MAY 2024

Investment Strategy Focus

No Transition without Transmission

Summary

1. **Stock, bond markets correct as US inflation remains sticky.** The US 10-year Treasury bond yield has increased 0.7% to 4.6% since start-2024 on the back of stubborn core inflation. European and US stock markets have eased 2%-4% from end-March peak so far but are still up year-to-date.
2. **Adjusting our US interest rate cut outlook**: rate cuts are pushed out including into 2026 given more stubborn inflation. We expect only one 25bps cut in 2024, four more cuts in 2025 and two in 2026. On a 12-month horizon, we forecast lower US Treasury bond yields with a new target of 4.25%, and a new EUR/USD target of USD1.12.
3. **Middle East tensions drive up market risk:** the escalation of military actions between Israel and Iran has triggered higher stock market volatility and wider credit spreads. But the oil price reaction remains muted, thus a limited spillover effect to the world economy for now.
4. **Breakout in key industrial metals:** copper, aluminium and tin all surge to their highest levels since January 2023 as the London Metals Exchange bans Russian-origin metals from its system, adding to an already tight demand-supply balance in these metals. Medium-term positive on key energy-related industrial metals.
5. **Invest in electricity transmission networks:** renewable energy, battery electric/hybrid vehicles and Artificial Intelligence datacentres drive electricity demand growth and the need to upgrade electricity transmission networks. Invest in the smart grid, circular economy and energy efficiency investment themes.

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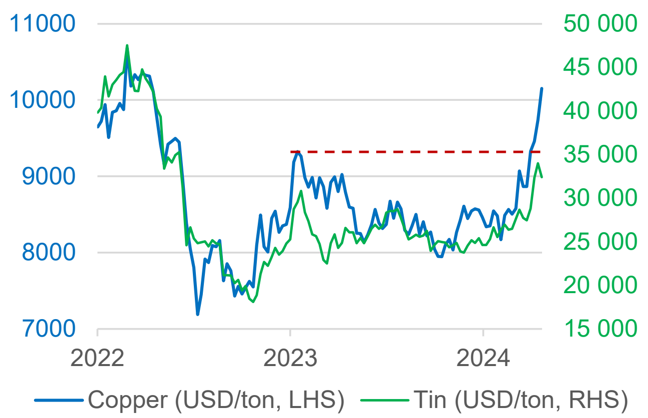
COPPER, TIN PRICES HIT NEW 2-YEAR HIGHS



Source: BNP Paribas, Bloomberg

Edmund Shing, PhD

Global CIO
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Macro, Market Views

Macro		– Monthly inflation prints have diverged, US inflation stubborn while Euro inflation declines towards target. – ECB should cut interest rates starting in June, Federal Reserve in September. US Fed Funds rate to end-2024 expected at 5.25% (1 cut), ECB deposit rate expected at 3.25% (3 cuts). – GDP growth is running at an annualised 2.7% in the US for Q2 2024 and is improving from zero in the eurozone, led by a manufacturing rebound.
Rates	=	– Following the recent rise in 10Y bond yields, there is now significant price upside to our 12-month US Treasury 4.25% yield target. – Favour intermediate maturities in both EUR and USD government (5-10 years) – EM sovereign bonds (local currency and USD) still offer attractive 6%+ yields.
Credit	+	– EUR spreads offer more potential to tighten more than US spreads in our view. – Prefer maturities up to 7 years in the eurozone and in the US. – For higher yield (at higher risk), consider the US *fallen angels* strategy, asset-backed securities funds. – We favour Euro financial sector corporate bond exposure.
Equities	+	– Key drivers include easing long-term interest rates, buoyant macro liquidity, and easing energy prices. – Favour eurozone, UK, Japan, Latin American markets post multi-year highs. – Key pick: eurozone cyclicals (Industrials, Banks, Insurance).
Real Estate	=	– Latest INREV quarterly survey suggests better European real estate sentiment – Lagged impact from higher interest rates to fade, which should allow real estate prices to slowly stabilise. – Industrial/logistics exposure preferred for healthy yields, higher expected rental growth on robust underlying demand growth.
Commod-ities	+	– Oil (+) Brent should remain in the USD 85-95 range due to gas/oil substitution, substantial OPEC+ spare capacity & the progressive ban on Russian oil. – Gold (+) is our preferred safe-haven – a lower Fed Funds rate, weaker USD and stable long-term rates should help. – Copper (+) is breaking out on the back of robust end-demand and constrained global supply. A global supply-demand deficit forecast for this year and next.
Alternative UCITS/ Private Assets	=	– We favour relative value equity, credit and event-driven funds for their robust risk-adjusted returns at low volatility. – Private equity buyout funds are a preferred private asset subclass, given robust long-term returns and an abundance of public market opportunities
FX		– EUR/USD target is USD 1.12 (value of 1 euro) in 12 months, on narrowing US vs. EU interest rate gap in 2025.

