CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

2024 Revealed: ten convictions for a blinding future

Candriam Outlook 2024

2024

Marketing communication

Table of contents.

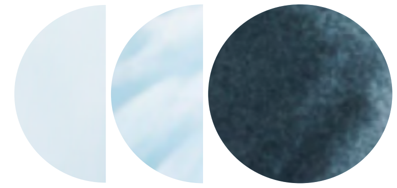
Introduction
Chronicle of a recession foretold **04**

Central Banks
Monetary policy:
High rates... for how long? **08**

Rates
In a land of opportunities...
select carefully **12**

Equities
Can equities fall, even *without* a hard
landing? **16**

Sovereigns
Should we be concerned about the
sustainability of public debt in the
Eurozone? **22**



Financing Energy
Energy Transition Turbulence: Structural or Cyclical? 28

Real Estate
Real Estate – a Spring Thaw? 34

Emerging Markets
In the emerging markets galaxy, meet the new rising stars 40

Health Care
Will the healthcare sector play an expected defensive role next year? 46

US Elections
United States: What can we expect in the election year? 52

Asset Allocation
What diversified portfolio for 2024? 56

Conclusion
Investing with Conviction 60

Chronicle of a recession foretold

Nicolas Forest
Chief Investment Officer

Once again this year, the financial markets reveal a shifting horizon, strewn with challenges and offering investors a captivating odyssey.

Geopolitical tensions and economic uncertainties continue to exert considerable influence on world markets. Added to these immediate concerns are the no less critical issues of global warming and biodiversity loss, which remain pressing challenges for 2024 and future generations. These issues, which are more interconnected than we can measure, demand concerted attention and action from investors, businesses and governments alike.

In these volatile conditions, a thorough understanding of the underlying factors shaping the global economy is - more than ever - an essential prerequisite for identifying compelling investment opportunities. What's more, in an election year fraught with pitfalls, where populist temptation will unfortunately be the chant in the background, we believe that integrating extra-financial considerations into our investment decisions remains the best way to create value for our investors, while promoting the transition to a more sustainable future. It's a necessity in an increasingly uncertain world, and it is our commitment to our customers.

Year on year: the global economy in resistance mode

2023 will have contradicted many Cassandras and financial laws that were thought to be immutable. Indeed, despite monetary tightening of unprecedented speed and magnitude, an inverted yield curve and a banking crisis, the most telegraphed recession in history... didn't happen. However, the last twelve months have been particularly tumultuous and testing for convulsive markets, buffeted by geopolitical conflicts, economic uncertainties and central bank moves more closely watched than those of Taylor Swift.

In fact, bond market volatility has made a comeback. And as is often the case, the surprise came where it was least expected. While we were anticipating positive growth and a slowdown in inflation, honesty compels us to admit that the strength of the US economy took us by surprise -- household purchasing power turned out to be much stronger than anticipated, supported by wage increases and a comfortable savings cushion, swollen since the Covid crisis.

A year on, with the cycle further advanced and financial conditions tighter, the spectre of recession is knocking at the door, and it seems more necessary than ever to think about investment prospects in terms of the new bond paradigm. As we build up our allocations, we are addressing this challenge and its consequences through a series of ten questions to which our experts will be contributing their answers and convictions, throughout the month of December. Here's an overview.

A new bond paradigm

"High for longer?" While central banks have so far managed to keep inflation in check, it's the question, the one that many of us - myself included - put on paper before anything else. Will they be less restrictive in 2024? With bond yields once again at attractive levels, is this the right time to increase duration and continue to favour the credit market, whose resilience has surprised many?

Similarly, rising interest rates have had an impact on the dynamics of public debt. But in an environment of weakening growth and reduced purchasing programs by central banks, could the question of debt sustainability arise again in 2024? Nor has it been without effect on real estate markets, with a fall in construction and sales. While price declines have so far seemed limited, should we be concerned about an acceleration or, on the contrary, a tremendous opportunity for repositioning?

At the *equities theater*: several times, several places... several actions

Despite high real interest rates, equity indices held up well. However, this is a trompe-l'œil rise, marked by strong selectivity in favor of US mega-caps and a discounting of small and mid-caps. So which sectors and geographical areas should we focus on in the future?

After being penalized by rising interest rates in 2023, will defensive growth stocks regain some of their superb form to outperform in 2024? Will these companies, particularly in the healthcare sector, which are at a discount despite a solid balance sheet and low debt levels, once again benefit from demographic change and their strong capacity for innovation?

And what about the renewable energy sector, battered by rising interest rates, soaring raw material costs and flagging profitability? The consequences of global warming are unequivocal, reminding us that the energy transition is necessary even if it faces short-term challenges. Investments are still insufficient to meet carbon neutrality targets. Today and tomorrow, this theme will be unavoidable, but what role should it play, and what tactics should it adopt?

Finally, what about China's growth model? Has the country reached the end of its rope, and is it on the verge of the ‘Japaneseization’ of its economy? Do other emerging economies offer the growth and innovation potential to compete with the Middle Kingdom? What are the alternatives?

2024, a year of elections and challenges

In addition to the European elections, where many issues will be at stake - not least the crucial one of energy transition - all eyes will be on the United States this autumn. Despite an air of déjà vu, how could this election impact our scenario?

Ultimately, faced with an unstable geopolitical environment and a fragile economy where the immediacy of data is paramount, investors will continue to listen to the political and economic players, and will continue to interpret their signals to build their portfolios: should we still favour bonds over equities?

One thing is certain: a persistently tight labor market would support a scenario of higher inflation, and therefore potential further monetary tightening. The return of a Trump 1.2 to the Oval Office would rekindle tensions with Beijing. Finally, an escalation in the Middle East or beyond Ukraine's borders would reshuffle the deck in terms of economic scenarios.

Fortunately, there is still plenty of good (and not-so-good) news to come: an inflexion on the part of the major monetary powers would mark the long-awaited "pivot" and support the riskiest asset classes. A massive support plan in China would also be very welcome, especially in Europe. Finally - and even if it seems like wishful thinking at the time of writing - the end of the Russian-Ukrainian conflict would considerably reduce the geopolitical risk in Europe.

On this positive note, the entire Candriam investment team and I wish you all the best for a prosperous 2024. Together, we remain fully committed to working with you to navigate the challenges and opportunities that lie ahead.

Enjoy your reading!

Monetary policy: High rates... for how long?

Towards a more "normal" yield curve

Florence Pisani, PhD
Global Head of
Economic Research

Emile Gagna
Economist

"The process of getting inflation back down to 2% has a long way to go", declared Federal Reserve Chairman J. Powell last June; "we cannot declare victory yet", echoed his European counterpart Christine Lagarde a few weeks later. Despite the steady decline in inflation, the message hammered home by central banks on both sides of the Atlantic has hardly changed for many months: rates will remain high "for long". Even though central bankers have not really changed their tone, over the last weeks market operators have sharply revised their interest rate expectations: they now expect key rates to be cut on both sides of the Atlantic as soon as early spring. Looking further ahead, however, they remain very cautious and expect key rates to be slightly below 4% in the US and slightly above 2.5% in the Eurozone by the end of 2027. Are these expectations reasonable?

Recent monetary history as a guide...

Before their recent revision of expectations, markets seemed to have had blind faith in the commitments of central bankers. Yet, as monetary history regularly reminds us, central bankers cannot reasonably make promises that extend beyond a few months. When, in August 2003, the Federal Reserve pledged to maintain an accommodative monetary policy for a "considerable period of time", many wondered about the horizon of this promise. Would it be a few months, several quarters, or even years? Five months later, these words were cleverly removed from the monetary policy statement to prepare the markets for the next rate hike... which will actually take place at the end of June 2004.

The "considerable period" thus lasted "only" ten months. The promise made in March 2009 to keep interest rates low for an "extended period" will take much longer, but the devastation caused by the Great Financial Crisis was of an unprecedented scale. In August 2011, the "extended period" will be extended "at least until mid-2013" and then "until mid-2015". The Fed will not raise rates until January 2016. This time, the central bank will have kept rates low for... seven years. This brief review shows that the period associated with the qualifiers "considerable", "extensive" or "long" is, to say the least, variable. The safest thing for central banks to do is to make vague conditional promises, such as the one made by the ECB President at the end of August: the central bank will keep rates high "for as long as needed"!

Anchoring inflation expectations

Minutely parsing central bank speeches in an attempt to read future monetary policy into them several quarters in advance is therefore futile. Better to ask what conditions might lead central banks to loosen their monetary policy. Their objective today is to bring inflation back towards their 2% target, which in both Europe and the United States requires an easing of tensions on the labor market. In the absence of a shock that would tip economies into recession, this means that growth must slow below its potential pace for a year or two. Of course, no one knows exactly what this cruising speed is, but for central banks to consider a less restrictive monetary policy, the pace of growth will probably have to fall below 1.5% in the United States in 2024 and 0.5% in the Eurozone. Once this condition has been met, monetary policy could become less "restrictive". Here again, however, judging the "normal" level of central bank rates is far from easy. This level varies over time, depending in particular on economic agents' inflation expectations. The degree of restraint associated with a nominal rate of 4% is not the same depending on whether inflation over the next few years is expected to be 2%... or 4%! If central banks do indeed succeed in bringing inflation back to target, a nominal short rate of around 3.5% in the United States would not seem unreasonable; in Europe, it would probably be closer to 2.5%. From this point of view, the downward revision of market expectations since early November seems to be moving in the right direction, even if those expectations still overlook the risk of a recession in the next few years.

Deflating balance sheets

There is one final argument in favor of lower short-term rates in the medium term. Since the "Great Financial Crisis", central bank balance sheets have played a very special role in the conduct of monetary policy. Both the Federal Reserve and the ECB have resorted to quantitative easing policies which have led to an explosion in the size of their balance sheets, from less than 1 trillion (in national currencies) at the beginning of 2005 to almost 9 trillion at the beginning of 2022. Each at their own pace, they are now trying to reduce their balance sheets. The economic situation indeed no longer justifies the implementation of unconventional policies. The political argument is not without importance, either. If central banks can make losses and operate with negative equity, a balance sheet lightened of securities bought yesterday at high prices would facilitate their return to profitability. It would also help central banks reaffirm their independence. Finally, in the case of the ECB, the legal aspect is also important: the 2018 ruling by the Court of Justice of the European Union on the legality of the PSPP (*Public Sector Purchase Programme*) underlines the temporary nature of quantitative easing programs, which does not oblige the ECB to reduce the size of its securities portfolio, but does force it *a minima* to explain how it helps it achieve its price stability objective... Whatever the reason, the ongoing? reduction of central bank balance sheets - sometimes referred to as "quantitative tightening" - will push up term premiums[1] and, all other things being equal, call for lower short-term rates. All in all, the deflation of balance sheets will signal a normalization of monetary policy: after being flat, or even inverted, for several years, the yield curve will finally be able to return to a normal shape!

1 - The term premium is the additional yield demanded by investors to compensate for the uncertainty associated with holding long-term securities.

In a land of opportunities... select carefully.

Philippe Noyard
Global Head of Fixed Income

Charudatta Shende
Head of Client Portfolio Management - Fixed Income

***“Compound interest is the eighth wonder of the world”*, said Albert Einstein. Over the past decade, Fixed Income investors weren’t able to fully experience this wonder, as historically low and even negative yields obscured the power of compounding.**

Fortunately, since mid-2022, yields have roared back, firmly establishing rates in positive territory, and providing investors with a multi-decade opportunity and enticing entry points. Global sovereigns and corporate bonds offer yields last seen in 2011.

However, to truly benefit, investors will have to keep their eyes open. While external concerns have diminished, specific and idiosyncratic risks are gaining prominence across Fixed Income asset classes.

