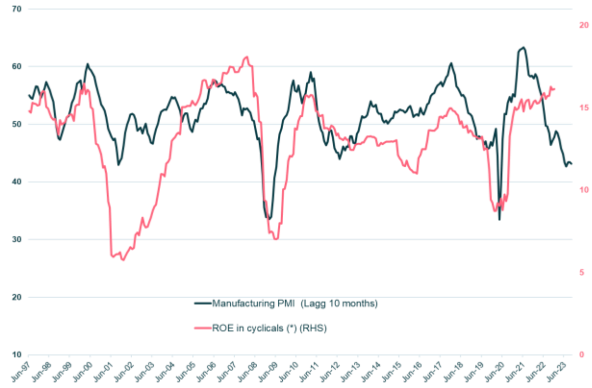


Source: Ostrum AM, Bloomberg, Morgan Stanley, IBES, Octobre 2023. (*) cyclical stocks defined as belonging to the consumer discretionary, industrial, technology and basic industries sectors. Defensive stocks defined as consumer staples, healthcare, telecommunication services utilities.

In 2024, global GDP growth will continue to slow, particularly in nominal terms, and the likely inversion of restrictive monetary policies will have very little impact. Corporate earnings, already on the decline in 2023, may prove disappointing compared to expectations which we estimate to be about 10% too high, even with inflation still supporting revenue.

This pressure on earnings is not going anywhere, in spite of growing revenues, lower interest rates and a stable dollar. Against this backdrop, the profitability of cyclical, industrial and consumer stocks is the most vulnerable in the short term.



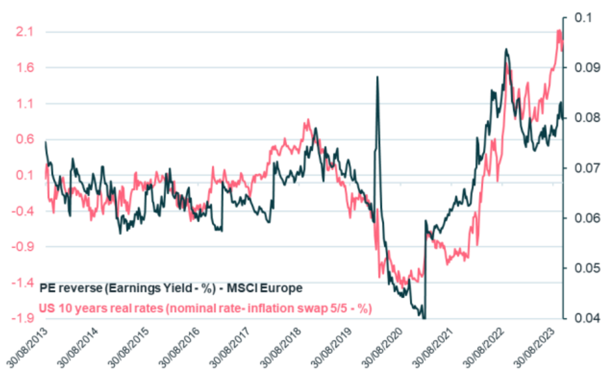


Source: Ostrum AM, Bloomberg, Morgan Stanley, IBES, October 2023

How do valuations look for the European equity markets?

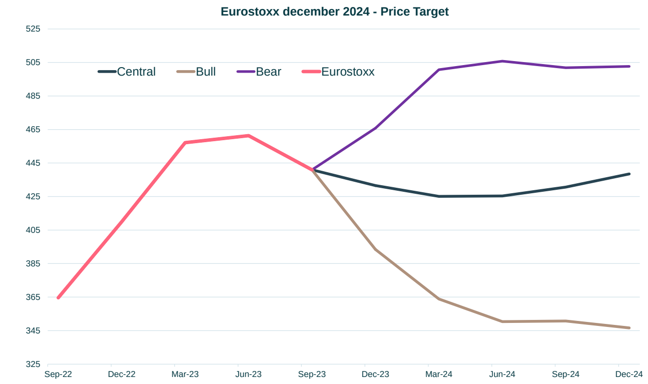
Valuations in Europe have been hurt by the rise in real rates and could grow more expensive as they ease in the second half of 2024.

Though moderate, this valuation level reflects the natural cyclical sensitivity of the market and high margin levels. Although real rates are already expected to ease slightly, we think the valuation is reasonable and could prove attractive for investors capable of expanding their investment horizon. Corrected for the cycle, it offers a high probability of positive returns over three years.



Source: Ostrum AM, Bloomberg, Morgan Stanley, IBES, October 2023

We see the European markets improving slightly in 2024 (performance calculated with dividends reinvested). Our central scenario calls for slight pressure on margins (60 bp) offset by an increase in the multiple to around 13x.