Pushing out US Fed Rate Cuts

Edouard Desbonnets, Guy Ertz, PhD

US inflation on a bumpy road lower

There has been a notable shift in Federal Reserve Chair Jerome Powell's communication style. Following the March inflation report, he indicated that persistently elevated inflation would likely delay any Fed interest rate cuts until later in the year. Consequently, we believe that a June rate cut is no longer likely. We believe that the Federal Reserve still intends to implement rate cuts this year. Such a move would be an "insurance cut" for risk management purposes, as there are risks to cutting rates too early, but also risks to cutting rates too late since the Fed aims to engineer a soft landing of the economy.

Inflation remains hot and tricky to assess. Some element have accelerated (Core Services ex Shelter, accelerating for the third month in a row), others have slowed (wage growth). We still expect inflation to moderate this year, but more resilient non-shelter services should make this moderation more gradual. We see inflation at 3.05% in 12 months' time, which is higher than the market pricing of 2.8%.

Meanwhile, economic growth continues to expand, despite a slight deceleration evidenced by the March Purchasing Managers' Index (PMI) readings. Nevertheless, robust March retail sales underscore the resilience of consumer spending.

Overall, we believe that the Fed will be more cautious this year than the market is pricing in (1.7 rate cuts). We expect only one 25bps cut this year, at the FOMC meeting on 18 September. It is very unusual for the Fed to initiate a rate cut cycle so close to an election (5 November), occurring only once since the 70s, in 1984. However, rate cuts have been expected for so many months that it is unfair to say that they will interfere with the election. Looking ahead, we anticipate more rate cuts than what's priced in, with a total of four cuts in 2025 and two in 2026. This would result in an end-of-cycle rate of 3.75%.

Adjusting our US bond yield projections

Bond yields could rise modestly over the next few months owing to several factors. First, the appetite for government bonds has diminished, as evidenced by the recent weak Treasury auctions across all maturities. Second, we believe that the market will continue to scale back its expectations for policy rate cuts. Third, given the increased volatility in expected inflation and concerns about the US deficit, the term premium should rise. Note that the term premium has moved back to zero, and it was close to 50 bps in October 2023 when there were concerns about the fiscal deficit. Conversely, we expect bond yields to decline on a 12-month horizon. We forecast lower bond yields with a new target of 4.25% for US government bonds. This projection is in line with historical patterns, where bond yields fall when the Fed actually cuts rates.

Lower depreciation expected for US dollar

The outlook for EUR/USD is highly sensitive to the interest rate differential and the outlook for future monetary policy changes. As mentioned, we now see the Fed cutting only once this year and only in September, while the ECB should start cutting rates in June, with 75bp of cuts this year. Thus, the new expected policy rate differential justifies a lower depreciation potential for the USD over the next 12 months. We revise our EUR/USD target from 1.15 to 1.12 (value of one euro).

We also revise our targets for the Yen. We keep the view that the end of Japan's negative interest rate policy in March should gradually increase the attractiveness of the Yen but the fact that the US Fed will cut less over the coming year reduces the potential for Yen strengthening. We adjust our USD/JPY 3-month target from 145 to 150 and our 12-month target from 134 to 140 (value of one US dollar).

	Spot	Forwards		New forecasts		Previous forecasts	
	18/04 2024	In 3 months	In 12 months	In 3 months	In 12 months	In 3 months	In 12 months
Fed	5.50%			5.50%	5.00%	5.25%	4.50%
US 2-year yield	4.99%	4.80%	4.60%	5.00%	4.25%	4.50%	4.00%
US 10-year yield	4.63%	4.65%	4.65%	4.75%	4.25%	4.00%	4.00%

Source: LSEG Datastream, BNP Paribas WM

Limited Middle East tensions effect to date on market volatility and oil

Monitoring Middle Eastern news for increasing risks

The current escalation of the 6 month-long Israel-Gaza conflict to encompass Iran evidently raises the risk both to the global economy and to financial markets.

