AXIOMA
Wealth Management AG

2024 Investment Strategy

19 December 2023

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2023 – Was a Year of...

- **…High Volatility.** Looking back, one will notice no move in US Treasuries medium-to-long term yields, however the maximum difference was 70 bp for 2-3 year and 110 bp for 10 year.
- **…"Higher for Longer" Narrative**. The total increase in Fed fund rate was only 100 bp, in comparison with 375 bp increase in 2022. BUT Fed rhetoric made market participants postpone their expectations of the first rate cut until mid-2024. Market participants also now expect an overall slow pace of any future cuts.
- **…China being the Laggard.** The Chinese real estate HY index lost around 50% in 2023 on the back of continuing problems in real estate sector, while Chinese equities are down more than 10%. The tactical measures approved by Chinese government turned out to be not enough and the country went into deflation as of 3Q23.
- **…Outflows**. From EM hard-currency bond markets YTD* outflow was registered at USD 23.4 bln, after USD 44.8 bln in 2022. That's historically the biggest combined outflow versus an average 6-year inflow of USD 8.4 bln.
- **…Swinging Valuations.** That was a roller coaster for bonds with YTD result hovering around 0% until the November rally.
- **…Increasing Sanctions.** In the Eurobonds space new names were added to the sanctions list, while banks have been adopting even stricter compliance procedures. Most Russian issuers continue to show high willingness to pay and offering alternative ways to receive coupons and redemptions: direct payments, tender offers, type D account in Russia. However, so far, all variants, being non-standard by nature, are lengthy, time and effort consuming and still there is no guarantee that any of them will work for every bondholder.
- **…USA Soft Landing.** The chances for hard-lending have diminished underpinned by strong statistics, thus soft-landing is now seen as the base scenario. Tight labor market was the driving force for the resilient US economy.

* As of November 30, 2023

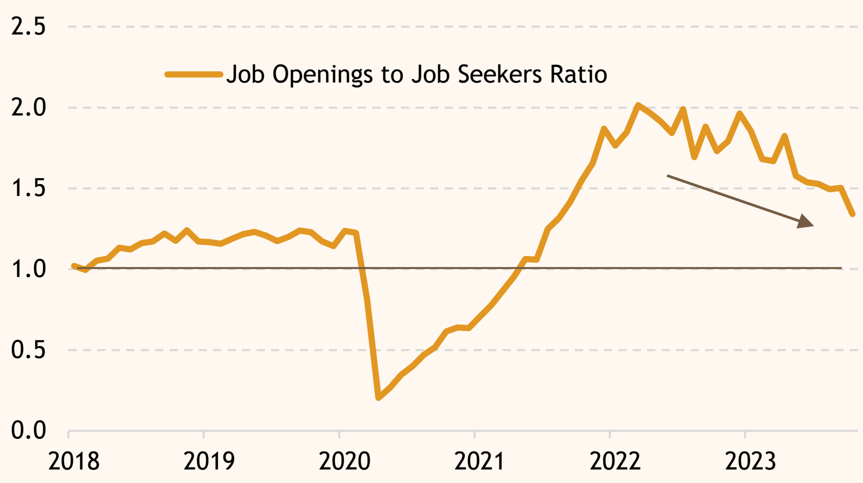
2024 – Finally Year of Bonds

- After a severe repricing in 2022 and lackluster 2023, the risk-return profile for fixed income as an asset class looks attractive, given the end of the hiking cycle. Our base-case scenario brings **low-double-digit return** in 2024.
- US Federal Reserve stays data dependent and keeps to the conservative side. Nevertheless, the dot plot shows a 75 bp decrease in the Fed funds rate in 2024 and another 100 bp decrease in 2025. Markets usually price in the change in policy before the actual change happens and we wouldn't be surprised to see **a full-scale bond rally in 2024** already.
- As concerns over the US economic growth is still there, **bonds** as an asset class **are better positioned** to withstand an economic slowdown or a light recession.
- **Volatility may increase** in the 2H24 closer to elections and fixed-income may prove to be a safe-heaven during this rocky period.
- Yield normalization will most probably contribute to other types of normalization, such as negative correlation between equities and fixed income. The **diversification benefits** may support demand for the asset class.
- The goal of investors will be to **lock in higher interest rates** for several years to come, thus proving support for longer maturities and HY/EM bonds.
- **EM bond** valuations **look fair** on average, but one could always find value in improving macro or micro stories, where valuations do not yet reflect the changes.
- **In a best-case scenario** when the Fed turns to a less restrictive monetary policy or risk appetite gives rise to large inflows into EM debt, EM bonds credit spreads may tighten providing for a price upside additional to the current yield, thus reaching **double-digit return** in 2024.
- **Geopolitical risk** will remain elevated with focus on Russia-Ukraine and Israel-Palestine, while closer to US elections US-China or US-Iran relationship may spark bouts of volatility, which will keep **creating opportunities** at markets.

