

2023 review and 2024 outlook

# Fixed Income Strategy

JANUARY 2024

→ Central banks' monetary-policy pivot will go down as the highlight of 2023. However, now that the disinflationary cycle solidly in place, questions are being raised regarding the pace and sustainability that it can maintain without triggering a major economic disruption. Is a perfect landing possible in 2024? Very hard to say...

## The wind has shifted

After spending 2022 in panic mode, the markets changed their tone radically in 2023. Core inflation<sup>(1)</sup> receded and investors seemed to be pricing in a perfect landing<sup>(2)</sup> scenario in which central banks would raise rates high enough to stop inflation, but not so high as to excessively compromise economic growth. Central banks were therefore believed to have done what was necessary to bring inflation under control, at the cost of steep interest-rate hikes that continued until October and hawkish language throughout the year.

However, the impact of monetary tightening is still not clear. Central banks are now in a wait-and-see phase. Inflation hasn't yet returned to the target, but it is on the right track and could gradually do so. While the economy is holding up for the moment, central banks are keeping a close eye on the effects of monetary tightening, as economic activity figures have become more lukewarm. Have central banks avoided making the one hike too many that might have caused a hard landing<sup>(3)</sup>? As they themselves admit, the direction of monetary policies will depend on a set of macroeconomic data that will guide their decisions in the coming months.

## Some divergences on both sides of the Atlantic

A distinction is to be made on the inflation fronts in Europe and the US. In the US, while it has declined, inflation remains high, and the job market is still strong. The US economy has been surprisingly resilient throughout the year, but the factors that supported it are likely to fade in 2024. The hyper-expansionary budget, the end of the student loan moratorium, the mostly used up Covid savings, etc. are all likely to sap momentum in the coming months. The ECB cannot easily take on a more hawkish stance than the Fed, as economic activity is weaker in Europe than in the US; nor can it be overly dovish, as inflation is still far from its target. Moreover, the euro zone job market requires less care, as it is more closely regulated.

(1) Ex food and energy.

(2) Perfect landing.

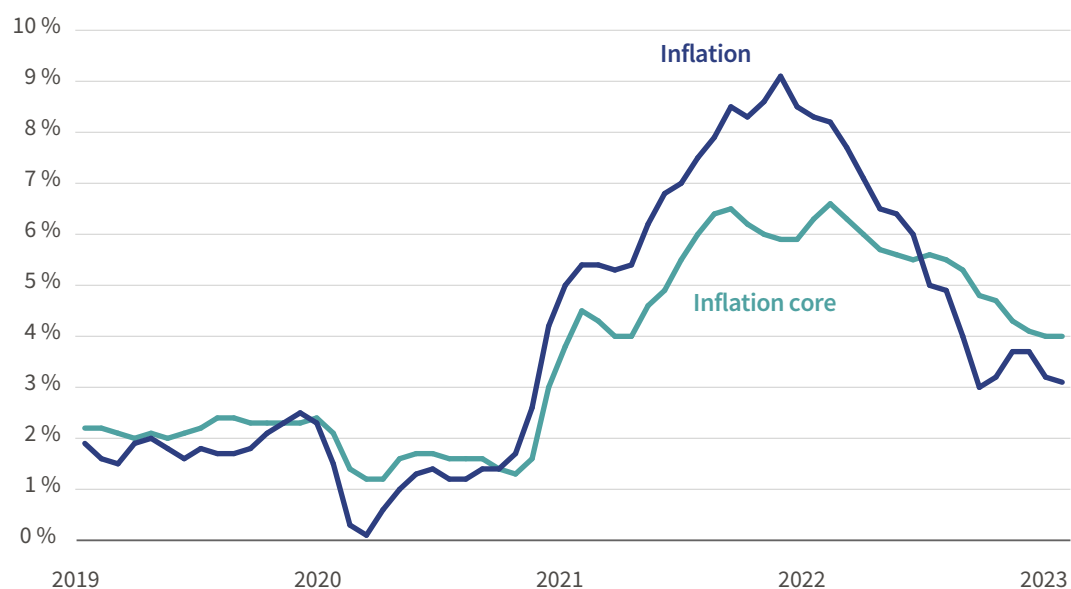
(3) Scenario that assumes the start of a recession.

