NOVEMBER 2023

Investment Strategy Focus
The one rate to rule them all

Summary

1. **The one rate to rule them all: the US 10-year Treasury bond yield.** The global economy is most sensitive to long-term interest rates, because so much depends on them. The US 10-year treasury yield is the key interest rate in the largest economy, in the world's reserve currency. The single critical indicator to watch.

2. **The US 10-year yield is now 1.5% higher than in May 2023:** then, the US 10-year yield sat under 3.5%. In just five months, this yield has risen to close to 5%. This sharp increase in bond yields has prompted large inflows to US bond ETFs and funds as investors seek to lock in the highest US bond yields observed since 2007.

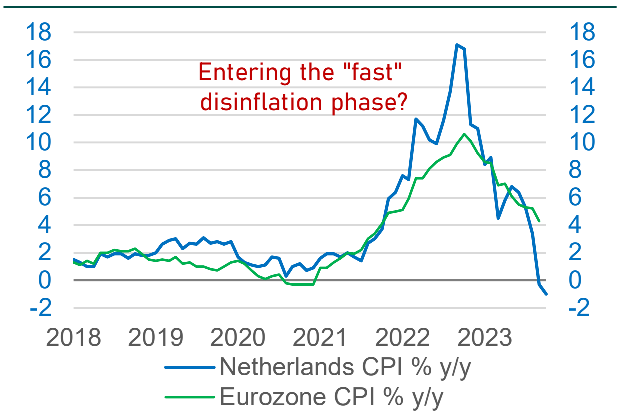
3. **Higher long-term rates do the Fed's job for them:** house mortgage and corporate loan demand have both declined as long-term rates have jumped. This cools future demand growth, and thus helps to calm inflation pressures. We continue to believe that the Fed Funds rate has peaked at 5.5% and should fall from mid-2024.

4. **US longest-duration bonds have suffered even more than stocks did in 2008:** 20Y-30Y US Treasuries have fallen in price by 64% since mid-2020. This is even worse than the 57% in stocks during the 2007-08 Financial Crisis. This represents the biggest US bond bear market in over 200 years.

5. **Look at US fallen angels within high yield credit:** *fallen angels* have historically offered a superior risk-reward opportunity to traditional high yield credit. Income investors could consider *fallen angel* ETFs and managed funds.

Contents

DUTCH INFLATION RATE DROPS INTO NEGATIVE TERRITORY



Source: BNP Paribas, Bloomberg

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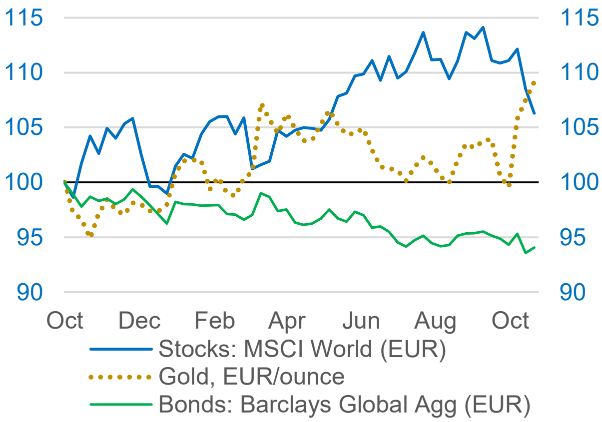
BNP Paribas Wealth Management

BNP PARIBAS WEALTH MANAGEMENT

The bank for a changing world

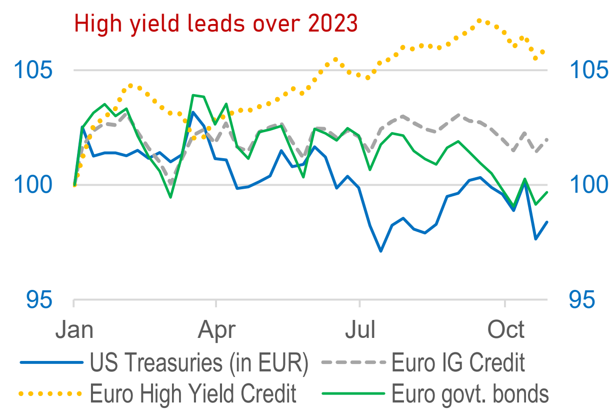
Key Calls: October was a tricky month for stocks and bonds

STOCK AND BOND CORRECTION CONTINUES



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

IN FIXED INCOME, HIGH YIELD CREDIT LEADS



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

Asset Allocation: gold proves a useful diversifier

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

Interest rates matter, a lot

Since the end of July, I believe that the one key factor driving stock, bond, and real estate markets has been interest rates.