US Economic Outlook

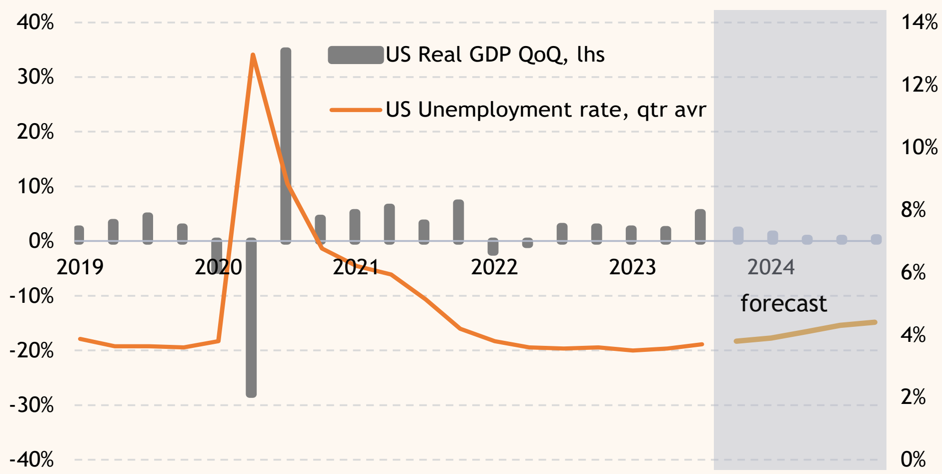
- US economy has proved to be resilient thanks to a strong job market.
- Soft-landing, that is avoiding a recession, has become the main scenario.
- But with cooling labour market, the growth will slow further and slip below trend, resulting in lower inflationary pressures.

Chart 1: Job market has cooled down, but remains strong



Source: Bloomberg, 7 December 2023

Chart 2: US economy may avoid recession, but average growth pace will be less than 1%