(4) Positioning favourable for a less hawkish monetary policy.

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## US – CPI inflation indices

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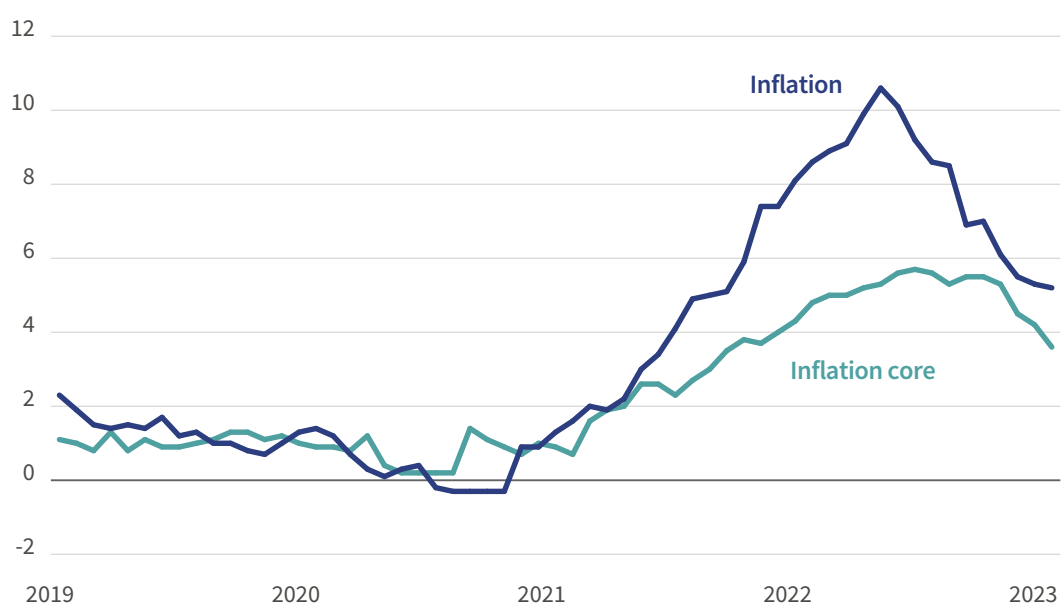


Sources: ECB, Bloomberg, Rothschild & Co Asset Management; 31 October 2023.

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## Euro zone – Total inflation and core inflation

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Sources: ECB, Bloomberg, Rothschild & Co Asset Management; 31 October 2023.

## The utopia of a perfect landing

Meanwhile, investors seem to be convinced that central banks have calibrated their stance perfectly, a conviction that is feeding the “perfect landing” scenario. Inflation expectations are adhering to this “Goldilocks” scenario with a gradual, steady and unified decline to the 2% target in all regions. This is not the first time that investors have read too much into a trend. With inflation having already begun to slow down in late 2022, the consensus was expecting far fewer hikes than actually occurred in 2023. In reaction, yield curves inverted drastically. This also forced central banks into very firm language, summed up in the expression ‘higher for longer’<sup>(5)</sup>, in order to make clear that no rate cuts were planned in the short term.

