

GLOBAL OUTLOOK 2023

THE END OF GLOBALISATION?



- The end of globalisation?

Global Outlook 2023

• Table of contents

01• Editorial	4
THE END OF GLOBALISATION?	
02• Key messages	6
03• Focus	8
THE RETURN OF BORDERS	9
REGIONALISATION OF SUPPLY CHAINS - MYTH OR REALITY?	13
EMERGING MARKETS: DE-GLOBALISATION OF TRADE OR THE DEVELOPMENT OF A DOMESTIC MARKET AND SERVICES?	17
ARE WE MOVING TOWARDS A RELOCATION OF SAVINGS AND GOVERNMENT FUNDING?	22
DOES DE-GLOBALISATION OFFER OPPORTUNITIES FOR DOMESTIC EQUITIES?	27
ARE WE SEEING A RETURN OF THE SOVEREIGN RISK PREMIUM AND CURRENCY DIVERGENCES?	31
04• Macro Economics	34
SLUGGISH GLOBAL GROWTH, INCREASING POLICY DIVERGENCE	35
05• Allocation: 2023 Scenario	40
IMPACT ON KEY ASSET CLASSES	41
06• Global presence	44
07• Glossary	46
Disclaimer	48

01 | Editorial

THE END OF GLOBALISATION?

Has the idea of de-globalisation become mainstream? Like all fashionable narratives, it runs the risk of being used in a somewhat dogmatic way, causing us to leave rational thought behind and enter the realm of political slogans.

For this is where this programmatic idea was born: a project that originated in the anti-globalisation movements, advocating the dismantling or reconstruction of a globalisation that is contested for its effects on inequalities, the environment or the fiscal and monetary sovereignty of a country.

This concept, initially synonymous with radicalism, has become central to the economic and political debate since 2016 and this phenomenon has been amplified since the COVID-19 pandemic. Brexit and the victory of Donald Trump both reflected a revolution of the middle class against the traditional elites, authors and actors of this globalisation that had previously accepted a rampant deindustrialisation. These political upheavals were probably a turning point in the growing acceptance of the idea of de-globalisation among the elite.

This is also quite logical: the globalisation of the 1990s, desired and initiated by the United States, is no longer to the advantage of the latter, which changes the situation. In short, to talk about de-globalisation in Washington or Davos is to ask the question of the loss of American leadership and the rise of China.

And if the social implications of globalisation were to undermine our political systems and challenge the powers that be, it would be urgent to rethink the terms of the equation. What is now at stake is both the continuation of an industrial model in Western countries and the survival of moderate liberal democracy, which has been based primarily on the emergence of a middle class for more than a century, and especially since 1945. The observation of political polarisation, the loss of influence of the traditional moderate parties and their disruption by candidates easily labelled as 'populist' leads us to question the links between globalisation, wealth distribution and the political model.

The COVID-19 pandemic was, according to Carmen Reinhart, «like the last nail in the coffin of globalisation» (21 May 2020). From now on, it is time for strategic autonomy, in the face of a pandemic that revealed our dependencies and vulnerabilities. The globalisation of production and supply chains, previously advocated by the major international groups, has been transformed into a form of trap; de-globalisation has therefore invaded the board rooms, prompting slogans and formulas in response (nearshoring, friendshoring¹), at the risk of substituting one dependency for another.

But the real nail in the coffin was the outbreak of war in Ukraine, which definitively put an end to the idea of a happy globalisation or post-Cold War world peace. The conflict precipitated geopolitical tectonic rifts and heightened Europe's sense of urgency to be less dependent on Russia for energy, but also to increase military autonomy. The paradox is that in the short-term, Europe will have to buy its gas even further away while accelerating its domestic energy transition. Environmental considerations (partly at the origin of the first anti-WTO (World Trade Organization) movements in Seattle in 1999) are at the heart of the debate: producing renewable energy rather than importing gas, recycling rather than continuing to import disposable products. Even if everyone is aware that one dependency often leads to another and that the electrification of our energy-mix relies on other imported raw materials.

This conflict and the accompanying sanctions seem to have almost reversed the order of priorities between politics and economics. For three decades, the West lived in a world where diplomatic relations (especially with China) were determined by economic considerations (signing contracts, exporting, taking advantage of the Chinese boom).

Now, the ability to produce and exchange is determined by the political and geopolitical framework. This is where the question becomes very concrete: where should we produce tomorrow? With whom can we trade? How can we integrate the long-term geopolitical framework into decisions on where to locate a factory or choose a partner? Can we still invest in emerging markets on a global scale as we did in the past? Are trade, industrial and technological interdependencies too strong now to turn back? Are Western countries just as dependant on the savings accumulated in Asia and the Middle East?

Over the years, the slogan seems to have become a statement that is sometimes a little too quick and simple to be true: we are already in a phase of de-globalisation. The decline in the weight of trade in world GDP and the relocation of production are evidence of this. But as with any easily accepted narrative, there is a risk of falsifying reality. Behind this slogan or this growing concern of the elites, what is really going on?

This is the purpose of this *Global Outlook*: to attempt to decipher, from several angles, the degree of reality of the globalisation movement that is certainly not as irreversible as we thought, but whose reconfiguration would not necessarily constitute a complete turnaround. In our view, the economic, industrial and financial stakes seem to be sufficiently important for us to devote the following pages to them.

We wish you an enjoyable read.



Vincent MANUEL
Chief Investment Officer

1 - A term used by US Treasury Secretary Janet Yellen, signifying a commitment to work with (or move to) countries that «have strong adherence to a set of norms and values about how to operate in the global economy and about how to run the global economic system».

02

Key messages

GEOPOLITICAL FRAMEWORK

- A more fragmented world, marked by the decline of international institutions and the multiplication of conflicts, highlighted by an increase in geopolitical risk.
- New fault lines in the world, with an increased risk of polarisation between the US and China.
- A new framework for investors and companies to better integrate country risk and geopolitical framework into their decisions.

TRADE

- A proven trend towards a decline in the share of trade in GDP and an increase in protectionist measures in recent years.
- However, recent data is also affected by the COVID-19 period and a slowdown in trade that does not necessarily reflect de-globalisation, but the rise of services in emerging markets.
- The search for strategic autonomy mentioned in Europe is just as strong in China, which seeks to substitute imports with domestic production.

VALUE CHAINS

- Value chains have been disrupted by COVID-19, and now by the conflict in Ukraine, as well as by sanctions or export restrictions.
- A search for a lower supply-chain dependence, but not in the form of de-globalisation, but through regional reconfiguration of value chains.
- Transforming energy models that can also reduce the weight of trade through the gradual replacement of fossil fuels with renewable energy.
- These trends contribute to a higher level of structural inflation and a lower return on investment (higher inventories, higher production costs).

PUBLIC FINANCING AND GLOBALISATION OF SAVINGS

- Several models can be distinguished between the United States (financed by pension funds and by exporting countries), Europe (refinanced by the regulated *bancassurance*² model) and Asia (with China and India financed by large domestic savings).
- There is no evidence of a trend towards nationalisation of savings or a more targeted use of foreign exchange reserves in the context of the rivalry with the US.
- However, the end of quantitative easing raises the question of the dependence of states on financing. The credibility of fiscal policies and the autonomy of monetary policies remain the keys to international refinancing capacity.

FOREIGN EXCHANGE MARKETS

- The current dominance of the dollar precedes the advent of the second globalisation by 40 years (1945) and has not been abated by either the end of Bretton Woods or the emergence of China as the dominant power of the 21st century.
- However, the regionalisation of trade and the multiplication of transactions in other currencies could give rise to a world of multiple currency blocks.
- The US dollar's loss of reserve currency status would be destabilising for the financial sphere and would make imbalances in the US economy more costly.

GLOBAL STOCKS VS. DOMESTIC STOCKS

- Sectors exposed to global consumption growth and based on offshoring production to emerging economies have been more vulnerable to supply disruptions and rising production and transport costs.
- Domestic stocks are also an option for investors to position themselves in a number of sectors that benefit from current trends such as energy transition and robotisation, without questioning the power of technology leaders or the resilience of global premium brands with strong pricing power.

OUTLOOK FOR 2023

- Global growth will be affected as much by geopolitical and energy tensions as by the consequences of inflation and rising interest rates on demand.
- The scenario is highly uncertain with: China's recovery lagging behind, Europe in recession, but with strong fiscal support and the United States seemingly escaping recession, but with a weakening of investment and consumption.
- More persistent inflation in the short-term, with a higher structural component due to a reconfiguration of value chains and the cost of the energy transition.

ASSET ALLOCATION

- Interdependencies are still strong and a source of imbalances, from trade to debt financing issues, including technology and energy issues. There will be a growing importance of energy, the environment and robotics thematics in this context.
- A financial macro framework that marks the return of yield and bonds, after a decade of growth and equities.
- The integration of a higher country risk premium by the markets, and a geographical diversification to be reinforced in investor allocation, with third-party countries able to benefit from this new energy and geopolitical context.
- Towards a structural recalibration of China's weight in portfolios, initially driven by secular trends, but affected both by domestic economic challenges and a transformed political and geopolitical framework.



Vincent MANUEL
Chief Investment Officer

03



Focus

Globalisation is not limited to an intensification of international trade and investment, but has a strong geographical dimension, reflecting worldwide unification and the disappearance of borders. While this geographical unity remains one of the main pillars of the European Union, the underlying trend is that of the return of borders.

The fall of the Berlin Wall was supposed to usher in a unipolar, borderless world dominated by the United States, whose hyperpower suggested a lasting *pax americana*. The international institutions built in 1945 were to be revitalised in the post-Cold War decade. It was a time for the construction of transnational political spaces marked by the partial or more substantial suppression of borders (European Union (EU), NAFTA³, Mercosur⁴). A symbolic date was the signing of the Schengen agreements in 1990, a prelude to the opening of borders in 1993. The United States, in turn, built NAFTA with Mexico and Canada in 1992.

A NEW DEFINITION OF NATION-STATES

This theme of the possible disappearance of borders was widely conceptualised in the 1990s, particularly by Bertrand Badie (*La fin des territoires*, 1995), who questioned whether a territory was indeed an expression of state sovereignty. This notion was redefined as a halo combining commercial and technological power with cultural soft power⁵, while military power was expressed primarily by the capacity to rapidly send out an army simultaneously to several areas thousands of kilometres away. At the same time, diluted sovereignty in European federalism seemed to challenge the classical notion of a nation-state. Defending the physical borders of a state no longer seemed to be an issue for our generals and the question of our security was now played out long distance: from extremist training camps to the financing of terrorism, as well as cybercrime. Classical warfare, defined as direct confrontation for the capture of a territory or the defence of a border, was seen as outdated.

Since then, we have witnessed a double phenomenon: on the one hand, a very strong increase in the circulation of goods and people throughout the world (interweaving of value chains, mass global tourism, economic migrations) and, at the same time, doubts emerging on a borderless world.

EASING OFF THE DISMANTLING OF BORDERS

The first challenges to borders have surprisingly come from the very countries that had planned to dismantle them, either to suspend Schengen or to propose its reorganisation or disappearance. This was the case in France during the terrorist attacks of 1995 or in Germany and Austria when faced with the migrant wave of 2015. The intensification of the migrant crisis in the Mediterranean has clearly put the issue of the external and internal borders of the European Union back at the heart of the debates within the European Council, and at the centre of the Italian political debate, as the peninsula has the most important Mediterranean coastline in the EU.

Both the election of Donald Trump and the Brexit referendum in 2016 marked a further step in the return of borders, whether they were merely propaganda (the wall against Mexican immigration) or very real (leaving the EU). The issue of borders and migrants from the EU was indeed central to the referendum debate. For the first time, it was conceivable to imagine leaving a customs union and a single market. Brexit was a real-life test of the consequences of closing borders, with a return of inflation and labour shortages. Beyond the British specificities of this referendum, it is possible to observe a multiplication of secessionist and regionalist attempts (from Scotland to Catalonia), showing that the return of borders can also be a response to an identity crisis in a culture of globalisation.



GLOBALISATION
in the 1990s:
CHALLENGING
borders and the
nation-state

3 - NAFTA: North American Free Trade Agreement, later replaced by USMCA; United States-Mexico-Canada Agreement.

4 - Mercosur: strategic trade alliance between various South American countries: Argentina, Brazil, Paraguay, Uruguay.

5 - Soft power is a concept used in international relations.



Even if “globalisation is not to blame” (Paul Krugman) for all the cultural, political and social tensions in Western countries over the past 15 years (as the technological revolution is also responsible for the widening of inequalities), it is clear that the erosion of countries’ external borders has been accompanied by the (re)birth of internal borders. Dualist concepts have multiplied to characterise this phenomenon: the insiders versus the outsiders (Lindbeck/Snowder 1985) on the labour market, and the anywheres versus the somewheres (David Goodhart, *The Road to Somewhere*, 2017) on the grounds of identity and politics, that were also described in *La France périphérique* (Christophe Guilluy, 2014) and in *L’archipel français* (Jérôme Fourquet, 2019). As this internal polarisation is accompanied by a growing awareness of the poorly distributed benefits of globalisation (and technical progress), the discourse of rebuilding external borders in the hope of reconstructing national unity logically resonates significantly in political terms. And this is not without consequences in the geopolitical arena, by undermining transnational political organisations, the logic of multilateralism and international cooperation or even participation in any logic of collective security.

FROM FLUIDITY TO SECURITY

The pandemic has overturned our conceptions of borders from the 1990s, namely the marker of passage from one territory to another, a passage that has been mostly fluid and quick. The first response to the pandemic showed the weight of our post-1989 conceptions and the polarisation and politicisation of the border: on the one hand, the idea that closing borders to protect one’s own population would be dangerous; on the other, the idea that the risks always come from outside. France and other EU countries initially refused to close their borders at the beginning of the pandemic. However, the idea that health security justified such an act quickly became standard, particularly in view of the measures put in place by China, the United States and the United Kingdom. So there is clearly a before and an after in this respect, and the idea of closing one’s borders in the face of an external threat could be repeated. The economic implications are of course significant, generating both supply chain disruptions and labour shortages in some countries.

Cybersecurity has become a new way of protecting a national digital territory, where the challenge is as much to guard against an attack on the State, as it is to protect its administrations and the country's companies. The cyber-attack of October 2022 on a French hospital shows that the list of possible targets is not limited to the State and companies. This is probably a central issue for Western powers: preserving a space of sovereignty and security, whose perimeter is not limited to actors within the territory. At the same time, obstacles to the free circulation of data are emerging, particularly from non-democratic regimes wishing to maintain social control through the control of information. The globalisation of the internet in the 1990s therefore ultimately gave rise to a landscape that was more fragmented and controlled than it appeared.