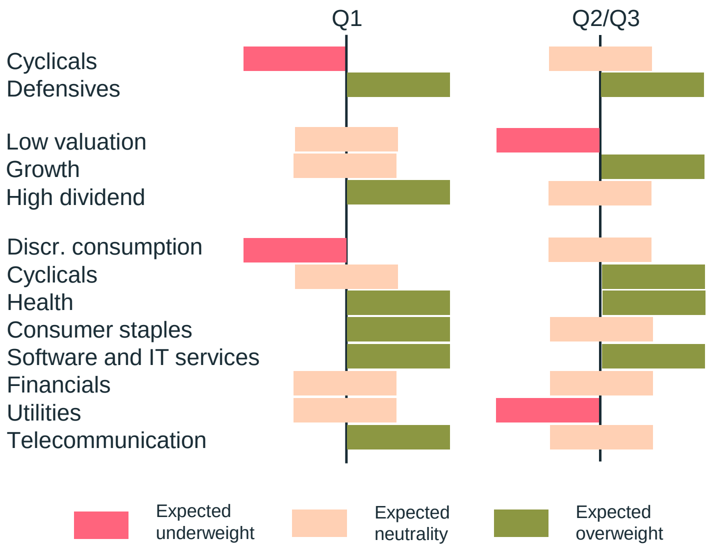


	Q1	Q3
Macro regime	Recession	Recovery
Real rates	Positive / increase	Positive / decrease
Credit spreads	High	High
Volatility	Normal / increase	Normal / increase

Source: Ostrum AM, Bloomberg, Morgan Stanley, IBES, October 2023

Where can we find value in European equities next year?

In early 2024, we will focus on limited cyclicality to avoid taking too hard a hit from the slowdown in progress. Sectors offering good visibility (healthcare, telephones, current consumption, IT services) should fare better. Staring in Q2, we see investors returning to growth sectors and certain more cycle-sensitive stocks. As for 2023, we do not think investment themes will play a crucial role in the performance of European equity markets.



Source: Ostrum AM, Bloomberg, Morgan Stanley, IBES, October 2023

INTERNATIONAL EQUITIES – Extreme valuation gaps expected to normalise

According to **Emmanuel Bourdeix, Head of Quant Strategies**, growth on the international equity markets in 2023 has largely been attributable to an expansion of valuation multiples, reflecting a sharp drop in rates.

This trend happened despite persistently high rates, constituting a genuine behavioural shift compared to the correlation that has dominated in recent years, and particularly in 2022 (right-hand chart).

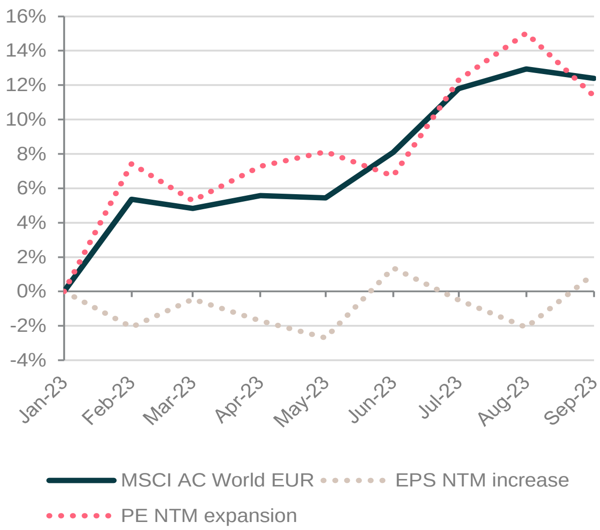


***Fig 1 – YTD performance breakdown of the MSCI AC World (EUR) index**, August 2023 – Source: Ostrum AM, Bloomberg, FactSet*

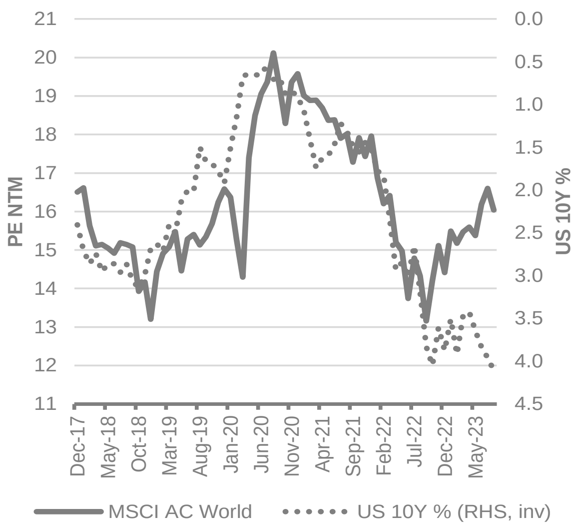


***Fig 2 - Valuation (PE NTM) of the MSCI AC World index vs US 10y rates**, August 2023 - Source: Ostrum AM, Bloomberg, FactSet*

The expansion of valuation multiples has predominantly been seen in the more speculative sectors (semi-conductors, auto, hardware, software), with a record peak in sector concentration in the equity universe.