Opportunities aplenty?

Money Markets yields approaching 4%[1] now make cash-parking attractive, allowing investors time to search for investment opportunities. Investors can also invest in this low-risk asset class to manage volatility of their bond portfolios.

Euro **Investment Grade** credit now allows investors to lock in very interesting yields of 4.3%[2] or more, with an extraordinarily flat maturity curve. Investors can lock in historic levels of yield over a longer period in a relatively high-quality asset class, as equity markets settle back into their more traditional role of lower dividend yields and higher volatility.

Global High Yield markets are also presenting a very different scenario, with attractive coupons above 8%[3], versus barely 4% two years ago. And the quality of the High Yield market has improved significantly since these rates were last seen, in 2011 (with Euro HY now composed of 75% BBs, vs only 50% in 2011, and US HY[5] now composed of 50% vs 35%). The higher-quality Global High Yield BB rated portion now yields well above 5%.

Government bonds stand out. Investors are unlikely to forget that almost the entire German sovereign curve was negative a mere two years ago. The short end of the European safe-haven now delivers roughly 3.6%[6], while its US counterpart is at a whopping 5.3%[7], offering low spread risk and no credit risk.

Emerging sovereign debt is leading the way with coupons over 8.7%[8]. A non-negligible portion of the market consists of potentially undervalued debt restructuring stories (countries closing in on agreements with creditors), and which we estimate to have a yield of over 12% on average.

Risks: From Macro to Micro.

While Fixed Income Markets feel particularly welcoming, we believe it will be essential to identify **idiosyncratic risks**. Yields may be back, but bond returns remain asymmetric. In the absence of central bank support, market values of corporate and sovereign issues are once again dependent on fundamentals. Bond markets which were recently driven by central banks are now more influenced by economic data, balance sheets and business models. Adding to this is the ever-growing importance of Environmental, Social, and Governance factors to credit risk.

Corporates are entering an environment in which the cost of debt service has increased considerably. Incidentally, we believe that current spread levels in Euro Investment grade (145 bps[2]) and Global high yield (420 bps[3]) fail to accurately reflect these risks. Within the high yield segment, we also expect spreads to widen around 500 bps (though with considerable volatility in 2024) and default rates to climb moderately to over 5%.

Digitalisation, automatization and artificial intelligence trends have a strong influence on business activities. Issuer ability to adapt will be vital. It seems obvious that large companies with highly-diversified businesses that are not geared towards the end-market consumer are much less exposed to economic slowdown. The new environment favours companies with low leverage and visible cash flows. Certain issuers will be more sensitive to repayment schedules, and under pressure to re-finance at higher rates. While the Investment Grade segment as a whole is unlikely to be impacted by a “maturity wall”, the high yield space could face a refinancing hurdle in 2025 and 2026.

Similarly, **Sovereign issuers** will increasingly be dependent on their economic and debt profiles, and specific risks will also be key in this sector. Fiscal policies and political risks will return to the forefront. Indeed, markets are paying greater attention to budgets, and to the impact of higher rates on debt sustainability. In the past, the distinction was primarily between core and peripheral markets, but we expect a very different future. Just take a look at the example of Portugal -- following its fiscal reforms, its bonds now trade at lower spreads than those for France. We also expect material volatility in a year where several large nations will be heading to the polls, with general elections in the US, UK, India, Indonesia.

A rising number of emerging nations will surely require assistance from the IMF, which is likely to base its help on fundamentals and political will. Some countries, such as Ghana, Zambia and Sri Lanka are well along in their restructuring, while other distressed countries are not.

Sustainability metrics now essential in assessing sovereign creditworthiness, as climate change is having a material impact economies. For example, India, a strong growth story, nevertheless faces an impact from pollution. Schools and public institutions were recently closed for several days in certain cities, and long term health impacts are already apparent. These elements will affect the overall debt profile of a country over the long run.

Investing: Make Haste.... Slowly

Fixed Income markets now offer a plethora of yield opportunities. The importance of carry in bonds is not just income, but also the strong cushion it provides against adverse market conditions. In case spreads widen for a particular fixed income segment, the carry can protect investors by partially offsetting the drop in market value. The new interest rate landscape – or shall we say, the return of a normal interest rate landscape -- favours a diversified fixed income allocation, with each segment both providing income and fulfilling a specific role in the portfolio.

To exploit these opportunities, investors must understand and analyse the **risks that surround individual issuers**. This bond-picker's market demands a careful selection of issuers and issues to achieve risk-adjusted returns. Rigorous and disciplined bottom-up research will be, more than ever, needed for both sovereign and corporate issuers, to gauge creditworthiness and understand the risks specific to each issue.

Incorporating ESG analysis across fixed income markets is a prerequisite to develop a full understanding of debt sustainability, which will be a vital part of bond portfolios in the future.

Einstein's observation continued, "compound interest is the eighth wonder of the world. ***He who understands it, earns it… He who doesn't – pays it…***

1 - €ster: 3.902% as at 24.11.2023 – Source: Bloomberg
2 - ICE BofA Euro Corporate Index as at 24.11.2023 – Source: Bloomberg
3 - ICE BofA Global High Yield Index as at 24.11.2023 – Source: Bloomberg
4 - ICE BofA Euro High Yield Index as at 24.11.2023 – Source: Bloomberg
5 - ICE BofA US High Yield Index as at 24.11.2023 – Source: Bloomberg
6 - German 12 month rate, as at 24.11.2023 – Source: Bloomberg
7 - US 12 month rate as at 24.11.2023 – Source: Bloomberg
8 - JPM EMBI Global Diversified Index as at 24.11.2023 – Source: Bloomberg

Can equities fall, even *without* a hard landing?

Thibaut Dorlet
CFA, Senior Multi-Asset Fund Manager

With the failure of a recession to materialise, 2023 has been a good year for equity indices. However, their rise was uneven, marked by strong selectivity among mega-caps in the US and underperformance by small and mid-caps, hit by the historic rise in interest rates.

For 2024, we anticipate a continued soft landing for the developed economies and stabilization of the Chinese economy.

But can we rule out the risk of a downturn in the equity markets?

The challenge of high real interest rates

High real bond yields are traditionally unfavourable to the expansion of price/earnings (P/E) ratios. Nonetheless, it was a rise in valuations that carried equity markets into 2023, against a backdrop of stronger-than-expected economic growth.

In 2024, we expect growth to slow and inflation to continue to fall, putting downward pressure on real rates and creating a favourable environment for stock market valuations. However, given the rate levels already reflected in equity valuations, we believe that this support will be relatively weak or non-existent.

US 12 month Forward P/E vs Real Yields

6 month change

Source: Bloomberg, November 2023.
Past performance of a given financial instrument or index or an investment service or strategy, or simulations of past performance, or forecasts of future performance do not predict future returns.

Support from margins and profits in 2024?

While valuation is unlikely to provide additional support for equities, weak but positive growth should nonetheless bolster corporate earnings. But to what extent?

For 2024, our economists forecast GDP growth of +1.9% in the United States and +0.5% in Europe (that is, a "soft landing"). Historically, these levels are compatible with corporate earnings growth of +7.5% in the United States and +2.5% in Europe. However, markets are already discounting higher levels for 2024 (+12% in the US and +6.5% in Europe), which should lead to a downward revision of earnings expectations for next year - especially as companies are likely to face further pressure on their margins.

On the one hand, profit margins are high in all regions, exceeding pre-Covid levels. With real wage growth likely in 2024, these margins should be harder to preserve.

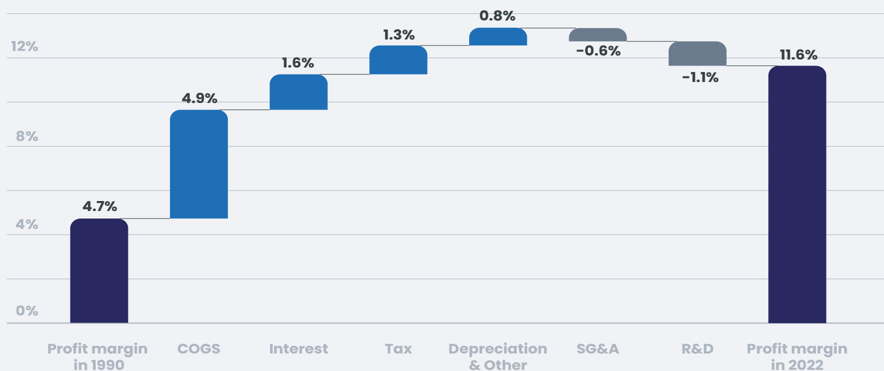
On the other hand, since the 2000s, companies have benefited from steadily falling bond yields, widespread tax cuts and globalization. This positive sequence could be coming to an end, due to:

- Growing government financing needs, at a time when debt levels are already high following the fiscal efforts made during the pandemic. Withholding tax rates have begun to rise (pressure on the banking sector in Italy, Belgium and Spain to introduce an "exceptional" tax; vote by the US Congress for a 15% minimum tax rate for large corporations and a tax on share buybacks), and this trend could continue into 2024.

- The end of ultra-accommodating monetary policies, which should lead to a lasting increase in corporate financial costs.

- Recent supply shocks, which are likely to affect company margins.

Drivers of S&P500 profit margin expansion since 1990



Source: Goldman Sachs
(CGOS: Cost of Goods Sold; SG&A: Selling, General and Administrative Expenses; R&D: Research & Development)

Given these downside risks to current earnings projections, we remain cautious about the ability of earnings growth to provide strong support for equity markets in 2024.

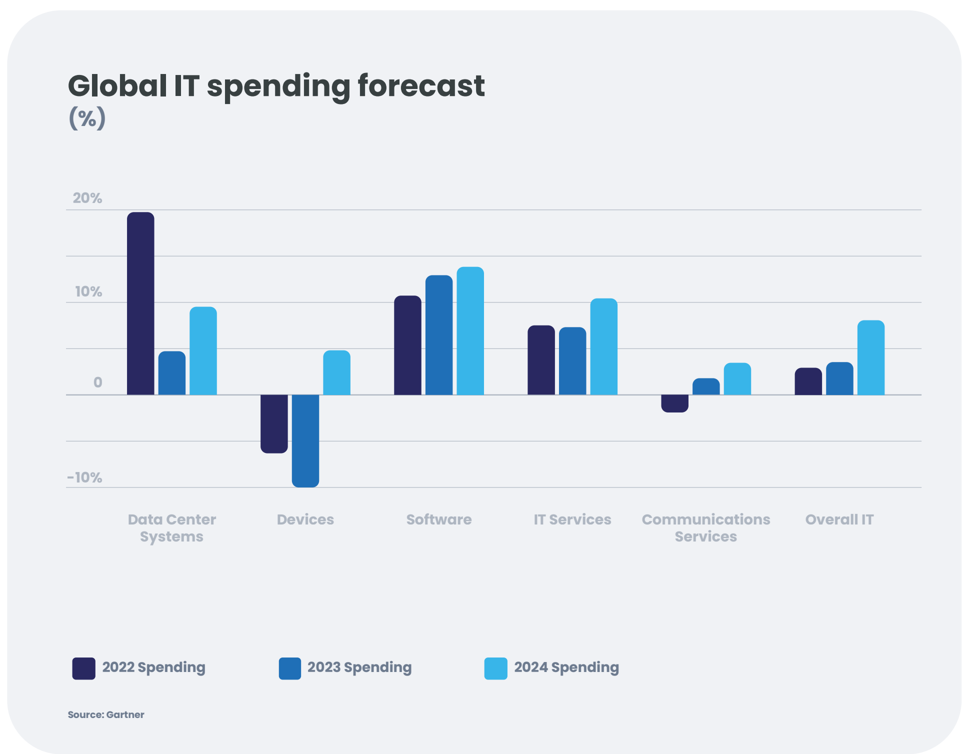
Moreover, we believe the good news has already been incorporated into valuations.