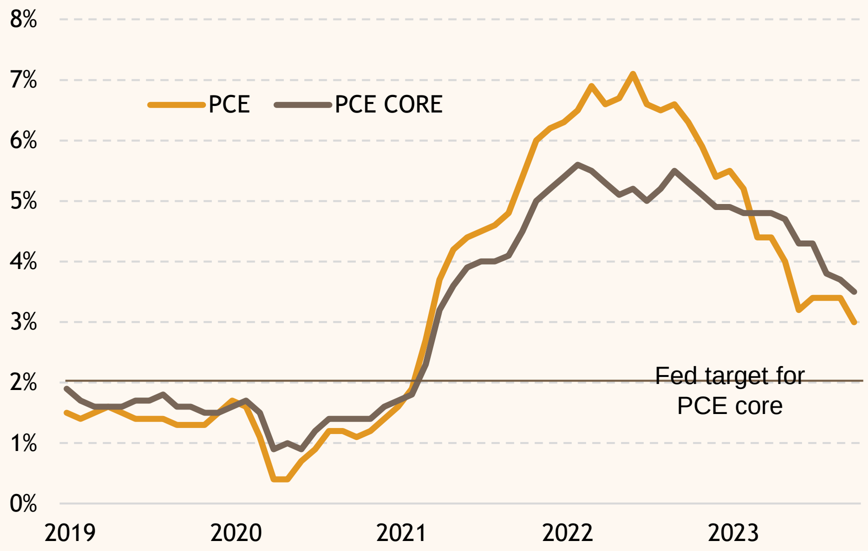


Source: Bloomberg, JP Morgan; 7 December 2023

US Economic Outlook

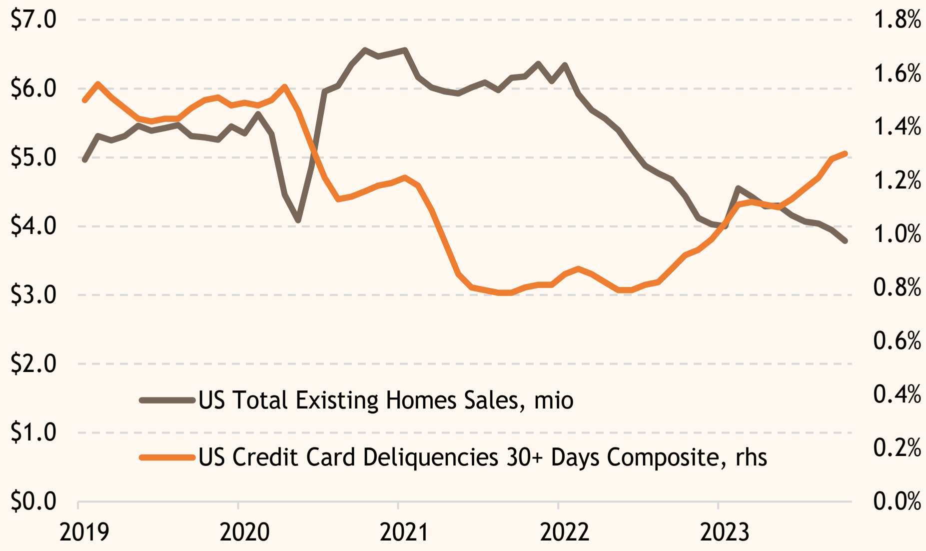
- Inflation has impressively slowed down but is still above the Fed's target. Currently markets are pricing only 50 bp rate cut in 2024, which will not dramatically decrease the interest rate burden for the economy.
- At the same time, high rates have started to influence the economy and the staggered impact will build up. There is already evidence that certain rate-sensitive sectors as real estate have begun to considerably struggle. Consumers have already spent all of their COVID savings, and the savings rate is now below the pre-COVID average, while credit cards delinquencies have begun to slowly increase.

Chart 3: Inflation is nearing to, but still above target



Source: Bloomberg; 7 December 2023

Chart 4: And challenges are being built up

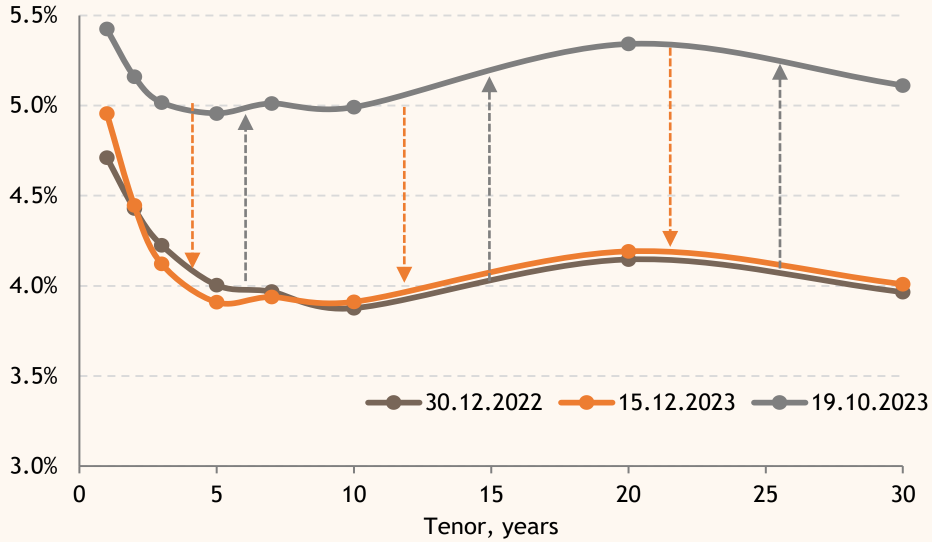


Source: Bloomberg; 7 December 2023

US Monetary Policy

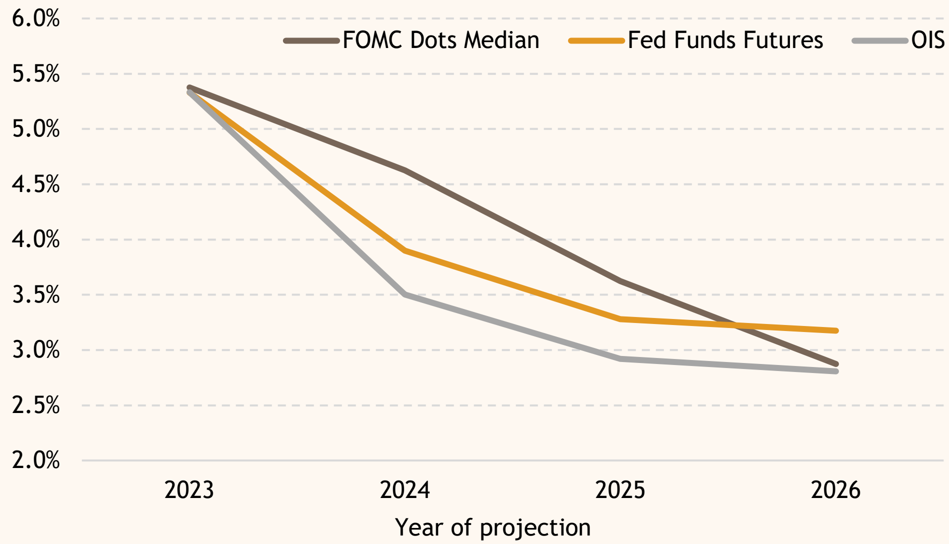
- The Fed has increased the interest rate by 100 bp in 4 equal rate hikes with the last one being in July'23. After the second decision to hold the rates unchanged the markets now believe that the peak rate has been reached.
- However, the Fed's narrative changed to "higher for longer", which market participants viewed as a hawkish stance from the regulator. First cuts are anticipated in the 2H24, but rates will stay restrictive for several years to come.

