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Discover our convictions for 2025

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LA FRANÇAISE
Crédit Mutuel Alliance Fédérale

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Looking for a neutral rate

Throughout 2024, we maintained a positive view on risky asset classes, mainly because our growth forecasts were generally less alarmist than those of the market.

The underestimation of US growth by the consensus in particular has been the reason of our preference for US equities over the last 12 months. The very good performance of risky assets in 2024 gives us reason a posteriori. On rates, the results were mixed with performances close to neutrality.

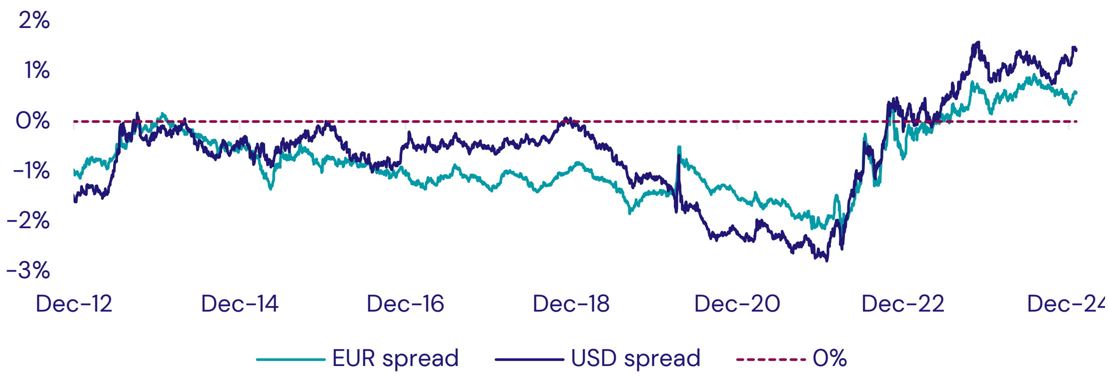
2025 consensus is very different from 2024 one. Recession fears have disappeared, growth forecasts have been revised upwards and earnings growth expectations are high. Valuations also leave little room for disappointments in a year that is likely to be rather turbulent due to political and geopolitical uncertainties.

Does this mean that we are shifting our allocations to a more defensive stance now? No

Global growth momentum remains positive, especially in the US, and the start of the year has historically been supportive for risk assets. However, we believe it is appropriate to gradually increase the sensitivity of our portfolios to interest rate levels that we consider to be asymmetric.

The equilibrium rate or neutral rate is a rate that we cannot by definition observe. This is nevertheless a very important notion for central banks (as a reminder, the real neutral rate is equal to the potential growth of an economy) and therefore, in consequence, for equity markets. Many models exist to try to assess the neutral rate of an economy, but none of them really refers. The markets now estimate that the equilibrium rate in the United States is around 4% (Swap 1Y1Y), which seems very optimistic to us. On a cyclical basis, it is clear that the neutral rate is higher than previously due to fiscal policies implemented since the Covid era. But is this sustainable? At these levels, the probability this equilibrium rate will be revised downwards rather than upwards by the end of 2025 seems strong to us. This can also be true for other countries like the UK for example.

10 year real yield vs neutral interest rates estimated using the HLW * method



Sources: Groupe La Française, Bloomberg. Data as of 31/12/2024
*HLW: Holston-Laubach-Williams

The decline in inflation risk, both in the US and the Eurozone, is another factor explaining our growing appetite for risk free fixed income assets, although here again, some geopolitical parameters could lead us to revise our positioning.

We wish you a wonderful 2025!

Traditional Fixed Income

At its last 2024 meeting, the FED dropped its key rates by 25 basis points (bps), a third reduction since the beginning of the monetary easing. Although expected, the Central Bank surprised by raising its inflation and rate forecasts. There are only two planned rate cuts in 2025, compared to four in last September. J. Powell pointed out that the committee's analysis believes in a more resilient economy, particularly in terms of growth, unemployment and inflation. In response, the US 10 year climbed to 4.60%, with a sharp steepening, and the spread between the 2 year and 10 year rates has reached 27 bps, a record since May 2022.