Consequently, although we do not anticipate a "hard landing" (sharp recession), the scenario of a horizontal equity market seems to us the most likely, with limited upside potential.

Which regions and sectors to favour in 2024?

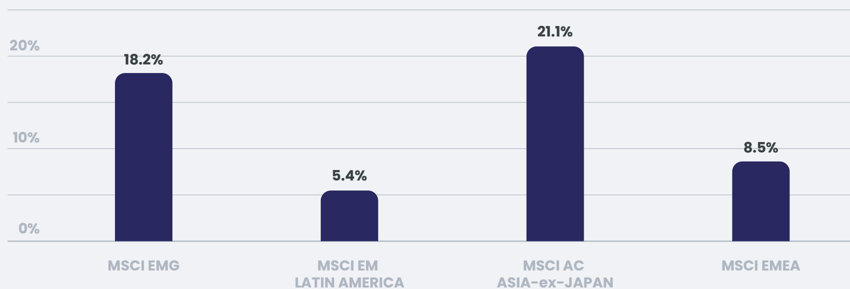
While the equity market as a whole lacks catalysts, there are nonetheless some attractive themes and sectors.

In the US, technology stocks should continue to outperform, taking advantage of their innovation capabilities, notably through the monetization of Cloud and AI services (+10%[1] of investments next year). Strong balance sheets and low debt levels make the sector even more resilient in the face of an economic downturn. Valuations appear reasonable in view of the sector's expected long-term growth.



In emerging markets, we see opportunities in **Latin America**, which should continue to benefit from the relocation of American industry ("nearshoring") against a backdrop of resilient commodity prices. Modest earnings growth expectations, moderate valuations and a supportive central bank environment should buoy the region's markets, especially Brazil, which is implementing fiscal reforms.

EPS Growth changes 2024 - Emerging Equities

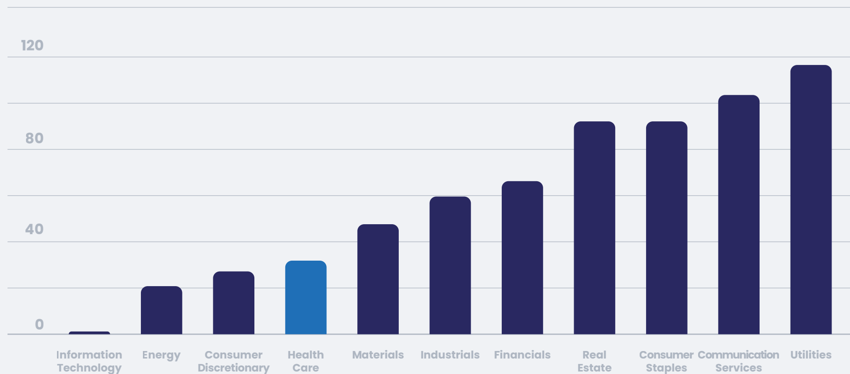


Source: Datastream, November 2023

In Europe, the economic situation remains more gloomy, with weak growth and no visible catalyst in the coming months (persistent volatility in energy prices, high key interest rates, Germany's need to reinvent itself). As such, we favour companies that are best positioned to defend their margins, have strong balance sheets and can benefit from lower rates in 2024, such as healthcare and consumer staples stocks.

- **Healthcare stocks**, with the exception of certain issuers such as Novo Nordisk2, have mostly underperformed the market in 2023. They should play a defensive role in 2024, their capacity for innovation supporting margins, while their business seems to have normalized post-pandemic. They benefit from good visibility on their cash flow progression in the absence of major patent expiries before the end of the decade, and with the possibility of being positively surprised by the arrival of newly developed drugs. The sector's low level of debt is also an advantage in a high interest rate environment.

Net Debt to Equity
European Equities
(%)



Source: Bloomberg, November 2023

- **Consumer staples** have significant pricing power, enabling them to maintain high margins while enjoying good visibility on their business. The sector's valuation has undergone a significant adjustment due to rising rates in 2023, and should benefit from a more favourable environment in 2024. Last but not least, the sector's defensive nature enables it to outperform in an economic slowdown.

To sum up, 2023 was a good year for equities, albeit with a high degree of dispersion. In our assumption of a continuation of the soft landing for the developed economies in 2024, the scenario of a horizontal equity market seems to us the most likely, with limited upside potential. We also see relatively little downside potential, given the room for manoeuvre that central banks have built up again. The stressful episode surrounding US banks in March showed us that the Fed is always ready to manoeuvre when necessary.

We prefer to avoid highly leveraged stocks, and instead to select companies offering resilience and visibility in this slowing environment.

In the US, technology stocks should continue to generate growth, although the scale of the outperformance achieved in 2023 is difficult to reproduce. In Europe, we favour quality defensive stocks.

1 - Source Gartner - 2024 IT spending forecast ex-Communication services
2 - The stock is present in certain portfolios managed by Candriam

Should we be concerned about the sustainability of public debt in the Eurozone?

Emile Gagna
Economist

Sylvain De Bus
Deputy Head of Global Bonds

Faced with a succession of shocks (pandemics and soaring energy prices), governments have allowed their deficits to grow in order to limit the economic and social consequences of the shocks. The "whatever it costs" approach to maintain incomes during the pandemic has been followed by the "whatever it costs" approach to protect purchasing power despite surging energy prices. While low unemployment figures illustrate the success of these policies, the rise in public debt provides an idea of their cost: between 2019 and 2023, public debt rose by 6 points of GDP in Germany, 8 in Belgium, 9 in Spain and Italy... and more than 12 in France! Even so, this rise in debt does not fully reflect the accumulation of deficits.

The cost of "whatever it takes" lightened by inflation

Equation (2) in the box shows that the debt burden increases not only with the primary deficit (i.e. the deficit excluding interest charges), but also with the difference between the average interest rate on the debt (*i*) and nominal growth (*g*). This effect, usually referred to as the "snowball effect" -- it increases the debt burden when the *i-g* spread is positive -- had this time *attenuated* the increase in the debt burden (the *i-g* spread being negative). Between 2020 and today, governments benefited from a favourable window of opportunity, during which nominal growth above the average interest rate has helped to lighten the "whatever it takes" bill (graph a). It should come as no surprise that this effect came into play at a time when the interest rates at which governments were increasing their debt burden were rising sharply. With an average maturity of around eight years, only a fraction of the debt is renewed at market interest rates: any rise in these rates is therefore only very gradually passed on to the average cost of debt. The effect of soaring prices (and therefore nominal growth) on the debt burden, on the other hand, is instantaneous! But the window of opportunity is now closing...

The arithmetic of debt

The debt equation is simply written:

$$D_t = (1 + i_t)D_{t-1} - P_t \qquad (1)$$

with D_t, debt at date t; i_t average nominal interest rate paid in t; P_t, primary balance (i.e. balance excluding interest payments) at date t: if positive, this is a primary surplus, and its amount reduces the debt.

By dividing (1) by the GDP for period t, we can show that:

$$d_t - d_{t-1} = p_t + \frac{i_t - g_t}{(1 + g_t)} d_{t-1} \qquad (2)$$

with g, nominal GDP growth rate; p, primary balance relative to GDP and d, public debt relative to GDP.

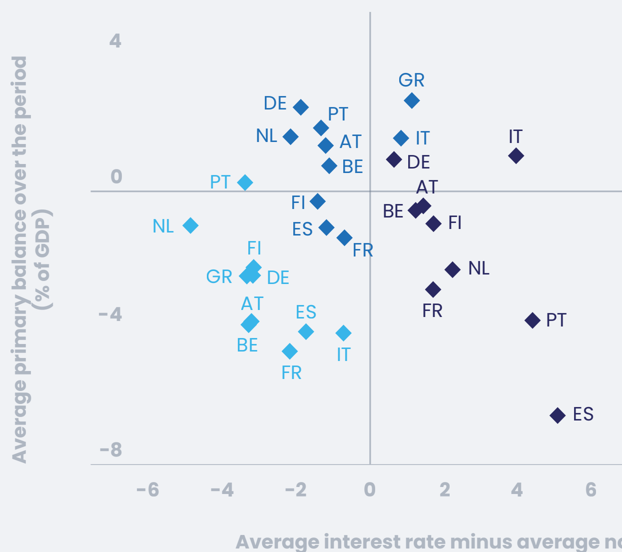
A less favourable arithmetic

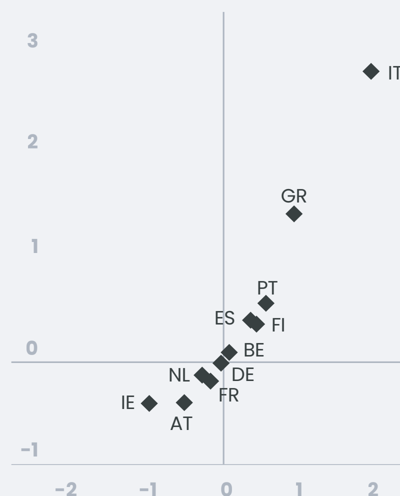
With the debt burden rising and primary deficits still high compared to 2019, governments are entering the next few years in a less favourable position. While the average cost of debt will continue to rise, falling inflation and weak growth prospects won't help. In the medium term, European governments have no choice: if they are to avoid a drift in their debt burdens, they must bring their primary budget balances back into balance (graph b). The equation is even more complicated for Italy: with a high debt burden, high interest rates and relatively weak growth, it will have to generate primary surpluses on a long-term basis.

Interest rate differential - growth and primary balance

by period

a. 2008-2023 **b. medium term**





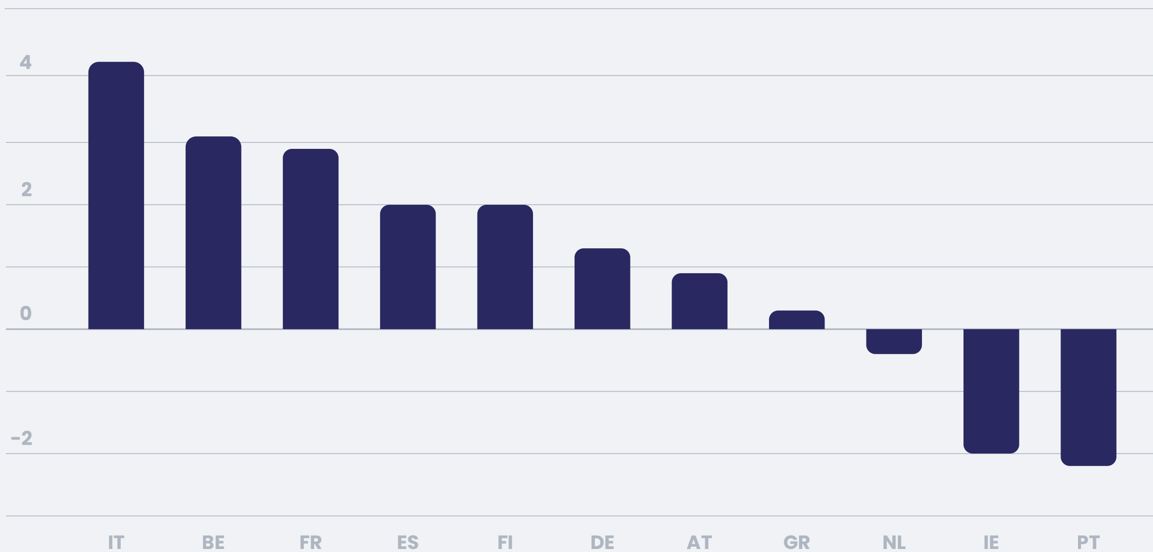
Average interest rate minus average nominal growth over the period (%)

2009-2014 2015-2019 2020-2023

Sources: LSEG Datastream, Candriam

In the end, for at least three countries, the efforts required over the next few years are far from negligible: France, Belgium and Italy must reduce their primary deficits by 3, 3.5 and 4 points of GDP respectively. However, those countries are far from having the same track record: since the creation of the Eurozone in 1999, Italy has only had a primary deficit for five years (in 2009 and since the pandemic), while France has had primary surpluses - some of them modest! -- for only five years.