Chart 5: We have most probably reached the peak rate, BUT…



Source: Bloomberg; 19 December 2023

Chart 6: … BUT the pace of lowering is unclear

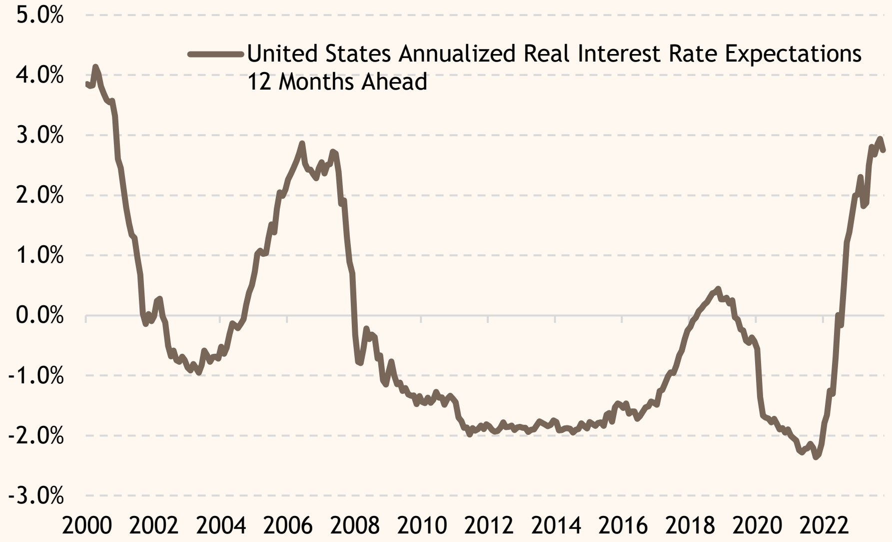


Source: Bloomberg; 19 December 2023

US Monetary Policy

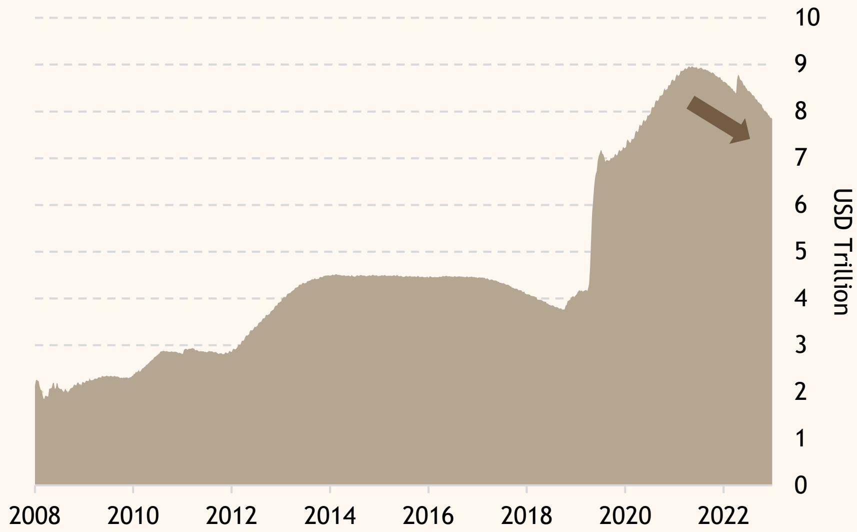
- The Fed’s target now is to keep real rates positive at least until the inflation target is reached, which could take several years, if no extraordinary situation comes.
- The Fed’s ambitious plan is to shed its bond holdings at an annual pace of about USD 1 trln. The regulator is already behind the schedule but is struggling to keep up with the initial target. Will the pace be maintained given the election year ahead and high budget deficit?

Chart 7: Negative real rates are in the past



Source: Bloomberg; 7 December 2023

Chart 8: Will Fed manage to continue decreasing its balance sheet?