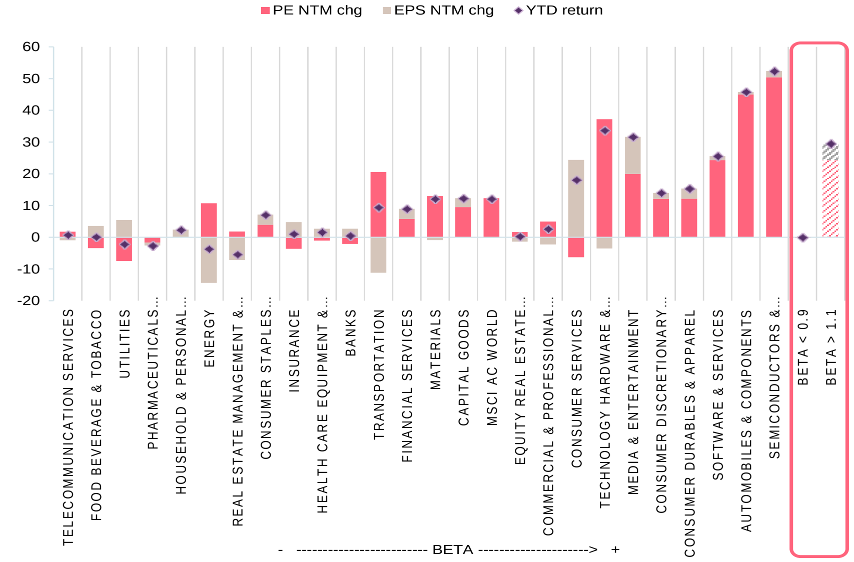


Fig 3 - YTD performance breakdown per sectors (MSCI AC World (EUR)) – classified by growing beta, *June 2023 - Sources : Ostrum AM, Bloomberg, FactSet*

In terms of contribution to performance, the impact of expanding valuations in the most volatile sector as opposed to less volatile sectors is comparable to the impacts observed before the TMT (Technologies - Media - Telecommunications) bubble burst and the Major Financial Crisis (2008).

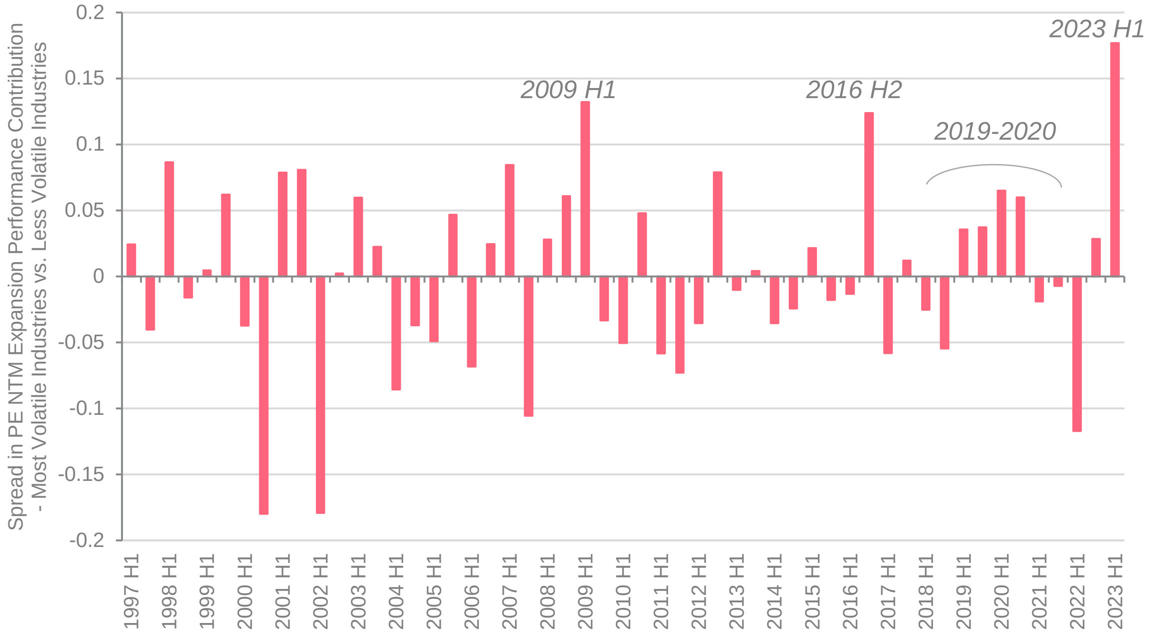


Fig 4 –Performances bi-annual spreads explained by the expansion of valuation multiples (most volatile sectors vs less volatile sectors), *August 2023 - Sources : Ostrum AM, Bloomberg, FactSet*

This peak of concentration in the markets is linked to a new phase of outperformance in the Cyclical/Growth allocation. After this phase, projected 5-year growth rates for the cyclical/growth and high beta segments are 3 to 5 times higher than their average since 2009, relative to the rest of the market.