Primary balance rebalancing effort needed to stabilize debt to GDP over the medium term (in % of GDP)
Effort (+) / Margin (-)



Sources: LSEG Datastream, Candriam

New spending needs

Rebalancing the budgets is all the more necessary as new financing needs loom on the horizon. The war taking place on Europe's doorstep and, more generally, the growing geopolitical risks are prompting many governments to increase their defence spending. Demographic ageing also imposes a growing cost on our societies (health, retirement, etc.). Last but not least, the energy transition requires major investment efforts, part of which will have to be borne by the public sector. The European Commission estimates that meeting its targets (*Fit for 55* in particular) will cost the European Union an additional 620 billion euros per year. If the public sector takes on 40% of the costs, public spending will be 1.5 GDP points higher over the decade!

What role for the central bank?

Against this backdrop, the end of the ECB's purchasing programs -- and even the deflation of its balance sheet -- complicates the fiscal equation a little further: while the central bank has absorbed a significant proportion of sovereign issuance in recent years, the private sector will now have to pick up the slack. It is therefore essential to prevent the kind of dynamics we saw in the early 2010s. In this respect, the central bank today seems better placed to prevent any doubts about a country's solvency leading to panic! Within the framework of its PEPP program[1], it can still, for the time being, as it did in the summer of 2022, reinvest in the securities of a country that is under undue market pressure. Lastly, provided that the country's public debt is deemed sustainable, the ECB can activate a final tool (*Transmission Protection Instrument*) and intervene on the secondary market.

"The Times They Are a-Changin' "

Exceptional fiscal support measures, approved by the European Commission, have greatly mitigated the shock of Covid and the effects of the energy crisis. However, the fiscal margins of some eurozone countries have been significantly eroded. Admittedly, tighter supervision of the banking sector -- and higher capital requirements in particular - reduces the risk of a vicious circle emerging in which concerns about the solvency of banks and governments feed on each other. Admittedly, the average cost of debt will remain moderate for some years to come, as governments generally took advantage of low interest rates before the pandemic to extend the maturity of their debt. The volume of sovereign debt to be absorbed by the private sector will nonetheless be high in 2024 (just over €1,200 billion in gross issuance). Against a backdrop of high interest rates, unfavourable growth potential and substantial investment needs, the fiscal credibility of national governments could be tested.

For those countries in the worst positions, committing to putting their budgets back on a sustainable trajectory must be a priority. But the rebalancing must be gradual: at a time when new fiscal rules are being discussed, it is important to remember the sovereign debt crisis of 2011...

1 - Pandemic Emergency Purchase Programme

Energy Transition Turbulence: Structural or Cyclical?

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Rising rates, changing regulations, whipsawing and rapidly-reversing input costs – Investments in clean energies have both never been as high and never been as challenged as in 2023.

While the markets seem to be throwing the whole sector out with the inflationary bathwater, it's time to separate the structural shifts from hiccups that inevitably arise when industries scale up … and which are likely to ease.

The transition continues

Despite wars, supply disruptions, inflation, and geopolitical uncertainty, clean energy remains at the top of the agenda for most governments -- just consider the number of participants in the recent COP 28 in Dubai. Not only does climate change remain the major global challenge of this century, but the need for decisive climate action is only going to grow in importance as the window of action closes in on us.

We have not (yet) seen a slowdown in the pace of the energy transition. To the contrary, the International Energy Agency -- IEA -- forecasts another record year, with 2023 renewable capacity new additions estimated to accelerate to 440GW, up more than 100GW from the 2022 additions. This is despite increasing costs in most areas. The electrification of passenger vehicles is occurring at a rate which the IEA describes as close to that required by its very ambitious Net Zero scenario. One out of five cars sold in 2022 was electric, versus only one out of 25 a mere two years previously.[1]

Yet financial markets have not been very supportive of clean technologies in 2023, and particularly not for renewables. Following several years of strong performance driven by strong regulatory support, the sector now suffers from the macro, geopolitical, and sector-specific headwinds.

Will the clean energy space deliver on the Paris-aligned global goal of tripling renewable capacities by 2030? Simply put, it will depend on governments' ability to sustain long-term investment incentives in the changing economic environment.

Profitability? It's complicated

After several years of improvement, the economics for renewables deteriorated for most of 2023. The Levelized Cost of Energy (LCOE)[2] for the broadly-defined clean energy sector increased around 15% to 25% from 2020 to 2023,[3] even including some segments where costs actually decreased. New fossil energy builds remain a much higher-cost choice, and themselves suffered input cost pressure from gas and coal in 2022.

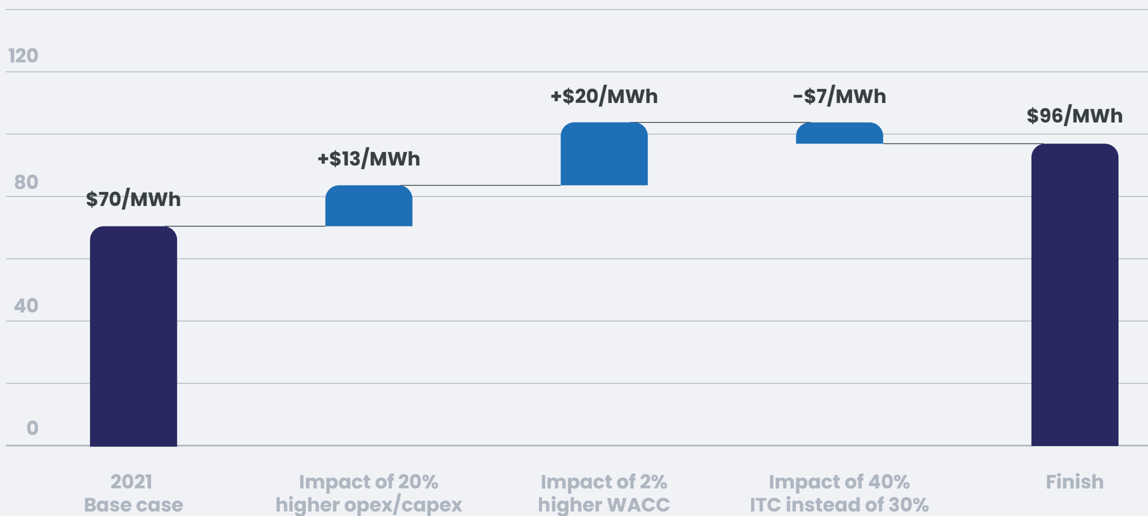
The profitability of the renewable energy sector is heterogenous, both by technology and by region – more politics than geography. But higher LCOE does not always mean lower profitability, as higher power prices have benefitted the installed base of existing renewable generating assets.[4]

Rising rates are decidedly a secular change. Yet despite the sharp rise in interest rates and the high capital expenditure in this industry, the cost of capital was only part of the explanation for the 2023 deterioration of renewable economics. The LCOE had deteriorated even before the hike in interest rates, due to rising input costs. (For clues, examine a steel price chart.) Whether you believe general inflation is a blip or a secular trend, the dramatic supply disruptions and squeeze of the last two years is hopefully not the new normal for future input cost increases. Already input costs in the fourth quarter of 2023 are easing from the sharp pain of 2022 and early 2023.

Offshore Wind Cost Change – 2023E

$25/MWh real award price increase needed to offset higher input costs and WACC, net of better ITC

Impact of higher costs, WACC and ITC on required real'23 award price to maintain 250bp IRR-WACC spread in US



Source: BNP Paribas

Renewables remain competitive. But not all clean technologies are equal.

Despite the rise in rates and the whiplash of input costs over the last several quarters, renewables remain very competitive on an LCOE basis, and we expect this to continue through at least 2030 both from technological improvements and supporting regulation such as the Inflation Reduction Act in the US.

However, the various technologies, and many parts of the renewables value chain, have shown differing levels resiliency to changing economic conditions. **Technological positioning, level of integration, and size are all key.**

Look behind the averages. As with any maturing industry, there are leaders and laggards. Some clean energy solutions are ramping up a bit more swiftly than others, such as solar PV (photovoltaics) and EV (electric vehicles), because of technology and cost reductions. Among the weak spots are the insufficient investment in energy grids, and offshore wind projects. Without re-designed grids, some renewable wind and solar energy is 'curtailed', that is, simply dumped because it cannot reach the end-users. And let's not forget that half the growth is coming from China – so look behind the 'headline' growth figures.

The overall growth potential is strong. Doubling efficiency and tripling renewables are necessary preconditions for the 1.5°C Paris-aligned scenario. Much of the valuation debate, and questions, centre on the order pipeline and which technologies will predominate. But as with any new technology – from railroads to dot-coms – high growth prospects can lead to overinvestment and overcapacity. Investors should analyse these technologies and business models with in-depth traditional analysis and emphasize ongoing competitive advantages, profitability, predictable regulatory environments, and financing conditions. Projects have mostly up-front cash flow, but some companies and equities within the sector face an almost constant need to raise capital to sustain the expected growth embedded in valuations – a problem if the sector falls out of favour.

Regulation remains the major secular trend

Today, most renewables projects more than cover their cost of capital.[5] But with all the factors involved, the picture can change like a kaleidoscope. Regulation must be predictable if private-sector investment is to succeed.

Europe and the US are holding elections in 2024 in which prominent candidates are fossil fuel supporters. Europe could also adopt a less climate-focused tone. Geopolitics, too, will play a decisive role. How will Europe and the US respond to China's prominence in clean tech supply chains? How will the source-in-the-US provisions of the IRA affect the marketplace? Will Europe double down on 'green protectionism'?

The goal of the authorities is to decarbonize our economies and to ensure energy supply security at an affordable cost for citizens. This energy 'trilemma' is all the more daunting when energy prices are high, as evidenced by recent government dithering over unsuccessful renewables auctions. The complexity will increase as use of renewables increases and potentially clashes with the current centralised "merit order-based" functioning of European power markets.

Renewable energies are an accelerating secular trend. The *pace* of the acceleration, as well as the resilience and profitability of the renewables, depends on leadership. Governments must decisively commit to the energy transition. They must simultaneously adapt to the more difficult macroeconomic environment and the intensifying climate urgency. Geopolitics is likely to become a key new factor in this structural energy 'trilemma', as clean tech becomes a new arena for trade strategies and a show of power.

1 - International Energy Agency, World Energy Outlook 2023, October 2023.

2 - To put the generation technologies on a comparable basis, we look to Levelized Cost of Energy (LCOE) – in which, of course, renewable energy has upfront capital costs with varying levels of maintenance, while fossil fuel energy requires upfront capital and ongoing annual fuel costs.

3 - International Energy Agency, Renewable Energy Market Update, June 2023.

4 - The recent cost comparison between renewable and thermal electricity generation is virtually useless for long-term forecasting, as the 2022 energy crisis in Europe caused thermal generation costs to soar in 2022 and drop in 2023, but thermal generation costs remain above long-term averages.