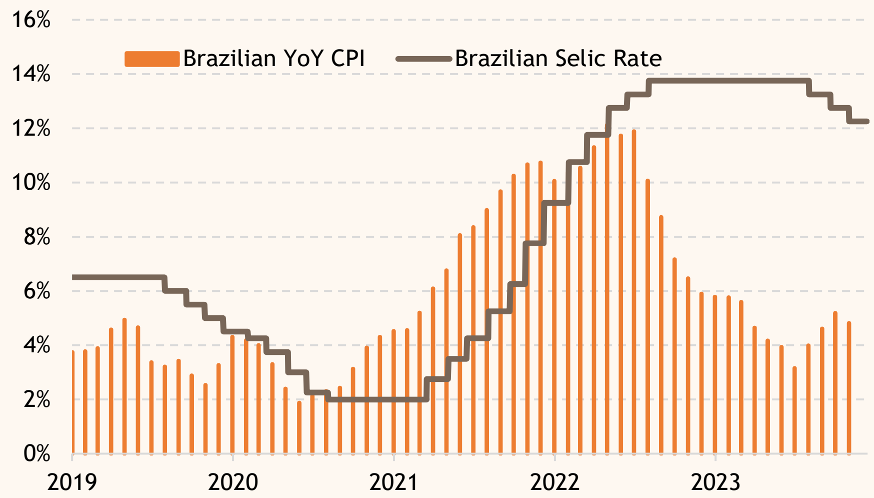


Source: Bloomberg; 7 December 2023

Emerging Markets Outlook

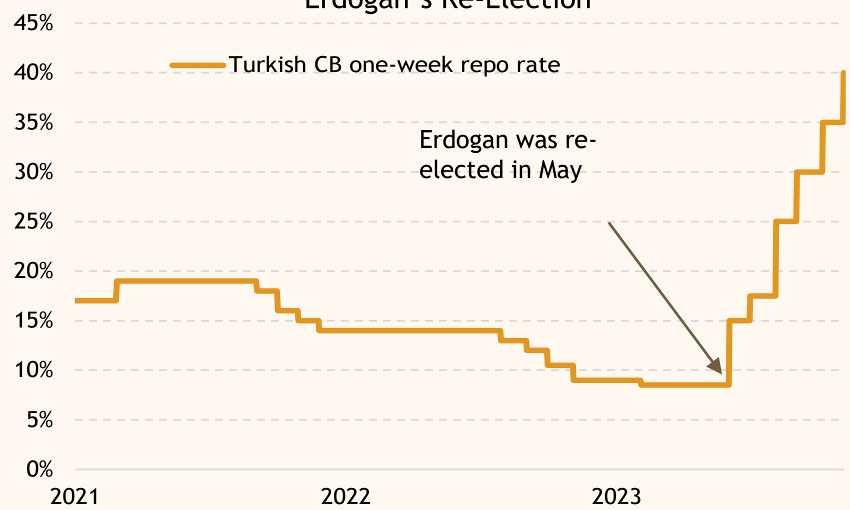
- Standalone fundamentals for EM corporates stay healthy. Inflationary pressures continue to subside, and most central banks have already begun to cut interest rates.
- Latin America in general is expected to grow faster than pre-COVID levels, with Brazil and Mexico being the major contributors thanks to recently implemented reforms. In general, abundant natural resources and human capital, as well as relative peace counterbalance weak governance and lingering political uncertainty.
- In CEEMEA region Turkey and Egypt should see tighter monetary policy and thus weaker growth next year. GCC economic performance will be the result of oil prices dynamics. The countries enjoy low inflation rates and resilient GDP growth, while geopolitical conflicts escalation may change bond valuations.
- China plays a big role for the global economy and for EM in particular. Subdued demand for natural resources from China casts a shadow on LatAm mining companies. At the same time, with extra fiscal measures and incremental monetary support Chinese economy is expected to resume its way to a potential GDP growth of below 5% for the nearest 10 years. The country will continue its battle with real estate crisis and bad debts.

Chart 9: Brazil has began cutting key rate in mid 2023



Source: Bloomberg; 12 December 2023

Chart 8: Turkish Central Bank Returns to Orthodox Policy After Erdogan‘s Re-Election