The 14 April Iranian missile and drone response to the alleged Israeli attack on the Iranian consulate in Damascus, Syria was well telegraphed to Israel and the US before the event. This suggests a will on the Iranian side to avoid further escalation. Time will tell whether diplomatic efforts by the US, Europe and Saudi Arabia will succeed in convincing Israel to do likewise and limit further escalation of military action.

To date, a limited rise in financial market volatility

Several financial market measures of risk have increased since the end of March – the VIX volatility index for the US stock market, the MOVE index of US bond volatility and the CDX US High Yield CDS index. But in each case, these increases have been modest, with current levels on these three indices far from the highs visited in 2023.

Moreover, these rises in financial market risk have coincided with a series of stubbornly high monthly US inflation prints, in turn triggering a repricing of expected US Federal Reserve interest rate cuts for this year. This has impacted short- and long-term interest rates, lifting US 2-year Treasury bond yields back to 5% and 10-year US yields back to 4.6%.

Long-term US bond yields above 4.5% pressure stock market valuations, particularly after a strong run-up in stocks since November last year. European, US stock markets have eased 2%-3% from end-March peak (as of 29 April) but are still up year-to-date by 10% and 7% respectively.

Main geopolitical risk impact comes from oil prices

Brent crude oil has reacted surprisingly little to the latest escalation in Middle East tensions, surprisingly easing to USD88/barrel. In our view, at this level there is a substantial geopolitical risk premium already built into the oil price, but this premium has not increased in recent days.

One reason for this lack of oil price volatility is the substantial spare capacity in OPEC+ oil-producing countries. If there is some unexpected disruption to the flow of oil globally, we could see some of this spare capacity added back into the oil market. OPEC+ nations led by Saudi Arabia and the United Arab Emirates have 5%-6% of spare capacity at present, following quota production cuts. So circa 6 million barrels per day could be added to current production, if necessary, to deal with any interruption of global oil supply.

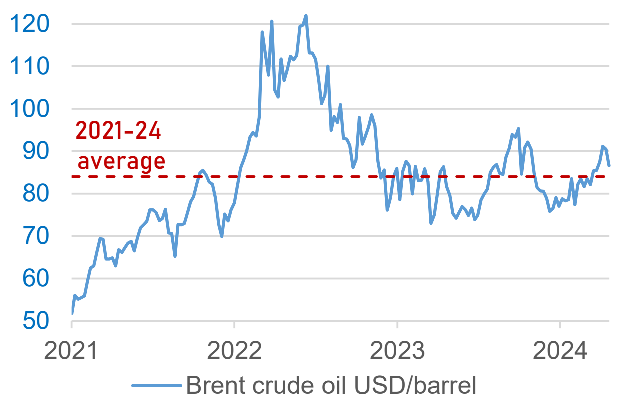
Secondly, while the US Strategic Petroleum Reserve (SPR) has already been heavily utilised by the Biden administration to manage their domestic oil price, they could still release further oil in the short term from the SPR to offset the impact of crude oil price spikes.

Middle East tensions drive up market risk

The escalation of military actions between Israel and Iran have triggered higher stock market volatility and wider credit spreads in April.

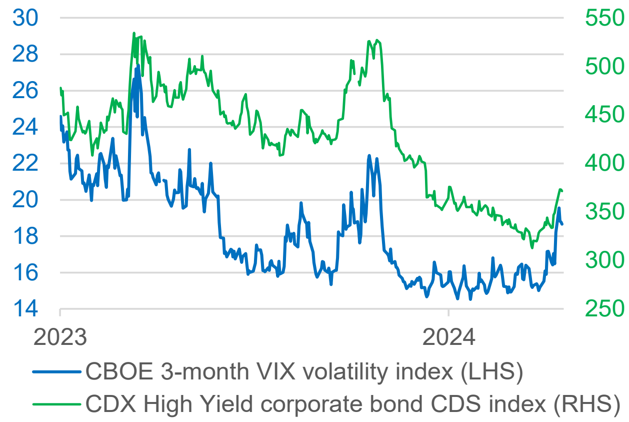
But the oil price reaction remains muted and there is little evidence of flight to "safe haven" assets, thus there is a limited spillover effect to the world economy and markets for now.

OIL PRICE RISK PREMIUM HAS NOT INCREASED OF LATE



Source: BNP Paribas, Bloomberg.

STOCK MARKET VOLATILITY RISE HAS BEEN LIMITED (SO FAR)



Source: BNP Paribas, Bloomberg.