5 - For example, according to Bernstein, based on recent auction prices, the projected internal rate of return (IRR) for all onshore wind and solar projects easily covers their weighted average cost of capital (WACC), except for the November 2022 Spanish onshore wind auction, which took place at the peak of steel prices.
The IEA is optimistic on the growth of renewable, in part because there is significant existing manufacturing capability in solar. For example, some Chinese solar manufacturers are believed to operating at only 25% of capacity.

Real Estate – a Spring Thaw?

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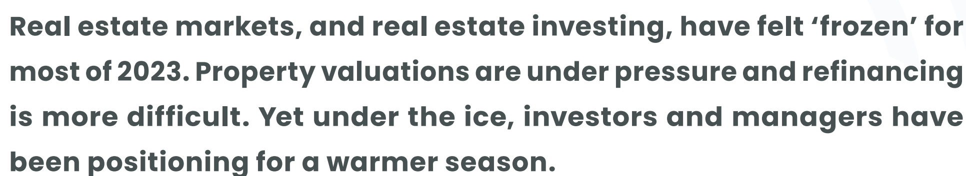


Real estate markets, and real estate investing, have felt 'frozen' for most of 2023. Property valuations are under pressure and refinancing is more difficult. Yet under the ice, investors and managers have been positioning for a warmer season.

Property under Pressure

With volumes plummeting due to the rapid rise in interest rates, transaction numbers in Europe are struggling to reach 20% of their pre-pandemic levels.[1] With the market starved of pricing information, over the last 18 months, valuers and appraisers have largely based property price estimates on interest rate changes. The scale and volatility of credit costs has meant that in most sectors, capitalisation rates have increased significantly, driving down appraised values. The magnitude of the mark-downs has been somewhat mitigated by the relative strength of the leasing/rental markets, and by indexation arrangements which have actually increased net operating income.

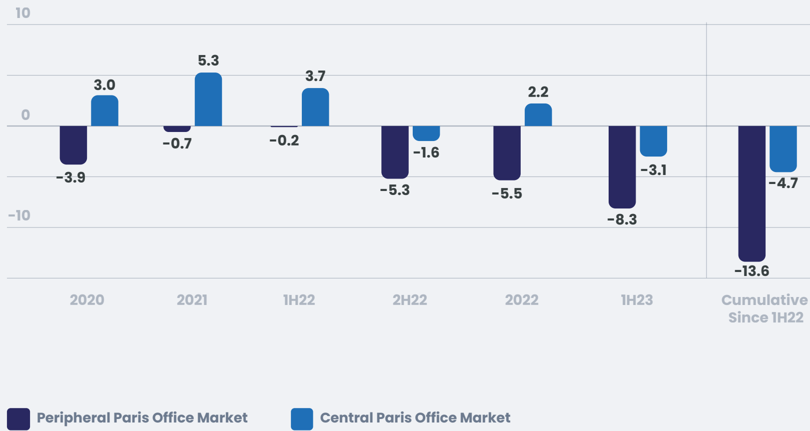
While prices have declined across the market, the magnitude has differed by sub-segment. Some segments are near a bottom, while others are likely to see further price declines.

Prime European central business district rental yields were about 4.5% for the first half of 2023, up 86 bps over the year-prior period, according to Savills.

The recent Greater Paris office market has bifurcated, with Central Paris valuations declining in the mid-single-digit range, while peripherical regions have seen mid-*double*-digit declines since mid 2022, albeit from different base levels. Average net initial yields reached 6.5% in la Défense, while prime Central Paris business district assets reported rental yields of about 3%.

1 - Real Capital Analytics.

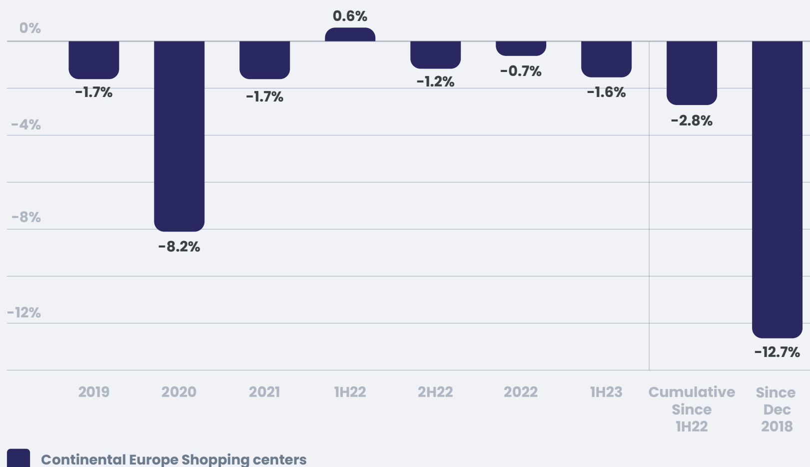
Paris in Two Parts: The Office Markets



Source: Candriam Analysis

Retail landlords in Europe have faced greater property valuation losses than most other segments. Since the first half of 2022, valuations of prime shopping centres in continental Europe have declined only about -3%, while they have fallen about -15% since 2018 and now offer net initial yields of about 5.5% as of H1 2023.

European Shopping Centres: Valuation Declines Slowing



Source: Candriam Analysis

Refinancing needs high, but lenders are shy

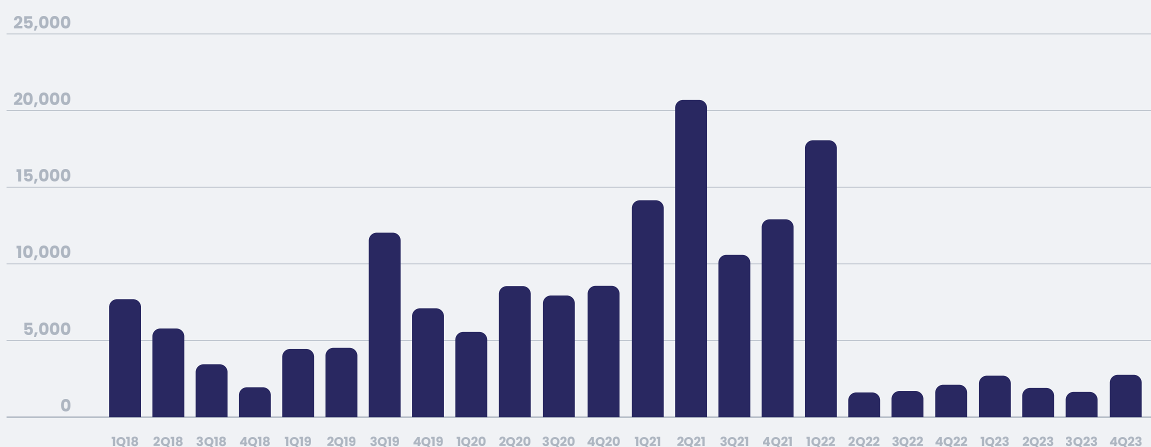
One result of the slow pace of transactions has been a surge in refinancing. Those in need of refinancing have turned to private capital sources in particular. Bank lending appetite has fallen dramatically while banking regulatory changes are biting. Issuers have responded to the lack of appetite for senior unsecured debt by offering security to banks.

As to publicly traded debt for refinancings, the senior bond market had been virtually closed to most real estate issuers since the second quarter of 2022, as shown in the graph. We have recently seen some 'green shoots' – a few large issuers such as Covivio and Unibail-Rodamco-Westfield have returned to the primary market, with investors showing strong appetite for these new issues.

With such large refinancing needs, the priority has shifted to cash preservation including dividend cuts, postponing calls of hybrid debt, and asset disposals.

Real Estate Public Issuance has Dried Up

EUR senior unsecured debt issuance in euro millions



Source: Bloomberg

Fundamentals – Looking to the Long Term

Long-term factors are supporting operating performance of the sector. Rents are beginning to turn up in Europe, and vacancy is down. For those managers with the best space, such as strong "green" credentials, good amenities, and location, the occupier appetite is robust and rising. Indexation clauses in leases and low levels of vacancy in high-quality assets have supported rents and, in some sectors, we have seen significant growth in incomes. This has reduced the impact of higher capitalisation rates, and valuations of properties are beginning to stabilize.

German residential market fundamentals are at their strongest point for decades – a surprise for some. Europe's largest market (in terms of investment) is experiencing its greatest supply/demand mismatch in at least a generation. Ask the tenants seeking a home; they are facing ultra-low vacancy rates. Lower supply, constrained both by higher construction and financing costs, is insufficient to meet increased demand from strong demographic trends, increasing the 'gap' in the German housing market.

Office space has been disrupted by the work-from-home trend, with tenants seeking sustainable buildings, and generally "better square meters". This flight to quality has resulted in prime assets being more resilient than secondary assets.

Logistics assets continue to enjoy strong demand, albeit normalizing after pandemic surge. The lack of appropriate locations, difficulty in obtaining building permits, E-commerce growth, and the appetite for supply chain onshoring should continue to drive growth over the longer term.

Shopping centres, along with other brick-and-mortar retail, have long suffered from E-commerce, followed by the pandemic. Valuations were cut even before interest rates began to rise. European shopping centre fundamentals are benefitting from the post-pandemic recovery, and with higher rental yields than other segments, they are less sensitive to higher interest rates (as long as operational performance continues).

Capital markets

With capital structures squeezed, well-capitalised real estate investors sense an opportunity. A handful of key players have raised capital, so there is significant funding in place for investment across a range of real estate segments. Further, some real asset owners with higher risk appetites are considering returning to some sub-sectors which were highly-leverage during the last leg of the upcycle, particularly in Germany and Sweden, and we are already seeing significant recapitalisation opportunities.

The wisest real estate companies took advantage of the low interest rates to extend their maturity profiles at very low cost. In the new interest rate environment the focus has shifted to net leverage and interest coverage ratios.

This could translate into opportunities for several investment asset classes. Equity markets have severely penalized real estate companies, making some of those with lower leverage and/or longer debt maturities attractive. All the better if companies have sound operations with free cash flow.,

In publicly-traded debt, yields of 5%-6% combined with more typical levels of issuance could make 2024 a pivotal year especially if interest rates stabilize and transactions rebound. This type of environment should favour high-quality issuers with healthy balance sheets and good operating performance.

We see an opportunity for private capital, especially if real estate values are near their floor. The combined effect of rates and spreads has lifted the potential returns on senior secured loans to “equity-like”. It is very rare for European private debt investors to be both paid this well and to have such an open playing field to work on.

This market is no longer cold as ice.

Conclusion

While the real estate market may still seem ‘frozen’ as we head into winter, key players are not hibernating. The sector offers opportunities for risk-aware participants. Capital providers and investors can now use the uncertainty and volatility of the last two years to their advantage, providing they do their homework.

Is 2024 the year in which the “freeze” turns into the ‘thaw’?

In the emerging markets galaxy, meet the new rising stars

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In an ever-evolving landscape marked by geopolitical tensions, the fore fronting of climate change, and a global economic reorientation, a discernible megatrend is unfolding. Growth is gradually shifting to developing countries outside of China, a shift intensified by demographic advantages and a changing global economic structure. While geopolitical rifts foster near-shoring, some developing nations face challenges as their once advantageous demographics now pose risks due to an aging population. The transformative impact of climate change and AI-driven automation further complicates the global economic equation.