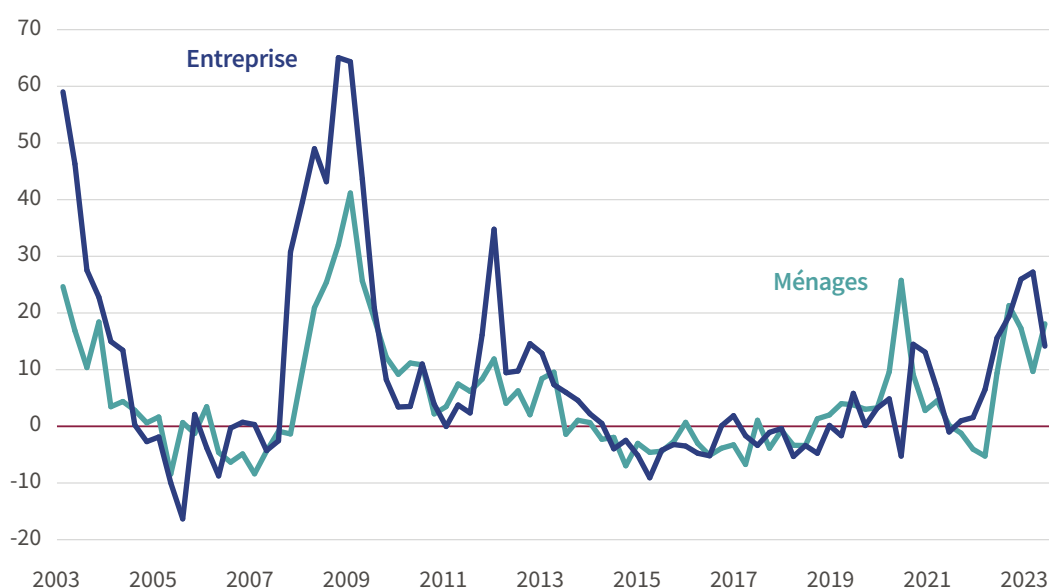
However, as they always want to stay ahead of the curve, investors are pricing in rate cuts for far earlier than announced. The consensus is forecasting six rate cuts in 2024, with a first

| (5) Higher for longer.

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### US – Credit conditions

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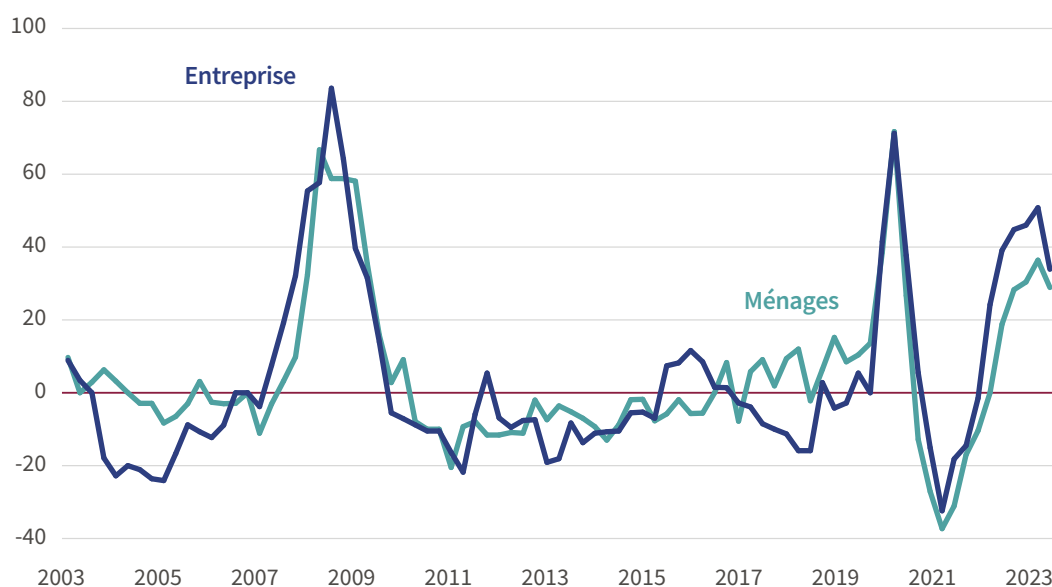


Sources: ECB, Bank Lending Survey, Bloomberg, Rothschild & Co Asset Management, 31 October 2023.

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## Euro zone – Credit conditions

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Sources: ECB, Bank Lending Survey, Bloomberg, Rothschild & Co Asset Management, 31 October 2023.

one coming in March, whereas the Fed itself is forecasting no more than three and late in the year. The easing of financial conditions arising from market expectations is raising the spectre of a game of liar's poker between the markets and the central banks and, hence, is causing volatility in interest rates.

## Careful of excessive optimism

Against this backdrop, we remain on high alert. Historically, each major monetary tightening phase has ended up causing negative impacts on the economy. The latest has occurred quite rapidly, and we have not yet seen heavy repercussions in this cycle. As it generally takes six to eight months for monetary policy to spill over into the real economy, we are still waiting for the impact of the latest rate hikes. Hawkish credit conditions are weighing on economic growth and the number of new corporate loans has already declined. In light of these conditions, we don't expect a soft or perfect landing and doubt the resilience of the economy in the coming months.