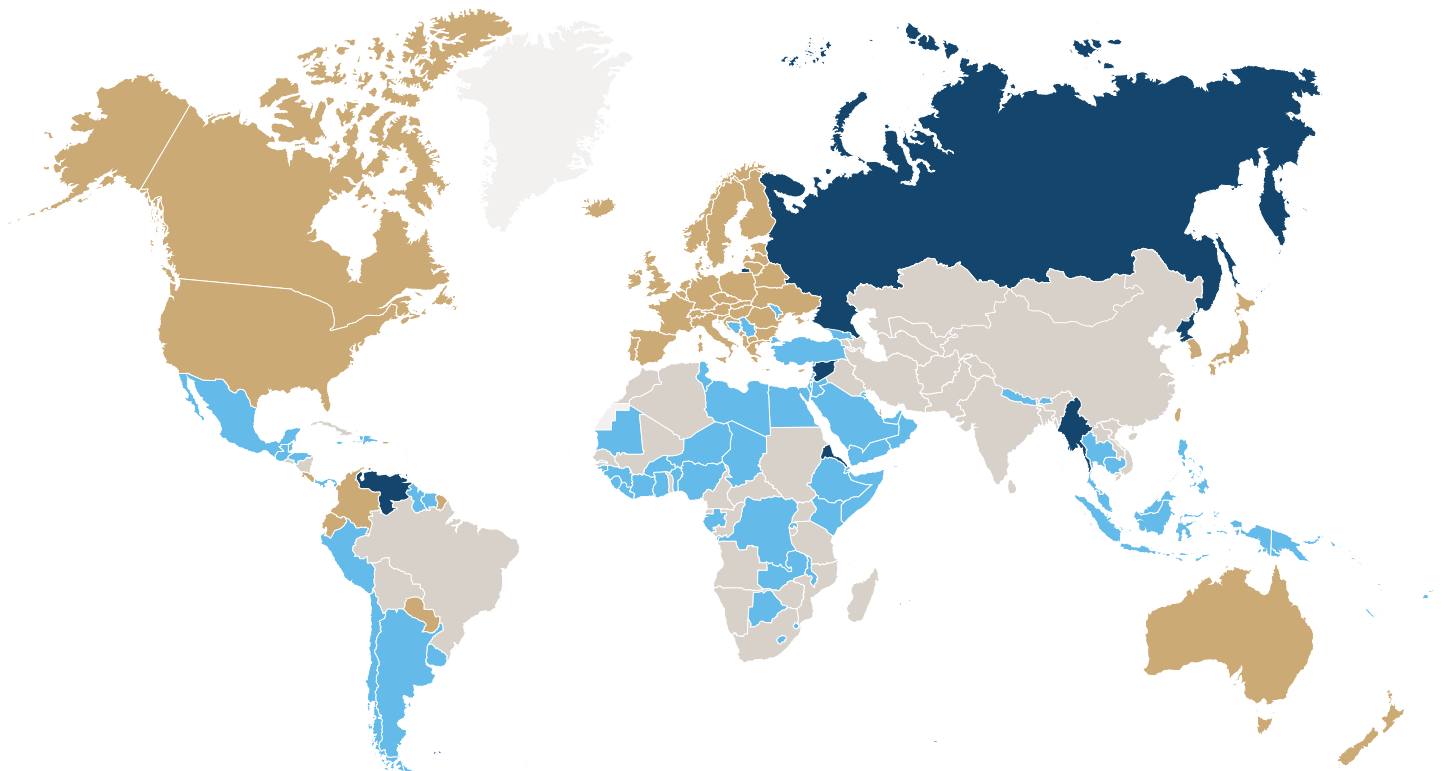
THE END OF THE PEACE DIVIDEND

The return of conflict to the heart of Europe marks a new stage in the return of borders (Chart1). On the one hand, because this conflict considerably raises the stakes for Eastern European countries to be inside or outside the EU and NATO borders. On the other hand, because Russia seeks to preserve a territorial vision of power, trying to bring its borders or zone of influence back to those of the USSR. Some geopoliticians are therefore wondering about a possible return to a "Westphalian" order (consisting of managing the balance between competing powers rather than dreaming of peace).

CHART 1: NEW DIVIDING LINES IN THE CONTEMPORARY WORLD

The reactions of all countries on 7 March 2022 to the Russian invasion of Ukraine:

● Condemnation with response ● Condemnation without response ● No condemnation ● Support



Source: Geopolitical Studies Group, Indosuez Wealth Management.

This era also marks the return to larger military budgets after decades of decline; the return of borders thus changes the allocation of resources within many countries. It is the end of the peace dividend; if the world's leading countries have to spend 3% or more of their GDP on defence or aid to Ukraine, the same amount is not being allocated to investors in innovation or education, probably affecting our potential growth in the long run.

This rivalry is also leading to the building up of technological borders (semi-conductors) and to changes in the rules of access to foreign shareholders (US listing of Chinese companies). The China-US rivalry will remain the geopolitical backdrop of this new century, but the latter does not limit this so-called bipolarity, which does not encompass the whole world.

The latest trigger for the return of borders is the fight against climate change, which calls into question continued relocation, which is now considered both more costly and dangerous for the environment. After several decades of a free-trade agenda, Europe is changing its tune and the idea of a carbon tax at the borders - whether effective or not - marks a turning point.

In conclusion, today's world shows a wide variety of new borders that can overlap, and which tend to multiply: energy, trade, capital, technology and geopolitics. They tend to produce a more fragmented, less legible and less fluid world, with tectonic movements that are difficult to anticipate and potentially fraught with consequences. This new map of the world will be decisive in how international investments are to be approached in the years to come, and marks the return of country risk. In concrete terms, attempts to relocate value chains outside China must take into account the future of certain countries (perceived as alternatives to China) and their future geopolitical positioning.

NEW TECTONIC PLATES

This period also marks the emergence of new dividing lines in the world. The list of countries that refused to vote for sanctions against Russia includes countries that are partly inspired by a tradition of non-alignment (such as India), and partly content to continue trading with Russia and buying the oil that the West no longer buys. The question of the Middle East - which is far from being equidistant from the West and China - is hotly debated and disputed today, between the United States and Europe on the one hand, which are seeking to renew their damaged relationships, and China on the other, which is a major partner in the region.

It is more likely that China, like the Middle East, is seeking to keep an equal distance from the US, Russia and the Middle East, without ever taking the step to a *de facto* co-belligerent role⁶. It has sharply increased its energy purchases from Russia, but for the time being it is refraining from any military cooperation. As a result, the West is trying to draw a line that must not be crossed, a form of partial separation between China and Russia. Against this new backdrop, China is trying to convince the world to renounce a new Cold War rhetoric, and is trying to blame the United States for rising diplomatic tensions, while claiming a role as a dominant regional power.



Vincent MANUEL
Chief Investment Officer



6 - States engaged in a conflict with a common enemy, whether in alliance with each other or not.

REGIONALISATION OF SUPPLY CHAINS - MYTH OR REALITY?

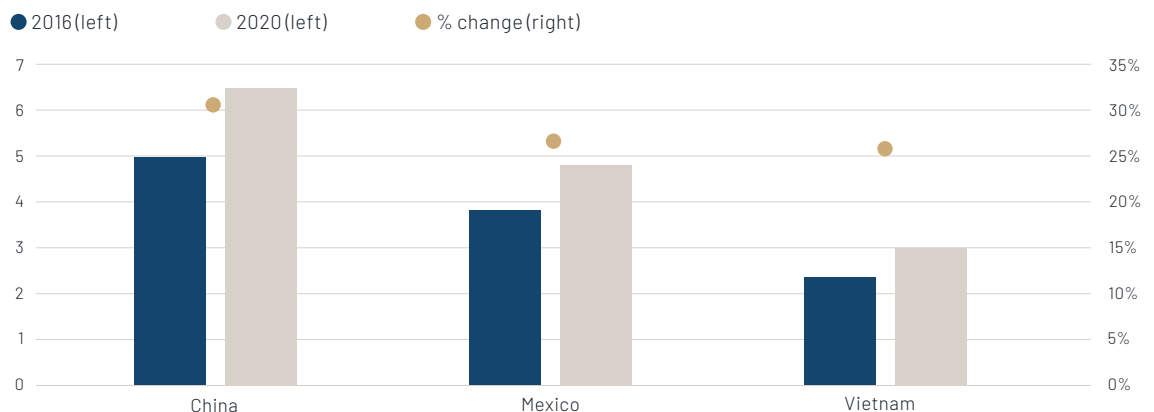
The disruption of the trade activities of multinational companies as a consequence of the pandemic and war in Ukraine has revived the debate on global value chains (GVCs) and offshoring risks. Data thus far does not support increased regionalisation, but the need to favour a more regional footprint for industries will increase for certain strategic sectors and in general due to decarbonisation.

IS REGIONAL THE NEW GLOBAL?

Regionalisation or nearshoring is described by the OECD as the decision to relocate previously offshored activities, not necessarily back to the company's home country, but rather to a neighbouring country. After years of large-scale offshoring in the hope of reducing costs and improving production efficiency, companies are increasingly seeking more diversified sourcing strategies and considering more options for structuring their production processes. Supply chain managers are taking into account the changing environment, with:

- Serious supply constraints experienced by manufacturers during the pandemic and the war in Ukraine, which require increased robustness in supply chains.
- Structural changes, where consumers have become much more a driver in the manufacturing value chain, demanding customised products and requiring greater proximity and flexibility in production.
- Increasing logistics costs, especially with sustainability criteria and the need to take into account better working conditions and lower carbon footprints.
- The development of new technologies, with increased robotisation replacing low-cost/skilled labour, is making regional value chains more attractive. McKinsey estimates that automation, artificial intelligence and additive manufacturing could reduce global trade in goods by up to 10% by 2030.
- The manufacturing labour costs per hour have increased by around 30% in China, Mexico and Vietnam (Chart 2). However, they remain 75% lower than in the same sector in the US.
- Finally, national security issues concerning the supply of strategic goods, whether in technology or healthcare.

CHART 2: MANUFACTURING LABOUR COSTS PER HOUR, USD



Source: Statista, Indosuez Wealth Management.

Regionalisation is a form of intermediary solution between globalisation and offshoring, allowing manufacturers to reduce the increased risks associated with globalisation, while maintaining a certain degree of diversification in their value chains and increasing proximity to end customers.

REGIONALISATION: FACTS AND FIGURES

Data is very limited when it comes to measuring the progress of regionalisation, particularly at sub-national level. Overall, despite a significant increase in interest in regionalisation, evidence of increased regionalisation is limited to date.

Manufacturing imports have shown little sign of slowing in the US

In the US, despite multiple policy actions under the Obama and Trump administrations to strengthen US domestic manufacturing, the facts say otherwise. Manufacturing imports as a percentage of total US manufacturing output rose from 37% in the early 2000s to 54% before the pandemic.



Regional trade was strongest in the ASIA-PACIFIC REGION

Distance traversed by merchandise trade

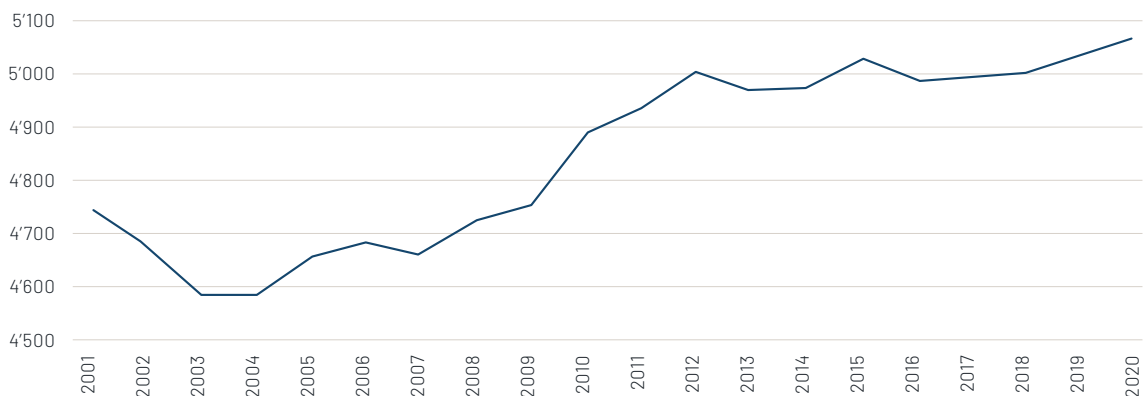
According to the DHL Global Connectedness Index, trade flows have expanded over longer distances since 2004, although there was a pause between 2012 and 2018 (Chart 3).

Outside Asia, intra-regional trade has not increased significantly over the past decade

Trade data gives a bird's eye view on the increase in regional exchanges within the four prominent regions in the world; we can observe (Chart 4, page 15):

- Regional integration of goods is highest among euro area member states and USMCA⁷ member countries, although both have experienced a downward trend since the early 2000s, with only a slight rebound after the global financial crisis.
- Regional trade growth was strongest in the Asia-Pacific region and was already increasing before the signing of the RCEP⁸ trade treaty in 2019. Moreover, trade has increased as these economies grow and are less dependent on demand from wealthier nations.
- Finally, regionalisation seems to have failed to bear fruit in the Mercosur.

CHART 3: AVERAGE DISTANCE OF MERCHANDISE TRADE, KILOMETRES



Source: DHL Global Connectedness Index, Indosuez Wealth Management.

7 - USMCA, United States-Mexico-Canada Agreement, also known as NAFTA, North American Free Trade Agreement.

8 - RCEP: Regional Comprehensive Economic Partnership, a free trade agreement between fifteen countries around the Pacific Ocean: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam, Australia, China, Japan, Korea, New Zealand.