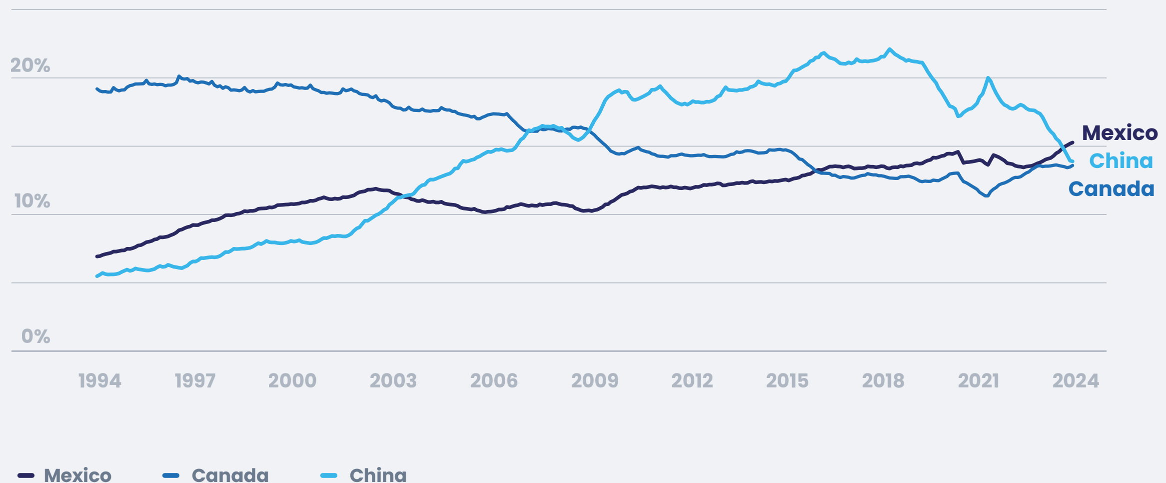
The global trade cards are being reshuffled

The 90s witnessed the rise of the modern technological revolution, leading to the outsourcing and offshoring of production to countries with cheaper labor and more relaxed environmental standards. Reshuffling supply chains or "China plus one" strategies create opportunities for many other developing countries, especially in Mexico, India and South East Asia, where global corporates have started to invest in alternative supply chains.

Mexico has emerged as an early winner given its geographic proximity to the US, and has already become the largest trading partner to the US. Back in Asia, supply chain diversification efforts are providing growth tailwinds for manufacturing and export driven companies in India – in sectors like Pharma, Biotech and Electronics manufacturing.

Mexico has become the US's largest trading partner

As a % of US total Imports



Source: Candriam, BNEF, December 2023

When considering the potential of each country to benefit from the new decarbonized global economy we need to consider population dynamics, and the country's capacity to take an active part in the transformation and exploit new sources of demand domestically and more locally.

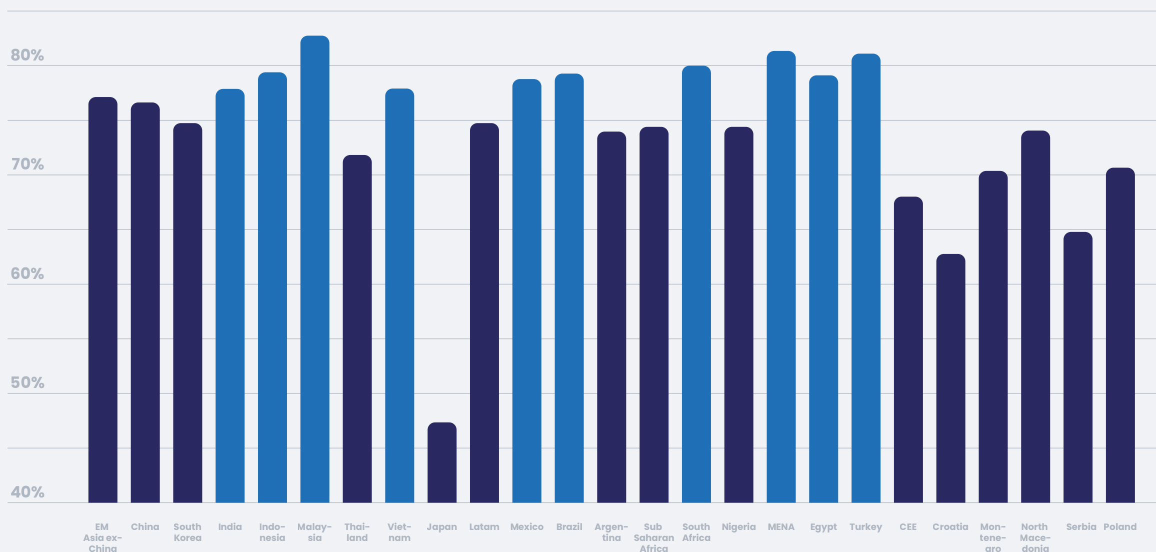
Demographic dividends are tilting in favor of new leaders in emerging markets

China has benefited from a substantial percentage of working-age individuals in its population for many years; however, it is now undergoing a demographic shift towards an aging population as it develops. To gain a clearer perspective,

we must consider various factors that impact future demand growth. Our sovereign sustainability model provides additional insights into the growth prospects of each region and country. Adjustments to the working-age population figures are necessary to account for labor market conditions, including gender composition, labor force participation, sectoral profiles, and working conditions. Additionally, the influence of healthcare systems extends to those above working age and very young individuals. Moreover, when assessing potential, the proportion of young people in each country should consider the quality and availability of education. Countries such as **India, Indonesia, and Malaysia** are poised to perform more favorably in the future based on this metric.

Population-driven potential

Population ages 15-64 (% of total population)



Source: The World Bank, Candriam Sovereign Sustainability Framework

New alliances in energy transition are opening growth avenues for emerging markets outside China

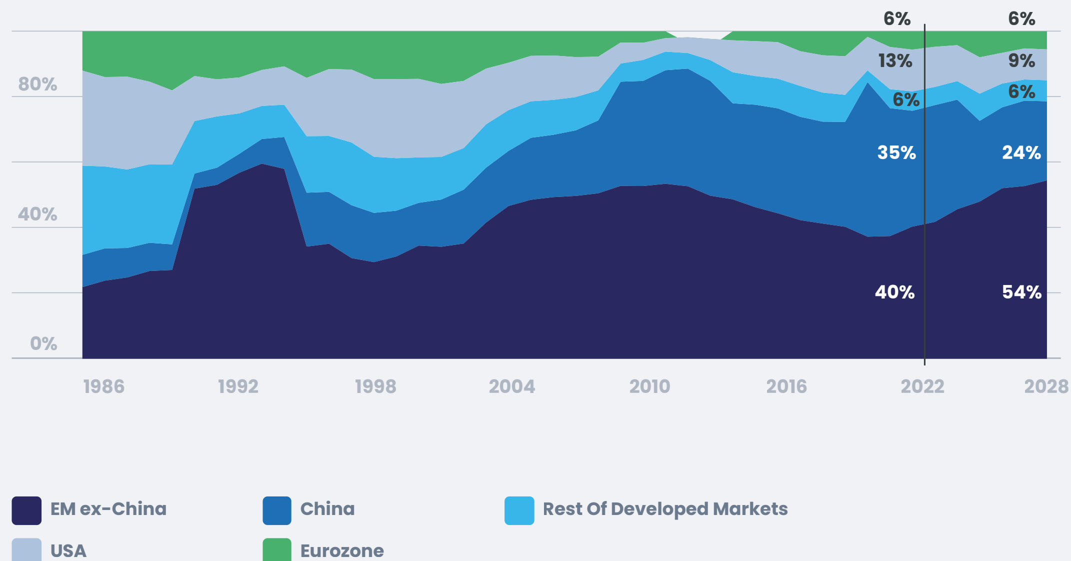
The world is transitioning towards new technologies driving the electrification of the global economy, with a spotlight on battery technology and semiconductors. Critical minerals like lithium, nickel, cobalt, graphite and manganese, pivotal for EV batteries, face concentrated supply chains, primarily dominated by Australia and China. Geopolitical considerations and policies in the US and EU aim to reduce dependence on foreign supply chains.

In terms of mineral extraction, diversification efforts can be made, particularly in graphite where Europe and Brazil hold substantial reserves. Improved geological surveys in emerging markets are crucial, along with advancements in recycling technology. Presently, China dominates battery cell production, but Korea and Japan play vital roles downstream. With supportive policies and geopolitical shifts, other developing countries are due to potentially catch up.

The EU/US energy transition aligns with partnering countries outside China, providing growth opportunities for other developing countries. Acts such as the EU Critical Materials Act[1] and US Inflation Reduction Act[2] lay the foundation for energy transition opportunities in countries like **Korea[3], Indonesia, and Latin America**.

Emerging markets ex China regions that are central to the AI technology value chain

The global semiconductor supply chain is dominated by **Taiwan and South Korea**, regions that have a high representation in emerging markets ex-China. A closer examination of the rich AI value chain in developing countries reveals their pivotal role in providing the essential infrastructure for the global AI gold rush, from semiconductor and hardware manufacturing hotspots in Asia to the emergence of innovative technologies like High Bandwidth Memory and chip-on-wafer-on substrate. As a result, these regions appear as key drivers of structural and technological developments across the AI supply chain, potentially promising substantial growth in the years ahead.



In conclusion, investing opportunities in emerging markets go well beyond China, and are at a pivotal moment. **Favorable demographic dynamics, positive geopolitical shifts, and opportunities in energy transition and semiconductor supply chains may position these markets to lead global growth sustainably.** It shouldn't come as a surprise that emerging markets ex China are expected to be the biggest driver of global growth in the coming years. The execution and delivery on these growth opportunities will determine their role as significant contributors to global economic expansion. As the world looks towards them, these markets must rise to the occasion, navigating the path to sustainable and robust growth in the ever-changing global economic landscape.

1 - European Critical Raw Materials Act, https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/european-green-deal/green-deal-industrial-plan/european-critical-raw-materials-act_en

2 - Inflation Reduction Act, CHIPS Fuel Construction Boom With Intel, TSM and Samsung Key Players Investor's Business Daily, https://www.investors.com/news/inflation-reduction-act-chips-fuel-construction-boom-with-intel-tsm-and-samsung-key-players/

3 -EU and Republic of Korea - Green Partnership, https://ec.europa.eu/commission/presscorner/detail/en/ip_23_2816

Will the healthcare sector play an expected defensive role next year?

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Healthcare sector, though not in as good shape as the pandemic's end, exhibits resilience with promising indicators, when the economy may start coughing.

2023: a disappointing out of breath sector

The health care sector is typically seen as defensive, and a sequential and stable grower. Still, the sector disappointed in 2023, despite the world facing a lot of issues, from inflation, economic slowdown to war. There are several reasons for this:

- The strong investor focus on AI and technology in general this year has left most other sectors out of the limelight.

- The broad under performance of small and mid caps did hit the innovative biotechnology sector hard.

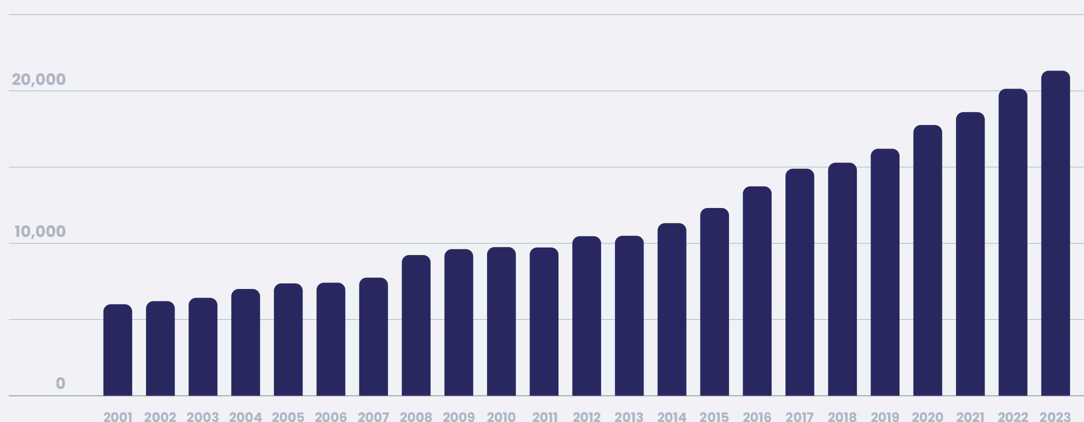
- And finally, de-stocking by customers of life sciences companies (biomanufacturing, biomedical research) has hit some companies also, and the post pandemic environment obviously punished those companies that could raise their sales based on their vaccine exposure, direct or indirect, and now face difficult comparisons.