Regardless of whether they are better or worse than expected, macroeconomic data are also likely to cause volatility in interest rates in 2024. The US presidential election and budget projections will also bear watching during the year. Donald Trump appears to already be on the winning track before the campaign has even begun, and election watchers are now wondering what policies he will pursue. Between the optimism of the consensus, a central bank that plans to keep rates higher for longer, and the risk of a steepening in the yield curve, it is hard to say which way the markets are headed.

## The credit market is still on track but the outlook is less favourable

Corporate bond spreads<sup>(6)</sup> are at their historical averages, and valuations are not stretched very much. But as investors are betting on a perfect landing scenario, if expectations were to worsen, risk premiums would rise. In investment grade<sup>(7)</sup>,

(6) Difference in yield between a corporate bond and a government bond of equivalent maturity regarded as “risk-free”.

(7) Debt security issued by companies or governments rated between AAA and BBB- by Standard & Poor's.

### Yields in investment grade and high yield

%



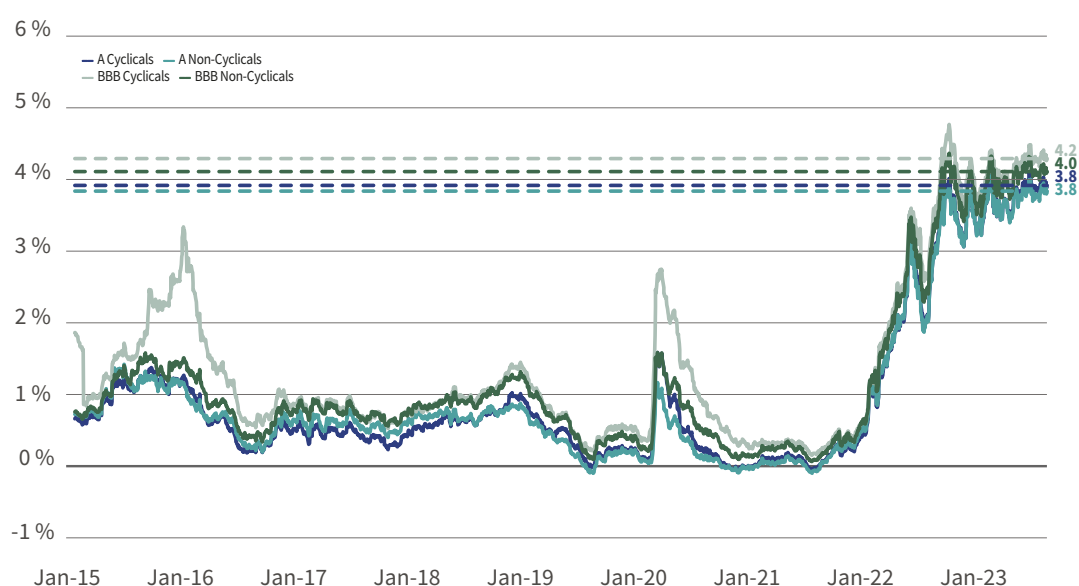
Sources: Bloomberg, Rothschild & Co Asset Management, 15 December 2023.

this trend will probably be offset by a decline in short-term rates, especially as many companies in the bond pool feature resilient profiles and solid fundamentals. Few defaults have occurred in recent months, and there have been more upgrades than downgrades. This trend could nonetheless reverse itself next year in reaction to higher financing costs and pressure on margins. High yield may therefore be in for a challenging period<sup>(8)</sup>.

More broadly, 2024 could be challenging on the credit market. It is hard to estimate the extent of the potential for a cyclical downturn, but there is clearly a risk of the market's getting carried away. Estimates of defaults were already generous in 2023 and could be even more so in the coming years. As things now stand, it is hard to outperform under a positive scenario, but if the situation were to worsen, we would have to be able to react rapidly. We therefore want to retain some manoeuvring room and to be able to handle an increase in volatility.

(8) High yield bonds are issued by companies or governments having a high credit risk. They are rated below BBB- by Standard & Poor's.