In the eurozone, December PMIs* showed activity slowed by a shrinking manufacturing sector, particularly in France and in Germany. However, services are again in expansion area and the composite PMI ex France and Germany rose to 52.6, reflecting a recovery in consumption. Risk premiums (spreads) among sovereign countries reflect this dynamic: the BTP-Bund fell to 116 bps (vs 168 bps in January), while the OAT-Bund rose to 86 bps, close to 2012 level.

On the Investment Grade segment, although marked by geopolitical and sectoral tensions, credit spreads remained close to the lowest levels (Euro IG at 90 bps and US IG at 124 bps). In 2025, the ECB's monetary easing will favour longer durations, especially in the 5-7 year zone, while the FED is expected to maintain a higher for longer strategy.

DRIVERS

Inflation is expected to fall further to around 2 % in the Eurozone. In this environment, The ECB is expected to adopt an easing monetary policy in the 1st semester.

Pursuit of **positive growth momentum in peripheral countries**, particularly Ireland, Spain and Portugal.

Demand in the European IG credit market will remain high (41 billion euros of positive inflows in 2024) and focused on traditional IG funds and target maturity strategies. In the United States, higher rates will support demand for IG credit.

WARNING SIGNS

The Fed's more restrictive monetary policy should have only a marginal impact on the ECB , as this one take decisions only considering economic conditions in the eurozone.

Central bankers and investors will observe how the **cross EUR-USD will evolve and its inflationary potential.**

The bond offer will be key, with the ECB stopping the reinvestment of APP** and PEPP*** in January 2025. The market will be forced to absorb 510 billion euros, in addition to already significant government issues .

POSITIONING ★★★☆☆

We are adopting, at the beginning of 2025, a neutral to slightly positive position in sensitivity, **favouring the core zone of the curve**. We are overweighted on Spain, neutral on Italy and underweighted on France.

On IG credit, risk premiums should stabilise in the absence of shocks, and **carry should remain the main performance driver**. We favour quality, defensive sectors and the median part of the curve (up to 7-8 years), maximising roll down return for a moderate beta. **We favour financials** over corporates because of their estimated strong fundamentals.

Sources: Groupe La Française, Bloomberg. Dtata as of 31/12/2024
*PMI: Purchasing managers index
**APP: Asset Purchase Programme.
***PEPP: Pandemic Emergency Purchase Programme.

Past performance is not indicative for future performance.

Specialised Fixed Income - High Yield

After a relatively calm 2024 on the credit market, 2025 should be characterized by a return of volatility, particularly on high yield bonds. This volatility could lead to a moderate increase in risk premiums. This one could reach 400 bps on the global High Yield index (vs. 350 bps on average over 2024).

The valuation of euro-denominated high yield bonds is relatively attractive compared to other markets, thanks to more favourable technical factors in this region. However, despite a less attractive valuation, US high yield is benefiting from a more favourable macroeconomic environment than European high yield. Finally, concerning emerging markets, not only risk premiums are at their lowest since 2007 and the premium vs other markets is very low, but they could also suffer from the FED's monetary policy and the new Trump administration's duty increases.

To sum up, for 2025, we expect potential positive performance on high yield market, thanks to the still favourable carry effect, which is also benefiting from historically low default rates. Indeed, we believe that the expected volatility will be a source of opportunity, as dispersion in the high yield bond market has never been so wide.

DRIVERS

The interest rate cuts already initiated by the **European Central Bank** should be supportive for European high yield bonds .

In **Europe**, the **volume of net issuance*** should remain **broadly stable** in 2025, or even slightly negative, thereby supporting demand for existing bonds and stable yields.

The **US macroeconomic environment** is supportive for high yield bonds in this region.

WARNING SIGNS

In the **United States**, **net issuance*** is expected to rise sharply in 2025, doubling from 2024 to around USD 100bn, fuelled by the revival of LBO** and M&A*** activity.

Uncertainty about changes in the **Fed's monetary policy** could have a negative impact on the US and emerging credit markets, which remain sensitive to fluctuations in US interest rates and to Fed policy.

Default rates for emerging market companies are likely to rise. The appreciation of the dollar has historically put a negative pressure on credit assets in this region.