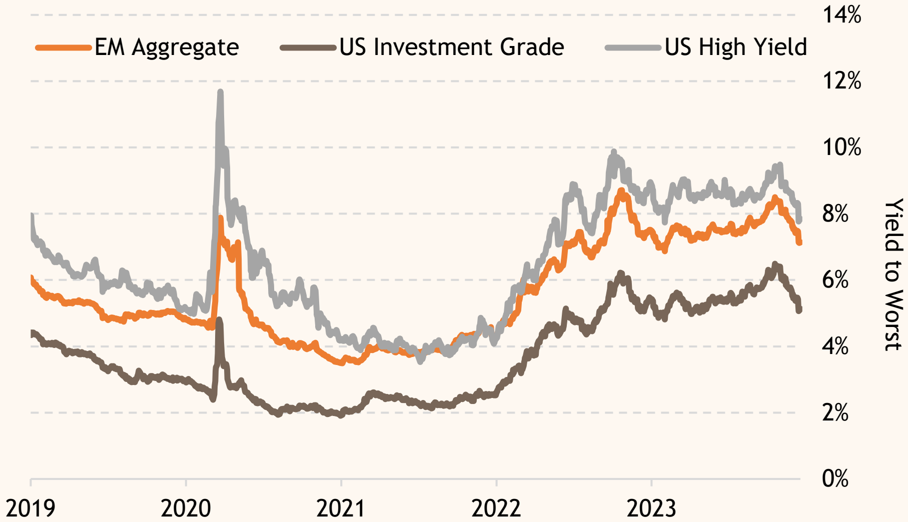


Source: Bloomberg; 12 December 2023

Bond Yields and Credit Spreads

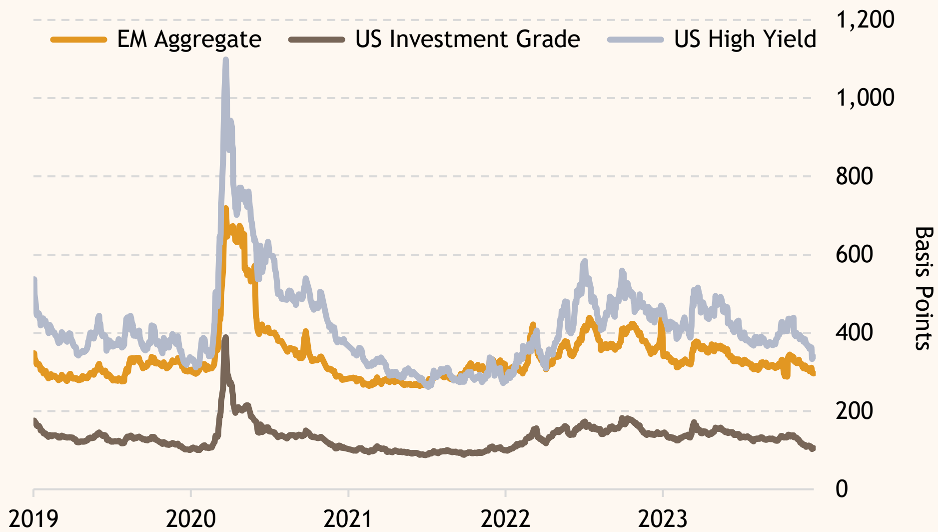
- Bond yields still fluctuate around peak levels not seen in decades, giving a chance to lock in high rates.
- Credit spreads however don't offer much upside potential. As it usually happens, when the market witnesses abrupt yield increase, credit spreads act like buffers. From now on, we don't expect much of a move in credit spreads without a major market event, such as a recession or another shock event. From the other side, we may see a moderate compression if risk appetite improves.

Chart 10: Yields remain appealing being well above 5-year averages…



Source: Bloomberg; 19 December 2023

Chart 11: … however spreads don't provide much space for upside



Source: Bloomberg; 19 December 2023

Our Investment Convictions

- We plan to use a **barbell approach** and focus on high-grade names with long duration to profit in case general yields go down, and EM corporates of shorter maturity to lock in high interest rates.
- In the **US**, we opt for **investment-grade bonds of long duration**. We are cautious on the high-yield segments, as their risk premiums will likely widen more with lower economy growth or a mild recession, and their current valuations don’t offer any downside protection. Although we do not expect a large pick-up in US HY default rates next year, we leave HY strategy to HY specializing Funds, which by nature expect 5%-10% of defaults in their portfolios.
- In **Emerging Markets**, we also focus on high-quality **bonds** and continue to prefer corporates **with revenues in USD**. We believe emerging-market hard-currency bonds currently offer decent risk-reward profile.
- Emerging Markets issuers will still represent the major part of our portfolios with a focus on corporate issuers. We will continue to maintain the share of **developed countries** at the level of **30-40%** in order to diversify the EM risks.
- At current valuations, we like **Latin America**, where GDP growth should activate thanks to stimulating local monetary policy and reforms in some countries, **Turkey**, where we welcome the return to orthodox monetary policy, and **North America**, where soft landing and lower interest rates may result in fixed-income rally. We use selected Asian and Western European issuers to diversify the portfolio.
- We continue to **avoid** investing in bonds of **Chinese issuers**, the main risks of which, in our opinion, are the opacity of corporate decision making, as well as the complexity of legal structures.
- **Selectivity** will remain **crucial**, and we continue to use bottom-up approach for the search of investment ideas, as well as monitoring companies to avoid problematic positions.