Interest rates can be divided into two types: short-term, and long-term.

Short-term interest rates are typically decided by central banks such as the US Federal Reserve, the European Central Bank or the Bank of England. These rates are typically decided on as a function of the level of inflation, growth, and employment.

Remember that a central bank's target is ultimately to keep inflation over the medium term at or around 2%. Whether 2% is the best inflation target is a moot point. In contrast to the 1970s, today's central banks have an explicit inflation target of low inflation, which is important for ensuring economic stability over the medium term.

How do short-term interest rates work to determine inflation and growth? The higher the short-term interest rates, the higher the cost of borrowing. But equally, the more that savers are remunerated for keeping money in a savings account. So, there are winners and losers. Borrowers, of course, lose from higher interest rates, while savers gain.

What does this do? It raises the cost of financing of loans, particularly for consumers and, of course, for smaller businesses which depend more on loans from banks and loans which have a shorter payback period. The finance costs of these loans tend to be based on variable interest rates, which in turn are based on a central bank's reference rate.

Long-term interest rates are even more important

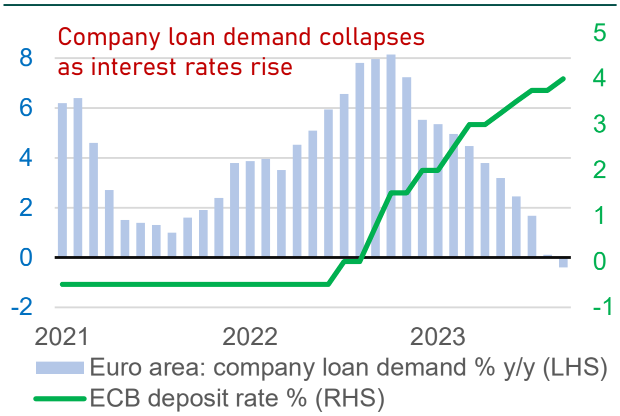
These days, if anything, the global economy is more sensitive to long-term interest rates. These long-term interest rates are not directly determined by central banks, but are rather determined by bond markets.

These are the fixed interest rates (or yield) that an investor demands in order to lend money to the government for a fixed amount of time such as five or ten years - when an investor buys a government bond. Or it is the fixed rate of interest that investors demand to lend money to large companies, again for a fixed period – when buying corporate bonds.

Today, the global economy is in many ways much more sensitive to these long-term interest rates, because so much depends on long-term interest rates: i) the cost of borrowing over the long term for governments; ii) the cost of borrowing for large companies is also largely determined by these long-term interest rates; and iii) most importantly for the real economy, the impact of these long-term interest rates on real estate markets.

Assets and markets which make the greatest use of leverage or borrowing of money are then most impacted by changes in interest rates. Remember that the largest asset class in the world is real estate - buying your own home (residential real estate) or investing in commercial real estate, such as offices, warehouses or retail outlets. Both types of real estate purchase rely heavily on long-term borrowing of money and therefore, are very sensitive to the prevailing level of long-term interest rates.

DEMAND TO BORROW MONEY FALLS AS INTEREST RATES GO UP



Source: BNP Paribas, Bloomberg.

RESIDENTIAL + COMMERCIAL REAL ESTATE IS THE LARGEST ASSET CLASS

Source: Savills (September 2023).

Surge in bond yields since July

Since the end of July, short-term interest rates have not fluctuated much as central banks have paused their series of interest rate hikes.

In contrast, we have seen a huge increase in long-term interest rates i.e., long-term bond yields. This cost at which governments can borrow money for a fixed period of 10 years or so, has risen sharply since July.

Back in the middle of July, the US government could able to issue 10-year bonds and thus borrow at a fixed rate of 3.7% for the next 10 years.

This was already a much higher rate than the lows seen in 2021 when the cost of borrowing for the US government for this 10-year bond money at a fixed rate was as low as 0.5%.

But, from mid-July until today, this cost of borrowing for the US for 10 years has leapt from 3.7% to 4.8% today, an increase of well over 1% in a matter of just three months.

Similar is true for other countries, notably in Europe, where the cost of borrowing for members of the eurozone has risen sharply. The Italian government needs to pay about the same as the US, i.e. 4.8%, to borrow today for a period of 10 years at a fixed rate.