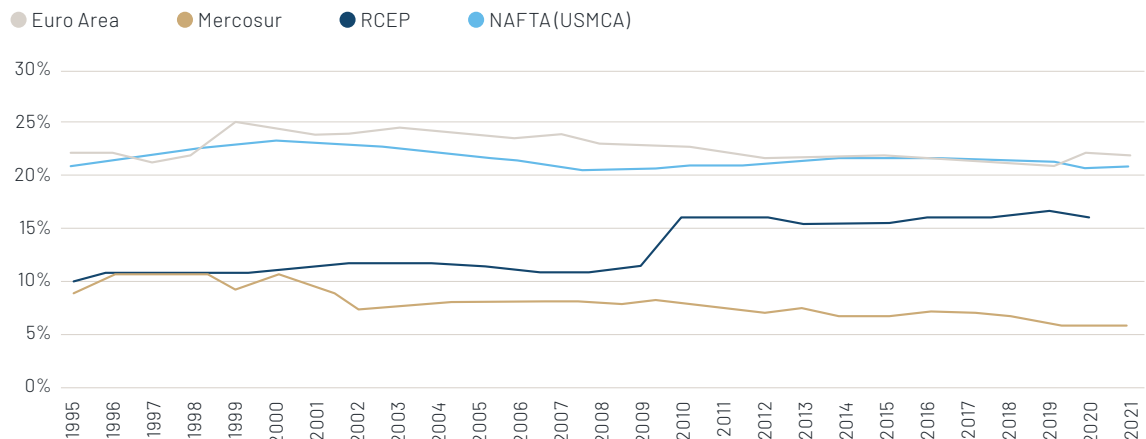
There has, however, been solid growth in merchandise trade within these regions, but growth in intra-regional trade has been lower than growth in total trade in the region. From 2000 to 2021, intra-regional trade in the euro area grew by 137% compared to 163% for total trade, in USMCA countries, by 112% compared to 137%, in RCEP member countries, by 347% compared to 430% and in the Mercosur, by 115% compared to 296%. At the same time, trade with China has increased tenfold in the US and Germany (although it has weakened since 2018). Finally, it is important to note that these trends are exclusively related to the opening up of trade in goods; trade in services, as a share of GDP, has grown significantly more. According to a 2020 McKinsey report, among traded goods, automotive, chemicals, and food and beverage products are commonly imported from regional partners; by contrast, goods in aerospace, medical devices, and pharmaceuticals are more likely to go through long-haul trade.

THE PANDEMIC HAS SO FAR NOT BEEN THE EXPECTED STIMULUS FOR REGIONALISATION

According to the *Harvard Business Review*⁹, the pandemic has actually increased long-distance trade as exports in Asia grew to meet demand. In addition, the International Monetary Fund (IMF) observed an increase in the market share of Asian factories in Europe and the US. According to researchers, this may be linked to:

- **Globalisation of trade fostering specialisation and economies of scale in manufacturing**, which allowed some Asian companies to increase their exports during the pandemic. The reconfiguration of supply chains takes time to be implemented. According to the IMF, market share gains by Asian factories in mid-2020 were large and rapid by historical standards, but they also appear to be reversing rapidly.
- **Increasing inventories is an easier solution in the short-term.** Companies could favour increasing inventory levels and dual sourcing of raw materials over regionalising supply chains and relocating their own production. According to a Goldman Sachs manufacturing analysis (2022), companies are targeting inventory turnover ratios that are on average about 5% higher than before the pandemic.
- **Many of the consequences of the war in Ukraine have favoured long-distance trade.** For example, Europe is increasing its energy imports from further afield to reduce its dependence on Russia. At the same time, Russia trades more with Asia than with Europe, despite a greater distance.

CHART 4: EVOLUTION OF INTRA-ZONE GOODS TRADE, % OF TOTAL TRADE



Source: COMTRADE, Indosuez Wealth Management.

9 - Harvard Business review (May 2022) *Trade Regionalization: More Hype Than Reality?*



THIS TIME IS DIFFERENT?

Regionalisation is not a one-size-fits-all phenomenon. A number of low-cost products and long value chains will most likely remain, not least because of increased specialisation. Furthermore, as the OECD has pointed out, regionalisation is not a zero-sum game, nearshoring and offshoring can be compatible and necessary in this agile environment. What is clear after the pandemic is that domestic production alone will not guarantee robust supply chains. However, for pharmaceuticals and semiconductors, change will be inevitable for strategic reasons.

Finally, the role of decarbonisation in the trend towards regionalisation/de-globalisation will be gradual, but inevitable. Gradual because investments in renewable energies are part of a long trajectory (and even longer in the case of nuclear energy), but will eventually allow the substitution of domestic energy for fossil energy imports. Decarbonisation is a major global coordination issue. A border tariff adjustment mechanism will probably be necessary to prevent carbon leakage to less regulated production regimes; this may act as a driver for greater European regionalisation, although its application will remain complex.



Bénédicte KUKLA
Senior Investment Officer

EMERGING MARKETS: DE-GLOBALISATION OF TRADE OR THE DEVELOPMENT OF A DOMESTIC MARKET AND SERVICES?

The post-Cold War hyper-globalisation has been a significant growth factor for emerging market countries due to their role in value chains. The pandemic has brought the sensitivity of emerging economies to global trade back into focus. The relative weakening of trade dynamics and rising doubts on the benefits of the globalisation may force some emerging markets to rethink a sizeable share of their economy.



37%

share of trade in China relative to GDP (COMPARED TO 67% IN 2007)

A WEAKENING OF WORLD TRADE SINCE 2008

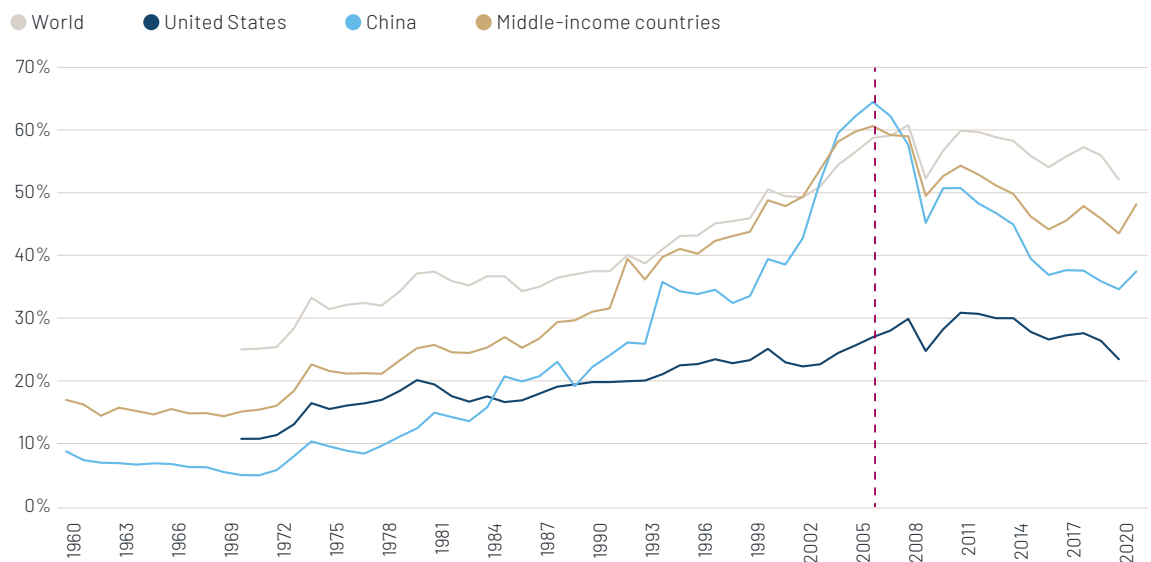
Between 1970 and 2007, the share of trade in world GDP more than doubled, rising from 20% at the beginning of the period to 60% on the eve of the great financial crisis. This acceleration was facilitated in particular by: the development of transport infrastructures, and the results of the Uruguay Round of negotiations which gave rise to the World Trade Organization (WTO). This new framework laid the foundations for a wave of tariff reductions (from an average of 8.5% in the early 1990s to 2.5% in 2017¹⁰), one of the consequences of which was an increase in international trade.

However, since 2008, the share of trade in global wealth seems to have plateaued. Middle-income countries are those for which the share of trade in GDP has fallen the most (including China from 62% in 2007 to 37% of GDP, Chart 5) while their weight in world wealth has increased (China now represents 18.5% of world GDP compared with 11 % in 2007).

Several arguments can explain this trend.

Firstly, in the case of China, the rise in living standards has been reflected in the development of the domestic market and services.

CHART 5: DECLINE IN THE TRADE-TO-GDP RATIO, %



Source: World Bank, OECD, Indosuez Wealth Management.

Secondly, the last decade has seen a shift from a world of fragmented production with an increasing number of components imported into emerging economies, particularly in Asia, for assembly and re-exportation, to a new system with more vertical integration where some previously imported products are substituted by local production. In China, for example, the share of imported components has decreased (Shafaeddin, 2014), narrowing the gap between the share of value added in Chinese imports and exports (Kee and Tang, 2014). This transformation has resulted in a slowdown in the expansion of supply chains, which has altered the relationship between growth and trade, a phenomenon more widely discussed by a World Bank report¹¹ which shows that the long-term elasticity of trade to growth fell from 1.5 between 2001 and 2007 to less than 1 over the following five years.

Thirdly, the reduction in cost competitiveness, together with the increase of wages in emerging countries, as well as the weakening of the share of (trade-intensive) investment in GDP after 2008, are also headwinds for world trade. More recently, the return of national preference, linked to the need for autonomy in strategic sectors, has led to an increase in customs duties and in the number of protectionist measures (Chart 6), which reassesses the trade-off between imports on the one hand and domestic production on the other, generally in favour of the latter.

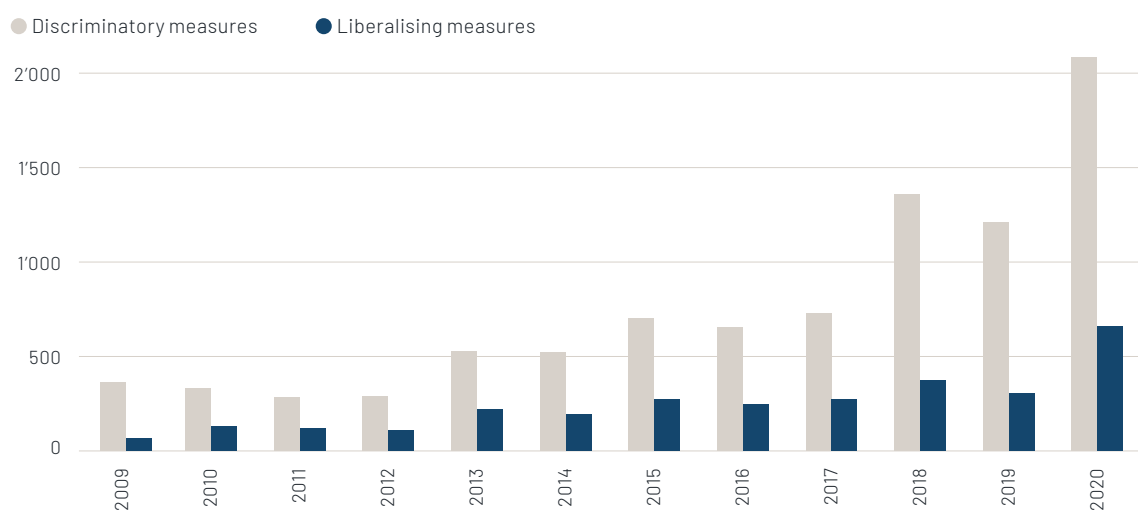
Imports of Chinese products to the United States fell by almost 25% between mid-2018, when new import taxes were introduced, and mid-2019 (although it should be noted that part of the fall can be explained by lower demand linked to the tightening of financial conditions in the United States during 2018), while diversion to other Asian economies was limited.

FINDING A GROWTH DRIVER IN SERVICES

Public economic policies in emerging markets have long been geared towards trade openness (introduction of special economic zones, subsidies for export-oriented manufacturing) and the development of the manufacturing sector.

But this new environment is forcing some countries to rebalance their growth mix. The technological revolution, one of the consequences of which is robotisation and a reduction in the need for cheap labour, is reshuffling the deck. Emerging countries will no longer be able to rely solely on international trade to continue their catch-up with developed economies.

CHART 6: ACCELERATION OF THE NUMBER OF PROTECTIONIST MEASURES



Source: Global Trade Alert, IISD, Indosuez Wealth Management.

11 - C. Constantinescu, A. Mattoo, M. Ruta (2015), *The Global Trade Slowdown: Cyclical or Structural*.

Nations that focus on upgrading physical infrastructure to accelerate the development of fifth-generation technologies, artificial intelligence and robotics, will be best placed tomorrow. Hence the path taken by China in its 14th five-year plan to accelerate investment in these areas of highest productivity gains¹².

The improvement of living conditions for the populations of emerging markets must also be taken into account by governments: McKinsey pointed out in 2005 the quasi-linear relationship between the share of services in a country's overall income and GDP per capita (in purchasing power parity).

Poverty reduction, increased bank penetration and internet access, combined with technology transfers that emerging markets have been able to benefit from, have unlocked new opportunities in services (Chart 7). These could provide the basis for more sustainable economic growth at a time when emerging markets demographics have become increasingly unfavourable, implying that growth will have to increasingly rely on productivity gains. It should be noted that within services, the sub-sectors with the best opportunity gains are not the ones that create the most jobs, hence the need of a more comprehensive government policy (education, social services, redistribution, etc.) in order to integrate the whole population into the transformation of the domestic economy.

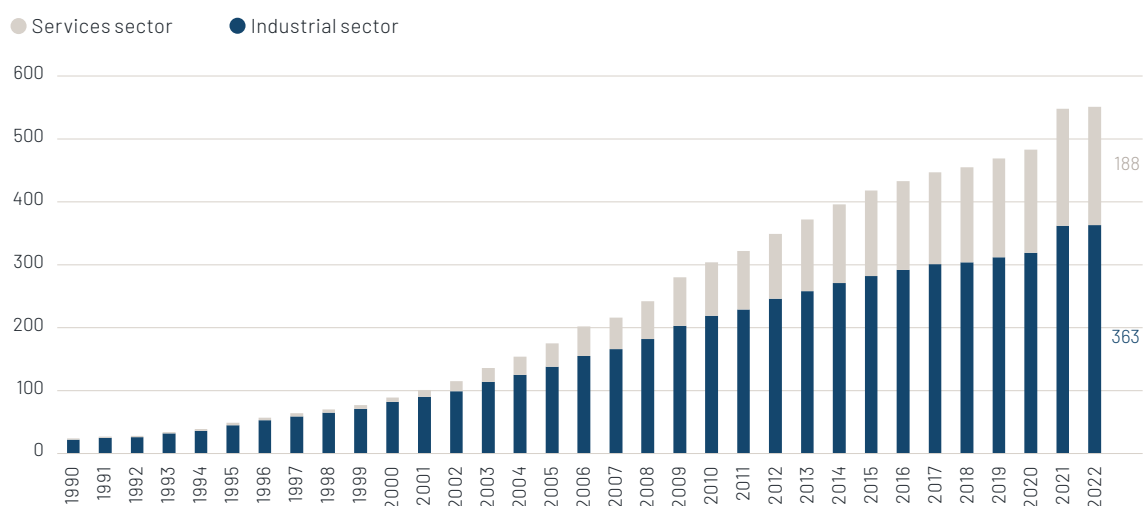
From an investor perspective, this shift towards services indirectly changes the sector mix of emerging market equity indices. The combined weight of the energy and materials sector represented one third of the MSCI EM index in 2009, but has since declined significantly in favour of consumer discretionary and technology, whose combined weight has doubled (now at 33%).