Selected Issuers

- **Braskem** (BB+/BBB-) is a leading petrochemical company, with industrial units spread across Brazil, Mexico, USA and Germany. It is controlled by Odebrecht Group, while Petrobras, Brazilian state oil company is a significant minority shareholder (owns 36% of shares). The company has been on a sturdy deleveraging path over the last years, being upgraded by both S&P and Fitch to investment-grade status in 2021. Braskem's USD-denominated bonds maturing 2030 and 2050 currently trade at yield-to-maturity of 10.1% and 9.2%, respectively.
- **Ulker** (B/B3) is a multinational food and beverage manufacturer based in Turkey with Revenues of almost USD 2 bln. Its products are exported to 110 countries, however exports account only for 35% of its EBITDA. The company has consistently reported strong results and dealt with its financial investment portfolio and related-party receivables, which were among the major concerns of investors. The company maintains a conservative Net Leverage ratio of 2.0x. We are positive on the outlook of the company, as given the return to orthodox monetary policy, the pressure to Turkish lira should diminish, easing another concern of investors: unhedged exposure to USD. Ulker USD-denominated bonds with maturity 2025 are currently trading at 8.2% yield-to-maturity.
- **SAN Miguel Industrias Pet** (BB+/Ba1) is a leading rigid plastic packaging company in Latin America, serving beverage, food, personal and home care and pharma markets. The company is well-diversified geographically, with 38% of its revenue sourced in Peru, and the rest across several other countries in Central and South America. The credit quality is supported by the ability to pass through volatility of its raw material costs to customers, which provides protection for the margins, and by the long-term duration of its contracts. The company has been successful in its deleveraging efforts over the last few years. The main constraint is the relatively small size of the company, although it has grown considerably over the last ten years. SAN Miguel Industrias Pet Bond with maturity 2028 and a is currently trading at a yield-to-maturity of 7.4%.
- **Office Cherifien des Phosphates** (BB+/BB+) is among the top three global phosphate fertilizer producers, and it has access to roughly 70% of the world's phosphate reserves. The company is 94% owned by the Government of Morocco. OCP's financial results depend on fertilizer prices and thus could be volatile, however net leverage stays within 3x even at downcycle. It has several USD-denominated bond issues, the one maturing in 2031 is currently trading at 6.18% yield-to-maturity and the longest one, with maturity in 2051, has 7.20% yield-to-maturity.

Note: Bond Prices as of 15-Dec-2023

Our Scenario Forecasts

Our **3 market scenarios for a 12-month horizon**:

Optimistic Scenario: 5-year US Treasury yields decline by 120 basis points compared to their level as on 15 December 2023 in 12 months: 2.7%. Credit spreads tighten by 100 basis points, on average. Average leverage cost for the period: 5.5%.

Base-Case Scenario: 5-year US Treasury yields decline by 70 basis points compared to their level on 15 December 2023, reaching 3.2% in 12 months. Credit spreads tighten by 50 basis points, on average. Average leverage cost for the period: 6.0%.

Worst-case Scenario: 5-year US Treasury yields decline by 20 basis points compared to their level as on 15 December 2023: 3.7%. Credit spreads widen by 40 basis points, on average. Average leverage cost for the period: 6.5%. We assume -1.5% loss due to potential defaults in this scenario.

Table 1: Expected total return under the strategy for a 12-month horizon by scenario

Strategy Return	Optimistic Scenario	Base-case Scenario	Negative Scenario
Coupon Component	5.2%	5.2%	5.2%
Price Change due to UST Yields Move	5.7%	3.3%	1.0%
Price Change due to Spreads Move	5.1%	2.3%	-2.5%
Default	0.0%	0.0%	-1.5%
Total:	**15.9%**	**10.8%**	**2.2%**
Return Subject to 25% Leverage	18.5%	12.0%	1.1%

Note: Calculations as of 15-Dec-2023, based on Axioma Leveraged Bond Fund Non-Russian Portfolio

Our Scenario Forecasts

Our **3 market scenarios for a 3-year horizon**:

Optimistic Scenario: 5-year US Treasury yields are 225 basis points lower compared to their level on 15 December 2023: 1.65%. Credit spreads tighten by 160 basis points, on average. Average leverage cost for the period: 3.0%.

Base-Case Scenario: 5-year US Treasury yields decline by 125 basis points compared to their level on 15 December 2023, reaching 2.65%. Credit spreads tighten by 100 basis points, on average. Average leverage cost for the period: 4.0%.