Sources: Groupe La Française, Bloomberg. Data as of 31/12/2024
* Gross issues adjusted for redemptions and coupon flows. ** LBO: Leveraged buy out. *** M&A: Merger & acquisition

Past performance is not indicative for future performance.

POSITIONING ★★★☆☆

In terms of **geographical allocation**, we prefer European high yield bonds to US high yield bonds. We are staying away from emerging high yield bonds.

In terms of **sector allocation**, we prefer sectors that should benefit from the interest rates drop, particularly in Europe, like TMT (technology, media and telecoms), healthcare, utilities and residential property. We are staying away from cyclical sectors (industry, chemicals, automotive suppliers, retailing, etc.) and those sensitive to sovereign risk. Finally, in terms of **curve positioning**, we prefer the 3-5 year part, which offers the most estimated attractive volatility-adjusted carry.

A diversified allocation to favor

Alternative investments naturally complements traditional investments by exploiting market inefficiencies, particularly in times of dislocation. As such, the market volatility expected for the 2025 financial year should favour this universe and its various specialties.

Investment grade credit and convertible arbitrage activities should continue to perform well, although more selectivity is needed for the high yield segment, where default risks are increasing.

Widening public deficits and economic uncertainties will generate volatility on sovereign debts. Relative value strategies on these issuers should be one of more interesting of the year.

Finally, the campaign of deregulation and exemption announced in the United States should free up the capital needed to accelerate merger and acquisition operations. Easing monetary conditions will also facilitate the return of private equity activity and improve the return profile of these deals. The merger and acquisition arbitrage activity should therefore benefit from this buoyant environment and has interesting potential.

DRIVERS

Alternative funds aim for a **recurrence of performance regardless of market events.**

Volatility is typically managed using management techniques (shorts positions, using of derivatives and hedging tools) that allow **for greater resilience** than other asset classes, particularly during crisis time.

The correlation of hedge funds with equity markets and the main credit and bond indices is also very low, which makes it a **natural complement to traditional management**.

WARNING SIGNS

Alternative investment, relative value strategies and arbitrage are **sometimes misunderstood as risk free**. It is important to note that investing in this type of hedge fund carries the risk of capital loss, particularly during periods of market dislocation.

Considering the decoupling between monetary policies and the increasing geopolitical tensions, the 2025 financial year could be volatile. For this reason, recommended periods of detention are generally 3 to 5 years. Only on this investment period that the contribution of portfolio managers can be appreciated.

Sources: Groupe La Française, Bloomberg. Data as of 31/12/2024.

Past performance is not indicative for future performance.

POSITIONING ★★★★☆

More broadly, the current market environment, characterized by many uncertainties, both geopolitical and economic, appears particularly **favorable for alternative investment and arbitrage strategies that benefit from periods of volatility.**

Between equity markets that look expensive considering this macroeconomic environment and bond markets that will become less attractive as interest rates fall, **there are opportunities for arbitrageurs**. This explains the strong appetite of investors for this type of diversifying strategy, which finds its place in a global portfolio allocation.

Equity expertise

Large cap

In 2024, the US market confirmed its strength, driven by the 4th Industrial Revolution and the rise of AI, concentrating value creation on a few companies like Nvidia (+171.3%). Only 30% of S&P companies outperformed the index.

Global recession fears were replaced by soft landing scenarios. Concerning Europe, the dissolution in France weighed on equities, while the re-election of Donald Trump widened the gap between the S&P and Stoxx 600 (+24.3%).

On the EM side, the Chinese trajectory will depend on stimulus packages, US duties and the currency evolution. Brazil and Mexico, affected by political tensions and high rates, could see a recovery in the second half of the year.

In 2025, the US economy is expected to remain strong with resilient consumption and positive corporate sentiment. Trump' promised tax cut will support markets, although a strong dollar and potential tariff increases will need to be monitored.

DRIVERS

An **inequal global growth** driven by the US, with Europe lagging behind and a slow but structured recovery in China. Dynamism of emerging markets.

Economic stabilisation and valuation gaps **favouring a recovery potential** between **Europe** and the United States despite weak growth.

Gradual decline in inflation, supporting consumption and business confidence.