TOWARDS NEW ECONOMIC COOPERATION

Changes in the structure of international trade are also at play. These are linked to a more global questioning of globalisation, made more acute by the pandemic, and can be found in:

- The lack of political will, such as the failure of the Doha Round to facilitate the integration of the least developed countries into world trade.
- The US trade policy under President Trump ("America First") which has reduced the power of the WTO and transformed multilateral agreements (e.g., NAFTA watered-down into USMCA) while pointing the finger at China, accused of dumping and theft of intellectual property.
- The will to have economic autonomy in order to avoid supply bottlenecks (COVID-19 effect and Russian-Ukrainian war).

CHART 7: ACCELERATION OF NOTIFICATIONS OF REGIONAL TRADE AGREEMENTS, ESPECIALLY IN SERVICES



Source: WTO, RTA-IS, Indosuez Wealth Management.



RCEP
accounts for
30%
of global GDP

In response to this very “Western-centric” trade organisation, emerging economies had already created regional new free trade blocs (Mercosur launched in 1991, Southern African Development Community (SADC) created in 1992). Since then, these agreements have accelerated with the creation in 2018 of the African Continental Free Trade Area and with the entry into force of the Regional and Global Economic Partnership (RCEP) in 2022, which brings together 30% of the world’s gross domestic product and 2.3 billion inhabitants (Chart 8, page 21).

The latter agreement aims to reduce 90% of customs duties between members, but also to simplify supply chains and also covers the services sector, telecommunications, investments and intellectual property rights. From this point of view, the trend is therefore more towards a reorganisation of trade flows (with a growing share of South-South flows) than a simple halt to trade relations between countries.

WHAT ARE THE IMPACTS?

The latest crisis has pushed emerging markets to turn inwards and protect their national interests (reduction of Indian wheat exports in 2022, redirection of Russian raw material exports towards Asia to escape Western sanctions). Globalisation has therefore evolved towards a regionalisation of economic, political and social interests. As a result, we are witnessing the formation of three major trading blocs, centred on the United States, Europe and China-Asia, each with the objective of relocating sensitive industries (technology, health-care, and defence) and a preference for cross-border trade, exacerbated by the soaring cost of raw materials and freight.

This also reflects the end to imported disinflation. Emerging economies, having been the world’s production factory, are gradually turning to the production of higher value-added products as mentioned above. The example of the “Made in China 2025” and “China Standards 2035” plans illustrate this economic shift. The objective of the new project is to reduce its dependence on advanced technologies in order to become an economic powerhouse focused on high value-added production, to boost internal growth and to participate in setting international standards for new generation technologies. It is inspired by the examples of Japan, Korea and Taiwan. The Chinese authorities want to achieve 40% of electronic component manufacturing by 2020 and 70% by 2025 and become the world leader in 10 key sectors ranging from agricultural equipment to high-tech equipment and electric vehicles.

CONCLUSION: A NEW ORGANISATION OF TRADE

We cannot therefore speak of the de-globalisation of trade (in nominal terms, the exchange of goods between countries even continues to grow) but rather of: i) the new role of China in international trade and ii) a redefinition of the terms of trade (linked, for example, to the rise in protectionism) resulting in a new organisation of trade based on a regional approach to domestic consumption and proximity of emerging economies.

The issue of climate transition will be key to determining the future dynamics of trade: the increase in investments - more trade-generating between countries - that it requires, should be a supporting factor, while the appearance of new constraints (carbon pricing, increase in the cost of negative externalities linked to climate disruption, securing the supply of metals for the ecological transition) will be at the heart of the redistribution of existing flows towards new trade players (Africa, Latin America, for example).

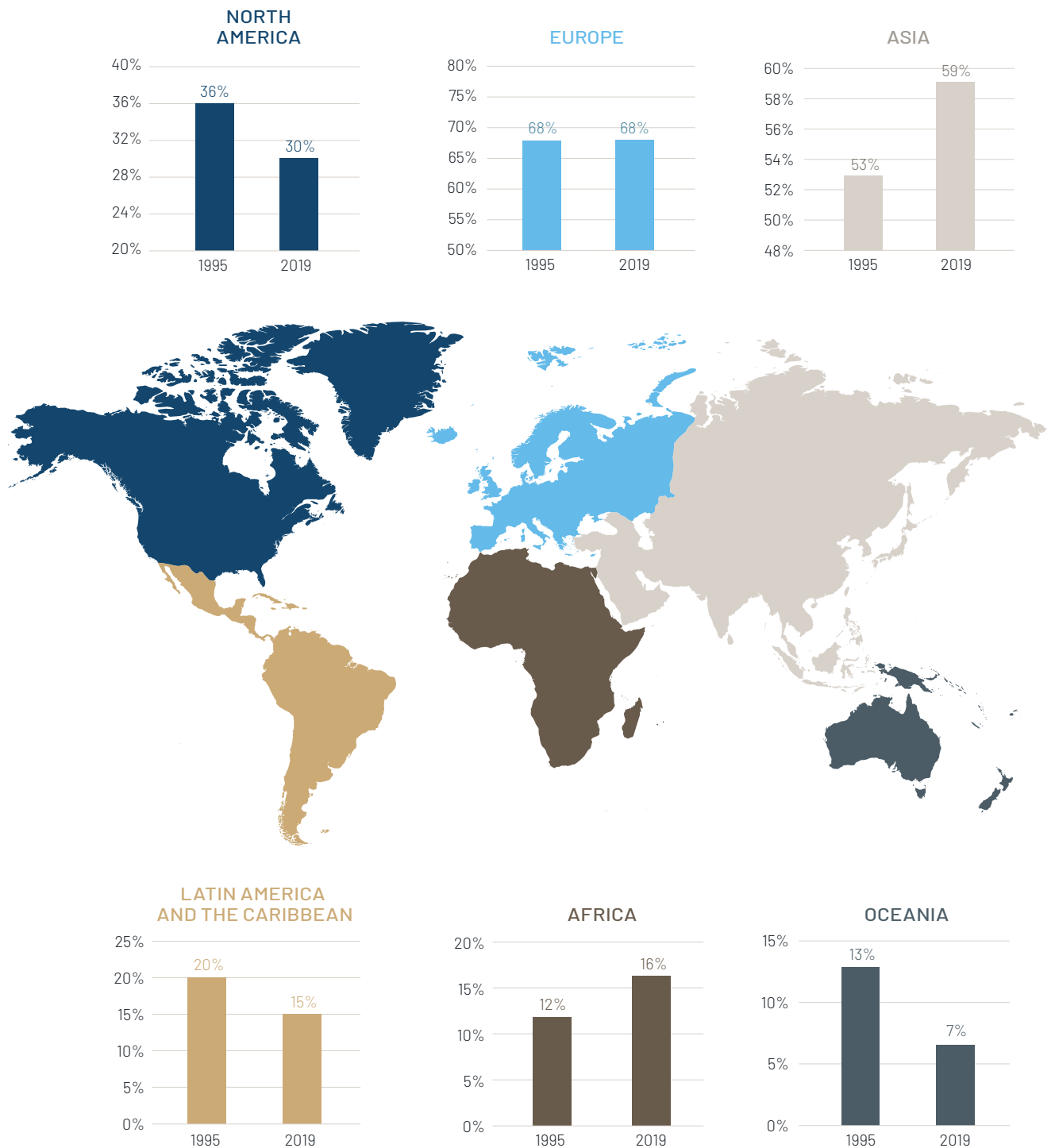


Thierry MARTINEZ
Asset Allocation Portfolio Manager



Adrien ROURE
Investment Strategy Analyst

CHART 8: INCREASE IN INTER-REGIONAL TRADE IN ASIA AND AFRICA, %



Source: UNCTADstat, Indosuez Wealth Management.

ARE WE MOVING TOWARDS A RELOCATION OF SAVINGS AND GOVERNMENT FUNDING?

Rising political tensions and the increasing regionalisation of trade are challenging the durability of financial globalisation. International investors' reliance on US Treasuries and/or dollar-dominated savings products may not be as permanent as previously thought, but the nationalisation of balance sheets also implies risks that some (even highly liquid) borrowers such as the US may not be willing to take.

GOVERNMENT FUNDING: THE IMPACT OF TRADE BALANCES AND FOREIGN EXCHANGE RESERVES

The dominance of the US dollar in capturing international savings flows applies to institutional investors (central banks, sovereign wealth funds).

Depending on the country, a trade surplus, when realised on dollar-denominated goods and services, contributes to the growth of a country's central bank reserves. These surpluses can be exchanged in currencies other than the dollar. However, investment opportunities in the US market, and more specifically the bond market, make it possible to benefit from the advantages of the most liquid market in the world, and one of the best-rated signatures, although no longer holding the famous AAA rating since 2011.

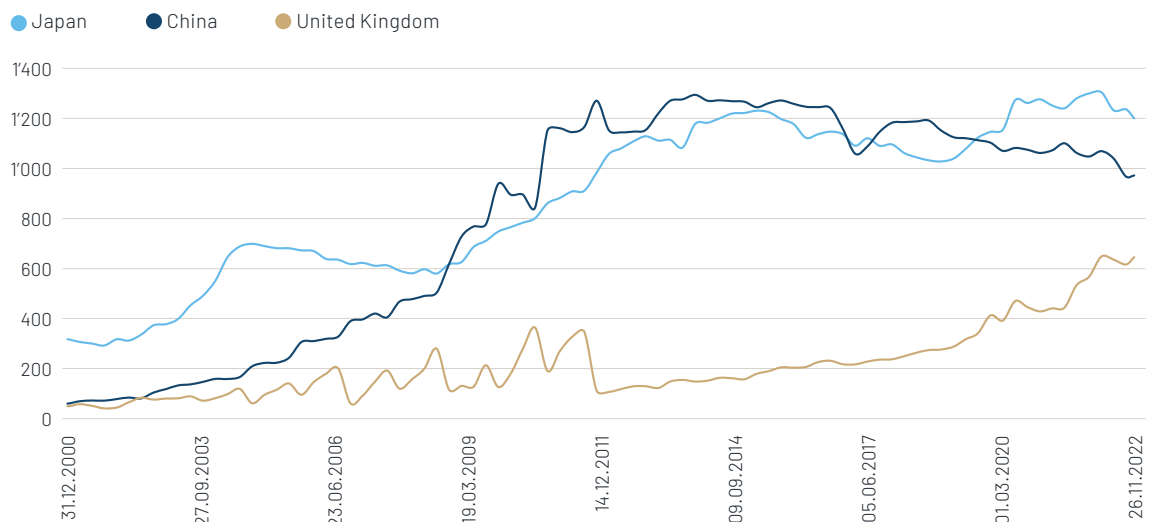
Asian countries hold massive amounts of US government debt (Chart 9). This is both a consequence of their large trade surpluses with the United States and a reflection of their desire to stabilise their currency against the dollar. Japan and China between them hold nearly 2'200 billion dollars out of a total in circulation of 31'000 billion dollars (Source: Department of the Treasury, Federal Reserve Board). Some countries have also learned from the Asian crisis of 1997 by building up larger foreign exchange reserves.

But this weight of the dollar on the balance sheet of central banks is not mandatory or permanent. As a matter of interest, Russia sold all its securities (around 100 million dollars) in 2018. This was well ahead of the international sanctions reducing the country's ability to use the dollar as a transaction currency.



THE WEIGHT OF THE DOLLAR
on the balance sheet
of **CENTRAL BANKS**
is not permanent

CHART 9: FOREIGN CENTRAL BANKS' HOLDINGS OF US BONDS, BILLIONS IN TREASURY BONDS



Source: Federal Reserve Board, Indosuez Wealth Management.

One question that could arise is whether the reduction in trade surpluses and the regionalisation of trade could lead to a reduction in this accumulation of foreign exchange reserves (and thus financial interdependencies). Indeed, by 2022, there may be a 7% decline in central bank foreign exchange reserves, albeit mostly due to central banks mobilising their reserves to stabilise their country's currency.

In the face of these recent developments, however, we may see several changes:

- The risk of sanctions on foreign exchange reserves (a reality in the case of Russia) could result in a lower allocation of dollar reserves by some central banks.
- The willingness of some countries to trade more outside the dollar (in renminbi for example) could lead to a further regionalisation of foreign exchange reserves and therefore of financing flows.

PRUDENTIAL REGULATION: A FACTOR IN THE LOCALISATION OF SAVINGS?

After the 2008 financial crisis, financial actors coined the term Great Financial Repression to describe the wave of regulation that hit banks, insurers and pension funds in order to increase their solvency ratios, and thereby counter any new systemic failure.

These regulations (Basel IV and Solvency II in particular), produced by bodies close to or directly derived from governments, encourage financial corporations to direct part of their investments towards government debt by lowering the latter's weight in risk calculations.

For example, the reform of money market funds in the United States implemented by the SEC¹³ in 2016 requires the holding of highly liquid assets in portfolios. The most liquid assets are T-bills, issued by the US Treasury.

Over time, money creation is shifting from the central banks to governments. This new environment can be clearly observed in the United States, where the Department of the Treasury steers liquidity in circulation through its account at the Fed.

However, paradoxically, European regulators also wanted to harmonise and "denationalise" the balance sheet of European commercial banks (i.e., ensure that banks in the Euro Area do not only hold the debt of their own country) in order to reduce the risk of systemic transmission. However, this regionalisation *de facto* involves the issuance of euro bonds and raises the question of coordination between fiscal and monetary policy.

FISCAL SUSTAINABILITY AND INTERNATIONAL DEPENDENCE

Quite quickly, debt sustainability can become a challenge for markets. The United Kingdom went through this bitter experience in September 2022. The announcement of a tax cut plan, not financed by a reduction in spending, immediately caused the currency to fall and interest rates to rise.

This example is similar to the behaviour of emerging markets, which depend on foreign capital flows to balance their current account. In this particular case, an important nuance should be noted: the assets of British pension funds amount to GBP 6'100 billion (source: Office for National Statistics). This compares with the country's debt of GBP 2'069 billion, or 94.5% of GDP.

13 - US federal agency for the regulation and supervision of financial markets.