Inevitably this has had a significant impact on financial markets in several ways. The two main ways are a) via the relative valuation of different asset classes, and b) via its economic impact on growth and inflation.

Competition for investors' savings

First, there is the impact of so-called relative valuation. As an investor, you have a choice of where to invest your money. You can invest your money, for instance, in stocks, bonds, real estate or in a range of other alternative assets.

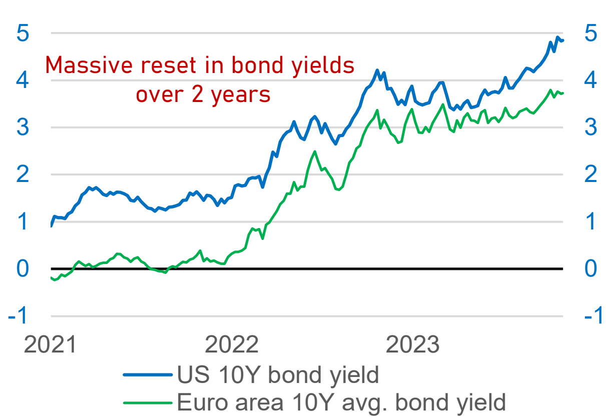
Now, the attractiveness of each of these will vary largely as a function of interest rates. As bond yields have gone up, the price of bonds has thus gone down and bonds therefore now look more attractive.

But this increase in the attractiveness of bonds has put pressure on the valuations of other asset classes, such as stocks and real estate. In relative terms they suddenly look less attractive until they fall in price, which is exactly what we have seen when the bond yield has risen in the US and Europe.

Stock markets have shed around 7-8% on average in the US and Europe at the same time. Stock market valuations have clearly adjusted to these higher bond yields, because stocks can be seen as what we call a long duration asset. In other words, much of the value of the stock is not what it delivers to you today in terms of the current dividend, but in terms of its future value. Moreover, that future value needs to be discounted at a long-term rate of interest. When that rate of interest goes up, the value in today's money of a company then goes down.

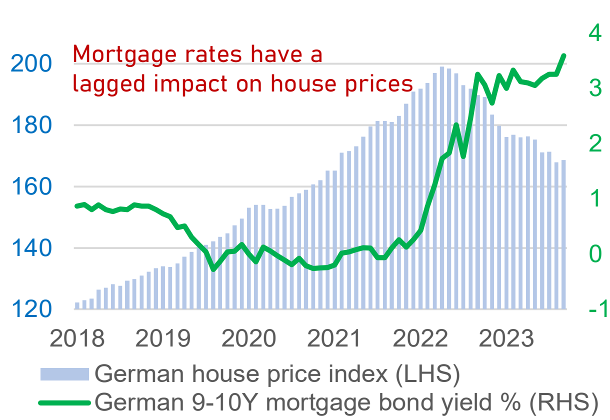
Hence, the correction in stock markets and other asset classes such as real estate seems entirely logical. The cost of borrowing has gone up, the pressure on valuations increases, and real estate values fall.

US 10Y BOND YIELD: 1% AT LOW IN 2021 TO NEARLY 5% TODAY



Source: BNP Paribas, Bloomberg.

MORE EXPENSIVE MORTGAGE RATES DRIVE HOUSE PRICES LOWER



Source: BNP Paribas, Bloomberg.

The direct economic impact of higher long-term rates

But there is a second effect of higher long-term interest rates which has a direct effect on economic activity.

As these long-term interest rates go up, the cost of financing, particularly for companies, tends to go up. Also, the cost of financing for real estate development goes up. All of this acts as a brake on economic activity, slowing it down. Investments that would perhaps have made sense at lower interest rates no longer make financial sense at these new higher interest rates. So then, you see an effect on relative valuation between the different asset classes.

There is thus a direct impact on economic activity, (which of course can affect the earnings and cash flows of companies) and therefore on the value of these stocks. Similar is true of real estate investments, particularly for commercial property in economically sensitive segments such as offices, warehouses and retail.

In general, when central banks raise interest rates, in order to raise the cost of financing, which in turn slows down the rate of economic growth. As they cool economic demand for both consumers and companies via these higher interest rates, they aim to cool inflation through falling demand.