Energy transition: deployment of investments in the US (IRA) and Europe (Green Deal).

WARNING SIGNS

There are many political and geopolitical uncertainties on both sides of the Atlantic.

China's structural slowdown: weak domestic consumption, ageing population, real estate under pressure, recovery plans.

Long term sovereign yields are likely to remain high, with a rate cut cycle by central banks likely to slow down. The dollar is likely to remain strong.

An optimistic consensus for 2025: cautious on the risks of downward revisions of earnings, especially on IT players.

POSITIONING ★★★☆☆

US markets are likely to remain on a trend in 1st semester, but inflation expectations will remain key. In Europe, the lack of visibility encourages more caution, favouring defensive stocks (health, food, insurance). The structural theme of electrification stands out among the big winners, including automation, AI and data centers. Consumption could play a key role, driven by leisure and hotel spending, while luxury sector should recover.

AI remains a long term, major disruption **with likely volatility on stocks exposed to it**. If semiconductors benefit from massive investments, **the software sector will offer new solutions** and benefit from this dynamic.

Sources: Groupe La Française, Bloomberg. Data as of 31/12/2024

Small Caps

Since the Covid period, European small and mid caps have gone through a period unfavorable to their performance. First, the global economy and supply chains have been profoundly disrupted in the aftermath of the pandemic, a phenomenon that has been exacerbated by major geopolitical conflicts. Second, although the inflation period was initially positive, it finally put under pressure free cash flows by companies (especially the smaller ones) and the purchasing power of households, which tended to consume less, especially in Europe. Finally, flows have logically been polarized towards the United States, whose economy has done better than resisted where the European economy is suffering.

While the recovery in the asset class is long overdue, these stocks continued to underperform in 2024, with a performance of 0% for the Stoxx Europe Total Small ex UK (vs. +3.5% for the Stoxx Europe 600 ex UK) and an even greater gap in France.

These companies, more sensitive to the rates environment and the domestic economy, failed to deliver the expected performance. However, the digestion of oversupply continues to normalize. In addition, the historical valuation gap between small and mid caps and large caps in the US and Europe combined with a widely consensual US call suggests that diversification toward small and mid caps in 2025 could be an interesting opportunity.

DRIVERS

At the lowest levels, **current valuation** are a strong support for the performance of small and mid caps companies on medium term.

The **profit growth** of small and mid caps has always been higher than that of large caps, which has historically proved to be the main criterion for the valuation premium and the outperformance against large caps.

Easing monetary policy is positive for Growth companies, which are well represented in the asset class and are favoured in our allocation choices.

WARNING SIGNS

The path of future PMIs is to be analysed, as small and mid caps historically have tended to outperform large when PMIs are buoyant.

The political and geopolitical situation is a factor to consider when assessing small and medium caps stocks. Indeed, the asset class is sensitive to market sentiment and investors' willingness to take risk.

Flows will be a key determinant in the potential performance of the asset class. Although fragile, a notable start is visible in 2024.

Sources: Groupe La Française, Bloomberg. Data as of 27/12/2024

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POSITIONING ★★★★☆

We maintain our high **conviction in the medium term**, supported by valuations, expected earnings growth and a likely pick up in PMIs.

In the short term, a driver is necessary such as a rebound in PMIs, tax benefits or an acceleration of rate cuts.

On the European markets, we favor **estimated quality stocks with endogenous growth**. We take profits on stocks that have performed well in 2023 and 2024, while increasing positions on those that have suffered to the Covid and the low macroeconomic cycle. In France, we take a balanced approach between visible growth companies and countercyclical ones (turnaround, asset rotation) and deep value companies.

Green Bonds in the spotlight

2024 is the second record year for the amount of sustainable debt issued by corporate issuers. The year ended around 370 billion dollars of bonds issued, above 2022 (360 billion dollars), but below 2021 (460 billion dollars). While banks have issued less green and sustainable bonds this year, this has been offset by a sharp increase in non financial corporate and supranational issuance.

The majority of projects funded by these obligations were focused on mature technologies such as renewable energy, electricity transmission and green mobility.