SEVERAL GOVERNMENT FUNDING MODELS

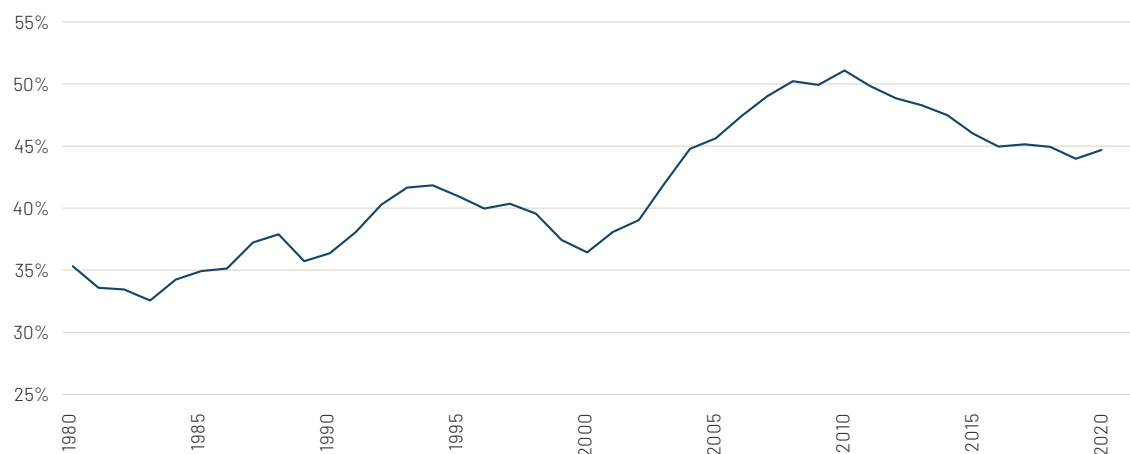
In the Euro Area, government funding has been at least partly based on purchases by the European Central Bank (ECB) since the sovereign crisis of 2011-2014. It also relies on domestic savings directed towards sovereign bonds (pension funds in the Netherlands and nearly EUR 1'900 billion from life insurance in France according to 2021 data from the ACPR). In parallel, the banking system uses government bonds as collateral for derivatives transactions. The securities accepted as collateral must be of good quality and liquid: once again government bonds! The regulatory mechanism for European banks is the Basel Committee on Banking Supervision. The last major regulatory change dates back to 2017 and required banks to maintain an initial margin and then a variation margin, which can be likened to protective buffers for banks. As a result, banks' collateral requirements have increased.

On the US front, as mentioned in the article on foreign exchange markets, page 31), the colossal level of federal debt continues to be refinanced by the rest of the world and thanks to the "exorbitant privilege" of the dollar, the main worldwide reserve currency.

However, the question of the durability of this double dependence between China and the US (the Chinese trade surplus finances the federal debt) could be raised if the dynamics of trade were to be regionalised, if the United States were to diversify its suppliers more and/or if a growing share of this trade were to be conducted in currencies other than the dollar. But what allows the US to continue to attract a significant level of financing today is the attractiveness of the US yield curve and the confidence in the currency that remains.

Finally, in China, the financing model is not very dependent on international flows and is mainly based on very high domestic savings (Chart 10), which makes it possible to deal with a debt ratio that is also rising sharply. The debt of the central government remains moderate compared to the ratios of developed countries (75% of GDP). On the other hand, the country's total debt, including the provinces and households, has almost doubled since the beginning of the 2000s, now representing 300% of GDP (source: Bloomberg), one of the highest in the world. Without making the shortcut meaning that recent Chinese growth has been achieved through credit, the in-depth restructuring of the property sector is accompanied by a forced reduction in debt.

CHART 10: GROSS DOMESTIC SAVINGS IN CHINA, % OF GDP



Source: World Bank, OECD, Indosuez Wealth Management.



The stigma of the
**EUROPEAN
SOVEREIGN
CRISIS**
still drives
capital flows

Gross domestic savings in China have stabilised at over 40% (source: World Bank), allowing the economy to be financed by domestic resources and providing a cushion for future consumption which has not been released to date. At the same time, the real estate crisis that has been underway for more than a year - and the increasing defaults on dollar-denominated bonds by real estate developers - is contributing to the growing mistrust among international investors. In addition, the confirmation of Xi Jinping's third term at the 20th National Congress of the Chinese Communist Party in late October 2022 has reinforced the hard line in power, causing unease among international investors. Even though the government has undertaken a strong modernisation and opening of the capital markets, the refinancing of Chinese growth is likely to rely mainly on domestic resources.

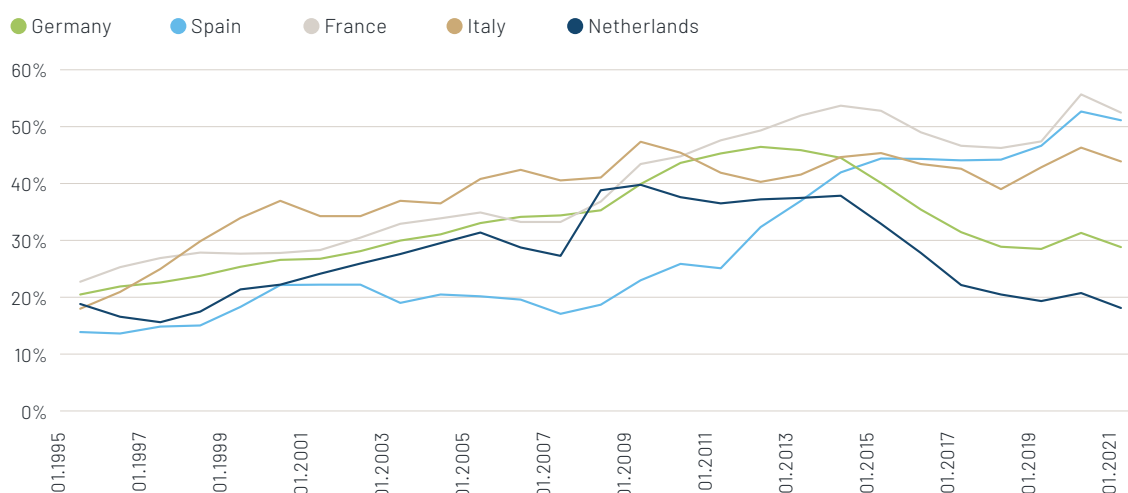
A STRONG RELATIONSHIP BETWEEN DEBT STATUS AND INVESTOR TYPOLOGY

The credibility of a government to repay its debt in the future, or more precisely to keep its access to funding sources open, also determines the type of government-debt buyer. Sovereigns with the best ratings attract institutional investors (pension funds, central banks) whose sensitivity to counterparty risk is greater than their search for yield. On the other hand, governments categorised as emerging markets will attract investors who are less risk-averse and more yield-seeking, and therefore subject to greater volatility.

The ability of a government or geographical area to issue debt in its own currency also affects the quality and stability of the buyers of its debt. Japan has for decades defied concerns about the sustainability of its debt, which is mainly held by domestic institutions. Net debt represents 170% of GDP, while gross debt reaches 263%. The Bank of Japan's control of the interest rate curve ensures that interest rates are kept very low.

In Europe, the scars of the 2011-2012 sovereign crisis are still directing capital inflows from abroad to the highest rated countries. In France, more than half of the debt is held by non-residents, (source: Banque de France, Chart 11). By trickle-down or adhesion effect, European domestic savings then flow towards the less highly rated and more volatile countries of the zone. The end of expansionary monetary policies raises the question of how to replace central bank purchases by other investors. The end of an "administered" European bond market has already had a double effect on: prices (rising rates) and volatility. European institutional investors, who had moved up the risk curve by increasing their allocation to corporate debt, should return to government debt.

CHART 11: NON-RESIDENT OWNERSHIP OF GOVERNMENT DEBT FOR THE MAIN EURO AREA COUNTRIES, % OF GDP



Source: Eurostat, Indosuez Wealth Management.



In conclusion, government funding and global savings flows depend on the stature of a country to attract capital from institutional investors, and then on the capital mobility of individual savings, constrained by domestic regulations aimed at limiting this mobility. In 2008, developed country governments introduced tools to direct domestic savings towards their own financing. In light of international tensions, it could be possible that China is using its holdings of US Treasuries as an instrument of influence, or worse, as a weapon against the United States, by threatening to proceed with a partial or total sale. The limitations of this kind of question are quickly apparent: which financial actor could replace China as debt owner?

Only American institutions would be able to absorb this flow, so they are in a position of price maker, which would necessarily be to the seller's disadvantage. Another adjustment channel would be the exchange rate: which counterparty would be able to convert the dollars received from the sale of securities into yuan? A sudden increase in demand for yuan, disconnected from trade flows, would push the currency into an upward spiral, to the detriment of the Chinese economy, which is still exporting. The weapon represented by the possible halt to the refinancing of US federal debt by China could therefore be turned against the latter. The de-globalisation of savings and financing flows is therefore perhaps not on the agenda.



Thomas GIQUEL
Head of Fixed Income

With the contribution
of the Fixed Income Team

DOES DE-GLOBALISATION OFFER OPPORTUNITIES FOR DOMESTIC EQUITIES?

Domestic companies have performed better since the start of the geopolitical crisis. Supply difficulties, discussions on the need to restore local industrial capacities and energy dependence are pushing companies to move away from the Ricardian dogma of comparative advantage.

RETHINKING GLOBALISATION?

In a letter to shareholders on 24 March 2022, BlackRock's CEO Larry Fink announced that the Russian invasion had put an end to the globalisation experienced over the last three decades. Without question, the conflict in Ukraine has upended the world order and questioned the sustainability of a globalised economic model. More intrinsically, each country has been forced to rethink its position on in the globe's political chessboard, leading each country to reconsider certain strategic matters such as energy independence, national security or industrial sovereignty.

The COVID-19 health crisis had already weakened the existing model and called into question the organisation of production and supply chains. The inflation inherent in the disruption of international trade, added to the consideration of ESG (Environmental, Social and Governance) requirements and the rise in wage costs in emerging countries "disrupted" by the robotisation/automation of production systems, had already led some companies to relocate part of their means of production.

According to Joseph E. Stiglitz, winner of the Nobel Prize in Economics, "globalisation must be radically rethought". The polarisation of the world, exacerbated by the Ukrainian conflict, is undoubtedly leading countries to redraw their strategic priorities through their national policies.

It is also an opportunity for each country to build a more sustainable economic model by accelerating the climate transition in order to achieve energy independence as soon as possible.

DOMESTIC COMPANIES: ACTORS OF ENERGY INDEPENDENCY

Indeed, the war in Ukraine has highlighted the energy dependence of European countries on Russian fossil fuels. From a more global point of view, the commitment of major developed countries to reduce their carbon emissions reinforces the need to increase the share of renewable and low-carbon energies within the energy mix. To that end, Europe has launched its REPowerEU plan, which aims to strengthen energy savings, diversify energy supplies and accelerate the roll-out of renewable energy. This ambitious strategy aims in particular to increase the share of solar energy from 3% to 15% and more generally to reach 45% of renewable energy in the European energy mix by 2030. In this context, domestic electricity production and distribution companies will have to support governments in achieving their objectives. Iberdrola, for example, Spain's leading energy producer and distributor, is one of the world's leaders in wind energy. For their part, the United States will be able to rely on their champions in cutting-edge technologies, which are essential for the transformation of solar energy into electricity, such as Enphase and SolarEdge.

The American government is also active on climate issues. Even if the United States is structurally almost energy independent, the Biden administration's renewed desire to achieve carbon neutrality by 2050 requires the implementation of proactive policies.



**USD 30
BILLION**
in aid to be
**ALLOCATED
TO US NUCLEAR
POWER**

The Inflation Reduction Act (IRA) provides for a budget of 400 billion dollars to combat global warming, in which more than 30 billion dollars will be allocated to nuclear energy, considered to be an important source of low-carbon electricity. Although some of this plan may be diluted after the mid-term elections, companies such as Constellation Energy (the largest owner of nuclear power plants in the United States) will be a direct beneficiary of this aid. Other companies, such as Cameco, the largest integrated supplier of uranium, operating only in North America, should also benefit from the government's support for the entire industry.

COUNTRIES ARE REINVESTING HEAVILY IN THEIR DEFENCE

Another major change in the budgetary expenditure of governments is defence (Table 1). In his budget proposal in March 2022, President Biden called "for one of the largest investments in our national security in history with an increase in defence spending of around 4% of GDP, reaching USD 813 billion in 2023. This is by far the largest military budget in history.

A large part of this budget (about USD 300 billion) is devoted, not to weapons, but to research and development of new technological equipment, particularly in the fields of cybersecurity and artificial intelligence. The strategic challenge faced by governments today is indeed more in the race for technological innovations linked to information systems, than in the development of the military-industrial complex. For example, the Pentagon's main partner is now Leidos, a company which specialises in scientific, engineering and information technology services.

The Ministry of Defence is also working in this direction with other private technology companies that are almost exclusively dedicated to the needs of the government, such as Booz Allen Hamilton or Science Applications. Security constraints naturally mean that contracts are awarded to national companies. And the needs are such that other technological and/or industrial flagships could emerge in the coming years.

TABLE 1: EVOLUTION OF DEFENCE SPENDING, GOVERNMENT ANNOUNCEMENTS

	2021, billion USD	% GDP	Forecasts announced
United States	778.2	3.5%	4% increase in the 2023 budget
Germany	52.8	1.4%	Target: > 2% of GDP by 2024
Italy	28.9	1.6%	Target: 2% of GDP by 2028 (i.e., an increase of 40% vs. 2021)
France	52.7	2.1%	3 billion increase in 2023
Poland	13.4	2.1%	Target: 3% of GDP by 2028 (i.e., an increase of 40% vs. 2021)
Norway	8.3	1.9%	Target: 2% of GDP by 2028
Romania	5.8	2.0%	Target: 2.5% of GDP by 2023
Denmark	5.5	1.4%	Target: 2% of GDP by 2023
Lithuania	1.3	2.1%	Target: 2.5% of GDP by 2023
Latvia	0.9	2.3%	Target: 2.5% of GDP by 2023
Estonia	0.8	2.3%	Target: 2.5% of GDP by 2023
Sweden	6.7	1.2%	Target: 2% of GDP by 2028
Finland	4.1	1.5%	Announced its intention to join NATO and increased its budget by 50%
Austria	3.6	0.8%	Target: 1% of GDP by 2023

Source: NATO, World Bank, Indosuez Wealth Management.

Europe is not to be outdone. The European Commission has proposed the first European Defence Fund representing EUR 7.9 billion. This Defence Fund complements and reinforces national investments in research, development and the acquisition of defence technology equipment. Moreover, after a steady decline in defence budgets over the past 40 years, most European countries intend to significantly increase their spending in the sector.

Germany has decided to double its defence budget to EUR 200 billion per year (or 2% of its GDP) by 2024, Italy is also aiming for 2% of its GDP by 2028 (a 40% increase on 2021 levels), and Poland is aiming for 3% by 2023. European champions in the sector such as Thales or Leonardo, which are mainly exposed to Europe, will therefore be called upon to contribute.