## Senior non-financial bond yields in %



Sources: Morgan Stanley Research, Rothschild & Co Asset Management, October 2023.

## Reducing risk and raising sensitivity

We have reached a point in the cycle where we believe it is worth raising the sensitivity of portfolios. Meanwhile, we are positioned on the short section of the investment grade curve while seeking to enhance the aggregate credit quality of selected bonds and while preferring defensives to cyclicals. However, the yearend fixed-income rally is pushing us into a more tactical stances in managing sensitivity. Although yields may look attractive, especially in high yield or financial subordinates, they carry a high beta<sup>(9)</sup> that we have sought to gradually reduce within portfolios throughout the year. We nonetheless continue to engage in bond picking<sup>(10)</sup> to exploit the carry trade on these bonds in intermediate maturities and through some sector opportunities such as financials.

(9) A measure of the risk of volatility of a share vs. the market as a whole. The market's beta coefficient is 1.00. Any share having a beta higher than 1 is regarded as being more volatile than the market and, hence, riskier.

(10) Stock-picking.



# Our fund selection

## R-co Conviction Credit Euro

SRI risk :



### EURO-DENOMINATED INVESTMENT GRADE BONDS

Inception date: 08/11/2019 | Recommended investment period: 3 years | Article 8 SFDR

The flagship fund in our bond range, R-co Conviction Credit Euro offers active and opportunistic management of the euro-denominated bond market. Its core portfolio consists of securities, complemented by satellite strategies and a careful selection of high yield and non-rated bonds. The investment strategy aims at a constant optimisation between yield and maturity as well as a careful monitoring of the portfolio's sensitivity.

### Performance and risk indicator

	2023	2022	2021	2020	2019	2018	1 year volatility
R-co Conviction Credit Euro C EUR	9.35%	-13.17%	1.00%	2.72%	5.17%	-3.58%	3.43%
R-co Conviction Credit Euro IC EUR	9.74%	-12.86%	1.37%	3.09%	5.55%	-3.23%	3.43%
Markit iBoxx™ € Corporates	5.07%	-14.17%	-1.08%	2.73%	6.29%	-1.29%	1.57%

Source: Rothschild & Co Asset Management. 29/12/2023.

## R-co Target 2029 IG

SRI risk :



### MATURITY FUNDS | EURO-DENOMINATED INVESTMENT GRADE BONDS

Inception date: 28/09/2023 | Recommended investment period: until 31/12/2029 | Article 8 SFDR

A credit fund based on a bond-carrying strategy until maturity, R-co Target 2029 IG invests in Investment Grade bonds from all geographical areas. This strategy is based on a selection of securities with an average maturity between January and December 2029 while benefiting from active management allowing for arbitrage in order to control the portfolio's risk level or seize market opportunities. The marketing period runs until 31 December 2024.

**Yield to maturity:** 5.4 %<sup>(1)</sup>

(1) Source: Rothschild & Co Asset Management, 29/12/2023.

## R-co Thematic Target 2027 HY

SRI risk :



MATURITY FUND | EURO-DENOMINATED HIGH YIELD BONDS

Inception date: 24/07/2023 | Recommended investment period: until 31/12/2027 | Article 8 SFDR

R-co Thematic Target 2027 HY is a high-yield bond maturity fund that invests in euro-denominated bonds from all geographical areas. The selected securities have an average maturity between January and December 2027. The investment approach includes active, agile and disciplined management, making it possible to seize opportunities, arbitrage and even sell if the risk of default becomes too great. The marketing period runs until 1 September 2023.

**Yield to maturity:** 7.4 %

Source: Rothschild &amp; Co Asset Management, 29/12/2023.

## R-co Valor Bond Opportunities

SRI risk :



GLOBAL BONDS | CARTE BLANCHE

Inception date: 28/08/2019 | Recommended investment period: over 3 years | Article 8 SFDR

R-co Valor Bond Opportunities is an global bond fund with a «carte blanche» approach means that it can be invested in all segments of the bond market, across ratings, maturities and in geographical areas. Thanks to its flexibility and based on the analysis of growth, inflation and monetary policy outlooks, this investment solution aims to take advantage of the diversification of fixed income products by combining satellite strategies around a core credit portfolio.