Economic contraction in Europe, but growth persists in the US

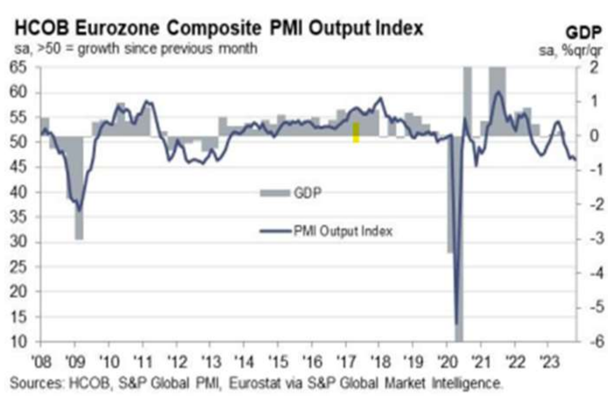
This cooling of consumer and corporate demand can be observed clearly in Europe, where economic activity is arguably falling into recession, i.e., economic contraction, as opposed to growth. This is evident from the latest PMI readings where both manufacturing and services have dipped below 50, indicating that they are shrinking as opposed to growing.

In the US, this is rather less clear, particularly given the latest GDP reading for the third quarter to the end of September, which registered a very healthy 4.9% annualised growth. I would argue that this US economic growth is due to slow quite sharply over the next three to six months, and that indeed, a recession in the US is still quite possible or even likely over the first half of next year, as flagged by the US manufacturing PMI survey well below the 50 level.

I say this because advanced indicators already point to slowing activity, slowing employment growth. We know that interest rates take time to have their full impact on economic activity. We should not assume that the cumulative 5.25% of interest rate hikes put in place by the Fed have had their full impact on slowing the US economy just yet. In fact, I believe much of this impact is still to come over the next few months.

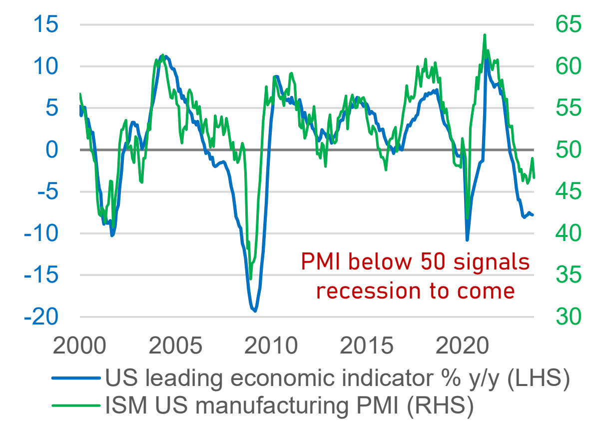
I would suggest then, that both growth and inflation should remain low or should slow sharply both in the US and in Europe over the next six months

EUROZONE PURCHASING MANAGERS' INDEX BELOW 50 HIGHLIGHTS MACRO WEAKNESS



Source: S&P Global

US LEADING ECONOMIC INDICATORS SUGGEST A RECESSION TO COME



Source: Bloomberg, Conference Board.

Good chance that long-term bond yields will fall

I thus believe that bond yields may be in the process of peaking now, and that these long-term interest rates can potentially fall quite significantly over the next six plus months.

This would no doubt be good news for bond investors, as when yields fall, prices rise. This would also be much better news for stock and real estate investors as the pressure of valuations will ease and perhaps even start to reverse.

In my view, bond yields may be in the process of peaking now, and could potentially decline significantly over the next few months.

Consider what we have witnessed in US long-term Treasury bonds since 2021. The longest-dated US government bonds (20- to 30-year maturities) have fallen over 60% in price terms from their mid-2021 peak. To put this scale of decline in some context, this is the biggest crash in the recorded history of the US bond market. It is far worse than the 50% fall in global stock markets during the 2007-2008 Great Financial Crisis.

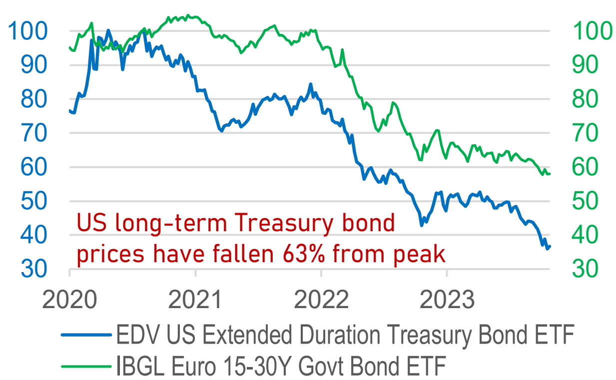
Lower bond yields could herald a rally in markets. Seasonality tends to suggest lower bond yields and higher stock markets between now and the end of the year. Should US and European inflation data reports prove to be on the low side (as I suspect) in the coming months, this would certainly help the fundamental case for lower bond yields.