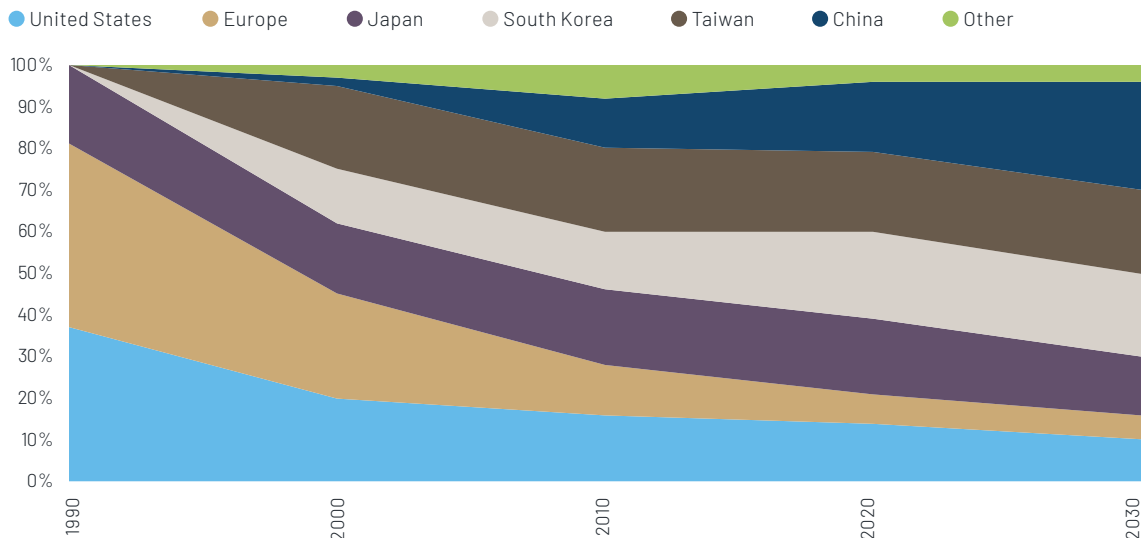
This rise in geopolitical tensions on a global scale, coupled with the disruption in global supply chains due to the COVID-19 pandemic, has also raised the issue of industrial sovereignty.

AUTONOMY IN CERTAIN AREAS OF INDUSTRY, SUCH AS SEMICONDUCTORS, HAS BECOME A STRATEGIC MATTER

Electronic components, also known as semiconductors, are at the heart of all modern electronics, and equip a majority of manufactured products (from smartphones to helicopters). Almost 80% of these chips are currently produced in Asia and this proportion is set to increase in the coming years (Chart 12). By way of comparison, in 1990, Europe supplied more than 40% of the electronic chips manufactured in the world, compared with less than 10% today.

The dependence of the United States and Europe on Asian factories threatens the industrial sovereignty of countries. In addition, the supply of components is not secure and weakens production chains. Finally, the weak protection of intellectual property also constitutes an issue for national security (military equipment often operates with the help of these components).

CHART 12: THE EVOLUTION OF GLOBAL SEMICONDUCTOR PRODUCTION BY COUNTRY, %



Note: These projections do not take into account the ambitions of the American and European plans. Source: BCG, Semiconductor Industry Association, Indosuez Wealth Management.



**USD 52.7
BILLION**
for companies
**RELOCATING
SEMICONDUCTOR
PRODUCTION**

It is in this context that the US government has blocked the sale of certain chips dedicated to high-performance computing and artificial intelligence, manufactured by Nvidia and AMD, to China and Russia.

At the end of July 2022, the US Congress passed the Chips Act to support semiconductor production in the United States. The law includes a USD 52.7 billion budget for companies that relocate the production of these components or place orders with American manufacturers. Micron Technology has already announced that it will invest USD 40 billion in memory chip manufacturing in the US by 2030.

Europe also wants to boost investment in the high-tech industry with the ambition of accounting for 20% of global semiconductor production by 2030. In July 2021, the European Commission launched the Industrial Alliance on Processors and Semiconductor Technologies, which brings together companies, Member States, academics and research and technology organisations. In particular, it will be able to draw on the expertise of ASML, the world's leading manufacturer of lithography equipment for the semiconductor industry, as well as other European leaders such as STMicroelectronics, NXP, Soitec and Infineon, to develop a regional ecosystem and potentially strengthen its digital sovereignty.

As economic agents rethink globalisation, some companies are already moving towards a more sustainable business model based on local industries and shortened, less energy-intensive supply chains. This paradigm shift would then be an opportunity for domestic companies to contribute their expertise to build upon public efforts.

ARE DOMESTIC COMPANIES THE WINNERS?

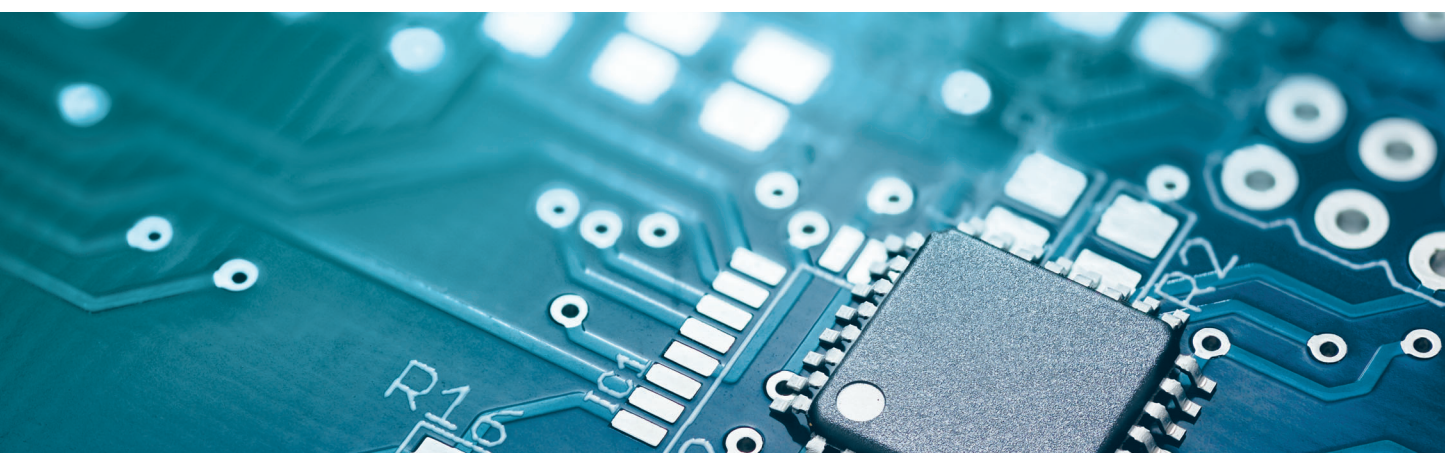
What are known as domestic companies are more likely to be identified in sectors such as energy, utilities or real estate. Indeed, certain economic activities are intrinsically linked to the place of production: gas and electricity are produced and distributed on the territory by companies operating on regulated markets (governed by specific national legislative frameworks). This group of equities has benefited from the geopolitical context and, as a result, has a better annual performance than internationally exposed equities, for which the strengthening of the US dollar has been a headwind for several months. In addition, these more international companies often have a higher capitalisation, with more technology stocks that are in turn more sensitive to rising interest rates.



Laura CORRIERAS
Equity Portfolio Manager



Melanie GONTIER
Equity Portfolio Manager



ARE WE SEEING A RETURN OF THE SOVEREIGN RISK PREMIUM AND CURRENCY DIVERGENCES?

After a period characterised by narrow trading ranges, volatility is making a comeback in the foreign exchange market. The rise of the dollar, the divergence of monetary policies, the intervention in the foreign exchange market by the Japanese to support the yen or by the Bank of England to reassure financial markets, as well as the return of the sovereign risk premium, are increasing market tensions.



DIVERGENCE
between
central banks
INCREASES
TENSIONS
in the foreign
exchange market

DE-GLOBALISATION INCREASES CURRENCY VOLATILITY

In 2022, volatility made a noticeable return to the foreign exchange market. After a long period dominated by accommodative monetary policies and very low interest rates, the situation changed rapidly: the COVID-19 crisis, the war in Ukraine, the surge in commodity prices, the return of inflation and its lasting impact are just a few examples.

The economic collapse caused by the pandemic two years ago and the recovery that followed were shared globally. During this period - and indeed since the financial crisis of 2008 - the majority of central banks in the developed world have adopted coordinated, relatively accommodative monetary policies in order to restore growth. The situation changed rapidly at the beginning of 2022 after the US Federal Reserve (Fed) shifted its focus to curbing runaway inflation. The result was a dramatic strengthening of the dollar with the dollar index reaching its highest level in over twenty years.

Russia's invasion of Ukraine has created an energy shock generating a difference between energy importing and exporting countries: Europe, the UK, Japan or China which import energy are negatively impacted while the United States which is rather self-sufficient in energy has fared better.

The high volatility that we observed at the end of October 2022 (Chart 13) on currencies can be explained by several parameters:

- The new cycle of divergence between central banks is increasing tensions on the foreign exchange market. The case of Japan illustrates this point well: the divergence between Japanese and American monetary policies has weighed heavily on the Japanese yen. This has led the Japanese to intervene in the foreign exchange market in order to support their currency which is in free-fall against the dollar.
- Concerns about financial stability in the UK in September 2022 and the crisis in the pound sterling have also prompted the Bank of England to intervene.
- The strength of the dollar has created a kind of instability that has led other countries such as India, Brazil and Chile to intervene in the foreign exchange market to reduce the volatility of their currencies or stabilise them.

CHART 13: VOLATILITY IN THE FOREIGN EXCHANGE MARKET



Source: Bloomberg, Indosuez Wealth Management.

A PARALLEL WITH THE PLAZA ACCORD

In the early 1980s, the US Federal Reserve raised interest rates sharply to combat inflation, causing a massive influx of capital and a surge in the dollar of more than 50% against major currencies. In response, the central bankers and finance ministers of the five major economies - United States, Japan, Germany, France and the United Kingdom - reached an unprecedented agreement: the Plaza Accord of September 1985, which stipulated joint intervention in the foreign exchange markets to weaken the greenback.

In an economic context similar to that of the 1980s, with high inflation, a soaring dollar affecting economies and disrupting financial markets, it is not surprising that debates regarding a new Plaza Accord abound.

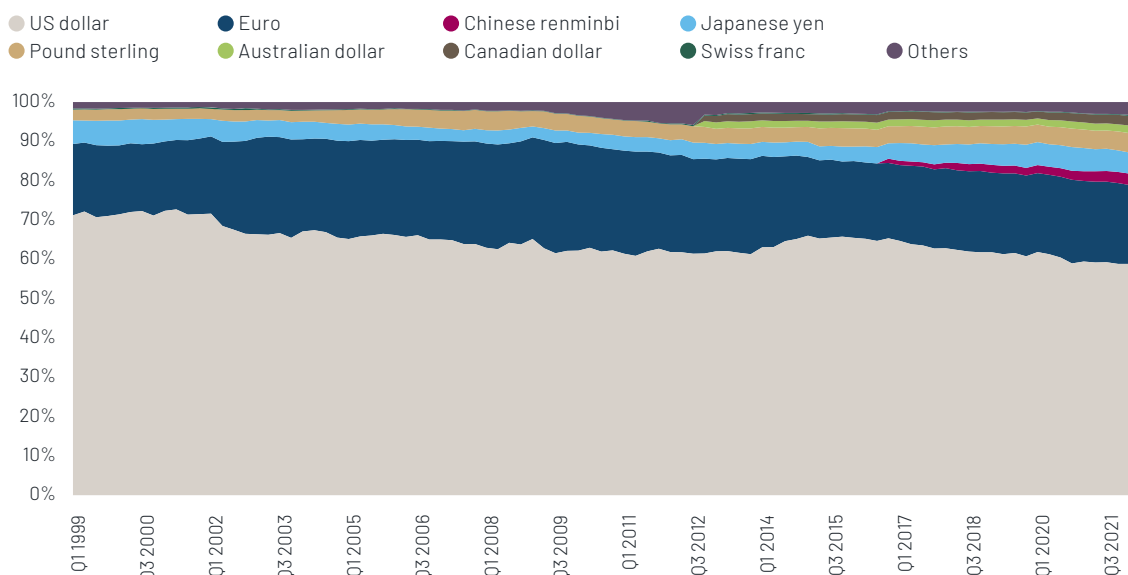
However, we believe that similar coordination is unlikely to happen again in today's world, especially with the tensions between China and the United States. The aim of the Plaza Accord was to weaken the dollar and it took long discussions between the major powers before it was achieved. This agreement was possible because the US economy was in a disinflationary phase and the Fed could afford to lower rates, while Saudi Arabia was starting its oil counter-shock. Conversely, today, a weaker dollar would compromise the Fed's objective of fighting inflation, while OPEC is pursuing a policy of supporting oil prices.

FREEZING RESERVES: A PRECONDITION FOR DE-DOLLARISATION?

Since the Second World War and the Bretton Woods Agreement in 1944, the US dollar has dominated world trade and international trade. While the greenback still dominates, de-dollarisation is not a recent concept. A report published by the IMF in March 2022 shows that even though the US economy has accounted for a declining share of world output for several decades, the dollar still plays an important role in international trade. According to the Bank for International Settlements (BIS), 88% of foreign exchange transactions are in US dollars. On the other hand, the diversification of central banks' foreign exchange reserve allocations started several years ago. Since the launch of the euro in 1999, the dollar's share has fallen from 71% to 59% by mid-2022 in favour of other currencies such as the Australian dollar, the Canadian dollar, the Chinese renminbi or gold (Chart 14).

With about a quarter of the world's population under US sanctions, it is not surprising to see de-dollarisation intensifying around the world. Shortly after the invasion of Ukraine in February, the West froze USD 300 billion in foreign exchange reserves of the Russian central bank. These sanctions made other emerging markets aware of the risk of a heavy dependence on the dollar and triggered doubts about the role of the greenback as a reserve currency.

CHART 14: CURRENT COMPOSITION OF OFFICIAL FOREIGN EXCHANGE RESERVES IN THE WORLD, %



Source: IMF, Indosuez Wealth Management.



Towards a
**NEW
PLAZA
ACCORD?**

For Russia, de-dollarisation had already started in 2014, after the annexation of Crimea. The ensuing sanctions significantly reduced the country's ability to raise capital in financial markets, forcing Russia to reduce its dollar holdings in order to increase its exposure to alternative assets, such as gold.

This has sent shockwaves through international investors who now have to incorporate a much higher country risk filter into their allocation choices, and no longer view a currency or central bank reserves as a liquid, marketable asset. This has accelerated the pre-existing tendency of emerging markets to trade in their currencies without using the dollar, not only to escape extraterritorial sanctions, but also to reduce their dependence on the greenback and the need to build up reserves. This is notably the case of China, which now wishes to buy its oil in renminbi from Saudi Arabia.