### Performance and risk indicator

	Year to date	2022	2021	2020	Since inception	1 year volatility
R-co Valor Bond Opportunities C EUR	9.56%	-9.71%	3.66%	6.74%	10.87%	4.94%
<i>ESTER Capitalisé + 2.585%</i>	<i>5.91%</i>	<i>2.90%</i>	<i>2.50%</i>	<i>2.51%</i>	<i>15.48%</i>	<i>0.11%</i>
R-co Valor Bond Opportunities I EUR	10.06%	-9.31%	4.14%	7.01%	12.87%	4.94%
<i>ESTER Capitalisé + 3.035%</i>	<i>6.37%</i>	<i>3.34%</i>	<i>2.95%</i>	<i>2.96%</i>	<i>17.69%</i>	<i>0.11%</i>

Source: Rothschild &amp; Co Asset Management. 29/12/2023.

### R-co Conviction Credit Euro

We have classified this product as risk class 2 out of 7, which is a low risk class and mainly reflects its positioning on private debt products while having a sensitivity between 0 and +8. In other words, the potential losses associated with the future performance of the product are at a low level and, should market conditions deteriorate, it is very unlikely that our ability to pay you would be affected. The risk indicator assumes that you hold the product for 3 years, otherwise the actual risk may be very different and you may get less in return.

**Main risks:** Discretionary management risk, interest rate risk, credit risk, counterparty risk, performance risk, risk of capital loss, risk related to the use of derivatives, risk related to temporary acquisitions and sales of securities, specific risk related to the use of complex subordinated bonds (bonds with a maturity of less than one year) of securities, specific risk related to the use of complex subordinated bonds (contingent convertible bonds, so-called «CoCs»).

### R-co Target 2029 IG

Recommended investment period: until 31/12/2029.

Risk indicator: 2/7.

The synthetic risk indicator is used to assess the level of risk of this product compared with others. It indicates the probability that this product will incur losses in the event of market movements or our inability to pay you. The risk indicator assumes that you hold the product until 31 December 2029. The actual risk may be very different if you opt to exit before maturity, and you may get less in return. We have classified this product in risk class 2 out of 7, which is a low risk class and mainly reflects its positioning on credit risk and fixed-income products with a maximum residual maturity of 31 December 2029. In other words, the potential losses linked to the future performance of the product are low and, if the situation were to deteriorate on the markets, it is very unlikely that our ability to pay you would be affected. As this product does not provide protection against market fluctuations or a capital guarantee, you could lose all or part of your investment.

### R-co Target 2027 HY

Recommended investment period: until 31/12/2027.

Risk indicator: 3/7.

The synthetic risk indicator is used to assess the level of risk of this product compared with others. It indicates the probability that this product will incur losses in the event of market movements or our inability to pay you. The risk indicator assumes that you keep the product until 31 December 2027. The actual risk may be very different if you opt to exit before maturity, and you may get less in return. We have classified this product in risk class 3 out of 7, which is between low and medium risk, and mainly reflects its positioning on credit risk and fixed-income products with a maximum residual maturity of 31 December 2027. In other words, the potential losses associated with the future performance of the product are low to medium and, if the situation were to deteriorate on the markets, it is unlikely that our ability to pay you would be affected. As this product does not provide protection against market fluctuations or a capital guarantee, you could lose all or part of your investment.

### R-co Valor Bond Opportunities

We have classified this product in risk class 2 out of 7, which is a low risk class and mainly reflects a discretionary management policy that exposes the portfolio in a diversified way to the interest rate markets over the medium term. In other words, the potential losses related to the future performance of the product are low and, if the situation were to deteriorate in the markets, it is very unlikely that our ability to pay you would be affected. The risk indicator assumes that you hold the product for 3 years, otherwise the actual risk may be very different and you may get less in return.

**Main risks:** Discretionary management risk, interest rate risk, credit risk, credit risk («speculative» or «high yield»), counterparty risk, performance risk, risk of loss of capital, risk linked to the use of derivatives, specific risk linked to the use of complex subordinated bonds (convertible contingent bonds known as «CoCos»), exchange rate risk, equity risk, risk linked to exposure to non-OECD countries (including emerging countries).

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