Lower long-term interest rates could provide some welcome relief not only to government bonds, but also to corporate bonds, stocks, real estate and even infrastructure markets.

Bond yield movements outweigh modest shifts in economic momentum: even if US economic activity slows markedly over the next 6-9 months as we expect, the key driver of financial markets should remain the direction of long-term interest rates. We believe that investors will look through a modest recession to the recovery beyond, as was the case during the 1989-1991 recession in the US.

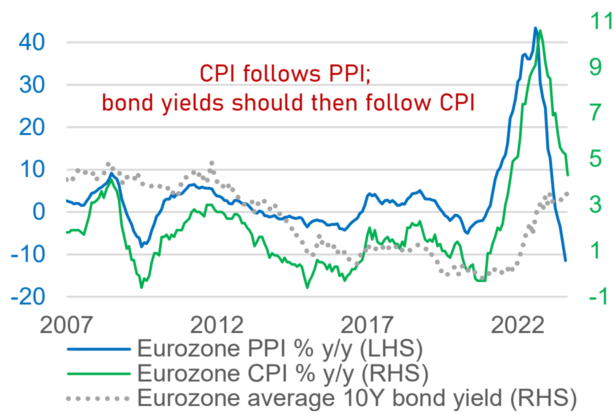
Bear in mind that since February 2020 (prior to the COVID crash), global stocks have only progressed 12% in total. This equals an annual average of only 3.1% p.a., well below historical average returns.

US LONG-TERM BONDS HAVE ALREADY LOST MORE THAN STOCKS DID IN 2008



Source: BNP Paribas, Bloomberg. Indexed to 100 at end-July 2020

LOWER PPI LEADS LOWER CPI, IN TURN EVENTUALLY LEADS LOWER BOND YIELDS



Source: BNP Paribas, Bloomberg.

INVESTMENT CONCLUSION

We expect bond yields to decline: We maintain our 12-month forecast of 3.75% for the US 10-year bond yield and 2.5% for the 10-year German bund. Lower bond yields should aid stock, bond, credit and real estate asset prices.

Since the October 2022 stock market low, the average US stock has only advanced 4%, versus a 9% advance for the average European stock and 14% for the average Japanese stock. Outside of the US Magnificent Seven, there remain plenty of undervalued stocks globally, even in the US.

High yield credit offers 9% gross yield today

One segment of the fixed income universe that has received a lot of interest in recent months is the high yield credit market. For both institutional and retail investors, a gross bond yield of 8.9% for European high yield and 9.4% for US high yield credit look incredibly attractive from a pure income perspective, after years of relatively low yields from bonds.

But this of course has been boosted by the general rise in bond yields across the entire fixed income universe. To look at high yield credit valuation relative to other fixed income segments, we should look at the level of credit spreads in high yield (i.e., the excess yield over an equivalent maturity government bond). These high yield credit spreads are only a little over the long-term historic average, at 4.4% in the US and 4.9% in Europe, and far lower than credit spreads at times of stress as in early 2020, when they spiked towards 10%.

Given the lack of obviously attractive valuations levels at a time when the global economy is slowing and could go into recession, causing a rising number of corporate defaults, we maintain a Neutral stance on global high yield corporate bonds. But, within this market, we see some interesting segments.

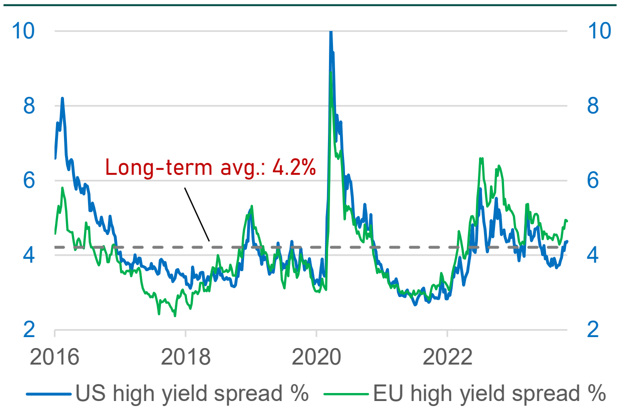
Fallen angels offer an attractive risk-reward ratio

I like to focus on the *fallen angel* segment of the US high yield credit market for more attractive investing opportunities. *Fallen angels* are high yield bonds of companies that had been rated as investment grade issuers when the bond was issued, but which have since been downgraded to high yield (or junk bond) status.