How do we see 2024 shaping up?

Many headwinds are disappearing, as both the covid pandemic base of comparison is getting easier in 2024 and many life sciences companies are signalling that the de-stocking by their customers is levelling off and orders are coming in again.

Moreover, the underperformance driven by the macro backdrop makes current valuations an attractive opportunity. The pharmaceutical subsector's price-to-earnings ratio at 15 indicates undervaluation, falling below its long-term average[1]. This becomes particularly intriguing when considering that core fundamentals, such as innovation, remain intact. Notably, the biotech and healthcare sectors have showcased a robust commitment to innovation, exemplified by the steady growth in the number of drugs in the development pipeline. From 5,995 in 2001, this figure has surged to an impressive 21,292 by 2023. Furthermore, the approval rate by the FDA reflects this momentum, with at least 60 new drugs approved in 2023 alone—a significant surge compared to the 39-53 approvals over the preceding four years (latest data as of December 8th, 2023)[2].

Total R&D pipeline size
by year, 2001-2023



Source: Pharmaprojects, January 2023

Other good news makes the diagnosis more favorable:

- A crackdown by the Chinese government on corruption in the hospital ecosystem had also negatively impacted some China-exposed companies, as hospitals froze and limited all ordering of new equipment and even consumables whilst letting the investigation pass. Again, this negative impact is expected to become a tailwind again (catch-up ordering) by the beginning of 2024.

- A big positive (at least for the health care sector) comes from our economic scenario: signs of a slowdown are already apparent in many regions, like China and some European countries but we also expect the US economy to move to a slower rhythm in 2024 as high interest rates continue to bite. Inflation is already moderating and we expect this “normalisation” to continue, opening the spectre of FED rate cuts in 2024 with long term rates also coming down. The combination of slower growth with lower rates is a very appealing macro mix for the health care sector, as the health care business is much less dependent on economic conditions compared to other sectors – the demand for treatment is always there, irrespective of economic conditions. Lower rates will help the investor sentiment towards not yet profitable but innovative biotechnology companies.

The temperature is expected to rise above 40 degrees for the GLP-1 drug category

Obesity, a global health challenge, affected over 40%[3] of US adults in 2020 and is projected to rise to 50% by 2035. The consequences of obesity are severe, and lead to a host of related health care expenditures. The history of anti-obesity drugs has been marked by safety concerns and market withdrawals, leading to scepticism about therapeutic options, whilst approaches based on lifestyle modifications often prove insufficient for sustained weight loss. Initial therapeutic options were riddled with off-target effects, low receptor specificity, replacement dopamine activation leading to addiction, and behavioural side effects. After 100 years of failures, the approval of a new class of drugs targeting glucagon-like peptide-1 (GLP-1) marks a paradigm shift, offering for the first time in history reasonably tolerable, effective treatments for weight loss, after proving useful as diabetes medicines. Reimbursement, driven by positive outcomes data on co-morbidities, gains support from commercial and government payors. The focus on safety and tangible endpoints, such as cardiovascular events and mortality, shapes the clinical and regulatory landscape, with GLP-1 therapies so far demonstrating effectiveness.

The sector might encounter some persistent infections

Some subsectors within health care have however suffered as investors fear that cardiovascular devices or orthopaedic implants will see less demand, as people will be healthier. We believe that GLP-1 medications are effective and a big advance in treating obesity, at the same time the decline of medical technology companies seems exaggerated as cardiovascular and other issues have multiple aetiologies and are also the result of decades of overweight. As such, we see this as a buying opportunity for the impacted MedTech companies. Furthermore, very obese patients do not qualify for some specific surgeries and moving to a less extreme Body Mass Index (BMI) might make it possible for those patients to qualify for an artificial hip for instance, hence the impact of the GLP-1 can also have some positive effects for medical technology companies. Looking at the details of Novo Nordisk's outcome trial shows that the health benefits were less pronounced for US patients, for reasons yet unclear but maybe linked to very high baseline BMI's at study entry – again, the assumption that cardiovascular and other ailments would disappear, as some stock reactions would make you think, seems exaggerated.

American elections good for social welfare?

With presidential elections looming in the US (and some seats in Congress open for re-election) there is the risk of negative comments on the cost side of the health care sector – obviously a relevant topic. We think it might be different this time, as health care does not seem to be the battlefield this time. The election is more on international trade, security, and broad social and societal issues, hence we are less afraid of negative rhetoric during these elections.

That does not mean there is no focus on health care costs in general.

In 2022, President Biden signed the Inflation Reduction Act, which includes provisions for Medicare. Under this act, Centers for Medicare & Medicaid Services (CMS) will now be able to negotiate drug prices. CMS will select the drugs with the highest total expenditures from among the top 50 qualifying single source drugs. The cumulative list will begin with 10 drugs from Part D (administered at home) in 2026, 15 from Part D in 2027, 15 from either Part B (administered at the hospital) and Part D in 2028 and 20 from either 2029.

The negotiable drugs are brand-name or biologics without generics/biosimilars, eligible only after being on the market for 9-13 years, depending on the drug type. It's worth noting that drugs face loss of exclusivity (LOE) or patent cliffs anyway, hence the protection of 12 years for biologicals offered in the Biden plan is anyhow close to the effective patent protection after start of commercialisation that a new drug de facto enjoys. So in the end, the impact of the plan is rather limited.

Furthermore, the IRA also specifies factors leading to exclusions from price negotiations, such as orphan drugs, drugs with generics/biosimilars available, or those from small biotechnology companies.

The precise impact of the plan remains uncertain due to various factors, including ambiguities in negotiation language, ongoing pharmaceutical lawsuits. Given the impending presidential election, even the implementation of this plan in 2026 is far from sure.

As the year 2024 gets underway with still a great deal of uncertainty, investors in the health care sector will, once again, need to exercise discernment and in-depth analysis in their stock selection and portfolio construction. We are convinced that innovation and companies creating the next breakthrough in drugs development represent the best protection against any political interference.. In the US, innovation will always be rewarded and the plan by Joe Biden does indeed protect innovation by excluding newly approved drugs from any price negotiation for a considerable time frame, giving visibility to the originating and innovating companies.

We believe the health care sector will be more resilient in 2024. But whatever it shape, we'll be there to support you and help your portfolios benefit from these opportunities. Wish you a healthy 2024!

1 - Sources: Bloomberg, Average 2018-2022, index: MSCI World Pharmaceuticals

2 - New Drugs at FDA: CDER's New Molecular Entities and New Therapeutic Biological Products, FDA, https://www.fda.gov/drugs/development-approval-process-drugs/new-drugs-fda-cders-new-molecular-entities-and-new-therapeutic-biological-products and Biological Approvals by Year, FDA, https://www.fda.gov/vaccines-blood-biologics/development-approval-process-cber/biological-approvals-year

3 - Lobstein, T., Brinsden, H., & Neveux, M. (2022). World obesity atlas 2022
"Obesity Exceptionalism: It's Different This Time. Framing the Opportunity and Challenges for a New Era of Obesity Treatment" (September 2023) by BMO Capital Markets

United States: What can we expect in the election year?

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On November 5, 2024, the American presidential election will be held. It will undoubtedly be the focus of market attention next year. A new Biden-Trump duel now seems the most likely. The finish line is still a long way off, however, and other scenarios are possible. Above all, even if the Biden-Trump duel were to be replayed, the effects on financial markets could be quite different this time. What can we learn from historical observations of market behaviour in an election year? What consequences might this election have for the US economy? Will stock market volatility rise? Will doubts about the sustainability of US public debt become more pressing?

"It's the economy, stupid"... really?

Almost a year before the presidential election, growth remains dynamic, as of 15 December, the S&P 500 is at a record high, the disinflation movement is well underway, unemployment figures are approaching record lows, the gap between highest and lowest salaries has narrowed and the reindustrialization movement is underway! The Biden Administration's economic record is therefore flattering... especially when compared to the expectations of most observers. Indeed, by the end of 2022, many of them believed that Federal Reserve tightening could only push the US economy into recession... indeed, wasn't that the only way to bring inflation down?

Betting that this record will put Biden in a position to win re-election, however, would be going a bit too far. The feeling of many American households is probably not as favourable as the indicators suggest: while inflation is down, prices are significantly higher than before the pandemic (+25% for food, +20% for new cars and even +35% for used cars). Rising interest rates, for both consumer credit and mortgages, could also have a negative impact on this perception, by weighing on household budgets and home affordability. Finally, in an extremely polarized political context, it is far from certain that this election will be decided on economic and stock market performance alone!

How do markets behave in an election year?

While it is difficult to draw lessons from previous episodes, historical election-year behaviour of the stock market does offer some lessons. Volatility tends to be higher than usual, and stock market performance is generally a little less than 'normal'. The limitation of these studies is, of course, the small sample size and the fact that severe recessions can significantly affect returns in some election years. However, these studies do reveal several lessons: since 1984, the average election-year performance of equities has been positive, but weaker than in other years.[1] This performance is underpinned by corporate earnings growth, which generally benefits from favourable economic conditions in the run-up to elections, while the risk premium also tends to rise. This increased performance as well as the rise in volatility could be explained by the growing uncertainty surrounding economic policy in election years. From the summer onwards, the "economic policy uncertainty" index tends to rise... falling back only once the results are known.

A constrained fiscal policy

Markets will be attentive to the fiscal choices made by candidates. While the agendas are still unclear, D. Trump has promised to extend "his" tax cuts: decided in 2017, they will expire in 2025. According to CRFB,[2] the cost to the Budget would be some $3.3 trillion over ten years ($3.8 trillion if the increase in interest payments is included). All else equal, this would increase the deficit by more than a full percentage point of GDP and push up public debt to 125% of GDP in 2033, compared with 115% if policy remains unchanged (i.e. if the tax cuts are allowed to expire).

Financing these tax cuts, as announced by former President Trump, with a 10% increase in tariffs on all American imports could, on paper, bring in $2.5 trillion to the Budget over ten years. However, this figure would likely be reduced by a contraction in imports and a fall in growth. Above all, such an increase would set the global economy on the path to a full-scale trade war! Rebalancing the Budget by reducing non-defence discretionary spending, as former President Trump is also proposing, is illusory. Such spending today represents barely 3% of GDP, and cutting it by more than 30% is unrealistic.

Moody's recently reiterated the risks associated with the country's fiscal situation, placing their AAA rating on negative watch. How will bond markets react to the continuing rise in the debt burden and a possible downgrade of the US rating? Investor confidence in the government's ability to manage its debt has steadily eroded over the years: the US CDS has already slipped from 10 basis points in 2021 to over 50 bps at the end of November (earlier in 2023, it was over 70bps by the time of the debt ceiling impasse last spring).[3] Investors will have good reason to tense up again...