Industrial metals in focus

Xavier Timmermans

Industrial metals rose sharply in April

We identify three key reasons for the double-digit gains for the copper (+15%), nickel (+16%), aluminium (+12%) and tin (+40%) prices since start-2024:

1. signs of demand recovery (first signs of returning Chinese demand, US & China Manufacturing PMIs returning to expansion territory),
2. demand growth driven by energy transition-related and Artificial Intelligence datacentre investment, and
3. concerns over tighter global supply given production shortfalls in Latin American producers and given the recent London Metal Exchange sanctions-related ban on Russian-sourced metals.

Short-term, supply shortages have intensified

The one part of the market where no one disagrees there is a shortage right now is semi-processed copper ore, known as concentrate. That is a function of: a) supply disappointments (closure of Panama Cobre mine for ecological reasons, drought in Zambia, disruptions in Chilean copper mines such as Los Bronces) which is curtailing output to reduce costs, as well as b) a breakneck expansion in global smelter capacity.

The result is deals in which smelters and traders are paying roughly the same price for cargoes of copper ore as the copper contained in it will fetch when processed. There are talks that Chinese copper smelters are nearing regulatory approval to cut output to avoid heavy losses.

Some questions over Chinese demand

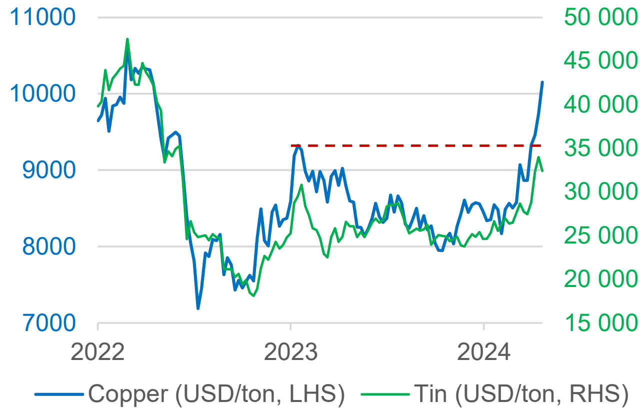
There are, however, disagreements on the imminent revival of final Chinese demand. Despite a floundering housing market, green energy investments have lifted Chinese copper consumption (+13% in 2023). Unlike steel, copper is typically used towards the end of construction projects. A further decline in completions will erode demand for copper wiring as well as copper-intensive household appliances such as refrigerators and air-conditioning units. The biggest deceleration in copper demand will occur in the green energy sector, where copper consumption growth is set to fall. Last year, copper usage in solar and wind projects increased by 146% and 96%, respectively, but has slowed recently. The Chinese power grid has struggled to keep up with the large surge in energy produced by many of these green projects. This has forced a number of provinces and regions to limit new projects.

There is a consensus that the new secular bull market will be (or is being) driven by booming decarbonisation-related demand growth from renewables, grid infrastructure, electric vehicles, and (notably US-centric) AI-focused datacentres.

Breakout in key industrial metals

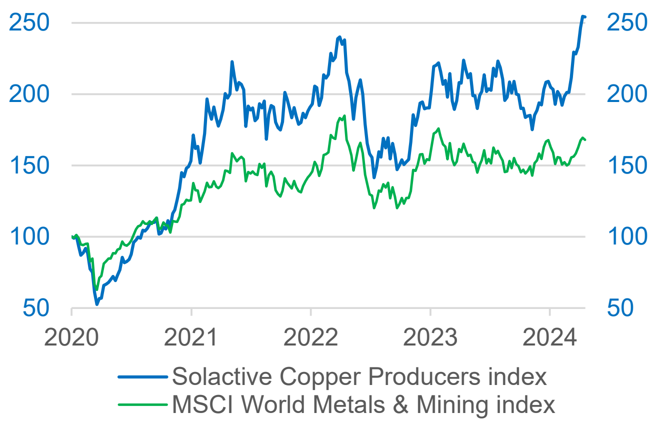
Copper, aluminium and tin have surged to their highest levels since January 2023, driven more by supply issues than by a strong demand revival. Short-term disruptions may ease, but the long-term under-investment in new mining capacity supports **a bullish medium-term outlook on key energy-related industrial metals such as copper.**

COPPER, TIN PRICES RALLY TO HIT NEW 2-YEAR HIGHS



Source: BNP Paribas, Bloomberg.

COPPER-PRODUCING COMPANIES LEAD COMMODITY SECTORS



Source: BNP Paribas, Bloomberg.