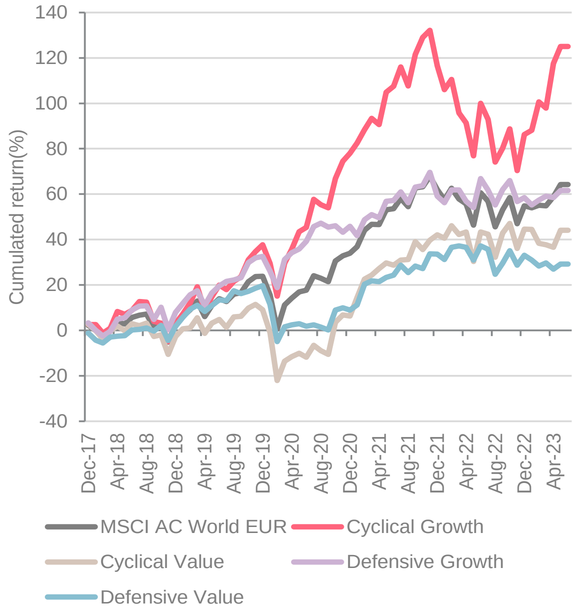


Fig 5 – Cumulated performance since Dec.2017 –MSCI AC World universe, *August 2023 - Source: Ostrum AM, Bloomberg, FactSet*

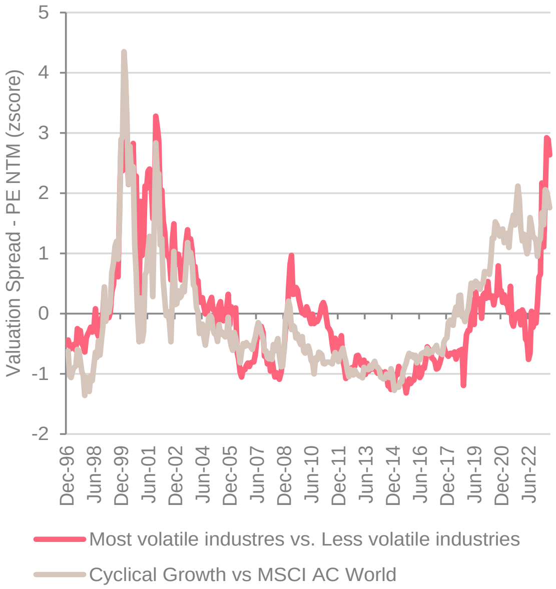


Fig 6 – Valuation spreads (PE NTM), *August 2023 - Source: Ostrum AM, Bloomberg, FactSet*

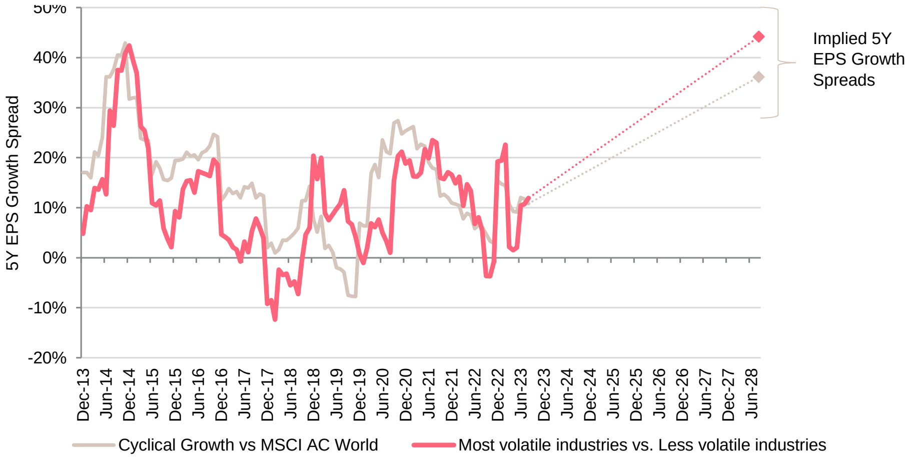


Fig 7 – Realised and anticipated growth spreads–MSCI AC World universe, *August 2023 - Sources : Ostrum AM, Bloomberg, FactSet*

Accordingly, in light of the economic downturn, we believe these historic valuation and implicit growth gaps in favour of a single sub-segment of the market will call for attentive risk management in 2024, while providing investors with opportunities liable to stem not only from the Value style catching up significantly, but also - and more importantly - from defensive sectors. Moreover, defensive sectors should be able to better absorb a potential increase in volatility during the year.

Additional notes

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