Over time, this *fallen angel* subsegment of US high yield credit has been concentrated at the higher ratings of BB and B within high yield, with almost no exposure to the worst-rated CCC corporate bonds.

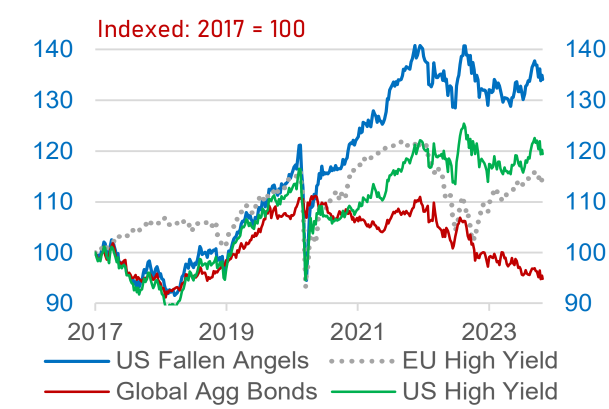
Given that investment grade credit investors like insurance companies are generally obliged to sell these bonds once they are downgraded to high yield status, these bonds tend to offer better-than-average risk-reward characteristics to subsequent buyers. This is borne out by the long-term outperformance of the Fallen Angel credit index versus global high yield credit. Today, the US Fallen Angel index offers a generous 8.9% gross yield, while 73% of the universe are rated BB (versus only 44% rated BB within the total US high yield universe).

HIGH YIELD CREDIT SPREADS ARE ONLY JUST ABOVE HISTORIC AVERAGE



Source: BNP Paribas, Bloomberg.

FALLEN ANGELS HAVE BEEN THE BEST PERFORMERS IN HIGH YIELD CREDIT



Source: BNP Paribas, Bloomberg. Total return indices in euros

Investment Conclusion

For investors attracted towards the generous income opportunities in high yield credit markets, we would suggest investment in ETFs and managed funds that focus on the US *fallen angel* credit subsegment of the high yield universe. We prefer its higher quality and better long-term risk-reward characteristics. *Fallen angel* credit may be a better alternative for many investors to government bonds and stocks, outperforming a 60:40 mix of global stocks and bonds by a large margin since 2016 (6.9% annualised return vs. 5.3% for the 60:40 mixed portfolio).

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 (selective), 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 & Utilities		**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	We add US govies (3Y-5Y maturities preferred). 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 %	2022	2023	2024
United States	1,9	2,4	0,8
Japan	1,0	2,0	1,0
United Kingdom	4,3	0,5	-0,1
Eurozone	**3,4**	**0,5**	**0,9**
Germany	1,9	-0,4	0,3
France	2,5	0,8	0,6
Italy	3,8	0,8	1,0
Emerging			
China	3,0	5,1	4,5
India*	7,2	6,1	6,0
Brazil	2,9	3,1	1,8

* Fiscal year

Source: BNP Paribas - 27/10/2023

BNP Paribas Forecasts			
CPI inflation %	2022	2023	2024
United States	8,0	4,2	2,4
Japan	2,5	3,2	2,6
United Kingdom	9,1	7,4	3,0
Eurozone	**8,4**	**5,6**	**2,8**
Germany	8,6	6,2	3,0
France	5,9	5,8	2,7
Italy	8,7	6,2	2,2
Emerging			
China	2,0	0,5	2,0
India*	6,7	5,9	5,0
Brazil	9,3	4,7	4,2

* Fiscal year

Source: BNP Paribas - 27/10/2023

	Country	Spot 01/11/2023		Target 3 months	Target 12 months
Against euro	United States	EUR / USD	1,05	1,06	1,15
	United Kingdom	EUR / GBP	0,87	0,86	0,86
	Switzerland	EUR / CHF	0,96	0,98	0,98
	Japan	EUR / JPY	159,10	154	154
	Sweden	EUR / SEK	11,83	11,00	11,00
	Norway	EUR / NOK	11,83	11,30	10,80
Against dollar	Japan	USD / JPY	150,98	145	134
	Canada	USD / CAD	1,39	1,32	1,30
	Australia	AUD / USD	0,64	0,68	0,70
	New Zealand	NZD / USD	0,58	0,60	0,63
	Brazil	USD / BRL	5,02	5,00	5,00
	India	USD / INR	83,29	82,0	82,0
	China	USD / CNY	7,32	7,20	6,80

Source: BNP Paribas, Refinitiv Datastream. As at 1st November 2023

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