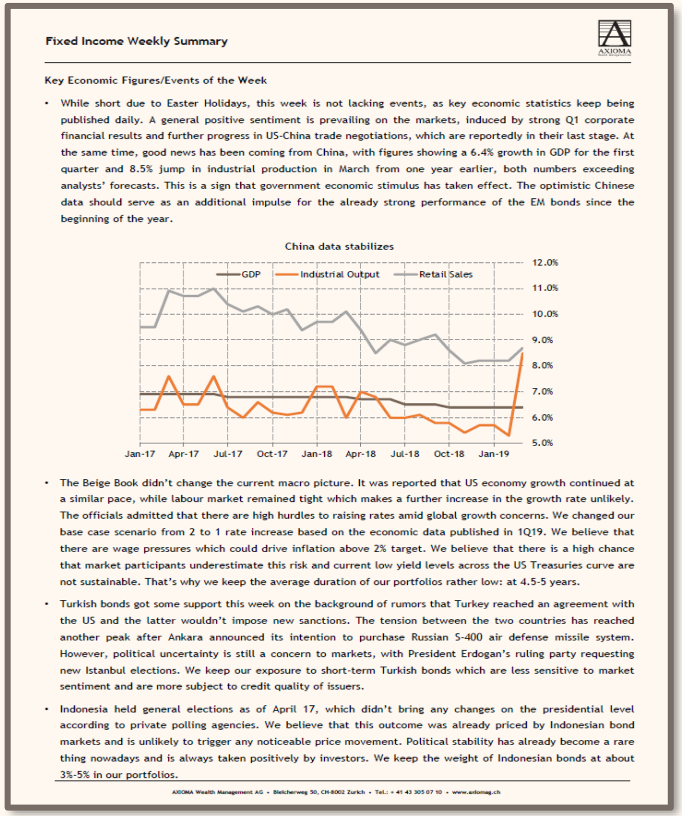
Worst-case Scenario: 5-year US Treasury yields decline by 25 basis points compared to their level on 15 December 2023, reaching 3.65%. Credit spreads stay approximately at the current level. Average leverage cost for the period: 5.0%. We assume -3.5% loss due to potential defaults.

Table 2: Expected total return under the strategy for a 3-year horizon by scenario

Strategy Return	Optimistic Scenario	Base-case Scenario	Negative Scenario
Coupon Component	15.6%	15.6%	15.6%
Price Change due to UST Yields Move	10.6%	5.9%	1.2%
Price Change due to Spreads Move	7.9%	4.6%	-0.1%
Default	0.0%	0.0%	-3.5%
Total:	**34.0%**	**26.0%**	**13.1%**
Return Subject to 25% Leverage	40.2%	29.5%	12.7%

Note: Calculations as of 15-Dec-2023, based on Axioma Leveraged Bond Fund Non-Russian Portfolio

Stay Informed about AXIOMA's Investment Strategy


Fixed Income Weekly Summary

Key Economic Figures/Events of the Week

- While short due to Easter Holidays, this week is not lacking events, as key economic statistics keep being published daily. A general positive sentiment is prevailing on the markets, induced by strong Q1 corporate financial results and further progress in US-China trade negotiations, which are reportedly in their last stage. At the same time, good news has been coming from China, with figures showing a 6.4% growth in GDP for the first quarter and 8.5% jump in industrial production in March from one year earlier, both numbers exceeding analysts' forecasts. This is a sign that government economic stimulus has taken effect. The optimistic Chinese data should serve as an additional impulse for the already strong performance of the EM bonds since the beginning of the year.

- The Beige Book didn't change the current macro picture. It was reported that US economy growth continued at a similar pace, while labour market remained tight which makes a further increase in the growth rate unlikely. The officials admitted that there are high hurdles to raising rates amid global growth concerns. We changed our base case scenario from 2 to 1 rate increase based on the economic data published in 1Q19. We believe that there are wage pressures which could drive inflation above 2% target. We believe that there is a high chance that market participants underestimate this risk and current low yield levels across the US Treasuries curve are not sustainable. That's why we keep the average duration of our portfolios rather low: at 4.5-5 years.
- Turkish bonds got some support this week on the background of rumors that Turkey reached an agreement with the US and the latter wouldn't impose new sanctions. The tension between the two countries has reached another peak after Ankara announced its intention to purchase Russian S-400 air defense missile system. However, political uncertainty is still a concern to markets, with President Erdogan's ruling party requesting new Istanbul elections. We keep our exposure to short-term Turkish bonds which are less sensitive to market sentiment and are more subject to credit quality of issuers.
- Indonesia held general elections as of April 17, which didn't bring any changes on the presidential level according to private polling agencies. We believe that this outcome was already priced by Indonesian bond markets and is unlikely to trigger any noticeable price movement. Political stability has already become a rare thing nowadays and is always taken positively by investors. We keep the weight of Indonesian bonds at about 3%-5% in our portfolios.

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