ARE WE SEEING THE RETURN OF SOVEREIGN RISK TO EUROPE?

Phases of rising US interest rates are generally associated with capital outflows from emerging markets. This is an opportunity for investors to take stock of the structural fragilities of some emerging markets, which benefit from phases of accelerating global growth, but are the first to suffer from international capital withdrawals. Monetary normalisation generally has the effect of placing certain emerging market central banks in a dilemma between supporting their currency and their domestic economic objectives while maintaining the freedom of capital movements necessary to access financing. This is the famous Mundell-Fleming Trilemma conceptualised in 1963. If we add to this equation the risk of government pressure on the central bank (as is the case in Turkey), the situation becomes unmanageable. The market knows this and sanctions the currency, in the face of the risk of galloping inflation.

2022 seems to mark the sudden return of this type of dilemma in developed countries, bringing us closer to currency crises on several occasions. The pound suffered greatly from the monetary policy dilemma introduced by stagflation, which the unsustainable tax plan of Liz Truss, former UK Prime Minister, amplified; the market sanction was immediate and contributed to the fall of the government in 45 days - 30 years after the speculative attacks on the fragile currencies of the European Monetary System (EMS).

ARE WE MOVING TOWARDS A MULTI-ZONE CURRENCY MODEL?

The strength of the dollar is the ideal culprit for the destabilisation of monetary and exchange rate policies. But if we moved away from a dollar-dominated model to a multipolar world in terms of currencies, clearly supported by the current trend in international trade (but not yet by the current disposition of foreign exchange reserves), would this make the world more stable?

The comparison with the past probably has no predictive power, but it has educational value. The world of the Interwar period was precisely that of a coexistence of currency zones (dollar, Swiss franc and pound sterling zones), halfway between the survival of colonial empires and rise of the dollar, while the loss of gold convertibility created the need for a peg. This was a world of great instability, but it was really the Great Depression and not necessarily linked to a tri-polar monetary model.

Let us return to the present. If we were to enter such a model, we would probably substitute one risk by another. The main risk of the new model would be the lack of coordination of monetary policies, less global and more regional reserve policies. The main negative consequence would probably be the end of the "exorbitant privilege of the dollar" (Barry Eichengreen), which would probably lead to a loss of value of the dollar and an increase in the cost of financing twin deficits.



Muriel ABOUD SCHIRMANN
Head of Capital Markets Advisory

04 | Macro Economics

SLUGGISH GLOBAL GROWTH, INCREASING POLICY DIVERGENCE

This is clearly a difficult macroeconomic context where GDP growth has been reduced in almost all geographical areas for 2023. Despite this cyclical slowdown, inflation persists and remains the top priority for central banks. The role of fiscal policy in this inflationary environment is to help, not hinder, central banks.

Global GDP growth will be below 3% in 2023, cutting short the post-pandemic recovery. Commodity prices are expected to continue to moderate in 2023, while oil prices are expected to remain persistently higher than in the past, with OPEC+ stepping up supply cuts to keep prices above USD 90 per barrel. The deleveraging process in China and the inability of Japanese companies to defer rising prices will make both countries global exporters of deflation in 2023. In the rest of the world, as the 2022 commodity price boom slows in 2023, large base effects and easing supply chain tensions should moderate the acceleration in prices. However, inflation is likely to remain higher for longer, supported by a combination of structural factors, with an inevitable energy transition, higher geopolitical tensions and a restructuring of global supply chains. The transition will be a bumpy ride, where innovation will be essential and defining policy direction, a tightrope walk.

UNITED STATES: SUBPAR GROWTH TO CURB INFLATION

Despite two quarters of negative GDP growth, US growth in 2022 has been helped by still resilient personal consumption spending, encouraged by a favourable jobs market, credit cards and savings. By 2023, these crutches will slowly be removed from US consumers. The housing market, a leading indicator of the US business cycle, is beginning to feel the full effect of the Fed's interest rate hikes, with mortgage rates approaching 7% in October 2022.

As a result, home sales have fallen by 20% year-on-year, which will continue to impact house prices in 2023.

Encouragingly, inflation began to peak in the third quarter of 2022, but some core components (excluding food and energy prices) continue to rise. For example, while house prices started to decelerate in July 2022, their full impact on the house price component of inflation is delayed by more than a year. House rent prices have continued to rise: US households are being pushed out of the house-buying market, resulting in increased demand for rentals. At the same time, signs of weakness in the US labour market indicate that it is likely to be the next domino to fall, with a reversal of the trend in job vacancies leading to an increase in the unemployment rate in the spring of 2023.

The US economy is therefore heading for below-potential growth (below 1% in 2023), with a possible contraction in growth in the second half of 2023. This should help moderate inflation as well as continue to unwind supply bottlenecks. Ultimately, the key factor to watch will be the Fed's ability to control consumer inflation expectations - which tend to be more backward-looking than financial market expectations. Finally, on the fiscal front, while President Biden's Inflation Reduction Act of 2022 is not expected to rein in inflation, rising government debt and the likely split in government next year should lead to a more restrictive fiscal policy in 2023.

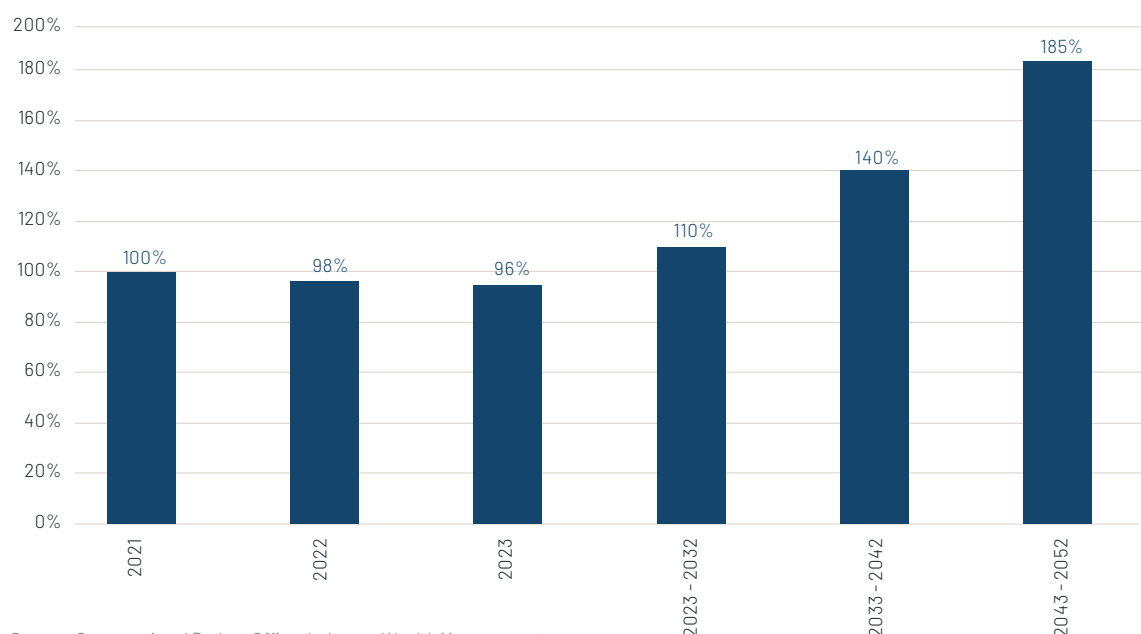
According to a projection by the non-partisan Congressional Budget Office¹⁴ (CBO), if policies remain unchanged, the US debt-to-GDP ratio would reach 175% in 2050 (Chart 15).

EUROPE: CONVERTING INFLATION INTO GOVERNMENT DEBT

Inflation in Europe has surpassed the US, and core inflation (excluding food and energy prices) continues to rise. Soaring producer prices in the Euro Area (four times higher than in the US) are putting companies at a real competitive disadvantage, which is only slightly mitigated by the weakness of the EUR/USD. The impact on industrial production is slow to emerge, due to the post-pandemic recovery and the backlog of orders in the automotive industry. However, the shock is spreading through the economy in the form of falling new orders, a collapse in business and consumer confidence and a decline in retail sales. In the services sector, the impact of high inflation on private consumption will further reduce purchasing power in 2023.

The ECB is now forecasting inflation of 5.5% in 2023, up from 3.5% in its June 2022 projections. The forecasts of the Organisation for Economic Co-operation and Development (OECD) and the IMF in autumn 2022 are even higher, at around 6%. The slight recession expected in 2023 (Table 2, page 37) is accompanied by an unusual degree of uncertainty, as the risks to the inflation/growth scenario are highly dependent on the development of fiscal measures and energy prices. On the one hand, second-round effects on wages could amplify the impact of energy prices and lead to a tightening of financial conditions (monetary conditions remain relatively accommodative), which would further weigh on growth. On the other hand, recent downward trends in commodity prices and the European Commission's move to cap wholesale gas and electricity prices could lead to a faster deceleration in inflation. In addition, private consumption could prove more resilient to rising prices if households make greater use of their current high level of precautionary savings.

CHART 15: US GOVERNMENT DEBT TRAJECTORY, % OF GDP



Source: Congressional Budget Office, Indosuez Wealth Management.

14 - Congressional Budget Office of the United States.



TABLE 2: GROWTH AND INFLATION FORECASTS, %

	Real GDP growth, annual average			Inflation, annual average		
	2022	2023	2024	2022	2023	2024
DEVELOPED COUNTRIES	2.6%	0.3%	1.0%	7.6%	5.1%	2.5%
United States	1.9%	0.8%	0.6%	8.1%	4.1%	2.3%
Japan	1.6%	0.5%	1.2%	2.3%	1.3%	0.4%
United Kingdom	4.4%	-0.6%	1.1%	9.1%	7.7%	3.8%
Euro Area	3.2%	-0.7%	1.1%	8.7%	7.5%	3.2%
Germany	1.7%	-0.7%	1.0%	9.0%	7.6%	3.1%
France	2.5%	0.0%	1.0%	6.1%	5.3%	3.0%
Italy	3.7%	-0.4%	0.8%	8.9%	8.1%	3.2%
Spain	4.5%	0.3%	1.3%	8.6%	4.3%	3.4%
EMERGING MARKETS	4.0%	3.5%	3.9%	8.8%	6.9%	4.8%
China	3.2%	4.5%	4.3%	2.1%	2.2%	2.1%
Brazil	3.1%	0.9%	1.6%	9.3%	4.3%	4.1%
Mexico	2.6%	0.7%	0.6%	8.0%	5.8%	4.2%
Russia	-3.3%	-1.5%	2.0%	13.9%	7.5%	4.5%
India	7.3%	5.6%	6.0%	6.9%	6.3%	6.0%
Indonesia	5.3%	4.8%	4.7%	4.3%	5.0%	4.1%
South Africa	1.7%	1.2%	1.5%	6.8%	5.6%	4.8%
Turkey	5.3%	3.1%	4.4%	73.1%	53.7%	24.1%
WORLD	3.4%	2.2%	2.7%	8.3%	6.2%	3.9%

Source: Amundi forecasts, November 2022, Indosuez Wealth Management.

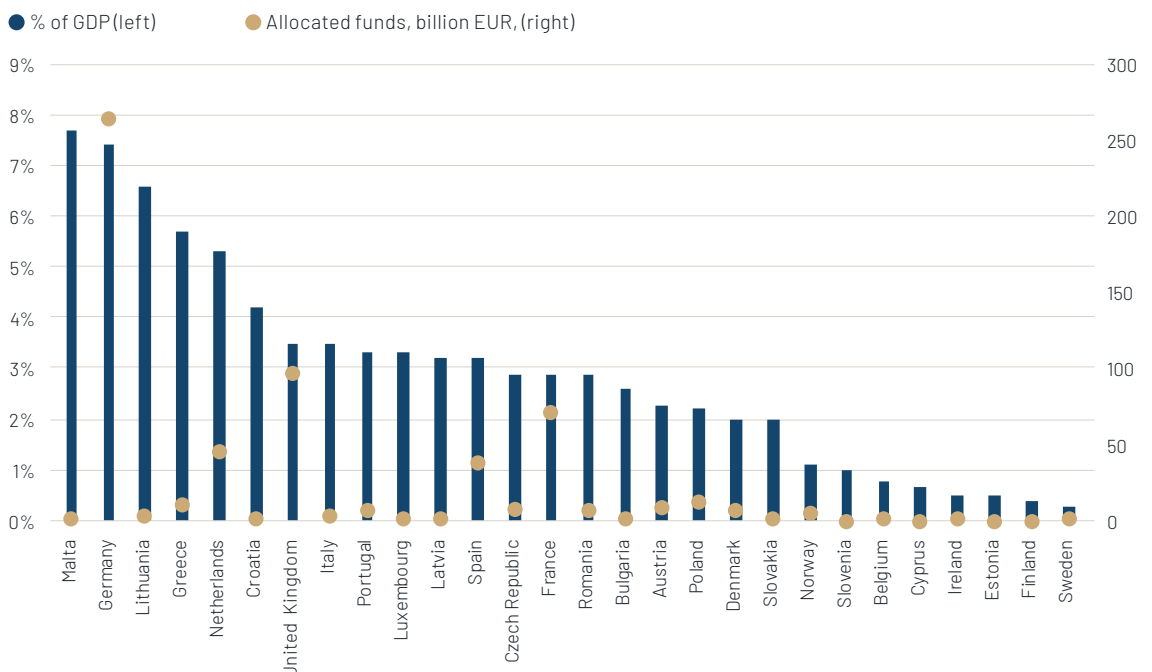
UNEVEN POLICY RESPONSES
across Europe

Policy coordination is also an important risk factor for the area in 2023. As the UK fiscal experiment in autumn 2022 highlighted, government shields can undermine central bank actions to tackle inflation and the sustainability of government debt ratios - a possible key theme for 2023. In this light, the new German tax shield was a bold move: a EUR 200 billion package (5% of GDP). The size of the German package highlights the unevenness of the policy responses we can expect between the richest and most indebted Member States (Chart 16), even though Germany will be among the hardest hit Member States this winter. The Euro Area is in for a long battle, with the risks to energy supply security now higher for the winter of 2023/2024 than for 2022/2023. Finally, dependence on US liquefied natural gas (LNG) supply (50% of total LNG imports in the first quarter) will be a major political issue for the EU in the run-up to the US presidential elections in 2024.