Sectoral rather than macroeconomic challenges

With fiscal leeway now more limited, the election will probably be more of a sectoral issue for equity markets, rather than a macroeconomic one. And yet, for markets, the lines drawn by the candidates point in radically opposite directions. J. Biden, for example, has promised a decarbonized electricity sector by 2025 and carbon neutrality by 2050. The previous Trump administration withdrew from the Paris agreement and scrapped several environmental protection laws and regulations. It's a safe bet that this direction will continued if there is a second Trump presidency. Similarly, the future of the ACA (Affordable Care Act) could also be seriously compromised if D. Trump were elected. The candidates' proposals for regulating artificial intelligence could also affect markets. However, the nature of the presidential majority will be just as important as the candidate elected. Either man will be unable as President to keep his promises unless his party wins a majority in Congress.

Monetary policy under pressure...

The question of the independence of the Federal Reserve could also worry the markets. D. Trump has often attacked the central bank, sometimes in violent terms -- in 2019, he called its boss, J. Powell, a "bonehead" -- and tried to appoint Judy Shelton, a fierce critic of the institution and a fervent supporter of a return to the gold standard. Should D. Trump be elected, J. Shelton could well join the Fed (provided, of course, that the Senate does not oppose her again), or even lead the Fed in place of J. Powell, whose term as Chairman expires in January 2026. Going back on central bank independence - or even just hinting at it - even before the memory of the recent inflationary episode has faded, would be dangerous.

Towards rising equity risk premia and volatility...

The programs of D. Trump and J. Biden will thus set the American economy on very different paths. As long as no candidate stands out, it's a safe bet that uncertainty will weigh on equity markets and fuel volatility. While the past isn't always a "good" guide, let's remember that in the 2020 election, Biden did receive 7 million more votes than his opponent, but because of the twists of the US electoral college system, the election came down to less than 100,000 votes, in a handful of states! The worst thing for the markets, of course, would be if the uncertainty were not lifted on November 5, 2024...

1 - Candriam analysis, Bloomberg data.
2 - Committee for a Responsible Federal Budget, a non-profit organisation.
3 - Source: Bloomberg. Data as of 2 May, and 30 November.

What diversified portfolio for 2024?

Nadège Dufossé
CFA, Global Head of Multi-Asset

The year 2023 was positive for bonds and equities, but marked by a high degree of performance dispersion and idiosyncratic risk. While investor sentiment has returned to more positive territory, risks to economic growth and the geopolitical environment persist. Pivoting on interest rates, equity themes... which asset classes should be emphasised?

In search of a "new" normal

The arrival of the pandemic in 2020 changed the minds of investors. The successive shocks of Covid and the energy crisis introduced extreme points into economic and financial data. This noise is beginning to fade, as in all wave phenomena. The year 2023 was marked by uneven economic performance and mixed corporate results. As the year draws to a close on a positive note for bonds and equities, but affected by a high degree of performance dispersion and significant idiosyncratic risk, what portfolio should we build for 2024?

2024 should bring greater visibility for investors

Better visibility, or better readability? Probably both. Some economic data are finally returning to "familiar" territory. Inflation gave way and is set to fall rapidly below 3% in both the US and the Eurozone[1], no longer a primary concern for investors. Similarly, according to IMF forecasts, the wide range in economic growth rates among countries should narrow considerably by 2024/2025, after the shocks have been absorbed. The same is true of monetary policy: We are at the end of the monetary tightening cycle, with central banks having succeeded in their mission and having restored their room for manoeuvre. The central question for investors has shifted from *whether* there will be rate cuts, to *when* they will take place.

Investor sentiment and positioning have become much more positive than they were at the beginning of 2023, and this is where the question for 2024 lies: To what extent has this seemingly more predictable and legible environment now been integrated?

Structural changes in interest rates modify portfolio balance

The pivot of the US and European central banks is likely to take place during 2024, but we do not anticipate any major rate cuts in our central scenario. Today, we are very close to our US and German rate targets for 2024. Inflation has decelerated rapidly, but medium-term inflation expectations (5-10 years) are anchored at 3% in the United States, a level in line with the average seen

over the 1998-2008 period[2]. The persistence of a higher-rate environment alters the balance of a diversified portfolio, as investors have a wider range of assets offering positive real returns.

As the year draws to a close, given the expected returns on equities and bonds, investors seem to have little incentive to increase the level of risk in their portfolios. In our view, the expected returns on equity markets are insufficient to cover the risk of disappointing economic growth and geopolitical risks. After all, half the world's population will be going to the polls in 2024! On the bond side, the carry provides a return for investors.

Our target portfolio for 2024 therefore favours bonds over equities, with a longer duration, as the US and European central banks declared their pivot at the last meetings of December. In bonds, we seek to invest in government debt (including dollar-denominated debt, with currency hedging). We also favour corporate credit (investment grade) in euros and dollars. Finally, emerging debt offers attractive yields in both dollars and local currencies, and should perform well in a world of slower but positive growth and a weaker dollar.

Selective investment in equities

As 2023 draws to a close, equity markets are once again integrating a "*Goldilocks*"[3] scenario, which is favourable to them. Based on the current level of the main indices, we expect a single-digit return, underpinned by low but positive earnings growth and dividend yields (see article on Equities). As a result, we expect **equity markets to be range bound**, i.e. without any major trend, with limited upside and downside potential. Indeed, in the event of economic disappointment or an exogenous shock, central banks should find it much easier to intervene than they did last year.

While the market as a whole seems to us to lack a catalyst, we nevertheless believe that **there are some attractive opportunities in certain themes**. For example, we look towards high-quality defensive companies in the **healthcare and consumer staples sectors**. These sectors largely underperformed in 2023, penalized in part by rising interest rates and by much stronger-than-expected growth in the United States in 2023. In 2024, these companies offer the dual advantage of lower sensitivity to changes in the economic cycle and relatively attractive valuations. We also remain positive on companies in the **technology sector, and beneficiaries of the AI theme**. Their stock market performance is underpinned by superior earnings growth, which should continue into next

year, while the interest-rate environment should not be an obstacle to their valuations. Finally, we see opportunities in stocks that have suffered from sometimes forced and undifferentiated selling. This includes some of the **smallest-cap companies in Europe, as well as in the United States**. However, a sustained rebound will depend on business activity holding up well.

"It's Difficult to Make Predictions, Especially About the Future". What if... we were wrong?

Is our allocation scenario-proof? Should fears of recession re-emerge, we expect government bonds should perform well, providing a partial hedge for the riskier part of the portfolio (notably equities). The correlation between the two asset classes, bonds and equities, is likely to become negative again in an environment where inflation has normalized. Other assets can help cushion the fall in equities: For example, gold, the yen and alternative strategies should perform well in this context.

We think rising inflation would be the worst-case scenario for a diversified portfolio, putting both bonds and equities at risk of a 2022-style downturn. In this case, liquidity and exposure to certain commodities such as gold or energy (oil) should be favoured to limit the decline.

The last type of risk is an exogenous risk (geopolitical risk, risk to financial stability). This type of shock causes a sharp rise in volatility, and would need to be assessed in terms of its impact on activity, which returns us to the first scenario: Government bonds, gold, the yen as well as alternative strategies can partially protect a diversified portfolio.

We therefore favour a balanced and selective approach for 2024: On the bond side, we are looking for longer duration carry, exposure to investment-grade credit and emerging debt; and on the equity side, more specific exposure to certain themes that have greater upside potential than the indices: Consumer staples, the technology sector, and smaller caps.

1 - Candriam estimates
2 - Source: Bloomberg
3 - An ideal scenario where economic growth is neither too high nor too low

Investing with Conviction: Conclusion

Nicolas Forest
Chief Investment Officer

As our experts set about last month describing their Convictions for 2024, it's clear that the market has already, in part, anticipated the hoped-for scenario!

The continuing fall in inflation and weakening macroeconomic data revived hopes that monetary policy would normalize more quickly than expected, supporting a 100 bps interest rate cut and a fine performance by risky asset classes.

But the year-end rally must not overshadow the ten structural questions we are asking this year.

Borrowing costs have certainly fallen, but haven't expectations of rate cuts become too rapid and too pronounced? Central banks should normalize in 2024, but will keep rates higher than they have been for the past decade. Determining the "neutral" level in the current context is far from easy. "**High rates...for how long?**" is a bold gamble! Rate cuts and their sequencing will depend on the extent of the economic slowdown and future inflation trends.

Bonds are back! Risk premiums may have come down, but the carry is still there. Selection will remain the order of the day, especially in the most heavily indebted areas.

"**Bond yields offer a multitude of opportunities ... but you have to choose carefully**".

In recent years, governments have taken on huge debts to mitigate the economic and social consequences of the pandemic and the energy crisis. "**Should we be concerned about the sustainability of public debt in the eurozone?**" The average cost of government debt will continue to rise, while falling inflation and weak growth prospects will not help to restore balance to public finances. In an election year, keep an eye on the evolution of deficits.

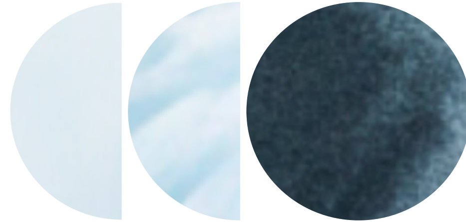
Rising rates have frozen the real estate market for the most part in 2023, but a thaw could continue! "**Real Estate... a spring thaw**". We see opportunities in several asset classes with relatively sound structures, including private debt.

In 2023, equities will end with a good year, albeit with a high degree of dispersion. "**In 2024, can equities fall even without a recession?**". While the upside potential seems unlikely after the end-of-year rally, some stocks still look attractive to us:

- Some companies, notably in the healthcare sector, are benefiting from demographic trends and their strong capacity for innovation, after facing headwinds last year. "**Will the healthcare sector play its defensive role as expected?**"

- The renewable energy sector has been battered by rising interest rates and soaring input costs, with profitability in the doldrums. But the energy transition continues and remains a priority, and as in any sector there will be winners and losers. Technological positioning, level of integration and size will be key factors. "**Turbulence in the energy transition: cyclical or structural phenomenon?**".
- Opportunities also exist in emerging markets outside China. Favourable demographic dynamics, positive geopolitical developments and opportunities in the fields of energy transition and semiconductors are giving certain countries a new role in global growth. "**In the galaxy of emerging markets, discover the new rising stars**".

As our experts set about last month describing their Convictions for 2024, it's clear that the market has already, in part, anticipated the hoped-for scenario!



In addition to economic challenges, electoral stakes will be a major feature of the calendar! Indeed, 60% of the world's GDP will be affected by elections, including the US presidential election in November. While a new Biden-Trump duel now seems the most likely scenario, there's every chance that the uncertainty will weigh on the markets and fuel their volatility. "**United States: what to expect in an election year**".

Ultimately, in an unstable geopolitical environment, a fragile economy and a year full of challenges, "**How should you build your portfolio?**". Our target portfolio to start off in 2024 favours bonds over equities, and selective investment. We believe there are opportunities in defensive companies in the healthcare and consumer non-cyclical sectors, in the technology sector, in companies benefiting from the AI theme, and in smallercaps. Let's not forget that gold, yen and alternative strategies can protect the portfolio.

The Candriam investment team and I wish you an exceptionally prosperous 2024! Together, we remain resolutely committed to working closely with you to overcome the challenges and seize the opportunities that lie ahead. May this year be synonymous with success and fruitful achievements.

Together, let's build a sustainable and promising financial future!

€144 B

AUM at end June 2023*

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*As of 30/06/2023, Candriam changed the Assets Under Management (AUM) calculation methodology, and AUM now includes certain assets, such as non-discretionary AUM, external fund selection, overlay services, including ESG screening services, [advisory consulting] services, white labeling services, and model portfolio delivery services that do not qualify as Regulatory Assets Under Management, as defined in the SEC's Form ADV. AUM is reported in USD. AUM not denominated in USD is converted at the spot rate as of 30/06/2023.

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