Renewable Energy and AI datacentres drive Electricity Grid investment

Surprisingly strong electricity demand growth

The US, Europe and China all continue to invest heavily in 2 long-term mega-themes:

1. Investment in net zero via renewable energy power generation (principally solar and wind energy), as well as battery electric and plug-in hybrid vehicles; and
2. The Artificial Intelligence investment boom, driving demand for power-hungry AI datacentres (processing power + cooling).

These two mega-themes imply the urgent need to upgrade the capacity of electricity transmission grid networks in these regions, given the continued growth in electricity demand that results.

Existing electrical grids were built in decades past when electricity demand was much lower. Rising domestic electricity consumption combined with aging infrastructure has begun to expose the limitations of the current grid. This increases the risk of localised electricity blackouts at periods of peak demand.

As homes and businesses incorporate ever-increasing numbers of electronic devices with expanded technological capabilities, utility companies need to respond to changing electrical demand in real time. A shift is underway toward a new and improved electric power grid that makes this real-time adaptation possible – a system that is designed to provide energy efficiency, reduced environmental impact and improved consumer choice: i.e., the smart grid.

The smart grid is thus a renovation of the electricity supply chain, which is designed to modernise how we produce, transport, use and store energy.

Transmission infrastructure investment has lagged

According to Jefferies, an American investment bank, the amount of investment in electricity grids in the US has heavily lagged investment in renewable energy power generation for the past 5-10 years.

Given the expected boom in investment in renewable energy to 2030, planned investment in electricity transmission networks needs to catch up. As Jefferies puts it: "*No transition without transmission*".

This investment theme is an obvious beneficiary of the huge US programmes of investment-related tax credits offered by the US government as a result of the Inflation Reduction Act (IRA) and the Infrastructure and Investment for Jobs Act (IIJA).

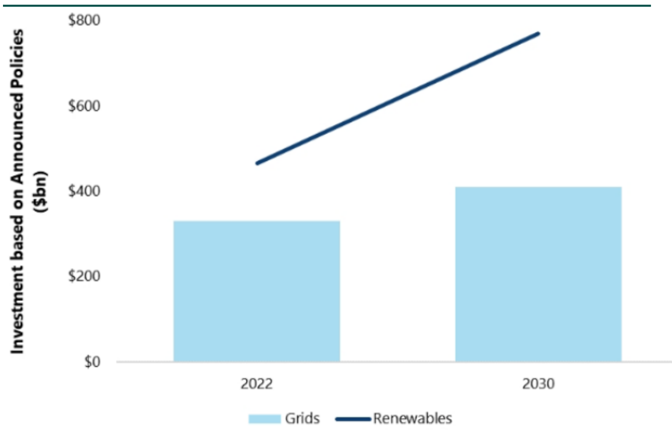
To invest in this theme, we prefer to focus on companies listed on the main North American, European and Asian stock markets which are classified as businesses involved in smart grid, electric infrastructure and/or other grid-related activities.

Two ways to invest easily in this expected boom in electricity transmission network investment is via ETFs based on two relevant thematic indices:

- **The Nasdaq OMX Clean Edge Smart Grid Infrastructure index**; and
- **The ECPI Circular Economy Leaders index.**

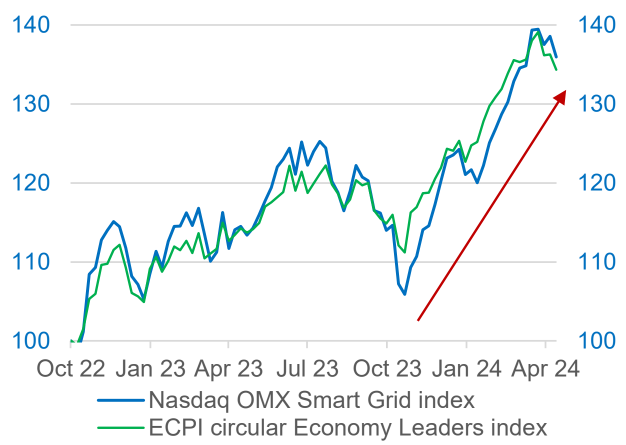
Both smart grid-related indices have performed strongly since 2020, outperforming the MSCI World index by a wide margin in each case.

INVESTMENT IN ELECTRICITY GRIDS LAGS RENEWABLE ENERGY GENERATION



Source: Jefferies.