The second half of the year saw a relative underperformance of European Investment Grade green bonds that are excluded from the PAB* criteria of fund naming. ESMA has since clarified its position by explaining that exclusions would not apply to the bonds under the European standard (EUGBS) requirements and that transparency via use of proceeds could be used for secondary green bonds.

DRIVERS

Labelled securities are an important source of financing the transition: **green bonds represent 44% of global energy transition financing** since the beginning of 2022, 52% if all labelled securities are included.

The remainder of the energy transition financing comes from 22% traditional fixed income debt, 16% from bank loans and 10% from private equity.

WARNING SIGNS

Three years ago, **green first time issuers dominated the ESG debt market**. Today, this market in Europe is heavily composed of recurring issuers, while in the United States, political dynamics have hampered the use of this format by many players.

Although regional diversification and the **emergence of new formats such as SLLBs**** continue, this will not be enough to create a significant driver for the growth of the sustainable debt market in 2025.

POSITIONING ★★★☆☆

For 2025, the market consensus expects a modest growth (+10%) with market that should reach $ 900 billion (corporate and sovereign). **Despite the higher sustainable issuance volume expected in 2025**, the share of sustainable issuance in the overall primary issuance volume will remain fairly stable and will only improve slightly.

Regarding the adoption of EUGBS, **the recent fund naming details are definitely more supportive**, especially for issuers that still have a very carbon mix. The new standard also synergies with the existing standards that issuers can easily adhere to, **but the taxonomic alignment will take time that may weigh on the adoption curve in 2025**.

Sources: Groupe La Française, Bloomberg. Data as of 31/12/2024

*PAB: Paris-aligned Benchmarks

**SLLB: Sustainability-Linked Loans financing Bonds

Past performance is not indicative for future performance.

Conclusion

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2024, a year of multiple challenges:

Financial markets have faced increased geopolitical, political, climate and fiscal risks, as well as renewed uncertainty around central banks policies. Despite this context, global performances were very positive, although marked by geographical disparities.

In terms of **equity indices**, the US market largely outperformed the European market, thanks in particular to an unprecedented concentration of performances on a few stocks and the rise of the dollar. Japan, after a strong 1er semester, stagnated at 2nd one while maintaining its gains. In China, government measures deemed insufficient limited the rise of the MSCI China to nearly 20%.

On the **bond side**, credit posted positive performances, both on high yield and investment grade, supported by solid company fundamentals and inflows that barely slowed down on this asset class, which continues to attract for the positive carry it provides.

Finally, volatility was only really present in the sovereign debt segment, penalized by central banks that were less positive about expected inflation perspectives in the United States, which thwarted expectations of falls at the beginning of the year, and by the lack of conviction from the ECB.

During the last two months of 2024, the strong resistance of the US economy, the victory of Donald Trump, and especially the estimated impacts of his program on inflation have caused a rise in US nominal and real rates. This has been replicated in the eurozone, to a lesser extent, however, in a much more risky macroeconomic situation.

2025: A mixed outlook?

Investors expect solid growth in the US, contrasting with Europe and China, weighed down by a cautious economic climate. Trump' victory could lift US inflation, but the scale will depend on the trade and migration policies actually implemented in 2025. After cutting 100 basis points in 2024, the Fed is considering two rate cuts in 2025 to moderate inflationary pressures.

In Europe, disinflation led the ECB to maintain its accommodative policy, with 4 to 5 rate cuts expected to reach 1.75% by the end of 2025. This dynamic should increase the appeal of sovereign bonds, particularly peripheral debts. German debt will remain a safe haven despite election uncertainty in February 2025.

On the corporate side, investment grade and high yield margins or spreads remain attractive thanks to solid fundamentals according to us. **We favor investment grade in the Eurozone given the fragility of growth.**

US equities are benefiting from robust growth and supportive taxation, while European monetary easing could be a key driver. However, attracting international capital will need to dissipate political risks.

Finally, we are maintaining our **diversification on gold stocks**, which offer a decorrelation with other asset classes.

Our multi asset allocations are therefore a bit more hawkish than the equity allocation and **close to neutral for overall sensitivity**, still with a significant allocation to corporate credit to capture the carry of the asset class.

Sources: Groupe La Française. Data as of 31/12/2024

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