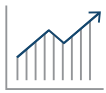
**EMERGING MARKETS:
ASIAN HEADWINDS VS. LATAM EFFORTS**

In China, deflationary forces are at work. The deleveraging process - driven by high corporate debt and a slowing property market - is underway and further complicates the ability of accommodative fiscal and monetary policies to increase private consumption. Chinese consumers are focusing on deleveraging and increasing precautionary savings, while wage growth and demand are compressed. Targeted measures to reassure households on the property market have not yet borne fruit. Risks are tilted to the downside in the medium-term, although some release of pent-up demand is expected if the reopening policy is accelerated.

CHART 16: ENERGY SHIELDS FOR HOUSEHOLDS AND BUSINESSES IN EUROPE



Source: Bruegel, Commission européenne, Indosuez Wealth Management.



**CHINA'S
CREDIT-DRIVEN
GROWTH**
is a thing of
THE PAST

With the government seeking to avoid corporate re-leveraging and reduce the share of real estate in the economy (now estimated at 25% of Chinese GDP), government measures to stimulate growth through credit are largely a thing of the past. This is unfortunate timing as the export-led recovery will also be moderate, given the expected slowdown in the US and Europe. The slowdown in China is not good news for the region. This is the case in Japan, where Chinese exports account for more than 20% of total goods trade and where the domestic demand engine is being slowed by high imported inflation.

The current period is indeed more secure for the more self-sufficient, domestic-demand oriented emerging economies. This is the case for India, but also for Brazil. Latin American countries will also benefit from better monetary policy management in 2022 (Brazil's central bank was one of the first to raise rates in response to inflation), which could allow them to ease interest rate pressure in 2023, when activity slows down after an influx of growth due to higher commodity prices in 2022.



Bénédicte KUKLA
Senior Investment Officer

05 |

Allocation:
2023 Scenario

05 • Allocation: 2023 Scenario

IMPACT ON KEY ASSET CLASSES

Several of the trends described above are likely to impact the investment framework for 2023 and beyond:

- A geopolitical framework durably transformed by the conflict in Ukraine which tends to accelerate the reconfiguration of the world's fault lines.
- Trade growth expected to remain lower than in previous decades.
- Continued increase in production and transport/logistical costs.
- A trend towards the regionalisation of supply chains.
- Still strong international technological and energy interdependencies.
- A search for strategic autonomy and transition of Europe's energy mix, which does not erase the transition from one dependency to another in the short-term, and the long-term need to resort to a set of imported raw materials necessary for electric vehicles.
- A shift from a global growth theme based on a model driven by the consumption of low-cost goods produced in emerging markets to an economic model based on significant investments in infrastructure and strategic resources.

Beyond the subject of de-globalisation, it is also important to recall key elements of the economic and financial outlook for the coming year:

- Very weak global growth, and a likely recession in the Euro Area and the UK.
- Inflation down compared to 2022, but persistent and still above central bank targets.
- Largely unsynchronised economic policies reflecting divergences between countries.
- Higher nominal and real interest rates than in 2022, thus less favourable to markets.
- Growing tension over the sustainability of government fiscal policies in a context of reduced central bank support for the government bond market.

- Corporate margins will logically decline in this context, with a possible contraction in profits of 5% to 10% in Europe.
- Default rates on high yield bonds to rise, but not to the levels of the 2008/2009 recession.

IMPLICATIONS FOR ASSET CLASS ALLOCATION

Such an investment framework would seem at first sight to lead to a cautious view on equities. However, after the significant correction experienced in 2022, largely reflecting the rise in interest rates, but also weaker earnings prospects, we believe that investors should rediscover in the coming years the fundamental attractiveness of equities in the long run: value creation and shareholder returns. The correction in valuation multiples has already been severe in Europe and China, and more moderate in the United States, which is admittedly more resilient economically. This correction has probably not reached its end point at the time of writing this *Global Outlook*, but the low point should be attained during 2023. Furthermore, the timing of the central banks' upcoming monetary policy pivot is likely to signal a recovery in growth stocks. Until then, the yield/quality style should be favoured.

The year 2023 should also mark the comeback of corporate bond attractiveness. Paradoxically, the landscape remains extraordinarily complex for investors in the bond world: with central banks continuing to raise rates (the end point remains highly uncertain) and extreme volatility in government bonds which could remain at high levels in 2023 if investors start to worry about the sustainability of government debt ratios. On the corporate side, the strong slowdown (and recession in some areas) is likely to lead to an increase in defaults, while higher interest rates and the reduction in some central bank balance sheets are drying up market liquidity.

This equation has led to a sharp spread in corporate bond risk *premia*, including investment grade bonds. The environment is therefore very conducive to the reconstitution of 3–5-year investment grade bond portfolios brought to maturity with yields well in excess of expected inflation over the next five years. This is simply the best entry point seen in 10 years.

The end of negative interest rates makes money markets and very short-term bond investments more attractive. Conversely, all investments that had been an alternative to zero or negative interest rates (in particular liquid hedge funds with moderate risk and high leverage in their arbitrage positions) could see a decline in investor interest.

Finally, the overall high volatility of assets offers interesting opportunities in option strategies and structured products.

IMPLICATIONS FOR GEOGRAPHICAL ALLOCATIONS

These trends lead to several inflection points in the investment scenario in geographical terms:

- A weakening of the industrial model of countries and companies relying too heavily on imports/re-exports and on an energy model weakened by this new geopolitical framework, such as for Germany.
- An economic and geopolitical risk premium that is likely to remain high in China, where valuations are very attractive, but which may no longer be investable for some institutional investors in the United States.
- A greater fragility of countries, sectors and economic models supported by the previous low interest rate policy of the last ten years and now more vulnerable, and of the real estate sector.
- Country risk is expected to remain high while investors should integrate a risk premium on new conflict risks.
- A strong dollar could i) penalise certain emerging markets (between imported inflation for some and forced tightening of monetary policy for countries with USD currency pegs), ii) affect American exporters and iii) support the results of multinationals in Europe or within emerging markets whose revenues are in dollars.

IMPLICATIONS FOR SECTOR EQUITY ALLOCATION

In sectoral and thematic terms, this framework may also lead to a reassessment of our preferences:

- While confirming our focus on quality and yield stocks, and increasing our short-term interest in European exporters, this structural context should eventually lead to a greater preference for domestic stocks, particularly those exposed to the investment issues mentioned above (strategic autonomy, renewable energies, infrastructure).
- While re-internalisation/re-industrialisation risks have raised many false hopes, conversely, the theme of robotisation remains a good investment theme, a necessity for industrial companies to both generate productivity gains (in the face of inflation cost) and relocate part of their production.
- The uncertain geopolitical framework should remain a factor supporting the security and defence investment theme.
- These themes may be of more interest than the global consumption investment theme.

REAL ESTATE: A SAFE HAVEN AGAINST INFLATION AND GEOPOLITICS, OR THE END OF A CYCLE?

Real estate is a good long-term protection against inflation because of the indexation capacity of rents. However, this is less true in a phase of rising interest rates, and in a phase of strong economic slowdown, which results in less solvent demand for residential property and a polarisation of rental demand towards the best assets in commercial or office property.

On the investor side, institutional investors such as insurers who had shifted from government debt to real estate (and corporate debt) may now be more cautious. The very strong rise in prices over the last two years (with a combination of positive factors between the shortage of supply, economic recovery and low interest rates) has started to reverse since the summer of 2022. The extent of the rise in borrowing rates (30-year mortgage rates at 7% in the United States) is mechanically deteriorating the solvency of buyers and is worrying economists in the sector who fear a correction.

This less favourable framework can be nuanced in market segments that show a shortage of supply and remain highly sought after (residential property, especially premium/luxury, city centre offices with environmental features in capital cities) and which usually escape the negative effects on demand. Furthermore, despite the debates on de-globalisation and the ecological impact of e-commerce, interest in logistics should remain high, supporting the increase in rents. Finally, and paradoxically, a slowdown phase translates into a slowdown in housing and office production, leading to periods of tension as the crisis comes to an end, with the exception of markets such as China where there is still an oversupply and the sector is restructuring.

Once the rate and slowdown phase has been digested and price adjustments have been made, the property market should return to a more favourable trend for investors, particularly those who are not constrained by the increase in financing conditions.

PRIVATE EQUITY: A REFLECTION OF GLOBAL TRENDS

Private equity has been exceptionally popular in recent years, reflecting a combination of very favourable factors, mainly: the democratisation/mainstreaming of the asset class and access to financing (which has led to very strong growth in the size of funds) and very strong performance in recent years, which gave investors the feeling that they could escape the difficulties encountered on the equity markets. However, in the medium-term, for comparable sectors, the valuations of unlisted transactions always end up adjusting, with the exception of the control premium that raises valuation multiples of merger and acquisition transactions.

It is therefore the exit multiples for companies bought in recent years that could reduce the return on investment from the record levels of recent years, while remaining above the medium-term returns in the world of listed equities.

Ultimately, private assets will continue to reflect trends observed elsewhere:

- A possible future volatility in Private Market valuations, beyond those already factoring in LBO¹⁵ large caps and venture capital, even though operational indicators remain solid in 2022, but a rather visible operational deterioration in margins in 2023.
- The return of yield increases the returns on private debt or infrastructure, for example.
- A drop in the equity valuations of current and future transactions, which bodes very well for the return on equity of funds currently raising or investing: the market is becoming investor-friendly again.
- This *momentum* should remain very strong in the secondary market. This should be driven by several factors, between a possible over-allocation of institutional investors in recent years, whose allocation is affected by the decline in the listed part of the portfolio, and a need for market liquidity in the face of outflows that could be slowed.
- A probably greater weighting of investments in strategic sectors and energy transition sectors (from infrastructures to innovative technologies via industrial recycling sectors), after years during which funds focused on technology, health-care and consumption. With a major advantage over the listed market: access to more niche players and domestic players than multinationals.



Vincent MANUEL
Chief Investment Officer

06



Global presence



OUR STORY

For more than 145 years we have advised entrepreneurs and families around the globe, supporting them with expert financial advice and exceptional personal service.

To this day we serve each and every client as an individual, helping them build, protect and pass on their wealth.

Truly personal service resonates with our clients and, when combined with the financial strength and complimentary expertise of Crédit Agricole Group, one of World's top 10 banks, it results in a unique approach to building value for entrepreneurs and families around the world.

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07 |

Glossary



Basis point (bp): 1 basis point = 0.01%.

Blockchain: A technology for storing and transmitting information. It takes the form of a database which has the particularity of being shared simultaneously with all its users and generally does not depend on any central body.

BLS: Bureau of Labor Statistics.

BNEF: Bloomberg New Energy Finance.

Brent: A type of sweet crude oil, often used as a benchmark for the price of crude oil in Europe.

CBO (Congressional Budget Office): Congressional Budget Office of the United States.

CPI (Consumer Price Index): The CPI estimates the general price level faced by a typical household based on an average consumption basket of goods and services. The CPI tends to be the most commonly used measure of price inflation.

Deflation: Deflation is the opposite of inflation. Contrary to inflation, it is characterised by a sustained decrease in general price levels over an extended period.

Duration: Reflects the sensitivity of a bond or bond fund to changes in interest rates. This value is expressed in years. The longer the duration of a bond, the more sensitive its price is to interest rate changes.

EBIT (Earnings Before Interest and Taxes): Refers to earnings generated before any financial interest and taxes are taken into account. It takes earnings and subtracts operating expenses and thus also corresponds to non-operating expenses.

EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortisation): EBITDA takes net income and adds interest, taxes, depreciation and amortisation expenses back to it. It is used to measure a company's operating profitability before non-operating expenses and non-cash charges.

ECB: The European Central Bank, which governs the euro and Euro Area member countries' monetary policy.

Economic Surprises Index: Measures the degree of variation in macro-economic data published versus forecasters' expectations.

Economies of scale: Decrease in a product's unit cost that a company obtains by increasing the quantity of its production.

EPS: Earnings per share.

ESG: Non-financial corporate rating system based on environmental, social and governance criteria. It is used to evaluate the sustainability and ethical impact of an investment in a company.

Fed: The US Federal Reserve, i.e. the central bank of the United States.

FOMC (Federal Open Market Committee): The US Federal Reserve's monetary policy body.

Friendshoring: A term used by US Treasury Secretary Janet Yellen, signifying a commitment to work with (or move to) countries that «have strong adherence to a set of norms and values about how to operate in the global economy and about how to run the global economic system».

GDP (Gross Domestic Product): GDP measures a country's yearly production of goods and services by operators residing within the national territory.

IMF: The International Monetary Fund.

Inflation breakeven: Level of inflation where nominal bonds have the same return as inflation-linked bonds (of the same maturity and grade). In other words, it is the level of inflation at which it makes no difference if an investor owns a nominal bond or an inflation-linked bond. It therefore represents inflation expectations in a geographic region for a specific maturity.

Mercosur: Strategic trade alliance between various South American countries: Argentina, Brazil, Paraguay, Uruguay.

Metaverse: A metaverse (portmanteau of meta and universe) is a fictional virtual world. The term is regularly used to describe a future version of the internet where virtual, persistent and shared spaces are accessible via 3D interaction.

NAFTA: North American Free Trade Agreement later replaced by USMCA.

Nearshoring (regionalisation): Described by the OECD as the decision to relocate previously offshored activities, not necessarily back to the company's home country, but rather to a neighbouring country.

OECD: Organisation for Economic Co-operation and Development.

OPEC: Organization of the Petroleum Exporting Countries; 14 members.

OPEC+: OPEC plus 10 additional countries, notably Russia, Mexico, and Kazakhstan.

PMI: Purchasing Managers' Index.

Policy mix: The economic strategy adopted by a state depending on the economic environment and its objectives, mainly consisting of a combination of monetary and fiscal policy.

Pricing power: Refers to the ability of a company or brand to increase its prices without affecting demand for its products.

Quantitative easing (QE): A monetary policy tool by which the central bank acquires assets such as bonds, in order to inject liquidity into the economy.

RCEP, Regional Comprehensive Economic Partnership: A free trade agreement between fifteen countries around the Pacific Ocean: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam, Australia, China, Japan, Korea, New Zealand.

SEC (Securities and Exchange Commission): The SEC is an independent federal agency with responsibility for the orderly functioning of US securities markets.

Soft power: A concept used in international relations.

Spread (or credit spread): A spread is the difference between two assets, typically between interest rates, such as those of corporate bonds over a government bond.

Secular stagnation: Refers to an extended period of little or no economic growth.

SRI: Sustainable and Responsible Investments.

USMCA: United States-Mexico-Canada Agreement.

VIX: The index of implied volatility in the S&P 500 Index. It measures market operators' expectations of 30-day volatility, based on index options.

WTI (West Texas Intermediate): Along with Brent crude, the WTI is a benchmark for crude oil prices. WTI crude is produced in America and is a blend of several sweet crude oils.

WTO: World Trade Organization.

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