SMART GRID INFRASTRUCTURE REMAINS A STRONG INVESTMENT THEME



Source: Bloomberg, BNP Paribas

Summary of our main recommendations, by asset class

	Current Recom	Prior Recom	Constituents	We like	We avoid	Comments
EQUITIES	+	+	Markets	UK, Japan, eurozone, Latin America, China, S. Korea Singapore and Indonesia		Buoyant global liquidity continues to support stock markets. Key drivers include falling US inflation, lower long-term interest rates, improving macro liquidity, and easing energy prices. Build stock exposure gradually on market consolidations.
			Sectors	Global Health Care, Industrials, Materials, EU Financials & Technology	Telecoms, Consumer Discretionary, Consumer Staples	**Materials** to benefit from rebounding Chinese activity and low base metals inventories. **European banks** should benefit from surprisingly resilient consumption, rising Net Interest Margins & high levels of ECB deposit rate.
			Styles/ Themes	Quality, Megatrend themes		Circular Economy, Electrification, Security, Deep Value themes
BONDS	=	=	Govies	Favour US 5-7 year duration. Prefer inflation-indexed bonds		Our 10-year bond yield targets are 4.25% in the US and 2.25% in Germany in one year. Favour US inflation-linked bonds.
	+	+	Credit	US, Euro IG credit		We favour investment grade Credit, focusing on EU credit (especially financials) on the back of decade-high yields and strong balance sheets.
	+	+	EM bonds	USD and local currency		Attracted by high yields versus US high yield, solid economic prospects
CASH	-	-				
COMMO-DITIES	+	+		Gold Oil Industrial metals		Oil (+) Prolonged OPEC+ production cuts, growing geopolitical risks and the prospects of a rate cut induced cyclical upswing should keep Brent prices in the USD85-95 range. Base metals (+) The outlook for the manufacturing sector is improving. Cyclical demand will meet structural while supply remains constrained. Gold (+) we remain positive on the medium-term for geopolitical reasons, 12-month range = USD 2200-2400.
FOREX			EUR/USD			Our EUR/USD target is USD 1.12 (value of 1 euro) in 12 months.
REAL ESTATE	=	=		Health Care, logistics/ warehouses		Unlisted real estate faces enduring headwinds from slowing economies and much higher financing rates. Prefer listed real estate.
ALTERNATIVE UCITS				Long/Short Equity, Credit and Relative Value, Trend-following		Relative value alternative UCITS funds have beaten bond/credit indices since the start of 2023, offering lower risk returns, at low volatility.
INFRA STRUCTURE	+	+		Energy, transportation, water		Excellent long-term returns expected from private and listed infrastructure given long-term underinvestment.

Economic, FX forecast tables

BNP Paribas Forecasts

GDP Growth %	2023	2024	2025
United States	2,5	2,8	1,8
Japan	1,9	0,4	0,9
Eurozone	**0,5**	**0,7**	**1,7**
Germany	-0,1	0,2	1,4
France	0,9	0,7	1,4
Italy	1,0	0,9	1,4
Emerging			
China	5,2	5,2	4,3
India*	7,6	6,5	6,4
Brazil	2,9	2,2	2,0

* Fiscal year

Source : BNP Paribas, Bloomberg - 30/04/2024

BNP Paribas Forecasts

CPI Inflation %	2023	2024	2025
United States	4,1	3,4	2,8
Japan	3,2	2,9	2,3
Eurozone	**5.4**	**2,4**	**2,1**
Germany	6,1	2,5	2,1
France	5,7	2,4	2,0
Italy	6,0	1,1	1,9
Emerging			
China	0,2	-0,1	1,6
India*	5,4	4,7	4,5
Brazil	4,6	4,1	3,5

* Fiscal year

Source : BNP Paribas, Bloomberg - 30/04/2024

	Country	Spot 29/04/2024		Target 3 months	Target 12 months
Against euro	United States	EUR / USD	1,07	1,06	1,12
	United Kingdom	EUR / GBP	0,85	0,86	0,86
	Switzerland	EUR / CHF	0,98	0,98	0,98
	Japan	EUR / JPY	167,86	159	157
	Sweden	EUR / SEK	11,71	11,00	11,00
	Norway	EUR / NOK	11,78	11,30	10,80
Against dollar	Japan	USD / JPY	156,69	150	140
	Canada	USD / CAD	1,37	1,32	1,30
	Australia	AUD / USD	0,66	0,68	0,70
	New Zealand	NZD / USD	0,60	0,60	0,63
	Brazil	USD / BRL	5,11	5,00	5,00
	India	USD / INR	83,48	82,0	82,0
	China	USD / CNY	7,25	7,20	7,20

Source: BNP Paribas, Refinitiv Datastream. As at 30 April 2024

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